

# Relationship Lending in Microfinance: How does it Impact Client Dropouts?

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## Abstract

Client retention has been identified as a critical factor for both social performance and financial sustainability of microfinance institutions (MFIs). It seems thus to be essential to examine the factors that can explain client dropouts in the microfinance sector. This study focuses on factors linked to the relationship clients have with their loan officer to analyze client dropouts. We assume that the higher the ratio between the number of different loan officers a client dealt with compared to the number of loans he received from the MFI, the less intensive the relationship between both actors is. Using a sample of 47,080 observations covering the time period 2005-2015 from a MFI active in Ethiopia and running an IV probit regression, our results demonstrate that a more intensive relationship between clients and loan officers decreases the probability that clients leave the MFI, showing the importance of close contacts between loan officers and their clients.

**Keywords:** Microfinance, Relationship lending, Client Dropouts, Loan Officers

## Introduction

Client retention is identified as a critical factor for both social performance and financial sustainability of microfinance institutions (MFIs). Undeniably, retaining clients helps MFIs to reduce administrative costs and loan defaults. Given the advantages offered by client retention, it seems essential to analyze the factors that can explain client dropouts in the microfinance sector. However, this field remains poorly documented in the literature. Among the few studies on this topic, some of them have shown that client exits may be mainly explained by attributes

linked to clients or their business, attributes of the services offered by the MFI, loan officer attributes, group issues or external shocks (Bardsley et al., 2015). This study focuses on factors linked to the relationship between clients and their loan officer in order to analyze client dropouts. We argue that without a close relationship between both actors, microfinance may lose its “raison d’être” and clients may be negatively affected. This close relationship is built up through relationship lending, in opposition to transaction lending. Relationship lending presents several advantages. It can reduce information asymmetry problems as banks obtain information about the borrower’s repayment history (Diamond, 1991). As asymmetry of information may be particularly problematic when dealing with poor people who are active in the informal economy and often lack collateral, reducing this barrier by relationship lending appears to be essential to include them financially.

While studies on relationship lending often consider the relation between the bank and the client without taking the role of loan officer into account, others spotlight the importance of this actor. We argue that when analyzing relationship lending in the microfinance sector, loan officers are particularly crucial as microfinance credit agents represent the key link and often the sole point of contact between the client and the MFI (Canales and Greenberg, 2016). To better understand this topic, we mobilize two strands of literature before applying them to the microfinance industry: relationship lending and client’s fidelity to a service worker.

## Relationship lending

Relationship lending is defined as “the process of collecting private, customer-specific information on

potential borrowers, and then using it to engage in profitable banking activities” (Scott, 2006, p. 545), this information being collected through social interactions between the lender and the borrower (Lehmann and Neuberger, 2001; Turvey et al., 2014). Relationship lending is particularly relevant when soft information is required and is consequently mostly used when a bank is dealing with SMEs. It helps reduce information asymmetry and improve access to credit. As soft information is not easy to acquire, loan officers, because of their numerous contacts with borrowers, appear as an essential actor when examining relationship lending. Actually, their activities are based on the production of soft information (Scott, 2006) because of their direct contact with the borrower (Uzzy and Lancaster, 2003; Akhavein et al., 2004; Uchida et al., 2012; Fiordelisi et al., 2014). Uchida et al. (2012, p.98) argue that “the ‘relationship’ in relationship lending is indeed the loan-officer-entrepreneur relationship, not the bank-entrepreneur relationship”.

#### **Clients’ loyalty towards a service worker**

The notion of personal loyalty, the “customer’s level of attachment to and exclusive use of a service individual” (Bove and Johnson, 2002) is particularly predominant in the literature on relationship marketing. Relationship marketing is defined as “attracting, maintaining and in multi-service organizations, enhancing customer relationships” (Berry, 1983; p.25). This concept is indeed particularly interesting as it is argued that it is less costly (Reichheld and Sasser, 1990) and more revenue generating (Schlesinger and Heskett, 1991; Reichheld, 1996) to retain existing customers rather than to attract new ones. Moreover, relationship marketing helps companies to better understand customers’ needs and thus respond to them (Berry, 1983). Gwinner et al. (1998) explain that users involved in a long-term relationship may benefit from higher confidence in the service provider, from social benefits such as the impression of being unique, and from a special treatment in terms of price reduction for example. Palmatier et al. (2006) showed that a relationship established between a client and a service worker made relationship marketing more effective than if the relationship was established with the firm. Close relationships with a service worker are known to particularly develop in service firms and in small companies (Barnes, 1997). Beatty et al. (1996) shown

in their study that clients affirmed to be loyal in the first instance to their service worker rather than to the firm. Personal loyalty may have substantial benefits for the firm. Clients involved in a strong relationship with their service worker are more likely to evaluate the firm positively (Brown, 1995), to spend more (Reynolds and Beatty, 1999), and to repurchase several time (Costabile, 2000). However, as the loyalty to a service worker can be higher than the loyalty to a firm, customers may be tempted to leave the firm when the service worker quits the firm (Beatty et al., 1996), is promoted or is transferred to another department (Bendapudi and Leone, 2002). Even if the client faces some difficulties to leave the firm in the short term because of high switching costs, he will be tempted to move to a competitor afterwards (Anderson and Robertson, 1995; Bendapudi and Leone, 2002) to follow the service worker. In the same vein, Bove and Johnson (2002) demonstrated that personal loyalty may represent an important factor justifying customer dropouts.

#### **Personal loyalty and relationship lending to explain dropouts in microfinance**

Microfinance represents a particularly interesting sector to explore when it comes to study personal loyalty and relationship lending. Microfinance, the delivery of financial services to poor people who are excluded from the traditional banking sector, differs from the latter for several reasons. Microfinance borrowers present a particularly high information opacity, increasing asymmetric information problems for microfinance institutions (MFIs). To mitigate these problems, MFIs rely, among other techniques, on relationship lending. They often use the progressive lending technique, increasing the credit amount only if the previous loan was correctly repaid (Armendáriz and Morduch, 2009). Moreover, as loan terms are generally short and reimbursements frequent in microfinance, borrowers are required to have frequent contacts with their MFI (Giné et al., 2010), and more particularly with their loan officer. Canales and Greenberg (2016) argue that microfinance loan officers are often the “sole points of contact” between the client and the MFI. They have numerous contacts with clients as they are in charge of finding new ones (Fisher and Sriram, 2002), advising them (Siwale and Rtichie, 2012)

during loan application, monitoring them by visiting their house, and enforcing reimbursement (Ito, 2003; Siwale and Ritchie, 2012). Regarding their informational role, loan officers are responsible for detecting and monitoring relevant information to select clients and for transferring this information to the credit committee (Siwale and Ritchie, 2012). Loan officers can also acquire soft information within the borrower's social environment where they diffuse information about non-repayments. According to Shchetinin and Wollbrant (2013), credit officers decide themselves which part of the information they will transmit to the microfinance institution. In microfinance, loan officers have a large discretion particularly in the screening and allocation processes (Agier and Szafarz, 2013), and in the way they choose to enforce rules (Piore, 2011; Canales and Greenberg, 2016). As borrowers in microfinance seem to build a close relationship with their loan officer, loan officers' turnover may be particularly detrimental. However, there are very few studies that examine the impact of loan officers' turnover and rotation in microfinance. One of them is the one conducted by Canales and Greenberg (2016). They demonstrate that when a borrower faces a change of loan officer, he will be more likely to miss repayments.

### Research objectives

As explained above, relationship lending may be particularly beneficial for borrowers in microfinance who often presents a high level of information opacity. Moreover, we argue that loan officers appear as an essential actor when examining relationship lending. This is particularly true in microfinance because borrowers tend to consider their loan officer as the unique representative of the institution as this one is often their sole point of contact. Borrowers may even develop a kind of loyalty toward their loan officer. As a consequence, even if microfinance borrowers do not have many other opportunities to obtain a credit if they cease their relationship with their MFI, they could be tempted to quit the MFI when they face a change in their loan officer.

This study tries thus to answer the following research question: "What is the impact of relationship lending on client dropouts in microfinance?"

### Methods

In this study, we used a sample of 47,080 observations covering the time period 2005-2015, collected at the Ethiopian microfinance institution Buusaa Gonofaa. To examine the influence of loan officers' turnover on microfinance client dropouts, we used a probit model defined as follows:

$$\Pr(Y_i = 1 | Z_i) = \Phi(\beta_0 + \beta_1 Z_{1i} + \beta_2 Z_{2i})$$

where:

$Y_i$  is the eventual departure of the client defined as a binary variable which takes the value 1 if the worker has left the MFI, and 0 otherwise.

$Z_{1i}$  is the variable to proxy the relationship between the client and the loan officer, computed as the ratio between the number of loan officers a client dealt with during its relationship with the microfinance institution and the number of loans received by the client.

$Z_{2i}$  is a vector of control variables associated to each borrower  $i$ , namely his gender, his year of birth, whether he lives in an agricultural or in a rural area, the number of dependent family members, and a dummy variable that takes the value 1 if the borrower was in default at minimum on time during his/her relationship with the MFI and control variables associated with the loans, like the amount of the loans or the number of transactions.

As endogeneity issues were suspected, we conducted an IV probit regression.

### Results

The results show that the coefficient of the ratio between the number of loan officers and the number of transactions is positive and significant at the 1% level. This suggests that microfinance borrowers are more likely to drop out when they face a higher number of changes of loan officer. Moreover, the coefficient for the variable called rural is negative and significant, meaning that rural borrowers tend to drop out less. The results also demonstrate that the probability of female borrowers to leave the microfinance institution is lower than the one of male borrowers. Having a large number of dependent family members reduces the probability to drop out. The results also show that younger borrowers have a lower probability to leave the institution. Contradictory with what we can think, people in defaults are less likely to leave the

institution. We also observe that after a certain amount of transactions, borrowers are more likely to leave the microfinance institution. However, the total amount of loans received by a borrower tends to decrease the probability of dropping out.

### Discussion

Client retention becomes a concern for many microfinance institutions. Indeed, in this sector, long relationships between a microfinance institution and its borrowers appear to be essential to face information asymmetry. By using the lending relationship technique, microfinance institutions can obtain the soft information required to serve this poor population. Loan officers are the staff members in charge of obtaining this information because of their several contacts with the borrowers. As the literature in marketing shows that clients develop a closer relationship with a service worker than with the firm he represents, we may argue that when this relationship is destroyed because a loan officer leaves the microfinance institution or is rotated, it can push clients to drop out. This is particularly detrimental for the microfinance institution as, by losing clients, all the efforts made to build a strong relationship with them in order to acquire soft information cannot be valued anymore. It may also be harmful for clients who leave the microfinance institution without being sure that they will find a funding alternative, and for remaining clients who will probably trust less their new loan officer. While relationship lending seems to present several advantages, there are very few studies examining the effect of loan officers' turnover or rotation in microfinance. Consequently, the aim of this study was to test the hypothesis according to which the microfinance borrowers are more likely to drop out when they face a higher number of changes of loan officer. Our results from an IV probit regression show that the higher the number of loan officers a client dealt with compared to the number of credits he received, the higher his probability to drop out. Our results are in line with some studies demonstrating the negative consequences of loan officers' turnover in the case of relationship lending in microfinance, regarding default rate and credit offer (Drexler and Schoar, 2014; Canales and Greenberg, 2016). Our results also support the view of some scholars arguing that employee retention is

essential to favor customer retention (Reichheld, 1993). Based on these results and as suggested by Reichheld (1993), we recommend to microfinance practitioners to avoid the rotation of loan officers through different branches. However, this practice, more and more used by microfinance institutions, can be useful to limit fraud. Therefore, when the risk of fraud from loan officer is relatively high, the managers should analyze the benefits that loan officers' rotation can bring compared to the cost it can represent. Managers should also find solutions to avoid a high turnover rate among loan officers, like setting up an adequate incentive scheme. Our results also show that rural clients tend to drop out less than urban borrowers. Indeed, due to the lack of competition in the microfinance sector in these regions, clients may face difficulties to find another MFI. As a consequence, we argue that relationship lending may be particularly attractive in rural areas because of the high level of information asymmetries in these regions. Our study presents some limits. First of all, theoretically, we assumed that client dropout was negative for microfinance institutions. However, we can argue that it may also be an indicator that the loans borrowers have received have enabled them to emerge from poverty and to have access to credit from the traditional banking system. This may be confirmed by our results showing that more transactions increase the probability of dropping out. In this case, client dropouts can be positive for the microfinance sector. Then, empirically, we had no data on the nature of social interactions within each group of borrowers. This could have been another factor influencing dropouts. Furthermore, data about loan officers' features and about clients' satisfaction with microfinance products are also lacking. It should be interesting to conduct interviews with clients to better understand their reasons of dropping out.

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