Entrepreneur & Innovation Exchange
Published online at EIX.org on December 04 2024
DOI: 10.32617/1167-67504d123d196

Microfinance Borrowers' Social Ties Can Bring Stability or Chaos

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KEYWORDS: financing, successful startup, microfinance.

In emerging economies, personal relationships encourage microfinance borrowers to repay their loans, but can spur panic when crisis hits.

In November of 2016, the government of India announced unexpectedly that it was invalidating 500- and 1,000-rupee notes to curb widespread corruption. While the government encouraged people to exchange the old rupee notes for new, valid ones at banks, India's rural, cash-reliant economies struggled to cope with the sudden liquidity shock. Many of these rural economies rely on group lending, a model widely used by microfinance institutions (MFIs) to achieve high loan repayment rates by harnessing peer pressure and community trust among low-income borrowers.

While this peer pressure and community trust, which we call social capital, can promote the desired financial behavior during untroubled times, it can have a downside when sudden financial crisis hits. We discovered this while conducting research that we published in an article in Strategic Management Journal. In particular, we saw that clusters of rural India's borrowers who received microfinance loans stopped paying them back when panic spread among their local communities following demonetization. This finding underscores the importance of designing resilience mechanisms for startups planning branches or franchises in emerging economies to mitigate the ripple effects of financial shocks. Similarly, socially minded institutions aiming to provide liquidity to resource-constrained communities should carefully assess and manage the dual-edged role of social capital in their business models.

The Upsides and Downsides of Shared Liability

We set out to study microfinance loan repayment behavior during times of crisis. We chose this problem to explore the promise and limitations of business models that rely on social ties to boost financial inclusion. Specifically, we examined group lending through Joint Liability Groups (JLGs). These are small collectives of low-income borrowers responsible for one another's loans: if one member cannot repay, the others must step in. This creates not only "economic liability" but also "social collateral," where peer pressure ensures timely repayment even without traditional collateral. This business model has helped microfinance institutions succeed across developing countries, using group accountability to achieve high repayment rates. But our concern was that, during a crisis, this same group pressure could accelerate defaults instead of preventing them.

JLGs have been praised for expanding financial access in impoverished settings where traditional, collateral-based lending does not work. But we were also curious about the potential downsides. Could the same community ties that ensure timely repayments in regular times become a liability during crises, spreading defaults across groups within communities?

We suspected we would find the ties within borrowing groups would influence loan defaults during crises, leading to clusters of loan defaults. The reasoning was that group lending, based on joint liability, could backfire during a liquidity crunch, spreading defaults across the JLGs and turning a few missed payments into a wave of financial trouble for the lending company.

What We Studied

Our study looked at how microfinance borrowers in India repaid their loans during the liquidity crisis induced by the 2016 Indian demonetization policy. We used data from a large microfinance company, covering around 2 million low-income borrowers, including their repayment histories and details about their borrowing groups and centers (or villages). We measured how often borrowers missed repayments before and after demonetization, focusing on whether formal economic and informal social ties influenced these behaviors. Specifically, we wanted to investigate if people were influenced by those with whom they had formal ties (i.e., within joint-liability groups or JLGs) or if they were also influenced by those outside JLGs but within their broader community or village. Overall, our goal was to understand how social relationships, rather than purely economic factors, shaped loan defaults during the crisis and whether loan defaults tended to spread within communities as a result.

What We Found

The key discoveries from the research were:

1. Community-Level Clustering of Defaults: Defaults (or missed repayments) after the 2016 Indian demonetization were clustered within specific communities, meaning that borrowers in the same group or community were more likely to default together rather than independently. This suggested that social influence played a major role in repayment behavior during the crisis.
2. Impact of Informal Ties: We found that both formal joint-liability ties and informal community ties influenced defaults, with the influence of informal ties being particularly strong when borrowers shared similar characteristics like religion. It was surprising how much these informal social ties mattered—beyond what one would expect from formal economic ties alone.
3. The Dark Side of Social Capital: Our research found that the same social pressures that ensure repayments are on track in good times can become a source of fragility during crises, leading to a wave of defaults. This is extremely vital to understand because while social capital is usually seen as a positive force in microfinance, it amplifies problems for the lending microfinance organization when a crisis hits the external business environment.

In sum, while social capital can be a strength, our findings highlight its fragility as well. We were particularly struck by how informal social influence could spread defaults beyond formal joint-liability groups, showing that community influence can lead to unintended consequences in times of economic stress.

Takeaways

Business owners and startup founders can draw three critical lessons from our research.

- First, social capital is a double-edged sword. Leveraging community ties can enhance loyalty and collective action under stable conditions, but it also creates vulnerabilities during crises. Founders should be mindful of the potential for adverse spillovers: What works well in good times could unravel quickly in a crisis if social pressure turns into a driver of collective default or disengagement.
- Second, it's crucial to focus on the need for targeted risk management strategies to address social contagion specifically. Group lending, and the microlending business model in general, is a brilliant hedge against the risk of individual default by leveraging community ties for repayment. However, these same ties can make the microlending business model particularly vulnerable to widespread defaults during “black swan” events. Businesses should focus on understanding the dynamics of social contagion. Doing so can inform the design of strategies that build resilience against the ripple effects crises typically trigger.
- Lastly, founders should appreciate the importance of local context. Our research showed that community dynamics vary significantly—what works in one setting might not in another. Tailoring business approaches to fit local characteristics and investing in on-the-ground relationships can be the difference between thriving and failing, especially in community-driven business models. Understanding and balancing the risks and rewards of interconnectedness will help founders build more sustainable business ventures.

Conclusion

Business startups and entrepreneur-led ventures—not

EIX.org (2024)
DOI: 10.32617/1167-67504d123d196

just in emerging economies but also in developed markets experiencing situations in flux—should rethink their over-reliance on social capital. Our research shows that while leveraging social ties can create strong group accountability and boost success under normal conditions, those same ties can amplify liabilities during a crisis. This has implications for businesses operating in areas where market conditions are unpredictable, as social influence can lead to cascading failures instead of resilience. To mitigate such risks, businesses should be proactive in building risk management systems and avoid relying exclusively on their customer networks. They should also diversify their reliance on networks. Instead of focusing solely on strong internal social ties, building broader, diverse relationships across communities can help manage risks more effectively. This means balancing the power of close-knit community support with external partnerships that provide a buffer when crisis hits. For instance, collaborations with government agencies and partnerships with financial technology firms to enable faster access to emergency liquidity or policy support can provide essential buffers when traditional, community-driven mechanisms may falter.

The most surprising takeaway from our study is how easily social capital—often seen as a business strength—can turn against an organization under stress. We found that informal social connections, such as those rooted in religion or community, significantly amplified defaults during the crisis, exacerbating financial distress for the lending organization. This "dark side" of social capital highlights the importance of not only leveraging social pressure for growth but also managing it carefully to prevent it from becoming a source of vulnerability.

Explore the Research

Community influence on microfinance loan defaults under crisis conditions: Evidence from Indian demonetization (https://onlinelibrary.wiley.com/doi/10.1002/smj.3558). Adbi, A., Lee, M., & Singh, J. (2024). Strategic Management Journal, October 2023.

EIX.org (2024)
DOI: 10.32617/1167-67504d123d196