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The impact of microfinance credit ratings

It’s been great to see business school faculty take an interest in microfinance. Gabriel Natividad of the strategy group at the Stern School of Business at NYU just published an interesting new paper that links asymmetric information, third-party credit ratings, the price of credit and the operations of microfinance institutions (MFIs). Empirical evidence on information problems lags behind theory and practice, so the paper’s especially welcome.

Natividad and co-author Mark Garmaise use data from MicroRate to measure the effect of credit evaluations by rating agencies on the cost of funds for MFIs. Specifically, they investigate the relationship between the quality of publicly-accessible information about MFIs and their operating efficiency.

The associations are dramatic: higher credit ratings are correlated with lower cost of funds for MFIs on the order of 550 basis points. This is particularly relevant for microfinance because information asymmetries are likely to play an important role in raising the costs of finance in developing economies. Additionally, the benefits are largest for MFIs that borrow from commercial lenders, which is consistent with the idea that these lenders are more sensitive to credit assessments of MFIs. Garmaise and Natividad also looked at operational efficiency gains, and found that evaluated MFIs had higher client-to-credit-officer ratio.

While the focus is on improving performance and lowering costs for MFIs, its unclear what the impact is on outreach. Joint FAI/World Bank research shows that commercial microfinance banks tend to serve richer customers (using average loan size as a proxy for poverty level). And Garmaise and Natividad’s work shows that commercial lenders—which are more likely to lend to commercial microfinance banks--enjoy the largest benefits of credit ratings. So does this add up to fewer poor customers being served?

Garmaise and Natividad asked this same question, and found the answer to be no. Their study shows that rated MFIs did not make larger loans on average. This suggests – but does not nail down – the idea that credit evaluations can bring benefits to broad sectors of the population without creating pressure for mission drift by MFIs.

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