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DOES THE PARAMETERS OF GROUP LENDING POLICY SUFFICIENT?

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Abstract

The paper intends to contribute to the ongoing debate of whether group lending policies are sustainable and able to achieve and maintain sound repayment performance. This paper is a policy paper by discussing the alternatives to the current policy option by enumerating and explaining each policy option in turn. Pros and cons of each policy option also has been discussed. Each policy option, then has been compared and contrasted to the other options as well as to the current policy. This paper also recommends the hiwalah (transfer of debt) contract in order to achieve and maintain sound repayment performance. The paper compared each policy parameters on group lending in current microfinance practice and thus initiates a new contract named hiwalah (transfer of debt) among the borrower.

***Keywords*:** Group Lending Policy, Hiwalah, Islamic Microfinance, *JEL Classification*:B11, D02

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Introduction

The joint-liability lending (also known as group lending policy) practice has been introduced since the establishment of Grameen bank in the 1970s. The practice has been widely adopted in microfinance programs in many developing countries as an important tool to provide credit to the poor. This practice has produced many positive results, likes the expansion of the number of microfinance institutions (Gan, Hernandez and Liu, 2013), and improvement of repayment rates (Giné and Karlan, 2010).

Understanding the factors affecting repayment performance, which may vary by (unobserved) group types, are thus of great policy relevance. In this paper, we will consider group lending policy still relevant. However, the current group lending comes with a variable contract. Here, we will suggest a loan contract with the transfer of debt via *hiwalah* (a binding contract) which includes the principles and the rules on how borrower and lender overcome the debt. The paper is organized into several sections. Section 2 will review the current group lending policy, section 3 discusses about the pros and cons of each policy and

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the parameters for each policy, section 4, recommendation of *hiwalah* contract and conclusion is presented in section 5.

Review the Current Group Lending Policy

The main important policy related to microfinance institution is group lending policy.

Group Lending versus individual lending

Initially microfinance institutions began their operations with the principle of lending to individuals.[3] Because, they believe that every person has the potential to become an entrepreneur. However, lending to individuals was replaced by lending to groups. Therefore, lending activities to groups have long been associated to microfinance. Under these activities or better known as joint-liability lending, a loan is given to a group of borrowers. The motivation behinds group lending is due to the economics of scale, as the costs associated with monitoring loans and enforcing repayments are significantly lower when credit is distributed to groups rather than individuals. From Besly and Coate (1995), in the group lending repayment game, they show the default of one group members can lead to a secondary default of a member who otherwise would have repaid an individual loan. Under joint liability, when at least one member has defaulted, an incentive to default exists for group members who repay promptly. In practice, members of lending groups rarely are held liable for repayment of loans of other group members, but they are barred from future access to loans if one of the members defaults on repayment.

Group Lending and Repayment

The loan given to a borrower in group lending depends upon the successful repayments from another borrower, thus transferring repayment responsibility off of microfinance institutions to the borrower. Hence, the whole group is liable for the debt of any individual member in the group, i.e., individual member is responsible for the repayment of each other's loans. Thus, joint liability provides as insurance against individual risks. In this sense, joint liability serves as a substitute for collateral. Group borrowers are treated as being in default when at least one of them does not repay. Subsequently, all borrowers are denied a new loan.

Economists also argue that higher repayment rates are frequently associated with group lending. Their belief is roughly divided into three explanations: (i) those that view the relational aspects of social capital as the key to the performance of group lending; (ii) those that view the informational aspects of social capital as as key to the performance of group lending; and (iii) those that view the merits of group lending (relative to individual lending) solely through its innate properties as a joint-liability contract, where social capital plays little or no role. The distinction is important. If the first two groups of explanations hold, the existing level of social capital in the form of strong personal relationships or local information may be critical to group lending's success. If the third group of explanations holds, then group lending may succeed whether or not it is implemented among borrowers with high levels of existing social capital.

[3]See Armendariz, B. and J. Mudoch (2005)

Research that falls in the first explanation therefore emphasize the potential for social sanctions as a primary factor in group loan repayment. Because group members are jointly liable for repayment of the loan of each group member, they have an incentive to pressure fellow members who fail to maximize the probability that their on share of the group loan will be repaid. Floro and Yotopolous (1991) who demonstrate that where social ties are strong, group lending can both improve loan repayment and relax credit constraints. While Besley and Coate (1995) argue that without the potential for social sanctions, group lending may offer little advantage over individual lending. Social sanctions, combined with peer monitoring also play a role in papers such as Stiglitz (1990) and Armendariz de Aghion (1999) though in focusing on peer monitoring, social sanctions are assumed to be exogenous. In the Wydick model (2001), sanctions in the form of group expulsion are endogenous in that they represent a credible threat that comprises part of a perfect Bayesian equilibrium punishment strategy.

Papers in the second explanation focus on the heightened informational flows that exist in high social-capital areas, and their impact on group loan repayment. Van Tassel (1999) and Ghatak (1999) who both demonstrate that the borrower self-selection process used in most group lending schemes improves repayment rates through mitigating adverse selection in credit markets. If borrowers have clear information over the riskiness of one another's projects, they sort themselves into homogeneous groups through an assortative matching process.

A third explanation of group lending downplays the influence of existing social capital in the performance of group lending altogether. The advantages of group lending over individual lending rest on neither the potential for social sanctions nor informational flows between members. Instead, the relative advantage of group lending arises simply from the terms of a joint liability contract. The best example of this view is Armendariz de Aghion and Gollier (2000). They show that, in a pool of "safe" and "risky" borrowers, if the higher return realized by a risky borrower in a good state of nature is (unique) sufficient to cover for a defaulting group member, then the group lending contract can reduce the equilibrium interest rate and induce higher repayment rates relative to individual lending. Wenner (1995) provides some evidence that active screening and social pressure among members of twenty-five Costa Rican credit groups improved group performance. Zeller (1998) finds credit group performance positively related to social cohesion within groups. Wydick (1999) finds that while peer monitoring appears to have some positive effect on group loan repayment, strong social ties within groups appears to make it more difficult to pressure fellow members to repay loans. The joint liability model assumes repayment always occurs if the borrower's project is successful, while in strategic default borrowers choose whether or not to repay based on ex post project outcomes. Here the incentive to repay depends on the outcome of other group borrowers and penalties for default. Both types of penalties are assumed to increase in the project outcome.

Group Lending and Ethical Elements

Borrowers in a group are neighbours. They know each other well, so they might be able to observe each other's usage of loans. By knowing each other, Li, Liu and Deinigner (2012) argues that the lender could distinguish deliberate default and default due to irresponsible behaviour(such as investing in projects that are too risky or spending on non-halal activities)

from default due to unexpected negative shocks. Thus, social penalties can be imposed to borrowers in order to increase the cost of deliberate default and default due to irresponsible behaviour. Social penalties can take the forms of exclusion such as not providing help in their production and other activities in the future.

Group Lending and Peer Effects

Early work by Stiglitz (1990) and Varian (1990) explore how joint liability may induce borrowers in a group to monitor each other, thereby alleviating moral hazard problems. Besley and Coate (1995) address the question on how joint liability contracts affect the willingness to repay. They show how they may induce borrowers to put peer pressure on delinquent group members, which may lead to an improvement in repayment rates.

Discussion

Although, there are pros of cons of each policy. Those who are pros said that group lending is: (i) helping financially, (ii) helping their businesses, (iii) women's empowerment; and (iv) social affair: It is also a chance for the business owners to chat about life while meeting session.

There are also others who are against the group lending. They said that group lending: (i) paying for someone else; (ii) group attrition; and (iii) differences in abilities and knowledge level. Basically, in most group lending practices, individual voluntarily forms a group based on a set of common parameters. These parameters, among others, are group size, loan size, and sharing risk.

The joint liability as collateral or insurance to individual risk - in practice, individual creates a group fund in order to recover the default payment by an individual. The group members will collect the group fund each week and if one member faced difficulties to pay, the group can use the fund in order to pay the lender. Similarly, the operator can also create a microtakaful group.

The repayment schedule - the standard of procedure in micro-financing states that each loan will be given a schedule of repayment. This schedule will be set according to the amount of loan and well-agreed period. The method of financing repayment is on a weekly-basis according to what has been prescribed. In the event of default, the other member will pay it. However, it can also take place in the following week. In this case,(Paxton, Graham, & Thraen, 2000) states that a group has a solidarity, when they willing to pay for one of its members on occasion. Designers of group lending programs hope that the group will offer to help a member with financial difficulties if the groups are selected carefully.

Selection process depending on the objective of Islamic microfinance institution. They might select their clients based on the clients' average monthly household income. Households with average monthly household income below the poverty line income (PLI) benchmark are eligible to get the loan facility. This benchmark was estimated based on the necessity of food and other basic needs and hence, it would be considered as absolute poor. Households with average monthly household income below half of the PLI would be categorized as hardcore

poor. Normally, micro-finance institutions only selects those households, whose average monthly household income falls below the PLI, which includes both poor and hardcore poor households. In practice, the members will choose voluntarily their members in the group.

Recommendation

The discussion in section 3 shows that loan contract has basically become the contractual basis of the relationship between the contracting parties, i.e., between microfinance institutions and the borrower. Under the sharia law, a debt contract only happens between a microfinance institution and an individual borrower. While, the individual can only transfer her debt to another borrower based on hiwalah contract. How does this additional feature in group lending policy work?

In principle, hiwalah means change or transfer. The Hanafi's define the term legally thus: "*The transfer of the liability for a debt from the legal personality of the debtor to the legal personality of the liable person named in the contract*". Thus, transfers of debt must be distinguished from guaranty contracts, since the latter entails the conjoining of liabilities rather than the transfer thereof. As a consequence, once a transfer of debt is concluded, repayment may not be sought from the original debtor. Here, the juristic definition of al-hawalah is "*the transfer of debt from being a liability on the principal debtor to being a liability on the transferee, as a means of ensuring the debt*."[4]

There are proofs in the Sunnah and Ijma' for the legality of transfers of debt to transfer debts, the obvious exception being the forbidden trading of debts for debts

A hadith from al-Bukhari, in book of Hawalah..from Abu Hurairahr.a.,(no 2166) *"When someone you transferred the debt to someone else rich, let him receive it". Referring to this, those who lend to people, then the debtor requesting that the debt be transferred to another person who will pay for it, then he (another person) is encouraged to receive this transfer, rather than mandatory."*

There are six cornerstones or components to the transfer of debt for the majority of (non-Hanafis) jurists: (i) principal debtor or transferor, (ii) creditor or transferred party, transferee or ultimate debtor, (iv) the transferred debt, (v) a debt owed to the principal debtor by the transferee or ultimate debtor, and (vi) contract language.(in Zuhailiy, 2007, pg 54).

In current practice, the word *Hiwalah* as defined by Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI) refers as a transfer of debt from the transferor (*muhil*) to the payer (*muhalalayh*)[5]. The Majallah (Art.673) defines it as "to make a transfer from one debtor account to the debtor account of another". Thus, *hiwalah* is an agreement by which a debtor is freed from a debt by another becoming responsible for it.[6]In the Arabic language, the term hiwalah means change or transfer. The Hanafi's define the term legally thus: "The transfer of the liability for a debt from the legal personality of the debtor to the

[4]Al-Zuhayli, Wahbah. Financial transactions in Islamic Jurisprudence, Vol 2, 2007,chapter 64,pg 51
[5]Shari'a Standard No.7: *Hawala*. Definition of *hiwala*from*Shari'a*Standards by Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI) Rabi' I 1424H – May 2003
[6] Refer also to Ismail et al (2013), chapter 12.

legal personality of the liable person named in the contract. Thus, transfers of debt must be distinguished from guaranty contracts, since the latter entails the conjoining of liabilities rather than the transfer thereof. As a consequence, once a transfer of debt is concluded, repayment may not be sought from the original debtor. The juristic definition of al-hiwalah is "the transfer of debt from being a liability on the principal debtor to being a liability on the transferee, as a means of ensuring the debt."[7]

Implementation

They are several steps that need to be taken in implementing the recommended policy option.

Step1: A Debt Contract between micro-finance institutions and individual borrower
Islamic microfinance institution may use the concept of *qard al-hasan.* However, there are some projects uses tawaruq contract which is for funding the bigger size of loans to borrower who are not under the categories of the needy or poor. In addition, the borrower has liability towards others. Usually, the loan amount under the contract of *qard al-hasan* is lower than tawarruq contract.

Step 2: A *hiwalah* (transfer of debt) contract among the individuals

This step involves the formation of *hiwalah* contract. As presented in Diagram 1, when A, a drawer, draws a bill upon B ordering him to pay C, he is in fact guarantees him i.e. C, the payment of his debt due on A. Similarly, when A, a holder of debt negotiates it to B, he secures the payment of the debt due on the bill. An acceptor of an instrument after accepting it becomes primarily liable while a drawer's liability becomes secondary and conditional. In the same way a transfer in a contract of *hiwalah* become primarily liable.

The principles of *hiwalah* also can also be applied in commercial-cum-financial transactions such as in the modern day negotiability of loan instruments. *Hiwalah* has the ingredients of guarantee. A hiwalah contract can also be formed for the purpose of guaranteeing or securing the payment of the loan due on a promissory note, a cheque or a bill of exchange.

Step 3: When a borrower default

When a default happens, the following steps will take place:

(i) Each member aware of the *hiwalah* contract as discussed in Step 1
(ii) Each member will have to cosign an agreement and accept it based on mutual belief
(iii) When a borrower default, a borrower has to mention to whom their debt will be transferred
(iv) Then, the payer suit to her ability, have an obligation to pay
(v) The debtor has to pay back the payer on the date prescribed.

Step 4: Group fund

[7] Al-Zuhayli, Wahbah. Financial transactions in Islamic Jurisprudence, Vol 2, 2007,chapter 64, pg 51

This step is an option to Step 3(iii). The group fund will be utilized if most of the members of the group cannot afford to pay the loan. This fund is collected on regular basis and saved as deposit Islamic microfinance institutions.

Conclusion

The paper intends to contribute to the ongoing debate of whether group-lending policy are sustainable and able to achieve and maintain sound repayment performance, while serving poor borrowers without the support of third parties such as takaful operator. By aiding new features in better promoting group lending policy with *hiwalah* it can further promoting the development and sustainability of Islamic microfinance institutions.

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