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Incorporating insurance provisions in microfinance contracts: Learning from Visa®?

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Incorporating Insurance Provisions in Microfinance Contracts

Learning from Visa®?

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Abstract

We examine a simple extension to existing credit contracts for the poor ('microfinance contracts'), that would allow financial institutions to provide repayment insurance to their clients. The proposed contract uses the repeated nature of loans to build credit records that borrowers in good standing can use to insure themselves against default in case of adverse income shocks. After documenting borrowers' desire for insurance using data from a microfinance programme in Guatemala, we derive sufficient conditions for the proposed contract to reduce borrower vulnerability while improving repayment rates. These conditions are quite similar to those that credit-card and automobile-insurance companies seem to apply to deter moral hazard and adverse selection among their subscribers. We close the paper with a discussion on why institutions lending to the poor may face particular implementation problems because of the history of past failures of credit programmes for the poor.

Keywords: microfinance, insurance, reputation

JEL classification: O17, G20, G22, D82

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1 Introduction

One of the important distinguishing characteristics of poor is their exposure and vulnerability to risk. The prevalence of agriculture and accompanying activities (such as seasonal work), the under-supply and poor quality of transportation and communication infrastructures, and the unreliability of the macroeconomic environment tend to create strong fluctuations in income. Furthermore, low-income households, due to their higher consumption requirement as a proportion of their income and their limited capacity to buffer the effects of shocks, find themselves less able to absorb risk without falling below binding subsistence-level consumption constraints [Rosenzweig and Binswanger, 93]. Low-income households are thus very *vulnerable* to risk: income shocks have a significant impact on household consumption.

In order to reduce the effect of shocks on their consumption patterns, households engage in strategies to mitigate their exposure to risk and lower the impact of shocks. However, these strategies often induce a reduction in future income growth opportunities. Risk-management strategies reduce household exposure to risk by the choice of less variable activities, but at the expense of more profitable ones [Reardon et al, 94]. Risk-coping strategies remedy the lack in income through (often disadvantageous) changes in asset position and resources [Alderman and Paxson, 94; Dercon, 00].¹ By reducing households' productive capacity, these risk-management and risk-coping strategies can impart severe and often long-term consequences to even temporary downturns.

In complete information settings, optimal contracts would involve payments contingent on the states of the world and private actions. In the non-anonymous settings of local or "village" economies, informational asymmetries are small enough to see such (at least partially contingent) contracts exist. This is the case for quasi-credit contracts, in which the repayment conditions of the contract depend on the relative outcome of the contracting parties (Lund and Fafchamps [97] report evidence for the Philippines, Grimard [97] for Côte d'Ivoire, and Udry [90] for Nigeria). This is also the case for remittances [Jensen, 98; de la Brière et al, 98; Lucas and Stark, 85] and informal insurance arrangements [Coate and Ravallion, 93; Morduch, 99]. However, these risk-sharing arrangements are incomplete even

¹Examples include pulling children out of schooling [Jacoby and Skoufias, 97], cancelling or postponing investments [Morduch, 99], over-exploitation of local resources [Platteau, 00], diminishing nutritional intake [Deaton, 88; Dercon and Krishnan, 00], and running down relationship-based insurance benefits [Goldstein et al., 01].

when agents have good information, and households – particularly poor households – remain subjected to substantial uninsured risk [Deaton, 92; Paxson, 93; Townsend, 94; Jalan and Ravallion, 99].

Furthermore, when one moves to settings in which agents have substantial private information, contracts with full contingencies become difficult to implement. Arrangements must thus rely on non-manipulable signals of performance, letting rise to long-term contracting and financial instruments in well developed markets; and to share-cropping [Akerberg and Botticini, 98], interlinked contracts [Besley, 1995], and other such arrangements in less developed countries.

In a classic paper, Townsend [82] makes the case for the feasibility of risk-sharing contracts even under private information. These contracts involve several periods with payments based on past reports to induce truthful revelation of private information. While these schemes may require complicated payments in a real-world situations,² they still suggest that optimal lending contracts under private information probably involve some mixture of credit and insurance.

In this paper, we argue that the repeated nature of microcredit contracts can allow the lending institution to set up insurance contracts through the creation of a reputation mechanism. Indeed, the success of microcredit institutions at successfully extending credit to the poor, while maintaining high repayment rates, is widely attributed to the particularities of the contracts offered [Morduch, 99]: the loans are uncollateralized (thus favoring outreach);³ and incentives to repay are created by granting borrowers access to larger future loans only upon successful fulfillment of current contracts [Stiglitz, 90; Ghatak and Guinnane, 99; Sadoulet, 99a].⁴ The idea in this paper is to use the repeated interaction between the banks and clients to allow borrowers to build a credit record, which they can use to insure themselves in case of temporary liquidity shocks. We derive the conditions for the evolution of reputation, of premia, and of the sanctions in case of claims, to protect the financial institutions against

²Townsend's [82] payment scheme has to induce truthful reporting of two possible states of the world. Allowing for more states would induce an exponential increase in the number of incentive-compatibility conditions.

³There has been a debate as what types of poor microcredit actually reaches. In particular, there is increasing evidence that it does not directly help the poorest of the poor [Alexander, 01; Navajas et al., 01].

⁴To reinforce these dynamic repayment incentives, loans tend to be small short-term loans with frequent payments (to minimize the benefits of deviation from repayment) and display a sharp growth upon repayment (to increase the benefits from repayment of the current loan) [Varian, 90; Jain and Mansuri, 01].

adverse selection, moral hazard behavior and fraudulent claims. These conditions are very reminiscent of the types of conditions put on credit-card contracts in the United States, or car insurance contracts. The caveat is that the contract we propose is not an optimal contract, since we derive sufficient conditions for the insurance contract to satisfy the participation and incentive constraints for borrowers and the financial institution. However, it is a simple and implementable contract that improves the ones currently offered.⁵

Very recently, the microfinance industry has developed an interest in providing insurance products to their clients. The benefit is two-fold: reduce borrower vulnerability, and improve the financial sustainability of institutions through a positive impact on repayment rates [Del Conte, 00]. While clients are clearly demanding insurance products, the challenge is to understand what types of products are best fitted to their needs. Recently, Brown and Churchill [00] have detailed insurance contracts in 32 institutions (out of the 60 institutions that have been identified world-wide as offering some type of microinsurance product). Their focus has been on the advantages and disadvantages of microcredit institutions at providing insurance products. The advantages such institutions carry are their experience at the grassroot level, having a client base they know, and their clients know and trust them. Their disadvantages lie in the capacity of the institution to provide insurance, because of the technicality of insurance products (actuarial analysis), and because of the insurability of highly covariate shocks. The solution proposed are alliances with specialized insurance companies, in which the insurer devises the products and the microcredit institution distributes them (referred to as “Partner-Agent model” in Brown and Churchill). However, most of these initiatives have been cantoned to life, property, health, disability, and catastrophe insurance – insurance for large and verifiable shocks [McCord, 01].⁶ The range of insurance product offered remains relatively limited.

The remainder of the paper is organized as follows. In the next section, we describe microcredit contracts and illustrate the empirical importance of insurance for borrowers using survey data from Guatemala. Section 3 presents a basic model which aims to capture the salient features of the observed microcredit contracts, namely individual loans and group

⁵The reason we do not derive the less restrictive necessary condition is due to a lack of closed form solutions. Necessary conditions for particular examples, however, would be relatively simple to simulate from the expressions we provide.

⁶Even in case programs that provide loan-payment insurance, the insurance payment is made only upon verification of an identifiable shock (e.g. Canadian Cooperative Association (CCA) in China [Del Conte, 2000]).

loans in which members are jointly-liable. This model is used to demonstrate the incentive mechanisms behind microfinance contracts, and how insurance is an important by-product of joint-liability loans. Section 4 extends the contracts to include insurance provision. The main contribution of the paper is to show the contractual conditions that allow these contracts to be sustainable for the institution and for the borrowers. We close the paper by discussing the historical and regulatory limitations on the implementation of these contracts, and point towards the importance of establishing transparent accounting practices.

2 Microcredit and Insurance

Microcredit contracts were introduced in the late 1970s by Muhammad Yunus, founder of the now-famous Grameen Bank in Bangladesh. The idea was to provide working capital for poor entrepreneurs to generate higher incomes and thus break the cycle of poverty that they faced. While many programs have emerged over the past 30 years⁷ and have adapted the original Grameen methodology, all rely on the same two basic principles: (1) poor borrowers need credit and are credit-constrained; (2) institutions can thus use conditional access to future loans as an incentive mechanism for repayment. As described in the introduction, borrowers are offered a sequence of (generally) uncollateralized loans, which grow overtime. Loan repayment grants a borrower access to a further loan; any default, however, is punished by a loss of access to these further loans.

Loan contracts have been offered in two general forms: individual loans, in which borrowers are individually responsible for their loans; and group loans, in which borrowers are asked to form groups (typically between 3 and 8 people⁸), each member receives a loan, and members are jointly liable for the entirety of the group loan: if *any* part of a group loan is not repaid, *all* members of the group are considered in default.

There has been a long debate in the literature on the relative benefits of individual versus group loans. Authors have argued that the joint liability in group loans can have positive effect on repayment rates by inducing borrowers to coordinate on safer projects [Stiglitz, 90; Wydick, 95], pressuring each other to repay [Armendáriz, 99], or providing a mechanism for institutions to charge different effective interest rates for different types of borrowers,

⁷The Microcredit Summit Campaign Report [2000] reports 1,065 programs serving 13.8 million clients in the world.

⁸Although some “village banking” models use larger groups.

thus diminishing the adverse selection inherent in contracts with asymmetric information [Ghatak, 99]. Others have pointed out that joint liability can actually lead to lower repayment rates both due to voluntary defaults and the (positive) covariance between incomes of group members [Besley and Coate, 95]. Furthermore, despite possible improvements in repayment rates, joint liability may lead to inefficiencies. Group members may over-monitor [Varian, 90] or put pressure on partners to take excessively safe and low return projects [Banerjee, Besley, and Guinnane, 94]. Nonetheless, implicitly or explicitly, all these papers recognize the importance of the repeated loans in creating dynamic incentives for borrowers to repay.

Unlike most of the academic work, practitioners have long focused on the “mutual help” aspect of group lending. Jointly-liable borrowers will scrutinize each others’ projects and actions, but will also come together and repay loans in case of trouble. As reported on the Grameen Trust’s website: “The Group Model’s basic philosophy lies in the fact that shortcomings and weaknesses at the individual level are overcome by the collective responsibility and security afforded by the formation of a group of such individuals.” In this paper, we concentrate on the insurance aspect of this mutual help in credit groups.

To illustrate the importance of this insurance provision, we turn to evidence from a 1995 survey that we conducted in Guatemala. We interviewed the 782 members of 210 credit groups that were clients of *Génesis Empresarial*, a Guatemalan Non-Governmental Organization (Table 1 provides descriptive statistics). They were small informal market sellers, very typical vendors found in markets in low and middle-income countries, characterized by low sales (\$400-\$500 in good weeks) which were quite variable (sales in a bad weeks were around 40% lower on average). They kept low stocks of merchandise and had a high rate of capital turnover as demonstrated by nearly half the sample buying merchandise more frequently than 2-3 times a week. Their activity was confined to one business, although a large proportion of households had other sources of income (only 40% of the surveyed entrepreneurs were the sole source of household income).

Their access to credit was limited, with only 4% having access to formal banks. Their main credit sources were money lenders and wholesale credit, although these tended to charge very high interest rates (15-25% over the loan). Family and friends were also possible sources of credit, but for small and short-term amounts.

Loans offered by *Génesis Empresarial* were two-month loans for working capital, with

regular payment schedules (weekly, fortnightly, or monthly). Loans started off relatively small (\$60) but grew rapidly upon successful repayment, typically by 10 to 30 percent. On average, loans represented around two weeks worth of inventory. Repayment problems were met with penalties: one late payment resulted in no increase in loan size; two late payments reduced the loan size; and three late payments in a year resulted in permanent exclusion from any further loan. Since payments start after the first week of the loan, a fair share of borrowers (19%) put part of the loan aside in order to make the first one or two payments, to reduce the chance of going into default.

While all borrowers surveyed were in groups – which *G enesis* requires to be between three and eight members – all borrowers (in principle) have access to both groups and individual loans. Both type of loans carried the same monthly interest rate (2.5%, as in the formal banking sector in 1995⁹) and had exactly the same growth paths and other terms. Yet, two thirds of borrowers *chose* group loans.¹⁰

A question thus naturally arises: why would borrowers ever choose group loans? The individual and group contracts are similar in every aspect except for the extra joint liability. Part of the answer, we want to suggest, stems from insurance that emerges in these credit groups.

The insurance-need measure we use records the number of times a borrower in a group declares having had difficulties making a payment in the previous year. As reported in Table 2, over 60% of groups report a need for insurance over the past year. Typically, shortfalls in income arise because of low sales or bad planning (74%), or of shocks such as robbery and family illness (23%) – shocks that can be classified as idiosyncratic (although not necessarily exogenous).¹¹ In 69% of the cases, help came from someone within the group. For 23% of cases, the help came from personal resources: either friends or family outside the group, or from personal savings or borrowing from a money lender. The help is for non-trivial amounts

⁹This amounts to a real monthly interest rate of 1.65 percent [International Finance Statistics, 1998].

¹⁰While there is some differential screening in practice, borrowers can opt for an individual loan easily after just a few rounds of group lending. People in older groups who remain in group loans therefore reveal their preference for those groups over individual loans (switching costs are negligible).

¹¹While it is probable that the risk of robbery and family illness varies little from group member to group member, repayment ability being affected by low sales or bad planning is typically the result of borrowers' choices of liquidity strategy. Borrowers who save earlier for the purpose of making the payment encounter fewer problems in case of bad sales the last days before the payment is due. However, this is at a high opportunity cost considering the high turnover of capital (payments represent 2-3 days of merchandise purchases, with half of the borrowers buying merchandise at least 2-3 times a week – see Table 1). The trade-off for borrowers is thus between risk and return.

since it covers around 20% of the payment due by the person who cannot repay.¹²

The evidence from the Guatemalan data suggests that the need for insurance is important and relatively frequent in credit groups. The next section examines how groups contracts are instrumental in the provision of insurance between borrowers. In section 4, we will propose a new contract that improves on the insurance sustained by joint-liability contracts.

3 Joint liability and insurance

In order to understand why some borrowers choose group loans over individual loans, we present a simple model (inspired from Sadoulet, 99a) which aims at capturing the most important features of microfinance contracts: the repeated loans, the informational advantage that borrowers have over the lending institution, and the sanctions in case of default. While the economic and social environments are somewhat stylized, the simplifying assumptions allow us to clearly identify the precise role joint liability plays in the establishment and sustaining of insurance arrangements.¹³ With these results, we will then be able to analyze how to improve the current microfinance contracts by incorporating an explicit institutional insurance aspect to them in Section 4.

Assume a continuum of individuals, each born with a sequence of one-period projects requiring a unit of capital in every period. Each project in every period has two states of nature: it can succeed and yield a positive return X , or fail and yield a return of zero.

Individuals are distinguished by their exogenous probability of success: in every period, i 's project succeeds with an exogenous probability P_i . There is no moral hazard in effort or choice of projects (there will be moral hazard in the choice of repayment). Individuals have no assets or other sources of income, and cannot save between periods.¹⁴ Projects must therefore be financed by a loan in every period.

Loans are provided by a unique financial institution. The objective of the lending institution is to maximize the number of *repaid* loans, subject to a break-even constraint. It, however, has no information on borrower type or on project returns. It can therefore not

¹²We refer to this “mutual help” as insurance because we have strong anecdotal evidence that suggest that members of groups pay each other risk premia to compensate for differential risks in the credit groups.

¹³For a complete analysis of repayment strategies and of equilibrium behavior in this model, the interested reader is referred to Sadoulet [99a].

¹⁴Alternatively, we could have assumed that the sequence of loans grow faster than the returns on individual projects. It limits individuals' incentive to default on the current loan and self-finance from then on with the amount they did not repay.

price-discriminate across borrowers or provide state-contingent contracts.

The financial institution offers two type of loans: individual loans, and group loans. Both types of loans have the same modalities – same interest rate, same term (1 period), and same amount – and operate on the same following principle: if a borrower fulfills the repayment requirements towards the financial institution, she is granted a future loan. However, any default is punished by the exclusion of the borrower from access to either types of loan from then on.¹⁵ The only difference between individual loans and group loans is a joint-liability requirement. In group loans, borrowers are asked to form a group; each partner receives a loan; and the members are jointly liable: if *any* part of the group loan is not repaid, *all* members of the group is considered in default.¹⁶ Once borrowers lose access to loans from the financial institution, they have no other source of credit and their future present discounted value is (normalized to) zero.¹⁷

Repayment strategies are governed by borrowers' ability and willingness to repay. When a borrower's project fails, she is unable repay her loan; she thus has no choice but to default. When her project succeeds, however, she is faced with a choice of actions: she is able to repay, but is she *willing*? In individual loans, willingness to repay has straight-forward consequences: if she chooses to repay, she gets access to future loans; if she chooses not to repay, she'll be considered in default. In the group loan, her (simplified) repayment strategies are similar: she can choose never to repay her share, irrespective of what her partners do; repay her share only if her partners repay their share; or repay not only her share but also her partners' share if necessary. We will refer to this third strategy as "insurance."¹⁸

To illustrate why people might choose group loans, we assume that borrowers have perfect

¹⁵It is clear that this permanent exclusion does not look optimal. However, this is the rule announced clearly by all microfinance projects we are aware of, and it is precisely a modification of this rule that the contract in section IV will call for.

¹⁶The equality of interest rates on group loans and individual loans is a characteristic that we adopt to replicate what is done in practice. It is clear that since individual loans and group loans are different products, they should carry a different "price." In personal communication, the financial manager of Accion International, an organization which provides a microlending methodology to institutions, evoked simplicity and fear of selection effects if each contrat was priced differently.

¹⁷Alternatively, borrowers' fallback option could be to turn to a money lender. Money lenders typically have information on borrower types and on projects, and are a monopoly source of credit. Moreover, they have recourse to severe punishments to control moral hazard. Evidence from the literature on informal money lenders is that they can extract much of borrower surplus. We could therefore normalize the present discounted value to borrowers of borrowing from this fallback option to zero.

¹⁸The repayment strategies in the group loan are in fact slightly more general than the ones we present in that individuals do not simply repay necessarily their own share but a proportion of the total group loan (see Sadoulet, 99a).

information on types and actions of all potential partners, that they have no external sanctioning mechanism, and that borrowers carry a non-verifiable reputation (observable only by other borrowers, but not by the financial institution). These assumptions are extreme but provide stark results as to the benefits of group loans. A weakening of these assumptions simply diminish the benefits of group loans as compared to individual loans.¹⁹

A few more unimportant technical assumptions are made for simplicity. Borrowers are risk neutral. We restrict our attention to groups of 2 to avoid the trade-off between group size and quality of partners. We assume that $X \geq 2L$ so that borrowers are always *able* to provide insurance when their project is successful. This assumption, while seemingly strong if taken literally (requiring 200% return on projects), is effectively not very restrictive since it is a direct consequence of our assumption that projects yield zero when they fail. In practice, projects rarely fail completely; the assumption is essentially that group members, when successful, are always able to cover the amount by which their partners fall short. When they cannot, it is as if their project had failed. A third assumption is that borrowers can only participate in one loan in each period, to avoid a possibility of self-insurance through investment in several projects. The probabilities of success are assumed to be independent over time and across borrowers to circumvent the potential trade-off between partner quality and covariance of returns. Borrowers are assumed to be infinitely lived (or to face an exogenous probability of dying). They share the same discount factor $\delta \in (0, 1)$. The borrower types are distributed according to some (discrete or continuous) distribution F and there is a unit mass of borrowers of every type (so that the equilibrium displays equal treatment within each type).²⁰ Since projects are identically and independently distributed over time, we restrict strategies to be stationary over time.

Under these assumptions, Sadoulet [99a] shows that all borrowers who are “safe enough” have an incentive to maintain access to future loans, where “safe enough” borrowers are

¹⁹Imperfect information between borrowers entail that intragroup contracts provide less than full insurance, thus diminishing the relative benefits of group lending as compared to individual loans. Similarly, outside sanctions could allow individuals to set up insurance arrangements without joint-liability, thus diminishing the role for joint-liability loans. If borrowers could become anonymous again after the group dissolve, in the sense that past actions are not remembered, groups would provide less than full insurance, as in the imperfect information case above.

²⁰Formally, each borrower is denoted by a pair $\{i, n\} \in [0, 1] \times [0, 1]$ where the first coordinate represents their type and is distributed on $[0, 1]$ according to F . See Sadoulet [99b].

defined by

$$P_i \geq \frac{L}{\delta X}. \quad (1)$$

For individual loans, this condition is straight forward: given that the project succeeds and the borrower *can* repay, as long as the discounted expected value of getting another loan next period and defaulting on it ($\delta P_i X$) is greater than the cost of repaying the current loan (L), then the borrower *will* repay his current loan:

$$X - L + \delta (P_i X) \geq X \iff P_i \geq \frac{L}{\delta X}.$$

A strategy of repaying loans when successful leads to the same condition. Repaying the current loan and maintaining access to future loans as long as projects are successful outweighs the one period benefit of not repaying a loan (and losing access to future loans) as long as P_i is safe enough:

$$X - L + \sum_{s=1}^{\infty} (\delta P_i)^s (X - L) \geq X \iff P_i \geq \frac{L}{\delta X}. \quad (2)$$

Similarly, for group loans, borrowers will repay their loans and provide insurance if they are safe enough that the benefit of maintaining access to future loans is worth the cost of repaying. More importantly, group loans provide a forum through which borrowers can set up an insurance agreement in an environment in which they have no other existing insurance opportunity (because of lack of external sanctioning mechanisms to enforce insurance agreements). The new technology allowing the enforcement of insurance agreements is precisely the joint liability: it prevents borrowers from renegeing ex post on insurance promises, since the borrower not fulfilling the insurance agreement would be considered in default too. In essence, the financial institution, despite being uninformed, provides a punishment for borrowers who do not conform with the insurance arrangement.

This new insurance opportunity through group loans offers a valuable service to borrowers who want to maintain access to future loans. This insurance is so valuable, in fact, that borrowers may voluntarily form in groups which are heterogeneous in risk in equilibrium [Sadoulet, 99b]: safe members join groups with riskier partners and “sell” them insurance. Both safe and riskier types are better off than in separate homogeneous group since the riskier member increases his inherent ability to repay the loan, while the safer member extracts more surplus from the trade than she loses from having a riskier partner .

Sadoulet [99a] shows that the condition for borrowers to repay their loans and insure their partners when necessary is exactly the same as the condition for individual loans (1). No borrower riskier than $\frac{L}{\delta X}$ would ever be accepted as a partner in a group loan. Furthermore, borrowers satisfying (1) either repay their loans and insure if the risk differential is not too high in their group, or opt for individual loans (which they repay) rather than group loans if they cannot find an acceptable partner.

Tables 3 and 4 look at the risk composition of groups and insurance flows within these groups.²¹ As we see in Table 3, not all groups are homogeneous in risk. In fact, groups homogeneous in risk are relatively scarce (18 groups out of 210). Furthermore, there exist a significant amount of extremely heterogeneous groups, with members in the two extreme risk quantiles (33 groups) or separated by 3 risk quantiles (43 groups). While matching frictions may prevent borrowers from finding their optimal partner, it would be difficult to argue that such pronounced heterogeneity would emerge from a homogeneous matching equilibrium, particularly considering how under-served the credit market was in Guatemala.²²

Moreover (Table 4), within groups, insurance flows from the safer part of the risk *distribution* to the risky part (not only from the safer borrowers to the riskier partners in a group). Groups are very heterogeneous in risk, and insurance is provided within these heterogeneous group. Unfortunately, the data does not contain information on the payments from the riskier members to their safer partners. Anecdotal evidence, nonetheless, does confirm the existence of such payments.²³

The evidence from the Guatemalan data suggests that insurance is important and rela-

²¹Borrowers' risk is measured by their liquidity strategy. The interested reader is referred to Sadoulet and Carpenter [00] for details.

²²Choice of heterogeneity to benefit from negative covariance does not seem to be an issue in this data. Covariance in sales did not appear to be an important feature in these urban markets, despite our prior intuition that they would be. The major shocks – rain and seasonal variation in buying patterns – tended to be perfectly covariate across activities and thus uninsurable within the group; and the patterns of sales do not differ greatly according to the products sold (except in case of durable goods).

²³In Sadoulet [99a], we report the case of a group composed of four borrowers. The leader of the group was a 50 year-old man with a well-established cloth business, stocked with several rolls of cloth (over \$2,500 worth). He had been selling in this market for 26 years and was a well-respected figure in that section of the market. The other 3 members of the group were shoe sellers, around 25 years old, all in their second year of business. Each of them had no more than 30 pairs of shoes on hand, making them very vulnerable to the fluctuations of the market. It rapidly became clear, in talking to each member of the group, that the younger members of the group were repaying part (if not all) of the group leader's loan at every payment. He essentially repaid only when the younger members needed assistance to repay the group loan. The younger borrowers were therefore ready to pay more than 35% extra in interest in exchange for insurance (they were free to disband the group and form a group between the three of them).

tively frequent, and that borrowers form groups to maximize gains from trading insurance. Yet, a financial institution is much better able than these small credit groups of absorbing credit risk. Transferring the credit risk from a lending institution to the (certainly more risk averse) borrowers has efficiency and welfare costs.

Furthermore, contracts offered by the lending institution do not take into account borrowers' repayment history. For example, a particular group that had been working with *Génesis* for seven years and suddenly faced repayment difficulties for the first time was evicted from the program. While the loan officer would have liked to keep the group for future loans, she recognized that making an exception would weaken the credibility of rules and could start an avalanche of defaults. Yet, *Génesis* clearly had more information on them than on first-time borrowers. Not using this information in the loan contract suggests an important loss in efficiency. In the next section, we propose a remedy by adding insurance clauses to credit contracts.

4 Insurance provisions in credit contracts

The environment is as described in section 3: individuals need one unit of capital to invest; projects yield an amount X when successful and 0 when they fail; borrowers are only able to repay their loan when their projects succeed. The projects outcome are independent and identically distributed over time for each borrower.

The financial institution introduces an insurance contract tied to the individual loan. The basic idea of the contract is that, since the institution has no information on the actual outcome of projects in any particular period, insurance will be awarded conditional on a measure of borrowers' reputation. Through their repayment behavior, individual borrowers build up a credit record and, as long as borrowers are in good standing with the financial institution, their insurance claims will be honored, thus protecting them from default.

The timing is as depicted in Figure 1. In each period, borrowers in good standing receive a loan. If they qualify for insurance, they choose whether to subscribe to the insurance contract or not, and pay the according premium out of the loan they just received. They invest the remainder of the money and their project succeeds or not. They then take the repayment decision. The stage game then ends and the game moves to period $t + 1$.

The financial institution starts with some prior distribution of types. Since the institution

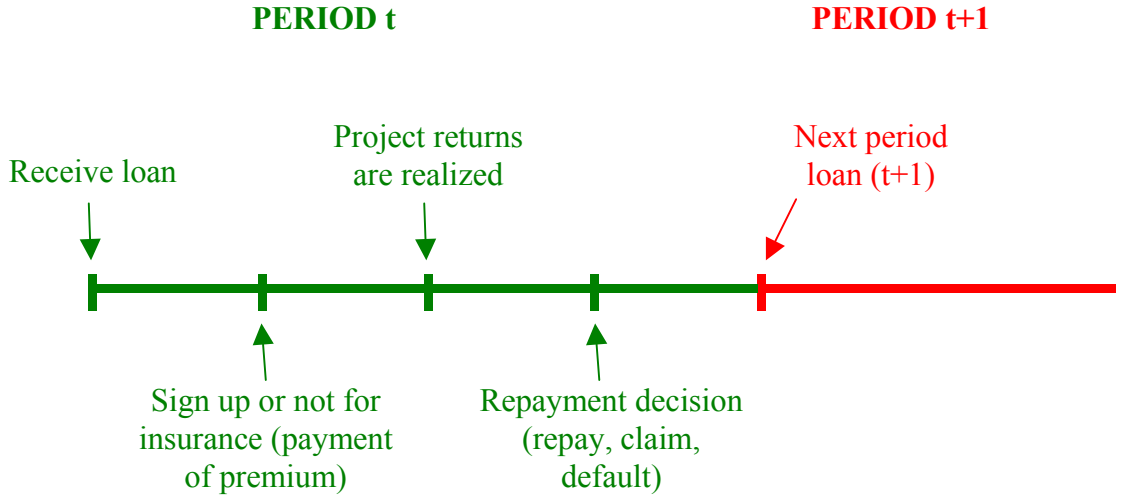


Figure 1: Timing of Loan and Insurance contract

initially has no information on any particular borrower, all borrowers start at the same reputation, say the mean of the institution's prior on distribution the distribution of types:²⁴

$$\mu_i^{[1]} = E^{[1]}(P_i) = \mu^{[1]}$$

where $E^{[t]}$ denotes the expectation taken by the financial institution at the beginning of period t (i.e. before observing i 's repayment outcome in time t).²⁵ As time passes, the institution updates individual borrowers' reputation according to observations of repayment or not. Borrower i 's reputation based on her repayment behavior after t loans is thus given by

$$\mu_i^{[t]} = E_t \left(P_i \mid c_i^{[t]} \right) \quad (3)$$

where $c_i^{[t]}$ represents the number of claims i has made up to the beginning of loan t .²⁶ An example is depicted in Figure 2. Repayment of a loan increases i 's reputation; a claim decreases her reputation.

In order to finance the insurance, the financial institution fixes an insurance premium. The

²⁴Recall, borrowers have no assets or other sources of income. They are thus unable to signal their type by any type of investment or bond posting.

²⁵The square brackets are used to distinguish the notion of "at the beginning of time t " from exponential powers.

²⁶Note that, since the returns for individuals are independent and identically distributed over time, the order of claims does not matter. More generally, this could be written as conditional on the history of repayment $h_i^{[t]}$.

Credit Score

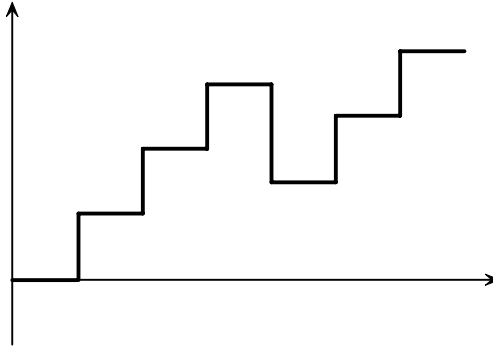


Figure 2: Evolution of borrower reputation

premium is charged at the time the loan is disbursed. We constrain the financial institution to charge actuarially fair premia to each subscriber (up to incentive constraints that will emerge below). The premium $\psi_i^{[t]}$ for borrower i in time t depends therefore on her reputation $\mu_i^{[t]}$ in time t :

$$\psi_i^{[t]} = \left(1 - \mu_i^{[t]}\right) L \quad (4)$$

From period to period, the premium is updated according to (3) as more information becomes available.

The financial institution has to protect itself from two sources of abuse. The first one stems from the borrowers who never repay any loan participating in the insurance scheme; the second one from borrowers filing false claims. We examine each in turn.

4.1 Excluding undesirable borrowers

As we saw in section 3 (equation (1)), borrowers of type $P_i < L(\delta X)^{-1}$ are such the cost of repaying a loan outweighs the benefit of maintaining access to future loans. If granted a loan without insurance, they would default after one period. The new possibility of insurance could allow them to default several periods before being evicted from the program. These risky borrowers would sign up for the insurance contract in order to benefit from a second

loan on which to default, as long as the premium is not too large of a cost:

$$\begin{aligned} & -\psi_i^{[1]} + P_i X + \delta (P_i X) > P_i X \\ \iff & \psi_i^{[1]} = (1 - \mu^{[1]}) L < \delta P_i X \\ \iff & P_i > (1 - \mu^{[1]}) \frac{L}{\delta X}. \end{aligned}$$

Any borrower in $[(1 - \mu^{[1]}) \frac{L}{\delta X}, \frac{L}{\delta X}]$ will thus sign up for the insurance contract and never repay, for any first-period estimate of mean risk $\mu^{[1]}$.²⁷

One way to advert this adverse selection is for the financial institution to deny insurance coverage to any borrower who does not have a reputation above a certain threshold $\tilde{\mu}$. As long as the threshold is such that it takes sufficient rounds of successful loan repayment to reach it (say N), the institution can weed out borrowers wanting to strategically default on the insurance contract:

$$P_i (X - L) + P_i \delta \left[P_i (X - L) + P_i \delta \left[\dots + P_i \delta \left[-\psi_i^{[N]} + P_i X + \delta [P_i X] \right] \right] \right] < P_i X.$$

The longer the waiting period, the fewer the borrowers that will undertake the waiting period rather than default immediately. Note that since the contracts are one-period contracts, borrowers have no incentive to sign up to the insurance until they have repaid sufficient number of loans to reach the threshold reputation $\tilde{\mu}$.

The insurance contract must thus provide some incentive mechanism encouraging borrowers to only claim insurance when they need it, and allow the financial institution to deny claims from borrowers it views as opportunistic. The insurance contract will therefore display the following two properties:

Proposition 1 *When the financial institution has no information on borrower types or project outcomes, to protect itself against adverse selection, the financial institution provides incomplete insurance in the sense that:*

- ▶ *No borrowers with reputations below some cutoff $\tilde{\mu}$ are insured;*
- ▶ *There is no insurance in the first round of loans:*

$$\tilde{\mu} > \mu^{[1]}$$

²⁷ Furthermore, there exist type distributions such that charging a premium corresponding to the average risk $\mu^{[1]}$ discourages participation of the safer types, leading to participation of only the high-risk borrowers.

The proof is in appendix A. The intuition is that to keep all undesirable borrowers from participating, the financial institution must put an entry cost to the insurance contract. This entry cost can take the form of several preliminary rounds of successful repayment – or a series of discouragingly high premia – until borrowers establish their reputation as willing repayers.

Do good types participate? Ignoring fraudulent claims for an instant, if the financial institution had perfect information on borrower types, the insurance contract would be priced such that the premium is exactly the expected cost of insurance, namely

$$\mu_i^{[t]} = (1 - P_i) L.$$

Borrowers' discounted expected return in the insurance contract would thus be given by:

$$\sum_{t=1}^{\infty} \delta^{t-1} (-(1 - P_i) L + P_i (X - L)) = \frac{P_i X - L}{1 - \delta}$$

which, compared to the expected returns without insurance:

$$\frac{P_i (X - L)}{1 - \delta P_i} \tag{5}$$

insures that all borrowers with $P_i \in \left[\frac{L}{\delta X}, 1 \right]$ would participate, were the institution to have perfect information:

$$\frac{P_i X - L}{1 - \delta} > \frac{P_i (X - L)}{1 - \delta P_i} \iff P_i > \frac{L}{\delta X} \text{ and } P_i < 1 \tag{6}$$

However, the institution does not have perfect information on types. Nonetheless, as long as the financial institution's assessment of a borrower risk is not too high compared to her actual risk, the borrower will participate.

To see this, examine the returns under the insurance contract if the financial institution estimated correctly a borrower's probability of failure, and compare them to the returns without insurance. Suppose that from $T(i)$ onwards, the financial institution correctly estimates borrower i 's riskiness. Take the period before the one in which the financial institution has perfect information, $T(i) - 1$. A borrower i satisfying (6) will sign up for an insurance contract in $T(i) - 1$ and pay the premium $\psi_i^{[T(i)-1]}$ if the expected return of doing so is greater than the expected return of waiting for one more period before getting insurance (and running the risk of losing access to future loans):

$$-\psi_i^{[T(i)-1]} + P_i (X - L) + \delta \left(\frac{P_i X - L}{1 - \delta} \right) \geq P_i \left(X - L + \delta \frac{P_i X - L}{1 - \delta} \right).$$

This holds as long as the premium does not outweigh the benefit of insurance:

$$\psi_i^{[T(i)-1]} \leq \delta (1 - P_i) \frac{P_i X - L}{1 - \delta}.$$

Working backwards, we show in appendix *B* that borrower i will sign up for insurance in period n as long as the premium $\psi_i^{[n]}$ is less than an upper bound $\psi_i^{[n]\max}$, where $\psi_i^{[n]\max}$ is given by:

$$\psi_i^{[n]\max} \equiv (1 - P_i) \delta \frac{P_i X - L}{1 - \delta} - (1 - P_i) \sum_{s=1}^{T(i)-n-1} \delta^s E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right) \quad (7)$$

We further show that this maximum premium $\psi_i^{[n]\max}$ is increasing with n : the better the information the financial institution has on borrower i 's type, the larger the (temporary) deviation from the accurate premium the borrower is willing to accept. And since the premium that borrowers face before signing up for the first time is decreasing over time and tends to zero – by virtue of borrowers having had to be successful for *all* periods before signing up for insurance or they are considered in default and lose access to loans –, there exists for, each $P_i > \frac{L}{\delta X}$, a number of waiting periods $n(P_i)$ such that a borrower i will sign up for insurance in period $n(P_i)$ and not before:

$$\forall P_i \in \left[\frac{L}{\delta X}, 1 \right], \quad \exists! n(i) > 1 \ni \quad \begin{array}{l} \psi_i^{[t]\max} < \psi_i^{[t]} \quad \forall t < n(i) \\ \text{and} \quad \psi_i^{[n(i)]\max} \geq \psi_i^{[n(i)]}. \end{array}$$

Since the premium tends to zero as the number of waiting periods becomes large, and that there are strictly positive net benefits from insurance for all $P_i \in \left(\frac{L}{\delta X}, 1 \right)$, all “good types” – the borrowers with projects which are socially beneficial – will eventually participate in the insurance scheme.

We now turn to the second source of abuse: fraudulent claims.

4.2 Deterring fraudulent claims

Since the financial institution has very little information on borrowers in the first rounds of the loans, the gains and losses in reputation for borrowers are greatest in those rounds. Each repayment or insurance claim represents a large proportion of the information that the institution has at its disposal to assess individuals. However, as the number of loan rounds gets large, this difference in reputation from an extra observation shrinks to the point that it becomes negligible. The effectiveness of the drop in reputation as a deterrent for

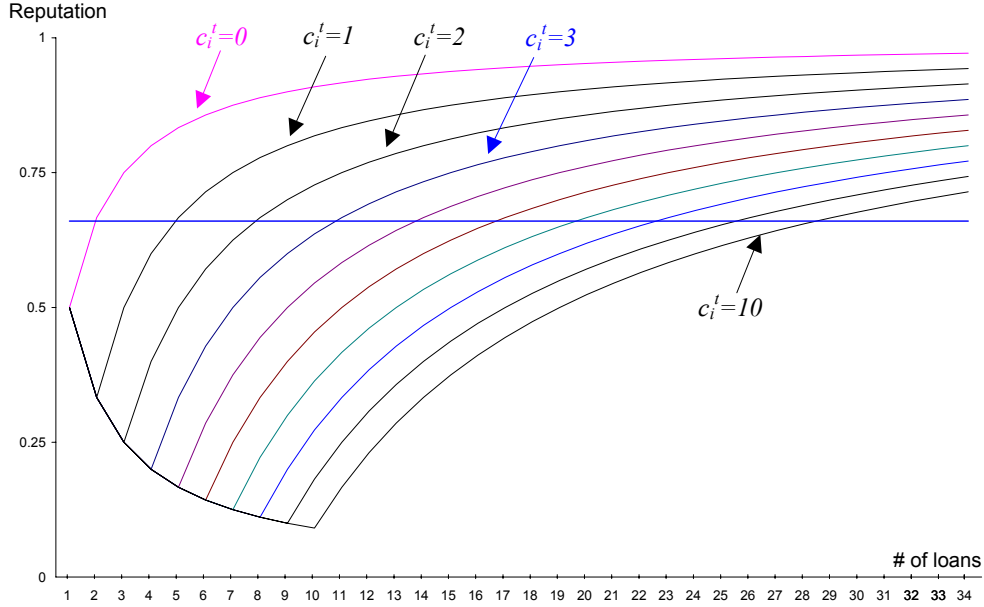


Figure 3: Evolution of Borrower reputation $\mu_i^{[t]}$

false insurance claims thus diminishes over time. The insurance contract thus has to rely on additional sanctions to deter false insurance claims.

Proposition 2 *The institution must impose costs beyond simple loss of reputation after insurance claims in order to deter fraudulent claims.*

The formal argument is given in Appendix C. The intuition is easy to follow on Figure 3, which represents borrowers reputation as a function on the numbers of loans repaid. The top curve is a borrower's reputation with no defaults; the second is a borrowers' reputation after one default; and so on. Any default drops the borrower down one curve.

By filing a false claim, the borrower gains the fact of not repaying the current loan and the insurance premium. The costs are an increase in the future premia due to a loss of reputation, and an increase in the probability of falling below the reputation cutoff after repeated failures. However, after enough loan repetitions, these two losses effects become infinitesimal. An extra cost of claiming insurance must thus be imposed to discourage borrowers from filing false claims.

One possible form this extra cost could take is one inspired by US-style credit-card contracts. Banks issue credit cards to customers who have stable incomes²⁸ and a credit record without great blemishes. If a customer were to miss payments early in the relationship, the issuing bank would severely restrict (and even stop) that customer’s use of that card. However, over time, responsible use and timely payments is met with increases in credit limits and a willingness from the issuing bank to accept late payments. Credit-card holders are therefore able to use their credit record (i.e. reputation as good payers) to smooth temporary shortfalls in income. The costs to the holder are a late-payment fee and, if the late payments are recurrent, negative entries in the holder’s record at various credit rating agencies.²⁹ These negative entries in the credit record have a sufficient impact that after relatively few missed payments, the financial institution will deny the card holder any further services and the card holder will find it difficult to get access to any other financial services due to the ensuing bad credit record. It takes a long time for a person with a bad credit record to “rebuild her credit.”

While the parallel to US credit-card contracts is not quite exact – credit cards allow *late* payments, not defaults³⁰ – the reputation and sanctioning mechanisms proposed in this paper are quite similar to the ones apparently applied in these contracts. Formally, the sanctioning to prevent moral hazard behavior is equivalent in our model to downgrading a borrower’s reputation *and* reducing her acquired “experience” (by which we mean the number of loans she participated in). Reducing a borrower’s reputation by more than dictated by the Bayesian updating rule (3) pushes the defaulting borrower closer to the cutoff below which she’ll be denied insurance; stripping away experience and considering her as a newer borrower than she actually is (i.e. using a lower t to calculate updates on her reputation) increases the risk that she will actually reach the cutoff due to repeated failures. Financial institutions can customize these losses in reputation and in experience in order to achieve exactly the punishment they intend. The argument in Appendix D proves the following proposition.

²⁸or to college students with co-signers with stable incomes. Thanks mom!

²⁹The idea of sharp important negative effects from reputation upon claims and slow rebuilding of reputation during periods of no claims is also prevalent in auto-insurance contracts. Accidents, speeding tickets, and other signs of hazardous driving are punished by large immediate losses of points that drivers typically need several years of faultless records to erase.

³⁰In essence, credit-card companies provide temporary loans to borrowers in good standing to make up income shortfalls.

Proposition 3 *There exists a cutoff, a sequence of insurance premia, and a sequence of costs in case of insurance claims such that the insurance contract is a Nash Equilibrium.*

The proof verifies that the contract modalities are sufficient to cover the financial institution's costs, do not exceed the benefits of insurance for participating borrowers, and induce truthful reporting from the part of the participating borrowers.

5 Conclusion

As documented in section 2, insurance is an important by-product of group-lending contracts. However, by the virtue of transferring risk to groups of borrowers less able to absorb it than the lending institution, these contracts entail an important loss in efficiency.

In this paper, we show that there exists simple credit-with-insurance contracts that financial institutions could implement in environments in which insurance mechanisms are incomplete. No new information is required; the contract is simple to implement; it is certainly welfare improving since building reputation is less costly than building savings. And furthermore, it maintains some borrowers who would have dropped out after a failure in the system.

The question is then understanding why institutions do not implement such contracts. In one sense, institutions have started to. Brown and Churchill [00] document insurance contracts in a number of institutions worldwide which are experimenting with life, health, and property insurance. Furthermore, implicit insurance arrangements exist, whereby institutions are more flexible on the terms of repayment with older groups.

Nevertheless, explicit repayment insurance has three important hurdles to clear. For microcredit programs, providing repayment insurance can impact institutional credibility. These programs are often located in areas in which public targeted credit programs have failed in the past due to their lax enforcement of rules. If the current institutions are seen as “soft” on the rules due to the provision of insurance, they may be faced with waves of default, like their predecessors. Furthermore, many of these institutions, in order to increase their credibility and their access to funds, are preparing for an eventual transition to becoming formal banks. Repayment insurance could be viewed by regulators as a “creative accounting” way to make their portfolio look in good standing, and thus derail the process of formalization. Third, institutions must be able to cover potential large-scale shocks. Since microfinance

institutions operate in relatively small geographical areas, they are not immune to a large fraction of their loan portfolio suffering bad outcomes (floods, fire in a market, earthquakes...). While large covaried shocks are easily observable, the ability of the institution to provide insurance is then in question. Institutions must then be able to reinsure these risks.

This suggests a very important direction for policy regarding accounting practices. For institutions to successfully manage loans and insurance, strict accounting rules are needed to separate true instances of insurance from non-performing loans. As we have seen in recent banking sector crises, even developed countries are far from adhering to the standards advocated by the Basel Accords. Transparency, however, is crucial for institutions to gain credibility: in the eyes of their clients, of their national regulatory agency, as well as with potential reinsurers.

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Appendix

A Proof of Proposition 1

The financial institution wants to keep all $P_i < \frac{L}{\delta X}$ from participating. At time 1, however, the financial institution cannot discriminate between borrowers; every borrower has the same reputation:

$$\mu^{[1]} = E(P_i) \quad \forall i$$

where the expectation is taken at the beginning of period 1. This, as we saw in the main text with equation (??), implies that all borrowers in $\left[(1 - \mu^{[1]}) \frac{L}{\delta X}, \frac{L}{\delta X} \right]$ sign up for the insurance contract even though they never intend to repay any loan. The issue is thus to put an entry cost to keep all $P_i < \frac{L}{\delta X}$ out.

When insurance is offered at time $t = 1$, the problem is that the net expected return from the insurance contract is greater than the expected benefit from strategic default for a range of borrowers:

$$\begin{aligned} -\left(1 - \mu^{[1]}\right) L + P_i X + \delta(P_i X) &> P_i X \\ \iff P_i &\in \left[\left(1 - \mu^{[1]}\right) \frac{L}{\delta X}, \frac{L}{\delta X} \right) \end{aligned}$$

When insurance is only offered first at time $t = 2$, the set of people for whom the net expected return of waiting for insurance in time $t = 2$ and then defaulting is greater than the expected benefit from strategic default in the first loan is as follows:

$$\begin{aligned} P_i(X - L) + \delta P_i \left(-\left(1 - \mu^{[2]}\right) L + P_i X + \delta P_i X \right) &> P_i X \\ \iff \forall P_i &\in \left[\frac{1 + \delta(1 - \mu^{[2]})}{1 + \delta} \frac{L}{\delta X}, \frac{L}{\delta X} \right) \end{aligned}$$

where $\mu^{[2]}$ denotes a borrower's reputation at the beginning of time t when she has repaid all her loans, i.e.

$$\mu^{[2]} \equiv E^{[2]} \left(P_i \mid c_i^{[2]} = 0 \right).$$

Note that whether the range of potential adverse selection into the insurance contract increases or not depends on the updating from period 1 to 2:

$$\frac{1 + \delta(1 - \mu^{[2]})}{1 + \delta} \frac{L}{\delta X} \geq \left(1 - \mu^{[1]}\right) \frac{L}{\delta X} \iff \frac{\mu^{[2]}}{\mu^{[1]}} \leq 1 + \frac{1}{\delta}.$$

If there is a big decrease in reputation from repaying in period 1, it might be worth for some P_i to do so, in order to qualify for insurance in period 2 (even though it would not have been worth signing up for insurance and strategically defaulting in period 1).

Similarly, if insurance is first offered at time $t = T$, the set of borrowers who benefit more from waiting until time T to default twice rather than defaulting in the first period is implicitly given by:

$$\sum_{t=1}^{T-1} \delta^{t-1} (P_i)^t (X - L) + (\delta P_i)^{T-1} \left(- \left(1 - \mu^{[T]} \right) L + P_i X + \delta P_i X \right) > P_i X. \quad (8)$$

The threshold reputation at each t is given by:

$$\mu^*(t) > \left((\delta P_i)^{-t} + \frac{(1 - P_i(1 + \delta))}{\delta P_i^2} \right) \frac{(1 - \delta P_i)}{\delta P_i^2 (1 - P_i \frac{\delta X}{L})}. \quad (9)$$

If there exists a pair $(t, \mu^{[t]})$ such that (9) holds for any P_i , then those borrowers will mimic being a “good borrower” for $t - 1$ periods and repay all their loans (if they can), in order to qualify for insurance in period t and immediately strategically default.

The thresholds are depicted in Figure 4 for borrowers with $P_i = A \frac{L}{\delta X}$ for values of A . Take any combination (μ, t) . If $\mu > \mu^*(t)$ for a particular borrower i , then she will mimic being a good borrower (for at most t periods. It might hold for some earlier combination of (μ, t)).

How many risky borrowers would mimic being good borrowers depends on the insurance premium charged, which itself depends on the financial institution’s prior. In figure 4, we illustrate the evolution of reputation of borrowers who successfully repay all their loans (a precondition to qualify for insurance) for 3 different priors: a uniform distribution, a bell-shaped distribution³¹ as an approximate to a normal distribution, and a distribution with a higher mass of risky types³² to reflect a “pessimistic” prior. In this illustration, if the financial institution imposes 3 periods of successful repayment before borrowers can qualify for an insurance contract, only borrowers with $P_i \in [\frac{9}{10} \frac{L}{\delta X}, \frac{L}{\delta X}]$ would mimic good types in order to qualify for insurance and then strategically default.

More importantly, note that, for any prior the institution may have, there will always be some adverse selection:

$$\lim_{P_i \rightarrow \frac{L}{\delta X}} \mu^*(t) = \infty \quad \forall t$$

³¹A beta(6, 6) distribution.

³²A beta(2, 6) distribution.

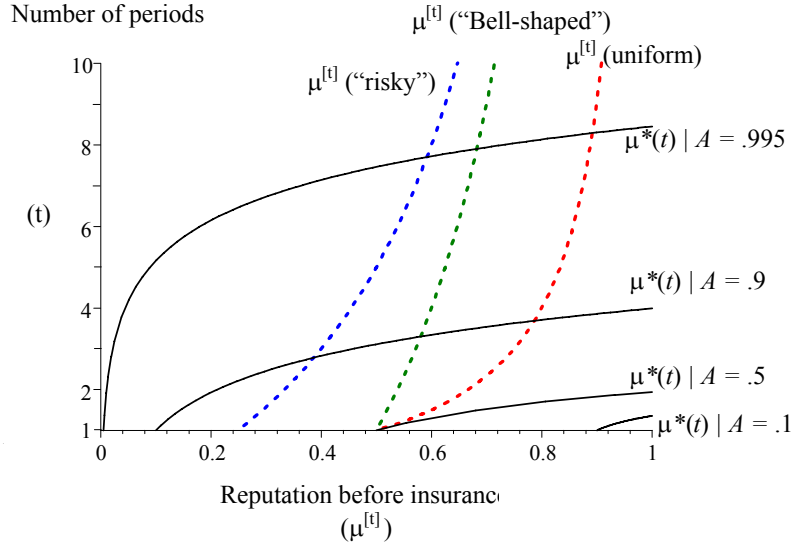


Figure 4: Bayesian reputations ($\mu^{[t]}$) for different priors, and thresholds (μ^*) for various values of $P_i = A \frac{L}{\delta X}$

Borrower with P_i close enough to $\frac{L}{\delta X}$ would require very long waiting periods to discourage them from mimicking good borrowers.

Nonetheless, for the financial institution, if a borrower repays $T-1$ loans before defaulting on two loans in a row, the expected cost of adverse selection for a borrower with probability of success P_i is given by:

$$\sum_{t=1}^{T-1} \left((\delta P_i)^{t-1} (1 - P_i) L \right) + (\delta P_i)^{T-1} (-(1 - \mu) L + L + \delta L)$$

i.e. up to period T , the borrower repays as long as she can; and at period T (reached with probability P_i^{T-1} and discounted by δ^{T-1}), the borrower pays a premium $(1 - \mu^{[T]}) L$ and then defaults on the two subsequent payments. This has to be compared to the cost L if a borrower simply defaults in the first period:

$$\sum_{t=1}^{T-1} \left((\delta P_i)^{t-1} (1 - P_i) L \right) + (\delta P_i)^{T-1} (-(1 - \mu) L + L + \delta L) \leq L \quad (10)$$

If the waiting period is long enough, the costs engendered by the borrowers defaulting

after taking insurance are smaller than the costs of immediate default without insurance:

$$\sum_{t=1}^{T-1} \left((\delta P_i)^{t-1} (1 - P_i) L \right) + (\delta P_i)^{T-1} \left(-(1 - \mu^{[T]}) L + L + \delta L \right) \leq L$$

$$\Leftrightarrow T \geq 1 + \frac{\ln \left(\frac{(\delta + \mu^{[T]}) (1 - \delta P_i) - (1 - P_i)}{(1 - \delta) P_i} \right)}{-\ln \delta P_i} \quad (11)$$

For a given value of δ , the right-hand side of (11) reaches its maximum value at $P_i = \frac{L}{\delta X}$, $X = 2L$ (since $X \geq 2L$ by assumption), and $\mu^{[T]} = 1$:

$$\max_{P_i \in [0, \frac{L}{\delta X}], \mu^{[T]} \in [0, 1]} \left(1 + \frac{\ln \left(\frac{(\delta + \mu^{[T]}) (1 - \delta P_i) - (1 - P_i)}{(1 - \delta) P_i} \right)}{-\ln \delta P_i} \right) = 1 + \frac{\ln \left(1 + \frac{\delta^2}{1 - \delta} \right)}{\ln 2}.$$

Note that, for reasonable values of the discount factor δ , the number of waiting periods sufficient for equation (10) to hold is reasonably low, as demonstrated in the Table below.

Values of T													
		$(X=2L)$							$(X=1.2L)$				
$\mu^{[T]}$	δ	.7	.8	.90	.95	.99	$\mu^{[T]}$	δ	.7	.8	.90	.95	.99
0.25		0	1	2	3	5	0.25		0	1	2	3	5
0.50		1	2	3	4	6	0.50		1	2	3	4	6
0.75		1	2	3	4	7	0.75		1	2	3	4	7
1.00		2	3	4	5	7	1.00		2	3	4	5	7

In summary, we have shown that the institution can never completely eliminate adverse selection through waiting periods, as some risky borrowers will mimic the behavior of safe borrowers to qualify for insurance in order to strategically default twice. However, the financial institution can control how much adverse selection it is willing to endure through the choice of the waiting period. Furthermore, even if there is some adverse selection into the insurance contract, the cost of this adverse selection is smaller than the cost of the original adverse selection in the loan contracts without insurance. Furthermore, repayment rates are improved since borrowers repay a certain amount of loans before defaulting (instead of defaulting on 100% of their loans).

B Properties of the Insurance Premium

B.1 Upper bound on Premium

In this section, we derive the upper bound on the premium that borrower i is willing to repay at the beginning of period $T(i) - N$.

Take period $T(i) - N$. The expected return of having an insurance contract from $T(i) - N$ onwards is given by:

$$-\psi_i^{[T(i)-N]} + P_i(X - L) + \delta \left(-E \left(\psi_i^{[T(i)-N+1]} \right) + P_i(X - L) \right) + \dots \\ + \delta^{N-1} \left(-E \left(\psi_i^{[T(i)-1]} \right) + P_i(X - L) \right) + \delta^N \frac{P_i X - L}{1 - \delta}$$

where the expectations are taken at the beginning of period $T(i) - N$. Rewriting³³, this is equivalent to:

$$-\psi_i^{[T(i)-N]} + P_i(X - L) + \left(- \sum_{s=1}^{N-1} \delta^s \left(E \left(\psi_i^{[T(i)-N+s]} \right) - (1 - P_i)L \right) + \delta \frac{P_i X - L}{1 - \delta} \right). \quad (12)$$

Compare this expected return of signing up for insurance in period $T(i) - N$ to the expected return if borrower i waits one extra period before signing up for the insurance contract (which she can do only if her project succeeds):

$$P_i(X - L) + P_i \left(- \sum_{s=1}^{N-1} \delta^s \left(E \left(\psi_i^{[T(i)-N+s]} \mid S \text{ in } T(i) - N \right) - (1 - P_i)L \right) + \delta \frac{P_i X - L}{1 - \delta} \right). \quad (13)$$

where $E \left(\psi_i^{[T(i)-N+s]} \mid S \text{ in } T(i) - N \right)$ denotes the expected value (taken at the beginning of time $T(i) - N$) of the premium in $T(i) - N + s$ conditional on the fact that borrower i 's project's success in period $T(i) - N$.³⁴

To decide whether to sign up for insurance at the beginning of period $T - N$, borrower i compares the expected returns (12) and (13). Signing up for insurance in period $T(i) - N$ yields higher expected returns than waiting one more period if the premium does not exceed the following bound:

$$\psi_i^{[T(i)-N]} \leq \delta (1 - P_i) \frac{P_i X - L}{1 - \delta} \\ + \sum_{s=1}^{N-1} \delta^s \left(P_i E \left(\psi_i^{[T(i)-N+s]} \mid S \text{ in } T(i) - N \right) - E \left(\psi_i^{[T(i)-N+s]} \right) \right).$$

Note that this is equivalent to:

$$\psi_i^{[T(i)-N]} \leq (1 - P_i) \delta \frac{P_i X - L}{1 - \delta} - (1 - P_i) \sum_{s=1}^{N-1} \delta^s E \left(\psi_i^{[T(i)-N+s]} \mid F \text{ in } T(i) - N \right)$$

³³Using $P_i(X - L) = P_i X - L + (1 - P_i)L$.

³⁴If the project is unsuccessful in $T(i) - N$, borrower i defaults and loses access to future loans.

since

$$E\left(\psi_i^{[T(i)-N+s]}\right) = P_i E\left(\psi_i^{[T(i)-N+s]} \mid S \text{ in } T(i) - N\right) + (1 - P_i) E\left(\psi_i^{[T(i)-N+s]} \mid F \text{ in } T(i) - N\right).$$

Define the upper bound to the premium that i is will to pay for a new insurance contract in period n as:

$$\psi_i^{[n] \max} \equiv (1 - P_i) \delta \frac{P_i X - L}{1 - \delta} - (1 - P_i) \sum_{s=1}^{T(i)-n-1} \delta^s E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right)$$

where $E^{[n]}$ denotes the expectation taken at the beginning of period n . This is exactly equation (B.2) in the text.

B.2 Proof that maximum premium $\psi_i^{[n] \max}$ is increasing in n

We want to show that the maximum premium borrower i is willing to pay in period n , namely (equation (7) in the text)

$$\psi_i^{[n] \max} \equiv (1 - P_i) \delta \frac{P_i X - L}{1 - \delta} - (1 - P_i) \sum_{s=1}^{T(i)-n-1} \delta^s E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right)$$

is increasing in n .

For a borrower with a given history up to time n , compare this maximum premium in two successive periods: n and $n + 1$. The difference is given by:

$$\begin{aligned} & \psi_i^{[n] \max} - \psi_i^{[n+1] \max} \\ &= - (1 - P_i) E^{[n]} \left(\psi_i^{[n+1]} \mid F \text{ in } n \right) \\ &+ (1 - P_i) \sum_{s=2}^{n-1} \delta^s \left\{ E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right) \right. \\ &\quad \left. - E^{[n+1]} \left(\psi_i^{[n+1+s]} \mid F \text{ in } n + 1 \right) \right\}. \end{aligned} \tag{14}$$

The first term is negative. To compare the terms inside the summation, we note that borrower i 's project has to be successful in n to receive a loan in period $n + 1$ since she has no insurance in period n . We can thus rewrite:

$$\begin{aligned} E^{[n+1]} \left(\psi_i^{[n+1+s]} \mid F \text{ in } n + 1 \right) &= E^{[n]} \left(\psi_i^{[n+1+s]} \mid S \text{ in } n; F \text{ in } n + 1 \right) \\ &= P_i \cdot E^{[n]} \left(\psi_i^{[n+1+s]} \mid S \text{ in } n; F \text{ in } n + 1; S \text{ in } n + 2 \right) \\ &+ (1 - P_i) \cdot E^{[n]} \left(\psi_i^{[n+1+s]} \mid S \text{ in } n; F \text{ in } n + 1; F \text{ in } n + 2 \right). \end{aligned}$$

Similarly, we can rewrite

$$E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right) = P_i \cdot E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n; S \text{ in } n+1 \right) \\ + (1 - P_i) \cdot E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n; F \text{ in } n+1 \right).$$

By the fact that premia go up with failures (claims) and down with successful repayments, and that project outcomes are *iid* over time,³⁵ we have that

$$E^{[n]} \left(\psi_i^{[n+1+s]} \mid S \text{ in } n; F \text{ in } n+1; S \text{ in } n+2 \right) < E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n; S \text{ in } n+1 \right)$$

and

$$E^{[n]} \left(\psi_i^{[n+1+s]} \mid S \text{ in } n; F \text{ in } n+1; F \text{ in } n+2 \right) < E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n; F \text{ in } n+1 \right).$$

This implies that

$$E^{[n+1]} \left(\psi_i^{[n+1+s]} \mid F \text{ in } n+1 \right) < E^{[n]} \left(\psi_i^{[n+s]} \mid F \text{ in } n \right) \quad \forall s$$

and, thus, that the difference in (14) is negative:

$$\psi_i^{[n] \max} - \psi_i^{[n+1] \max} < 0.$$

i.e. $\psi_i^{[n] \max}$ is increasing in n .

C Proof of Proposition 2

C.1 Bayesian updating of reputations

When a borrower undertakes her first loan, the financial institution has no information on her type. The new borrower's reputation is therefore set at the mean of the institution's prior on the distribution of borrower types:

$$\mu_i^{[1]} = \mu^{[1]} = \int_0^1 g(p) p dp$$

where $g(p)$ denotes the institution's prior. However, as the financial institution gathers information on the borrower's repayment behavior, it can update its assessment on her type. For example, before the second loan, a borrower's reputation is updated by Bayes' rule according to whether she repaid or not:

$$\mu_i^{[2]} = \frac{\int_0^1 p^{1-c} (1-p)^c g(p) p dp}{\int_0^1 p^{1-c} (1-p)^c g(p) dp}$$

³⁵i.e., it is not the order of success and failures that matter but the total number of each.

where $c = 0$ if i repaid her loan and $c = 1$ if i claimed insurance in period 1.

Since the projects are assumed to be independently and identically distributed for each borrower over time, borrower i 's reputation in time t depends simply on the number of loans $(t - 1)$ and the number of insurance claims $c_i^{[t]}$ that i has filed up to period t :

$$\mu_i^{[t]} \equiv \mu \left(t, c_i^{[t]} \right) = \frac{\int_0^1 \binom{t-1}{c_i^{[t]}} p^{(t-1)-c_i^{[t]}} (1-p)^{c_i^{[t]}} g(p) p dp}{\int_0^1 \binom{t-1}{c_i^{[t]}} p^{(t-1)-c_i^{[t]}} (1-p)^{c_i^{[t]}} g(p) dp}$$

The prior distribution $g(p)$ determines how much weight the institution puts on the new information for each type.

C.2 Eliminating false claims from safe borrowers

In order to gain intuition on the results, we restrict our attention to beta distributions as priors, since they are very flexible distributions that can take various shapes and that they have the advantage of being easy to use (see Rice, 89):

$$g(p) = \frac{\Gamma(a) \Gamma(b)}{\Gamma(a+b)} p^{a-1} (1-p)^{b-1}$$

Borrower i 's reputation at the beginning of period t is then given by the simple formula:

$$\mu_i^{[t]} = \frac{(t-1) - c_i^{[t]} + a}{(t-1) + (a+b)}$$

Note that the uniform distribution is simply a beta with $a = b = 1$, so that the initial reputation at $t = 1$ would simply be $\mu_i^{[1]} = 1/2$.

The marginal contribution of an extra insurance claim to borrower i 's reputation is given by

$$\mu(t, c+1) - \mu(t, c) = \frac{\int_0^1 (1-p) g^{[t-1]}(p) p dp}{\int_0^1 (1-p) g^{[t-1]}(p) dp} - \frac{\int_0^1 p g^{[t-1]}(p) p dp}{\int_0^1 p g^{[t-1]}(p) dp}$$

where $g^{[t-1]}(p)$ is the distribution of borrower reputations at the beginning of time $t - 1$, given c claims up to the beginning of period $t - 1$. Taking the prior distribution to be a beta, this difference works out to:

$$\begin{aligned} \mu(t, c+1) - \mu(t, c) &= \frac{(t-1) - (c+1) + a}{(t-1) + (a+b)} - \frac{(t-1) - c + a}{(t-1) + (a+b)} \\ &= -\frac{1}{(t-1) + (a+b)} \end{aligned}$$

which is negative and of magnitude decreasing in t .³⁶

False claims lead to a loss in income due to loss in reputation

This loss in reputation translates to a loss of income (through higher premium) in every period equivalent to:

$$(1 - \mu(t, c + 1)) \delta L - (1 - \mu(t, c)) \delta L = \delta \frac{L}{(t - 1) + a + b}$$

or a loss of expected income from t onwards (ignoring the increase in the probability of falling below the cutoff) equal to:

$$\sum_{k=1}^{\infty} \left(\frac{\delta^k L}{(t + k - 1) + a + b} \right). \quad (15)$$

As t becomes large, this cost goes to zero for any beta prior.³⁷

False claims lead to a loss in income due to a higher probability of losing access to insurance

In addition to the loss on income due to loss in reputation, there is a loss associated with an increased probability of falling below the cutoff due to repeated failures. Take a borrower with c claims up to time t :

$$\mu(t, c) = \frac{(t - 1) - c + a}{(t - 1) + a + b}$$

To reach the limit below which insurance claims are denied – denote it μ_* – it takes a certain amount of further claims. For example, denote by $s_t^c(0)$ the number of claims in a row to go from a reputation of $\mu(t, c)$ to a reputation just below μ_* , where $s_t^c(0)$ is the first integer such that:

$$\frac{(t - 1) - c + a}{(t - 1) + s_t^c(0) + a + b} < \mu_*,$$

Similarly, it takes $s_t^c(1)$ loans with $s_t^c(1) - 1$ claims (and 1 repayment) to go from a reputation of $\mu(t, c)$ to a reputation just below μ_* , where $s_t^c(1)$ is the first integer such that:

$$\frac{(t - 1) + 1 - c + a}{(t - 1) + s_t^c(1) + a + b} < \mu_*.$$

³⁶This is where the use of a beta distribution is convenient: the loss in reputation in each period is independent of the number of claims made up to that point.

³⁷By virtue of Bayesian updating, it is actually true for any prior. We restrict our attention to beta priors because of what follows.

More generally, it takes $s_t^c(z)$ loans with $s_t^c(z) - z$ claims (and z repayments) to go from $\mu(t, c)$ to just below μ_* , where $s_t^c(z)$ is the first integer such that:

$$\frac{(t-1) + z - c + a}{(t-1) + s_t^c(z) + a + b} < \mu_* \quad (16)$$

and is given by

$$s_t^c(z) = \text{int} \left\{ \left(\frac{1}{\mu_*} - 1 \right) t + \frac{z - c}{\mu_*} - \frac{(1 - \mu_*)(1 - a) + b\mu_*}{\mu_*} \right\} + 1$$

Note that $s_t^c(z)$ is increasing in t and $\lim_{t \rightarrow \infty} s_t^c(z) = \infty$ since $\mu_* < 1$.

If a borrower makes no false claims, the probability for a borrower with reputation $\mu(t, c)$ of hitting the limit μ_* is thus given by summing the number of ways a borrower can have $s_t^c(z) - z$ failures times the probability of having $s_t^c(z) - z$ failures for all values of z :

$$\sum_{z=0}^{s_t^c(z)} \binom{s_t^c(z)}{z} p^z (1-p)^{s_t^c(z)-z} \quad (17)$$

Note that, from (16), a borrower with an additional insurance claim at time t (i.e. $c+1$ claims) faces fewer rounds before hitting the limit:

$$\begin{aligned} s_t^{c+1}(z) &= \text{int} \left\{ \left(\frac{1}{\mu_*} - 1 \right) t + \frac{z - (c+1)}{\mu_*} - \frac{(1 - \mu_*)(1 - a) + b\mu_*}{\mu_*} \right\} + 1 \\ &= s_t^c(z-1) \end{aligned}$$

The probability of hitting the limit μ_* with $(c+1)$ claims is then given by:

$$\sum_{z=0}^{s_t^{c+1}(z)} \binom{s_t^{c+1}(z)}{z} p^z (1-p)^{s_t^{c+1}(z)-z} \quad (18)$$

We note that the difference between (18) and (17) is decreasing in t and converges to zero as $t \rightarrow \infty$. This is due to the fact that the difference can be written as

$$\text{eq}(18) - \text{eq}(17) = \sum_{z=0}^{s_t^c(z)} \left[\binom{s_t^c(z)}{z} - \binom{s_t^c(z-1)}{z} p^\xi \right] p^z (1-p)^{s_t^c(z)-z} \quad (19)$$

where ξ denotes the difference $s_t^c(z) - s_t^c(z-1)$; ³⁸ that each term in the sum is bounded above by:

$$s_t^c(z)^z (1-p)^{s_t^c(z)-z} > \left[\binom{s_t^c(z)}{z} - \binom{s_t^c(z-1)}{z} p^\xi \right] p^z (1-p)^{s_t^c(z)-z} \quad (20)$$

³⁸Note that $\binom{s_t^c(z-1)}{z} = 0$ for $z > s_t^c(z-1)$.

(since the term in brackets is smaller than $\binom{s_t^c(z)}{z}$, which itself is smaller than $s_t^c(z)^z$, and that $p \leq 1$); that the left-hand side of (20) goes to zero as t goes to infinity by the fact that

$$\lim_{n \rightarrow \infty} n^z p^z (1-p)^{n-z} = 0 \quad \text{for all } z \geq 0$$

(because $p \leq 1$); and that the limit of $n^z p^z (1-p)^{n-z}$ as z approaches n is zero (the sum in (19) hence does not diverge).

The loss associated with the increased probability of falling below the cutoff due to an additional false insurance claim thus goes to zero as the number of loans increases.

Net gains from false claims are positive for t large enough

The gains from deviating, however, remain significant and comprise of not repaying the current loan L . As we saw above, the costs of false claims are twofold: (1) false claims decrease future income due to a loss of reputation; and (2) false claims increase the probability of falling below the cutoff (19) in the future. Since both costs tend to zero as the number of periods increase, and since the cost of deviation remains constant, we have that all borrowers will thus eventually benefit for filing false claims. It is therefore necessary for the insurance contract to impose costs beyond simple loss of reputation after insurance claims in order to deter false claims, as stated in Proposition 2.

D Proof of Proposition 3

To prove the proposition, we have to show (1) that there exists a cutoff to deter adverse selection; (2) that there exists a punishment sufficient to deter false claims (moral hazard); (3) that the insurance premium is sufficient to cover the financial institution's insurance costs; and (4) that the contract satisfies the borrowers' participation constraint.

Cutoff to deter adverse selection

In the proof of Proposition 1, we showed that the financial institution can choose a number of waiting periods to make the adverse selection problem as small as it wants.

Sufficient punishment to deter false claims (moral hazard)

In the proof of Proposition 2, we showed that extra sanctions beyond simple loss of reputation were necessary to deter false insurance claims.

The gross benefits from filing a false insurance claim are equal to the cost of not repaying the loan L . To discourage moral hazard behavior, the sanction for a claim simply has to be equal to the benefit of the moral hazard.

The simple punishment we propose in this paper is the following. When a borrower files a claim in period t , the institution “demotes” the period- t borrower to a period- $(t - N_i^{[t]})$ borrower, where $N_i^{[t]}$ is the minimal integer such that:

$$\sum_{s=1}^N \delta^s \left(\mu_i^{[t]} - \mu_i^{[t-N+s]} \right) L \geq L. \quad (21)$$

The left-hand side of (21) is the premium costs above the current premium cost that borrower i paid in the $N_i^{[t]}$ previous periods. The financial institution chooses $N_i^{[t]}$ such that this extra cost is exactly equal to the benefit of deviation for borrower i in period t in order to avert any false claims.

Does this contract maintain the participation constraint in case of real claims? If borrower i already had an insurance contract in $t - N_i^{[t]}$, her participation constraint is clearly satisfied, since it is just a repetition of what she did in the past, which took into account this risk of failure. If $t - N_i^{[t]}$ is greater than a borrower’s insurance experience (i.e. borrower i did not have an insurance contract in $t - N_i^{[t]}$), then the financial institution considers the borrower in default.

Participation constraint for financial institution

As shown in the proof of how to limit adverse selection above (appendix D), the insurance scheme increase repayment rates for borrowers who strategically default. This softens the institutions’ participation constraint.

Furthermore, borrowers only participate once the premium charged is “not too high” compared to the actual cost of insuring the borrowers. On average, the institution thus charges borrowers higher premia than the actual cost of insuring them (although the institution cannot change this because of adverse selection issues).

If the institution offered credit without insurance, offering credit with insurance satisfies its participation constraint.

Participation constraint for borrowers

Participation in the insurance contract of the “good guys,” i.e. borrowers with $P_i > \frac{L}{\delta X}$, follows from the argument given in Section 4.1 (p. 16). They are willing to repay their loans even without insurance. This means that the waiting periods do not deter them from participation. They start participating once the premium has gone down sufficiently.

Table 1. Descriptive Statistics

Variables	Mean	Std. Dev.*	Median*	Min*	5%*	95%*	Max*	Number observ.
Personal/Business characteristics								
Average weekly sales in good weeks (\$US)	531	770	381	14	112	1203	13333	782
Bad week sales, as a fraction of good week	0.58	0.17	0.58	0.03	0.29	0.84	1.00	782
Buying merchandise daily	0.19	---	---	---	---	---	---	782
Buying 2-3 times per week	0.29	---	---	---	---	---	---	782
Buying once a week	0.35	---	---	---	---	---	---	782
Only one business	0.79	---	---	---	---	---	---	772
Sole income provider to household	0.40	---	---	---	---	---	---	782
Access to bank loans	0.04	---	---	---	---	---	---	782
Access to loans from money-lender	0.47	---	---	---	---	---	---	782
Money-lender interest rate (over loan)	15.84	7.61	15	3	5	25	40	330
Access to loans from family/friends	0.32	---	---	---	---	---	---	782
Loan characteristics								
Loan size (in US\$)	740	555	650	56	167	1700	5000	782
Loan size/average daily purchases	17	20	12	1	2	47	93	647
Payment size (in US\$)	124	97	93	5	29	276	718	782
Payment/average daily purchase	2.98	3.40	1.92	0.02	0.29	8.73	27.69	647
% keeping loans to make first payments	0.19	---	---	---	---	---	---	780
Number of payments kept	1.88	1.17	1.75	0.10	1.00	5.00	5.00	146
Group characteristics								
Group size	3.7	0.94	3	3	3	6	8	210
groups of 3	0.50 †							105
groups of 4	0.34 †							72
groups of 5	0.12 †							26
groups of 6	0.01 †							3
groups of 7	0.00 †							1
groups of 8	0.01 †							3

* Standard deviation, minimum, maximum, median, and 5% and 95% points are not reported for dummy variables.

† As a percentage of total number of groups.

Table 2. Insurance Occurances in Credit Groups

Insurance need in past year.	(Someone in group has had trouble making own payment in past year)		
			%
	none	79	0.38
	1-4 times	85	0.40
	more than 4 times	46	0.22
		210	
 Reason insurance was needed.		N	%
	low sales	155	0.63
	bad planning	30	0.12
	robbery	7	0.03
	family illness	49	0.20
	other	7	0.03
		248	
 Who provides insurance?		N	%
	a member of the group	128	0.52
	the whole group	42	0.17
	someone from outside	49	0.20
	self insurance	8	0.03
	resulted in late payment	20	0.08
		247	
			(savings, money-lender)
			(insurance failed)
 How much?		Amount (in \$)	As fraction of payment*
	mean	28	0.24
	median	17	0.17
	5%	5	0.04
	95%	88	0.67
	min	2	0.01
	max	167	1.25

* As we have only current payment information, and not the payment information at the time insurance was given, these are only approximations.

Table 3. Risk heterogeneity in groups

		Number of groups					
		Highest risk quintile in group					
		1	2	3	4	5	N
Lowest risk quantile in group	1	2	18	21	26	33	100
	2		5	11	13	17	46
	3			2	14	22	38
	4				1	17	18
	5					8	8
						210 groups	

(The small italics indicate cells with less than 5 observations)

Table 4. Net insurance provision in groups

		Net insurance provision				
		(mean # times provided - # times received)				
		Highest risk quintile in group				
		1	2	3	4	5
Lowest risk quantile in group	1	2.00 (0.00)	0.91 (0.46)	0.67 (0.33)	1.33 (0.46)	0.47 (0.25)
	2		0.75 (0.43)	1.00 (0.43)	1.00 (0.46)	0.00 (0.40)
	3			-0.50 (0.50)	-1.33 (0.31)	1.13 (0.14)
	4				0.00 (0.00)	2.00 (0.97)
	5					-0.50 (0.25)

(The small italics indicate cells with less than 5 observations)

(Bold indicates significance at 10% level)

(Standard errors of mean in parenthesis)