Requiem for microcredit? The decline of a romantic ideal*

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Introduction

During the past two decades microcredit has attracted the attention of politicians, policymakers and activists interested in community economic development in Countries of the South and the North. International and national actors have attributed remarkable power to this simple institution, which entails the organised supply of very small, fixed term, renewable loans, secured by unorthodox forms of collateral, normally in aid of self-employment.[1] According to the president of the World Bank, for example, microcredit has "brought the vibrancy of the market economy to the poorest villages and people of the world.... [and] allowed millions of individuals to work their way out of poverty with dignity"[2]; closer to home, a 1998 House of Commons report asserts boldly that "Microcredit has enormous potential in terms of community and individual development [in Canada]"[3]

Advocates maintain that in its home territory -- poor Countries of the South -- microcredit has had or could have a substantial impact on many dimensions of social

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[1] See for example, General Assembly, United Nations, *Resolution No52/194, Resolution Adopted by the General Assembly [on the report of the Second Committee (A/52/628/Add.6] 52/194. Role of microcredit in the eradication of poverty (1997).* Hillary Rodham Clinton "Speaking Out, Commentary from the Microcredit Summit Campaign Volume 3, no.2/3 (July/August 2000); see also, Maria Otero and Elisabeth Rhyne, *The New World of Microenterprise Finance* (West Hartford, CT: Kumarian Press, 1994); Elisabeth Rhyne, *Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia* (Bloomfield, CT: Kumarian Press, 2001).

[2] "Microcredit Summit: Declaration and Plan of Action http://www.microcreditsummit.org/declaration.htm#Empowering 2-4 February 1997.

[3] Maurizio Bevilacqua, M.P. (Chair) House of Commons Standing Committee on Finance, "The Future Starts Now: A Study on the Financial Services Sector in Canada," Report *of the Standing Committee on Finance* (Canada, November, 1998)

organization and economic development, including poverty eradication, democratization, women's empowerment, and the creation of sustainable financial institutions.[4] Many assert also that microcredit has the capacity to deliver significant benefits in poor areas – and among poor communities living in wealthy areas -- of rich countries of the North.[5]

These claims about the achievements and potential of microcredit initiatives, however, are questionable. A very few microcredit providers in Countries of the South have become major institutions, annually disbursing millions of dollars in loans. By contrast, most modern microcredit programmes have not lasted long and critics assert that they have had little discernable economic impact.[6] Some suggest the embrace of microcredit in the South has harmed poor people, trapping them in a cycle of debt and sucking resources away from measures to improve health, education and social conditions.[7]

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[4] *Supra*, note 1.

[5] See, for example, Rosalind Copisarow, "The Application of Microcredit Technology to the UK: Key Commercial and Policy Issues," *Journal of Microfinance* 2, no. 1 (2000): 13-41; Salome Raheim and Jason J. Friedman, "Microenterprise Development in the Heartland: Self-Employment as a Self-Sufficiency Strategy for TANF Recipients in Iowa 1993-1998," *Journal of Microfinance* 1, no. 1 (1999): 67-90; Jeffrey Ashe, "Microfinance in the United States: The Working Capital Experience-- Ten Years of Lending and Learning," *Journal of Microfinance* 2, no. 2 (2000): 22-57; Calmeadow Research, *The State of Micro-credit in Canada* (Toronto: Calmeadow, 1999); Lewis D. Solomon, "Microenterprise: Human Reconstruction in America's Inner Cities," *Harvard Journal of Law and Public Policy* 15, no. 1 (1992): 191-221.

[6] Von Pischke refers to "common estimates" of "between 7,000 and 10,000 specialized microlenders worldwide, of which possibly 60 make (subsidized) profits on microlending, up from possibly 20 in 1995 and 35 in 1998", John D. Von Pischke, "Microfinance in Developing Countries," in *Replicating Microfinance in the United States*, ed. James H. Carr and Zhong Yi Tong (Washington D.C: Woodrow Wilson Center Press, 2002), 74, citing to *MicroBanking Bulletin* (Washington, D.C.) 7 (2001) (Consultative Group to Assist the Poorest). See also Graeme Buckley, "Microfinance in Africa: Is it either the problem or the solution?" (1997) 25 *World Development* 1081-1093; Ben Rogaly, "Micro-Finance Evangelism, 'Destitute Women,' and the Hard Selling of a New Anti-Poverty Formula," (1996) 6 *Development in Practice*100-12.

[7] Speaking at the MicroCredit Summit in February, 1997, Poul Grosen, then Executive Secretary to the UN Capital Development Fund, commented:

> When I hear the word 'credit', the next word that often comes to mind is 'debt'. Indeed credit is not always the most appropriate approach to reducing poverty. In fact, it can even deepen poverty, subjecting borrowers to debt they cannot afford to repay. The poor are credit-worthy, yes, but sometimes grants – such as capital for start-ups and, training programmes, technology upgrades,

In countries of the North, microcredit emerged in response to two trends of the late 20th century: the withdrawal from disadvantaged areas of large employers and financial services suppliers, and state sponsorship of self-employment as a replacement for both waged employment and traditional forms of social security. These trends, which stem from the neoliberal restructuring that has accompanied the globalization of capital, produced a widening gap between demand for loan capital in aid of small business development and its supply. Attempting to close this gap, microcredit intermediaries materialised in the United States, Canada and some parts of Europe.[8] While these organisations proliferated in the 1990s, they have experienced rapid retrenchment in the last few years. Some view the decline of microcredit intermediaries as evidence of a need for greater sophistication and refinement of their programmes to meet the particular economic conditions of countries of

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> capacity building and rehabilitation – are a more appropriate approach to reducing poverty than extending loans"

Poul Grosen, "Statement by Paul Grosen, Executive Secretary, MicroCredit Summit, Washington, D.C., 4 February, 1997," in United Nations Capital Development Fund News Archive, United Nations Capital Development Fund, <http://www.uncdf.org/news/archives/pg-mcs.htm>, February 1997. See also, Sarah Blackstock, "Bandaid Bandwagon: Sarah Blackstock Believes the Reputation of Micro-Credit Has More to Do with Its Corporate Friendliness Than Its Success in Helping Poor People," *New Internationalist* 1999, 314; Gina Neff <ginasue@panix.com>, "Microcredit, Microresults," *Left Business Observer* 74 (October 1996), <http://www.panix.com/~dhenwood/Micro.html>; Gina Neff, "Microsummiting," *Left Business Observer* 77 (May 1997), <http://www.panix.com/~dhenwood/Micro_summit.html>.

8 In 1987 about ten microcredit programmes were known to exist in the United States; by 1997, more than 300 programmes were in operation "Microcredit Summit: Declaration and Plan of Action."; Edward S. Prescott, "Group Lending and Financial Intermediation: An Example," *Federal Reserve Bank of Richmond Economic Quarterly* 83 (1997): 23-48; Nitin Bhatt, *Inner-City Entrepreneurship Development: The Microcredit Challenge* (Oakland, California: ICS Press, 2002). Similar expansion occurred in Canada, as did the extent of the perceived need. Canada's first microcredit pilot project was launched in 1987 in three Ontario First Nations communities, Mary Coyle, "Conference Presentations: A Personal Perspective on the Evolution of Microcredit in the Late Twentieth Century," Coady International Institute, St. Francis Xavier University, <http://www.stfx.ca/institutes/coady/text/About_publications_presentations_personalperspective.html>, 2000; Cheryl Frankiewicz, *Calmeadow Metrofund: A Canadian Experiment in Sustainable Microfinance*, Calmeadow (Toronto: Calmeadow, 2001). A 1999 report lists 37 functioning programmes, estimated that more than 127,000 microentrepreneurs across Canada needed microcredit and forecast that this number would likely exceed 200,000 by 2005, see Calmeadow Research, *supra*, note 5.

the North.[9] Conversely, the president of Calmeadow, Canada's largest and most prominent microcredit intermediary, interprets the record as making the simpler point that "stand-alone, exclusively targeted micro-credit operations are not commercially viable in fully developed countries".[10]

Ironically, Canadian policy-makers began to show interest in microcredit shortly before Calmeadow arrived at this conclusion. Reports of the late 1990s observed that microcredit intermediaries could play an important role in the changing economic landscape of the time, and recommended limited financial and institutional support for their services in the form of subsidies from governments and traditional financial services providers.[11] The same Reports recognised, however, that "the market for microcredit [was] not well-understood" and noted a dearth of relevant research.[12] While studies of contemporary microcredit in Canada remain in short supply,[13] evaluations of microcredit

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[9] Bhatt, *supra*, note 8; Ashe, *supra,* note 5; Copisarow, *supra*, note 5.

[10] Martin Connell (President Calmeadow), "Calmeadow's Canadian Microfinance Experience," in Calmeadow: Investing in People, Calmeadow, <www.calmeadow.com/canadian.htm>. This comment was made at the end of Calmeadow's 14 year period of experimentation with domestic microloan funds in urban, rural and First Nations locations across Canada. See text, *infra*, part III.

[11] *Challenge, Change and Opportunity: Report of the Task Force on the Future of the Canadian Financial Services Sector* (Chair, Harold Mackay) (Ottawa: Department of Finance, 1998) (Financial Services Task Force) at 167: See also Bevilacqua, *supra,* note 2. The positions of the Task Force and Calmeadow are not necessarily inconsistent since Calmeadow sought to develop a sustainable "subsidy free" model of microcredit, whereas the Task Force and the Finance Committee Reports supported subsidies.

[12] *Financial Services Task Force ibid,* at 167.

[13] Canadian scholars have made significant contributions to critical debates about microcredit in countries of the South, see, for example, Aminur Rahman, *Women and Microcredit in Rural Bangladesh: An Anthropological Study of Grameen Bank Lending* (Boulder, Col: Westview press, 1999); Katharine N. Rankin, "Governing Development: Neoliberalism, Microcredit, and Rational Economic Woman," *Economy and Society* 30, no. 1 (February 2001): 18-37, but there are few published studies of contemporary microcredit in Canada. Notable contributions include essays in Eric Shragge (ed.) *Community Economic Development: In Search of Empowerment* (Montréal: Black Rose Books, 1997), see, in particular, Marguerite Mendell and Lance Evoy, "Democratizing Capital: Alternative Investment Strategies" 110-129 and Suzanne Merrill, "Loan Circles: The Montréal Experience" 130-146; Rafael Gomez and Eric Santor, "Membership Has Its Privileges: The Effect of Social Capital and Neighbourhood Characteristics on the Earnings of Microfinance Borrowers," *Canadian Journal of Economics* 34, no. 4 (November 2001): 943-66 and Michael Conlin, "Peer Group Micro-Lending Programs in Canada and the United States," *Journal of Development*

programmes together with a smattering of published research provide a foundation for critical assessment of microcredit in a Canadian context.

This article contributes to an emerging literature on the potential and limits of microcredit in Countries of the North by examining the Canadian experience of this distinctive form of lending. We argue that microcredit failed to meet its objective of stimulating the development of very small businesses because debtors rejected its core lending technology – the peer-supported loan. Peer lending transactions organise debtors into groups in which each group member assumes responsibility for repayment of all loans. Peer debtors obtain credit through their relationships with other group members; their transactions draw explicitly on 'sociability' or 'social capital' to mediate access to financial services. [14] This aspect of microcredit carries a romantic appeal, conjuring up images of supportive community relations and evoking echoes of Utopian mutual aid movements, but the lived experience of peer-supported lending may be fraught with

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Economics 60, (1999): 249-69. Canada also has a history of scholarly work on credit unions and cooperatives, which may be seen as more resilient members of the same institutional family as the microcredit intermediary, see Aidan Hollis and Arthur Sweetman, "Microcredit: What Can We Learn from the Past?" *World Development* 26, (1998): 1875-91; see generally, Murray E. Fulton (ed) *Co-operative Organisations and Canadian Society: Popular Institutions and the Dilemmas of Change* (Toronto: University of Toronto Press, 1990). For a legal perspective, see Christopher S. Axworthy, "The uniqueness of Credit Unions", (1987-88) 2 *Banking and Finance Law Review* 283-321.

[14] In the last few years, there has been a substantial growth in scholarship on social capital, much of which deals with the significance of social capital to social and economic relations. For Bourdieu's important conceptualisation of social capital, see Pierre Bourdieu "The forms of capital" in *Handbook of Theory and Research for the Sociology of Education*, ed. John G. Richardson, (New York: Greenwood, 1985) pp. 241-58. For a useful presentation of key theoretical debates, see Michael W. Foley and Bob Edwards, "Is It Time to Disinvest in Social Capital?" *Journal of Public Policy* 19, (1999): 141-73. For a valuable analysis of the spectrum of social capital literature, see Alejandro Portes, "Social Capital: Its Origins and Applications in Modern Sociology," *Annual Review of Sociology* 24 (1998): 1-24. For discussions of microcredit that draw on social capital analysis, see, Lisa J. Servon, "Credit and Social Capital: The Community Development Potential of U.S. Microenterprise Programs," *Housing Policy Debate* 9, (1998): 115-49; Thierry van Basetelaer, *Does Social Capital Facilitate the Poor's Access to Credit? a Review of the Microeconomic Literature*, Social Capital Initiative Working Paper No. 8 (Washington: The World Bank, 2000); Ivan Light and Michelle Pham, "Beyond Creditworthy: Microcredit and Informal Credit in the United States," *Journal of Developmental Entrepreneurship* 3, (1998): 35-51; Linda Mayoux, "Tackling the Down Side: Social

tension. Peer debtors manage complex relationships that require them to police and to be policed by their peers. They also expose their aspirations to a unique form of vulnerability since access to ongoing financial support depends not only on the efforts of each individual but also on the performance of other group members. Drawing on insights from economic analysis, we show why debtors may shy away from this source of credit because they find that the direct and indirect costs of peer-lending exceed the benefits.

A longer-term legacy of microcredit intermediaries may be the symbolic role that they have played in drawing attention to the demand for a reliable supply of small amounts of credit in support of self-employment and very small businesses. The identification of this demand may have stimulated further "consumerization" of credit supply for small-scale businesses by commercial lenders. Although financial service providers have long-established technologies for the supply of small amounts of unsecured and secured credit to consumers, lending in similar amounts to very small businesses until recently scarcely registered on the landscape of Canadian financial services.[15] Credit scoring facilitated the

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Capital, Women's Empowerment and Micro-Finance in Cameroon." *Development and Change* 32, (2001): 435-64; Gomez & Santor, *supra* note 13.

[15] Until recently, the Canadian Bankers Association classified any business loan of less than $250,000 as "small", Industry Canada *Key Small Business Statistics* Version 7.2 July 19, 2002, available at http://strategis.ic.gc.ca/pics/rd/key_small_business_statistics.pdf. By contrast, recent data published by the Canadian Bankers Association include loans as small as $25,000; see, for example, *Quarterly Synopsis of Business Lending by the Major Banks*, 2001, Canadian Bankers Association, available at: http://www.cba.ca/en/viewDocument.asp?fl=6&sl=110&tl=&docid=238&pg=1; Small Business Research and Policy Branch, Industry Canada, *Survey of the Suppliers of Business Financing*, 2000 table: Debt Financing by Authorization Size, (Statistics Canada), available at: http://strategis.ic.gc.ca/pics/rd/b2.pdf. In addition, Debt financing data published by the Small Business Research and Policy Branch, Industry Canada, show that the domestic banks, which continue to dominate small business financing, authorized significantly more financing in the form of lines of credit and credit cards, which are traditionally seen as consumer credit instreuments, than in the forms that have historically dominated business lending such as, term loans, mortgage loans and umbrella credit, see *Survey of the Suppliers of Business Financing*, 2000 table: Debt Financing by Instrument, (Statistics Canada), available at: http://strategis.ic.gc.ca/pics/rd/b3.pdf.

'democratisation of credit' in consumer markets,[16] and its extension to small business lending may expand access to loan capital for individuals who traditionally have been excluded from these markets. The full implications of this development merit further investigation.

The article also comments generally on the promotion of micro*enterprise* as a public policy initiative. A full analysis of this initiative requires a framework that encompasses labour market policy and regional development theory as well as the technologies that purport to expand access to credit for very tiny businesses. Nevertheless, the study of microcredit sheds some light on the informing ideas and likely prospects of the promotion of microenterprise as a local development strategy. The article concludes that the promotion of large scale microenterprise is not grounded in arguments of market failure but is largely a matter of ideology, which serves as a palliative for local disinvestment, the growing insecurity of labour markets and the shift from social insurance to private insurance against economic uncertainty in an era of global economic integration.

Part I examines the emergence of microcredit. This section summarises approaches to microcredit in countries of the South and outlines the elements of the microloan transaction. Part II analyses the central innovation of microlending, the peer lending transaction, using the framework of microeconomic analysis, arguing that there is little

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[16] See Lyn C. Thomas, David B. Edelman, and Jonathan N. Crook, *Credit Scoring and its Applications* (Philadelphia, Society for Industrial and Applied Mathematics, 2002) and in relation to credit cards see David Evans and Richard Schmalensee *Paying with Plastic: The Digital Revolution in Buying and Borrowing* (Cambridge, Mass, MIT Press, 1999) at 96-98 (noting that credit scoring was a significant factor behind spread of credit cards from upper middle class to lower income households). Ronald Mann has written extensively on lenders replacing asset or property based lending instruments, such as secured credit, with information-based credit technologies, such as credit scoring: see Ronald Mann, "The Role of Secured Credit in Small-Business Lending", (1997) 86 *Georgetown Law Journal* 1-44; "Explaining the Pattern of Secured Credit", (1997) *Harvard Law Review* 625-683; "Information Technology and non-legal Sanctions in Financing Transactions", (2001) 54 *Vanderbilt Law Review* 1627-1664.

reason to believe that peer lending will greatly extend credit supply to those whose credit needs are not served by conventional financial services suppliers. Part III discusses the experience of Calmeadow, Canada's major microcredit intermediary and the reasons why its microloan projects failed to achieve their objectives. Part IV reflects on the limitations of microcredit and the ideology of microenterprise promotion.

I. The (re)discovery of microcredit: an overview

Contemporary interest in microcredit can be traced to the flagship "Grameen" pilot project, which supplied tiny loans to poor, landless villagers in rural Bangladesh. Equipped with loan capital, the villagers created very small businesses (microenterprises) to employ themselves and other household members. Of greater significance to the subsequent global spread of microcredit, the borrowers repaid their loans on time and then assumed more debt. Observers interpreted repayment and renewal as indications that the initial loan had sufficiently increased incomes to cover the costs of credit. [17]

These results alone provoked interest in microcredit as a new development strategy. The Grameen project attracted support from aid agencies and foundations, which allowed it to grow rapidly and also to promote its lending technologies. A scant 20 years after the pilot project first disbursed U.S.$27.00 among 42 villagers, Grameen had become a bank, reporting annual disbursements of about U.S.$25 million among 2.23 million borrowers, and a cumulative total of about U.S$2.1 billion in loans. Despite this dramatic expansion in

[17] Credit, often supplied informally by moneylenders, is a well-established institution in many Countries of the South. The distinctive feature of microcredit is that loans are supplied (and assumed to be used) exclusively to generate income through microenterprise. On the historical role of credit and the variety of credit suppliers in countries of the South, see Gareth Austin and Kaoru Sugihara, "Local Suppliers of Credit in the Third World, 1750-1960: Introduction," in *Local Suppliers of Credit in the Third World, 1750-1960*, ed. Gareth Austin and Kaoru Sugihara (New York: St Martin's Press, 1993), 1-25.

the scale of its operations, the Grameen bank continues to report high repayment rates of 94 to 97 per cent.[18]

In addition to supporting the Grameen bank, development organizations and foundations have sought to replicate its success by sponsoring microlending projects in all parts of the world.[19] While many have failed and most of the surviving projects are very small, a very few microcredit intermediaries have developed into sizeable organizations that, like the Grameen Bank, report substantial and rapid increases in numbers of borrowers and funds disbursed, as well as very high repayment rates.[20] Largely based on the expansion of these organizations, the Microcredit Summit, a major international conference held in 1997, laid claim to a global base of 8 million microdebtors.[21]

A variety of organisations participate in the delivery of microloans. Some programmes were created by well-established financial institutions,[22] but many microcreditors are, or began life as, non-bank Non-Governmental Organisations with a development mandate, rather than as deposit taking institutions. They obtain funds through grants and loans from aid agencies, foundations and mainstream financial services suppliers. Banking partners may, for example, lend to the microcredit intermediary, subject

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[18] David Bornstein, *The Price of a Dream: The Story of the Grameen Bank and the Idea That is Helping the Poor to Change Their Lives* (Chicago: University of Chicago Press, 1997) citing to Muhammad Yunus, Grameen Bank, Grameen Bank Update (1997).

[19] See, generally, Von Pischke, *supra,* note 6.

[20] Otero & Rhyne, *supra*, note 1; Rhyne, s*upra,* note 1.

[21] "Microcredit Summit: Declaration and Plan of Action.", *supra* note 2. As a measure of the confidence of its supporters – and perhaps the power of its backers – the Microcredit Summit went on to announce a target of 100 million households using microcredit by the year 2005. *see also* "Yes to Micro Credit," Herald International Tribune, <http://www.grameen.org/bank/bankc3d.htm>, Monday 17, February 1997.

[22] For example, an established state bank in Indonesia, Bank Rakyat Indonesia (BRI), has a long record of microfinance programmes, which include both lending and savings components, Marguerite Robinson, *The Microfinance Revolution: Lessons from Indonesia*, (Washington, D.C: World Bank, 2002).

to loan guarantees from an aid agency or a foundation.[23] In some places, notably Bangladesh and Bolivia, microcredit intermediaries have become non-profit financial service providers -- somewhat akin to North American credit unions -- that offer a range of savings and lending services. These organisations may deploy deposits and investment income, as well as loan fees and interest to service their microcredit operations.

I.1. The Nature of the microloan transaction

The core activity of a microlending organization is the supply of credit -- a routine financial service. A combination of four factors distinguish microcredit services from standard loan products: first, the loans are very small and highly structured, with rigid repayment terms; second, microcreditors engage in outreach to relatively marginalized individuals; third, the loans are intended to be income-generating, advanced in support of microentrepreneurship; and finally the loans are supported by risk management technologies, such as peer lending, that rely on alternatives to legal enforcement and conventional property-based forms of security. In this section, we elaborate on these characteristics, mostly by reference to the microcredit experience in Countries of the South.

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[23] The Royal Bank was quite supportive of Calmeadow's Canadian projects, Frankiewicz, *supra,* note 8; Mendell & Evoy note however, that Calmeadow "had to put up considerable loan guarantees to get any partnership with banks" *supra*, note 13, 122. Other Canadian microcredit intermediaries reported significant difficulties obtaining support from established financial institutions, Mendell & Evoy; Merrill, *supra*, note 13. Some globally prominent financial institutions (none based in Canada) support microcreditors through the Global Network for Banking Innovation, launched in April 2001 by the Women's World Banking organisation: http://www.swwb.org/English/1000/gnbi/gnbi_members.htm.

I.1.1 Microloans as highly structured, renewable loans

Microcredit organisations specialize in providing very small loans, which mainstream financial service providers typically do not sell because of the perceived high risks of the clienteles for such credit and the transaction costs of administering the loans. Obviously, what constitutes "a very small loan" varies with the context -- particularly the economic environment -- in which the lender functions, so that the "micro" nature of a loan is a relative characteristic. [24] Microcreditors specialise in the supply of very small loans as part of their mandate to expand access to credit, presenting their services as complementary to rather than competing with established financial services suppliers.

Microloans are characterised by fixed loan amounts; short loan periods, typically 3-12 months, in which the entire debt (principal, interest and fees) must be paid; repayment by frequent instalments, which may be weekly in countries of the South, but is more often monthly in Countries of the North; and an expectation of refinancing after successful completion of a loan cycle. These characteristics construct microdebtors as inexperienced credit users, who need to learn – or to prove they understand -- the techniques of responsible debt management. They also implicitly shape the priorities of the fledgeling businesses that microcredit aims to support. Many microcredit programmes assume debtors will repay the loans out of increased revenues generated by the loan capital. Short repayment periods compel debtors to treat sales growth as a priority of their business

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[24] A microcredit programme in a poor rural economy of the South might disburse loans in the range of tens of dollars, a typical microcreditor in a transitional economy might lend US$1500-$2500, while loans as high as US$25000 might count as microcredit in a rich country of the North: Copisarow, *supra*, note 5; Beatriz Armandáriz de Aghion and Jonathan Morduch, "Microfinance Beyond Group Lending," *Economics of Transition* 8, no. 2 (2000): 401-20. FIELD "Business Capital for Microentrepreneurs: Providing Loans," in Microenterprise Fact Sheet Series, Issue 3 (AEO, Fall, 2000), available at http://www.microenterpriseworks.org.

development strategies while frequent instalments serve as a discipline for borrowers, and facilitate early detection of payment difficulties. Fixed loan amounts set limits to spending, thereby avoiding the problems associated with unstructured and variable forms of credit.

Microloans incorporate an expectation of renewal, which permits the rewarding of successful borrowers, creates incentives to repay and offers opportunities for debtors and microcreditors to demonstrate progress when subsequent loans increase in size. Although microcreditors market small loans for short terms, refinancing practices may result in successful borrowers ultimately managing a fairly substantial total debt. The structuring of the transaction as multiple, short term small loans rather than one larger longer term loan, or a flexible form of credit, reduces the risk of overindebtedness, helps to support the "culture of repayment" on which microcredit depends and limits the potential loss in the event of default.[25]

I.1.2 Microloans as outreach to marginal groups

All microcredit programmes aim to supply financial services to marginalised groups, underserved by mainstream financial institutions in their societies, but two distinct models have emerged among microcreditors working in Countries of the South. The "poverty alleviation" model, associated with the Grameen Bank and the Microcredit Summit, focuses on depth of outreach to "the poorest of the poor" and reports the achievements of microcredit in terms of reducing poverty.[26] Organisations working with

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[25] Rhyne, *supra,* note 1; Copisarow, *supra,* note 5.

[26] Graham A.N. Wright, "Examining the Impact of Microfinance Services -- Increasing Income or Reducing Poverty?" *Small Enterprise Development* 10, no. 1 (March 1999) 38-46 notes the importance of distinguishing between "increasing income" and poverty reduction goals since higher incomes will reduce povertly levels only when the income is deployed in ways that help to smooth consumption or reduce the impact of catastrophic risks.

this model may adopt a holistic approach in which they supplement lending with social development measures to improve health, nutrition and skills. This model supports microcredit as a more successful route to economic and social development than traditional aid programmes, but, recognising the gap between the target group's ability to pay and the cost of delivering financial services to them, it treats external financing as essential to ensure that the cost of microcredit remains affordable to "the poorest". The measure of a successful programme depends not on reduction in its level of subsidy, but on the number of "the poorest of the poor" it serves and the impact of a programme on their circumstances.[27]

By contrast, the "sustainability" or "financial systems" approach subordinates poverty alleviation to the goal of creating viable financial institutions that integrate low income persons into the mainstream economy.[28] Microlenders driven by sustainability goals shy away from the provision of costly ancillary services, seeking instead to support those microenterprises judged most likely to succeed. As a result, debtors borrowing from "sustainable" microlenders typically are less impoverished than those served by microcreditors that give priority to poverty alleviation.[29] Within this model, donations and

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[27] Some scholars have shown that even the Grameen Bank does not seriously attempt to reach the poorest of the poor: see Richard L. Meyer, "The Demand for Flexible Microfinance Products: Lessons from Bangladesh," *Journal of International Development* 14, no. 3 (April 2002): 351-68 at 352-353 for an overview of this research. For elaboration of a systematic framework to assess the social benefits of microcredit, see Mark Schreiner, "Aspects of Outreach: A Framework for Discussion of the Social Benefits of Microfinance," *Journal of International Development* 14, no. 5 (July 2002): 592.

[28] Schreiner, *ibid,* citing to; J.D. Von Pischke, *Finance at the Frontier:Debt Capacity and the Role of Credit in the Private Economy* (Washington, D.C.: World Bank, 1991); Rhyne, *supra*, note 1.

[29] In addition to Schreiner, *supra*, note 27, Rhyne, *supra* note 1, Von Pischke, *supra* note 6, helpful contributions to the substantial literature on the relationship between sustainability and other microcredit goals such as outreach and poverty alleviation include: Jonathan Conning, "Outreach, Sustainability and Leverage in Monitored and Peer-Monitored Lending," *Journal of Development Economics* 60, (1999): 51-77; World Bank, *The World Bank and Microenterprise Finance: From Concept to Practice*, Operations Evaluation Department, Report (Washington: World Bank, 15 November 1999); J.D. Von Pischke,

subsidies may serve to fund start-up costs and experimentation with lending technologies to minimise the costs of supplying financial services, but ultimately the debtors are expected to pay the full operational and capital costs of credit.

Poverty alleviation continues to shape much of the discourse of microcredit, particularly in media accounts of its achievements. Ever since the World Bank's 1995 endorsement of sustainable microlending as a viable development strategy, however, the financial systems model has been in ascendance amongst international aid organisations.

Within the framework of outreach to the poor, many microcreditors target women.[30] Officially, the recruitment of female debtors appears as a conscious strategy of poverty alleviation, social development and prudent financial management. Early experience cast women as disciplined, responsible borrowers and successful microentrepreneurs, who use credit to produce household income with which to feed, clothe and educate their children. Lending to women satisfies the goal of achieving maximum impact from tiny loans, both because women's economic circumstances are generally even more precarious than those

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"Measuring the Trade-Off Between Outreach and Sustainability of Microenterprise Lenders," *Journal of International Development* 8 (1996): 225-39; Lynn Bennett and Carlos E. Cuevas, "Sustainable Banking With the Poor," *Journal of International Development* 8, (1996): 145-52; Andrés Vinelli, "Financial Sustainability in U.S. Microfinance Organizations: Lessons from Developing Countries," in Carr & Yi Tong (eds.) *supra*, note 6: 137-65.

[30] There is a substantial literature on the targeting of female debtors; in addition to Rogaly, *supra*, note 6, Rankin, Rahman, *supra,* note 13, Mayoux, *supra,* note 14; see Jude L. Fernando, Nongovernmental Organzations, Micro-Credit, and Empowerment of Women, 554 *Ann. Am. Acad. Pol. Soc. Sci.* 150 (1997); Anne Maria Goetz & Rina Sen Gupta, Who Takes the Credit? Gender, Power, and Control Over Loan Use in Rural Credit Programs in Bangladesh, 24 *World Development* 45 (1996); Syed M. Hashemi, Sidney Ruth Schuler, and Ann P. Riley, "Rural Credit Programs and Women's Empowerment in Bangladesh," *World Development* 24, (1996): 635-53; Michael Kevane and Bruce Wydick "Microenterprise Lending to Female Entrepreneurs: Sacrificing Economic Growth for Poverty Alleviation?" (2001) 29(7) *World Development* 1225-1236; Mark M. Pitt and Shahidur R. Khandker, "The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of the Participants Matter?" *Journal of Political Economy* 106 (1998): 958-96; Nailaa Kabeer, "Conflicts Over Credit: Re-Evaluating the Empowerment Potential of Loans to Women in Rural Bangladesh," *World Development* 29, 63-84; Linda Mayoux "Participatory learning for women's empowerment in micro-finance programmes - Negotiating complexity, conflict and change." *IDS Bulletin-Institute of Development Studies* 29 (1998):39.

of men in poor countries and because their uses of the extra income from microentrepreneurship contribute substantially to their children's development. Finally, by giving women access to the valuable resource of credit, microlending purports to strengthen their position in the household, reducing their vulnerability to men. According to some advocates, microcredit not only creates access to new economic opportunities for women, but also empowers them in ways that may ultimately transform oppressive gender relations.[31]

Recent studies show, however, that women frequently borrow on behalf of men in their households.[32] More disturbing is the evidence that contrary to the expressed goal of channelling resources to empower women or at least to reduce their dependency on men, microlending programmes may result in women experiencing increased levels of violence, stemming in part from pressure on the household to meet the demand for high repayment rates.[33] Rahman suggests also that whatever the expressed goals of gendered lending, women have become preferred microdebtors because of their socialization to be compliant, arguing that women's "positional vulnerability meets the requirements of the microlending structure, which demands the regular attendance of borrowers in weekly meetings at the

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[31] Hashemi, Schuler, & Riley, *supra*, note 30.

[32] Goetz & Gupta, *supra,* note 30; Kabeer found that women are more likely to share their loans with male household members than men are to share with female household members. She argues that this pattern "strengthens the argument for lending to women [because] the entire family is much more likely to benefit economically, and women are much more likely to benefit personally and socially, when loans are directed at women rather than men. Loans to men do little to challenge the internal gender inequalities of households…" Kabeer, *supra* note 30, 83.

[33]. Rahman surveyed 120 female microdebtors about their experiences of "verbal aggression" and "physical violence" after joining the microcredit programme. He found that more than half (57 percent) reported increased verbal aggression, another 13 percent increased verbal aggression *and* physical assault, and five percent "reported encountering men's violence because of the women's refusal to give their loans to men or for challenging men's proposals for using the women's loans" Rahman, *supra*, note 13*,* 121.

loan center and a rigid schedule for repayment of loans".[34] Some commentators warn against simplistic interpretations of findings about the impact of women's preferential access to microcredit on their relationships with male relatives, pointing out that women who relinquish control over the loans may yet obtain "plausible benefits", such as increased status in the household.[35] Nevertheless, research findings from many localities suggest that microcredit's contribution to women's empowerment is open to question.[36]

I.1.3 Purpose of microcredit loans: income-generating debt.

Microcredit is intended to generate income for poor and marginalized groups. Within this project, microenterprise creation is the goal, enhanced access to credit the means of attaining it. The end matters as much as the means to development agenda in industrialised and non-industrialised countries. Thus the innovation of microcredit lies not solely in the supply of credit, but rather the combined effect of access to credit, the technologies for "securing" loans and the income-generating purpose for which credit is granted.

Based on the record of the original Grameen project, in which villagers established sustainable microbusinesses, advocates have promoted microenterprise as a viable route to economic development for areas where labour markets are thin and economic opportunities are sparse.[37] In these localities, which may be found in the North as well as the South, microenterprise is a response to the structural inability of local economies to attract or

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[34] *Ibid.,* 148.

[35] Goetz and Gupta, *supra*, note 30, 53; Kabeer, *supra,* note 30.

[36] Mayoux, *supra*, note 30.

retain substantial capital investment to support employment. Microenterprise purports to serve as a substitute for such investment and hence bears the burden of not only meeting the economic needs of the individual microentrepreneur, but also contributing to the (re)generation of the local economy. While this developmental approach may not quite treat putative microentrepreneurs as the authors of their misfortune, since they are not responsible for the structural weaknesses of their local markets, their entrepreneurial efforts are expected to contribute to the solution.

A second more disciplinary model of microenterprise appears in workfare schemes that have replaced welfare programmes in many Countries of the North.[38] This approach treats microenterprise as a way of integrating into the labour force those who through lack of skills, immobility, misfortune or personal circumstances have difficulty finding jobs. It assumes that abundant economic opportunities exist, but that some individuals lack the capacity to take advantage of them through the conventional mechanism of employment. The ideology of this model portrays microenterprise training and support as equipping individuals unable to find jobs through the market, in effect, to create their own.

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[37] See, for example, Atlantic Canada Opportunities Agency, Atlantic Canada Opportunities Agency, *The State of Small Business and Entrepreneurship in Atlantic Canada 1998*, (Moncton, New Brunswick: ACOA, 1998).

[38] John F. Else and Salome Raheim, "AFDC Clients as Entrepreneurs: Self-Employment Offers an Important Option," *Public Welfare* 50 (1992): 36-41; Raheim and Friedman, *supra,* note 5. For critical engagement with this model of microenterprise, see: Lisa J. Servon, "Microenterprise Programs in U.S. Inner Cities: Economic Development or Social Welfare?" *Economic Development Quarterly* 11, (1997): 166-80; Margaret Johnson, "An Overview of Basic Issues Facing Microenterprise Practices in the United States," *Journal of Developmental Entrepreneurship* 1998; Ivan Light, "Microcredit and Informal Credit in the USA: New Strategies of Economic Development: Introduction," *Journal of Developmental Entrepreneurship* 3, (1998): 1-4.

I.1.4 The risk management technologies of microcredit: peer lending

In the countries of the South that form the microcredit heartland, the vast majority of the population does not have access to conventional financial service suppliers, largely because they lack assets. Without land or other marketable property, they cannot offer the security for loans that lenders typically demand. Microcredit intermediaries address this problem through the reliance on collateral-substitutes, such as peer lending and other forms of security based on relationships.

These technologies draw on well-established kinship and community-based savings schemes, such as the West African "esusu", the Jamaican 'partner', the Korean Kye, and similar examples of rotating savings and credit associations (ROSCAs).[39] ROSCAs consist of groups of individuals who contribute regularly to a common fund that is disbursed as a lump sum to one group member at agreed intervals, usually each payment cycle. Members of ROSCAs combine savings and borrowing activities. Individuals who take a lump sum early in the distribution cycle essentially receive loans from other group members; those who draw from the fund at a later stage act as savers. The ROSCA is sustained by membership selection practices, participants' interests in the association's stability, robust

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[39] See generally, Clifford Geertz "The Rotating Credit Association: A 'Middle Rung' in Development" (1962) 10 *Economic Development and Cultural Change* 241-263; Shirley Ardener, "The Comparative Study of Rotating Credit Associations," *Journal of the Royal Anthropological Institute* 94, (1964): 201-29; Ardener and Sandra Burman, (eds), *Money-Go-Rounds: The Importance of Rotating Savings and Credit Associations For Women* (Oxford: Berg, 1995); Timothy Besley, Stephen Coate, and Glenn. Loury, "The Economics of Rotating Savings and Credit Associations," *Am. Econ.Rev*. 83, (1993): 792-810; Sudhanshua Handa and Claremont Kirton, "The Economics of Rotating Savings and Credit Associations: Evidence from the Jamaican `Partner'," *Journal of Development Economics* 60, (1999): 173-94; Michel Laguerre, "Rotating Credit Association and the Diasporic Economy," *Journal of Developmental Entrepreneurship* 3, (1998): 23-34. A useful bibliography on the ROSCA may be found at: <http://www.gdrc.org/icm/rosca-bibliography.html>

distribution arrangements, relations of trust, and powerful peer and reputational sanctions to deter premature exit.[40]

Participants may use ROSCAs to finance major social events and family rituals, such as weddings, reunions and funerals and also as a means of small-scale capital formation for business activities and economic development. While ROSCAs are commonly identified with countries of the South and societies that lack a strong infrastructure of commercial financial institutions,[41] similar principles shaped the development of the cooperative and mutual aid societies of 19th century Europe and the credit unions of North America.[42] Traditional ROSCAs have survived also in cities of the North, especially among "immigrant" or ethnically-defined communities.[43]

Modern microcredit programmes do not necessarily include a savings component, at least formally,[44] but they deploy similar practices of vetting, monitoring and enforcement to secure repayment. To this end, debtors form affinity groups, which approve loans to members, each of whom bears responsibility for repayment of every loan made to any group member. The lender enforces collective responsibility by withholding future

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[40] Lan Cao, "Looking at Communities and Markets," *Notre Dame Law Review* (1999): 841-924; Laguerre, *supra*, note 39.

[41] Timothy Besley, "Non-Market Institutions for Credit and Risk Sharing in Low-Income Countries," *Journal of Economic Perspectives* 9, no. 3 (Summer 1995): 115-27.

[42] Hollis and Sweetman, *supra,* note 13; see also, Paul Johnson, *Spending and Saving: The Working Class Economy in Britain 1870-1939*, (Oxford: Oxford University Press, 1985).

[43] Cao, *supra* note 40; Eric A. Posner, "The Regulation of Groups: the Influence of Legal and Nonlegal sanctions on Collective Action" (1996) 63 *University of Chicago Law Review* 133-197; Besley, *supra*, note 41; Besley, Coate & Loury, *supra*, note 39; Laguerre, *supra*, note 39.

[44] Some scholars maintain that microcredit programmes in general are a form of household 'savings', arguing that since the loans do not usually generate sufficient additional income to cover the repayment costs, borrowers tend to fund repayment out of existing income streams: Armandáriz de Aghion & Morduch, *supra*, note 24; Imran Matin, "The Renegotiation of Joint Liability: Notes from Madhapur," in *Who Needs Credit? Poverty and Finance in Bangladesh*, ed. Geoffrey D. Wood and Iffath A. Sharif (London: Zed Books, 1997), 262-70.

loans to all group members while any loan is in default, thereby creating incentives for debtors with loans in good standing to apply social and reputational sanctions that pressure defaulting peers into repayment.

Peer lending is often presented as the key to the success of microlending in countries of the South, where it has the effect of packaging resources to which the poor have access – other poor borrowers – as a "collateral-substitute" for the property endowments that they lack. Many microcredit providers in the North also have experimented with peer lending. Its implementation as a 'pure' collateral substitute, however, has proved to be more challenging among the mobile populations of rich urbanised societies.[45] In response to the challenges some microlenders in the North have supplemented collective responsibility with other lending technologies, such as vetting and monitoring of debtors and direct debits of loan payments.[46]

[45] Conlin, *supra,* note 13.

[46] Bernd Balkenhol and Haje Schütte, *Collateral, Collateral Law and Collateral Substitutes*, ILO Enterprise and Cooperative Development Department (Geneva: ILO Enterprise and Cooperative Development Department, 1997); Armandáriz de Aghion & Morduch, *supra*, note 24.

II Economic Rationales for Microcredit

The institution of microcredit is based on the assumption that mainstream financial services markets undersupply credit to poor but creditworthy individuals engaged in the development of tiny businesses. Market exclusion and undersupply of credit result from a combination of endemic information failures that plague credit transactions and low-income individuals' lack of access to collateral and other information-proxies trusted by creditors. Microcreditors seek to remedy market exclusion by adopting lending technologies that substitute for collateral, which itself serves as a substitute for relevant information.

This section uses insights from microeconomic analysis to assess the potential of the peer-supported loan to counteract the exclusionary dynamics of information imperfections. We begin by briefly summarising the nature of information failures in credit markets and outlining how collateral and other conventional lending practices purport to alleviate these problems. The analysis then turns to the claim that peer supported loans serve as functional substitutes for collateral. Our exploration of the implications of peer-lending shows that this lending device imposes substantial implicit costs on peer-debtors in addition to the explicit prices they pay for the loans. We suggest that given the nature and extent of these implicit costs microentrepreneurs are unlikely to experience peer lending as a viable means of increasing their access to credit.

II.1 Information failures

Credit transactions, like other contracts over time, must deal with uncertainty about the future, the problem that at the time of contract formation no one knows whether events might occur that change how the parties value the contract and hence their willingness to perform. Economists and lawyers alike assume that contractors manage uncertainty by using the contract formation process to allocate the risks of future events that would disrupt the parties' initial goals. Modern contracts, particularly in their stardardised form, include elaborate provisions for what should happen if circumstances change and disruptive events materialise. An extensive law and economics literature has produced sophisticated analyses of uncertainty and the types of responses it provokes.[47]

Financial services contracts belong to a class of transactions that face the additional problem of information asymmetry,[48] which exists when contractors have unequal access to privately held information pertaining to contract performance.[49] An important item of such hidden information in credit transactions is the likelihood of repayment. Where this information is privately held, the uninformed party – the creditor -- is unable to assess the risk of the contract failing as effectively as if the information were shared equally.

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[47] Disruptive events may cause one party to regret entering into the contract. On the concepts of regret contingencies and regret costs, see: Charles J. Goetz and Robert E. Scott, "The Mitigation Principle: Toward A General Theory Of Contractual Obligation," *Virginia Law Review* 69 (September 1983): 967; Charles J. Goetz & Scott, "Enforcing Promises: An Examination of the Basis of Contract," *Yale Law Journal* 1261 (1980): 967; Louis E. Wolcher, "The Accommodation Of Regret In Contract Remedies," *Iowa Law Review* 73 (1988): 797.

[48] Important contributions to the economic analysis of information problems in markets include: George J. Stigler, "The Economics of Information", (1961) 69 *Journal of Political Economy* 213, George A. Akerlof, "The Market for 'Lemons': Quality Uncertainty and the Market Mechanism", *Quarterly Journal of Economics* 84 (1970): 749; Kenneth J. Arrow, *Information and Economic Behaviour* (Stockholm: Federation of Swedish Industries, 1973); A. Michael Spence and Richard Zeckhauser, "Insurance, Information and Individual Action", (1971) 61 *American Economic Review* 380-387; Joseph Stiglitz, "Incentives, Risk and Information: Notes towards a Theory of Hierarchy" (1976) *Bell Journal of Economics* 552-579. For an overview of the development of the economics of information see, Joseph Stiglitz, 'The Contribution of the Economics of Information to Twentieth Century Economics" (2000) *Quarterly Journal of Economics* 1441.

[49] Stephen A. Ross "The Economic Theory of Agency: The Principal's Problem" (1973) 62 *American Economic Review* 134-139; Milton Harris and Arthur Raviv "Optimal Incentive Contracts with Imperfect Information" (1979) 20 *Journal of Economic Theory* 231-259; Eugene E. Fama and Michael C. Jensen, "Agency Problems and Residual Claims" (1983) 26 *Journal of Law and Economics* 327-349.

Asymmetry also may prevent informed parties from issuing reliable signals about the hidden information. These communication problems may be exacerbated by 'moral hazard', when the hidden information relates to decisions and actions that the informed party controls, such as how much effort to devote to contract performance when other demands on time and energy materialise. Under conditions of moral hazard it may be very difficult for reliable debtors to convince creditors that they intend to repay when creditors know, first, that not all debtors will pay, and second, that they lack information about the debtor's conduct once she has received the loan.

Information asymmetry may affect contract pricing, because the inability to assess risk accurately hampers the process of setting an optimal price. Of more significance to the development of microcredit, substantial information failures may cause creditors to "ration" their services, that is, to withdraw from some segments of the market. When rationing occurs, then even creditworthy potential borrowers within the impugned market segments will lose access to loans.[50]

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[50] Much of the early work on adverse selection and financial markets concerned insurance contracts, but interest in the effect of credit rationing and adverse selection on credit markets has developed significantly since the early 1970s. For early work in this area see, Dwight M. Jaffee & Thomas Russell, "Imperfect Information, Uncertainty and Credit Rationing", (1976) *Quarterly Journal of Economics* 651; Dwight M. Jaffee, Credit Rationing and the Commercial Loan Market (1971). The article that is widely cited as responsible for provoking widespread interest in credit rationing and adverse selection is Joseph E. Stiglitz and Andrew Weiss "Credit Rationing in markets with imperfect information", (1981) 71 *American Economic Review* 393. For critical analysis of the effects of the rationing of financial services, see the extensive literature on redlining and the policy response of promoting reinvestment in minority and marginalised communities, Gregory D. Squires (ed), "From Redlining to Reinvestment", in *From Redlining to Reinvestment: Community Responses to Urban Disinvesment* (Philadelphia: Temple University Press, 1992); Gregory D. Squires (ed), *Insurance Redlining: Disinvestment, Reinvestment, and the Evolving Role of Financial Institutions* (Washington D.C.: The Urban Institute Press, 1997). Redlining has not received an equivalent level of attention from Canadian scholars, in part because of lack of access to the necessary data on the selling practices of Canadian financial services suppliers, see generally the position papers of the Canadian Community Reinvestment Coalition, available at, <http://www.cancrc.org/>; see also <http://www.montrealmirror.com/ARCHIVES/2001/072601/news6.html>. The recently enacted Bill C-8, *An Act to establish the Financial Consumer Agency of Canada and to Amend Certain Acts in Relation to Financial Institutions* S.C. 2001 C-9 requires large financial institutions annually to report their contributions to the Canadian economy and society, the banks do not have to disclose the detailed information than is

Interactions between asymmetry and changed circumstances pose challenges for the design of optimal responses to information constraints since strategies that counter one type of imperfection might create opportunities for exploitation of the other. For example, a microenterpreneur might fail to generate sufficient income to repay a loan primarily because of circumstances that were unknown and unknowable when she assumed the debt, but to which she can adapt if given the opportunity. An optimal response to such contingencies might be flexibility on the part of the creditor, perhaps expressed in willingness to adjust the repayment schedule or to extend additional credit to accommodate the changed circumstances. Renegotiation might be feasible if the creditor trusts the debtor and believes she has the skills and commitment to make the business successful. The same business failure, however, could be at least partially attributable to unobserved incompetence or "shirking" by the microentrepreneur. Absent credible assurances of the debtor's honesty, this ambiguity may deter creditors from renegotiation out of concern that the debtor who requests flexibility is opportunistically seeking to revise the contract in her favour, or that she will do so in the future. In this situation, the solution to changed circumstances may open up the risk of opportunistic restructuring of the contract.[51]

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required under U.S. legislation. An indirect mode of disclosure of such information occurs when Canadian banks seek to enter U.S. markets since they will be required to comply with the U.S. Community Reinvestment Act 12 USC §§ 2901 et seq (1988 & Supp 1992). Despite the absence of robust local data, some Canadian researchers have documented redlining practices, see Anne-Marie Séguin and Gérard Divay, *Urban Poverty: Fostering Sustainable and Supportive Communities* Discussion Paper F27 (CPRN/RCRPP: December 2002) and sources cited therein. Predatory lending, that is the aggressive marketing of high cost debt to low-income and marginalised people, is another problem attributable to exclusion from mainstream financial markets. Once again an extensive U.S. literature on this practice exists, but there is little recognition of predatory lending in Canada. For a comprehensive discussion of predatory lending in the United States, see Kathleen C. Engel and Patricia M. McCoy "A Tale of Three Markets: The Law And Economics of Predatory Lending"(2002) 80 *Texas Law Review* 1255; see also the U.S. Senate Special Committee on Aging, "*Equity Predators: Stripping, Flipping and Packing their Way to Profits",* 105th Congress 2d Session, March 16, 1998.

[51] For analysis of the general problem of securing performance against opportunism, see Oliver E. Williamson "Credible Commitments: Using Hostages to Support Exchange", (1983) 73 *American Economic*

Formal credit markets offer a range of responses to information imperfections.[52] Creditors may react to risk by increasing the price of loan contracts, soliciting information about potential borrowers and their plans, or demanding collateral; and they may refuse credit to persons and projects they deem "too risky". Knowledge of how much a potential borrower is willing to pay provides some indication of how much she values the loan while investigation of a potential borrower's 'character' and capacity, her investment in a business and the conditions in the market it serves, may help a creditor to assess the probability of repayment.

Price and investigation operate as imperfect proxies for hidden and unknown information, however, since neither permits precise measures of honesty and risk. Investigation may fail to uncover hidden information pertaining to the risk of cheating. Reliance on price to manage risk when relevant information is hidden creates the possibility of 'adverse selection', which occurs when high prices attract 'dishonest' borrowers who do not care about the price because they do not intend to repay and incompetent borrowers who may be unable to pay. Even if the pool of buyers of high-priced loans includes honest and competent borrowers as well, information asymmetry may prevent them from credibly signalling intention and ability to repay. Following Akerlof, Stiglitz and Weiss's important paper argues that in the absence of reliable information, lenders' rates of return will diminish at higher prices as the bad risks drive out

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Review 519 and Williamson, *The Economic Institutions of Capitalism: Firms, Markets, Relational Contracting* (New York: the Free Press, 1985).

[52] For analysis of institutions that may respond to information problems in financing contracts, see, Ronald J. Mann, "Verification Institutions in Financing Transactions", (1999) 87 *Georgetown Law Journal* 2226-2272; Mann, "The Role of Secured Credit in Small-Business Lending", *supra*, note 16.

the good.[53] A predictable reaction to adverse selection, therefore, is refusal to lend at higher prices: in short, lenders ration credit rather than raise the price. One antidote to adverse selection is the development of credit bureaux and other sources of relevant information, but such institutions may be of limited value in the assessment of the credit risk of new small businesses, which lack credit histories.[54]

II. 2 Collateral as a response to information failure

Collateral refers to property pledged to a lender as security for the satisfaction of a debt. Some forms of collateral are marketable if the loan transaction fails, others may have little or no commercial value, but realization of them may yet impose significant costs on the defaulting borrower.[55] Another common form of security is the personal guarantee, in which someone other than the principal debtor undertakes to pay if the debtor does not. A crucial characteristic of both the pledge and the guarantee is that they empower lenders to call upon the legal system to enforce their interests in the security should a debtor fail to pay.

In a world of incomplete contracts created, performed and enforced under conditions of information asymmetry and uncertainty, collateral purports to reduce the

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[53] Stiglitz & Weiss, *supra* note 50; Akerlof, *supra,* note 48.

[54] On credit bureaux, see Tullio Japelli and Marco Pagano, 'Information Sharing, Lending and Defaults: Cross Country Evidence' (Working Paper No. 22 Centre for Studies in Economics and Finance, University of Salerno (1999); on the role of credit scoring, see Thomas, Edelman & Crook, *supra*, note 16; Schmalansee, *supra*, note 16.

[55] See Williamson, "Credible Commitments", *supra,* note 51; *Economic Institutions of Capitalism, supra,* note 51 ; Mann, "Verification Institutions", *supra* note 52; Lewis A. Kornhauser, "Reliance, Reputation, and Breach of Contract" (1983) 26 *Journal of Law and Economics* 691; David Charny, "Nonlegal Sanctions in Commercial Relationships" (1990) 104 *Harvard Law Review* 373.

costs of credit transactions relative to those of transactions not supported by collateral. First, by offering a means for debtors to signal a serious intention to repay, collateral provides information about reliability that may be particularly important to a creditor at the start of a transaction. This aspect of collateral enables creditors to limit or even avoid the costs of investigating potential borrowers and in this sense it operates as a substitute for some information costs.[56] Second, collateral increases the debtor's cost of breach, making repayment more likely than if the costs of breach were lower. By increasing the intensity of the incentive to repay, collateral may replace some aspects of performance monitoring by the creditor, once again substituting for information costs. Third, when a credit transaction fails, collateral in the form of marketable assets gives the creditor ready access to a means of recovering at least some of the outstanding debt. In this way, it may help creditors avoid some of the costs of proving their losses from non-payment in negotiations or litigation processes.[57]

In combination, the risk-management technologies of conventional lending may go some way to combat the costs of information imperfections. But these privately chosen protective strategies carry a social cost, namely, the exclusion of creditworthy individuals who lack the resources to offer acceptable proof of their reliability.[58] Those unable to

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[56] See Mann, *supra,* note 51, for discussion of how "verification institutions", including collateral, may solve information problems.

[57] Although the secured creditor is the most direct beneficiary of collateral, economic theorists maintain that the potential gains may extend to other creditors and to debtors. For a critical overview of the extensive debate over the rationales for and implications of collateral, see Lynn M. LoPucki "The Unsecured Creditor's Bargain, (1994) 80 *Virgina Law Review* 1887, see in particular the summary at 1888-1896, see generally, Balkenhol & Schütte *supra* note 46; Mann, "Explaining the Pattern of Secured Credit", Mann, "The Role of Secured Credit in Small-Business Lending", *supra*, note 16.

[58] In countries of the South persons excluded from formal credit markets may constitute a majority of the total population. Although credit is more pervasive in countries of the North, some groups may experience limited access to mainstream markets financial services, particularly for loan capital in support of small business development, see Timothy Bates, *Race, Self-Employment, and Upward Mobility: An Illusive*

offer collateral and whose histories and geographies preclude high scores in conventional screening and investigative processes may not have any means to convey credible information about their trustworthiness. Their resulting exclusion from mainstream credit markets constitutes the structural basis for the emergence of microcredit intermediaries.

II.3. The Economic anatomy of peer lending.

Microcreditors respond to the problems of unknown and hidden information through alternative lending and risk-management technologies. Most of the economic literature focuses on the capacity of peer lending to replace collateral. By framing the central issue in this way, economic analysis exposes a critical tension: microlending, which as Conning notes “is almost everywhere and always information-intensive lending”,[59] replaces a lending technology – collateral – that itself largely functions as a substitute for information. But peer lending differs from conventional investigation and screening practices because its costs fall directly on the debtors, not the creditor.[60]

To recap the definition given above: peer loan transactions organise borrowers into groups in which each peer assumes responsiblity for repayment of all loans. Group accountability is ‘enforced’ by way of an incentive scheme, which denies further credit to

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American Dream (Baltimore: John Hopkins University Press, 1997); Martha L. Olney, "When Your Word is Not Enough: Race, Collateral and Household Credit" (1998) 58(2) *Journal of Economic History* 408; Audrey G. McFarlane, "Race, Space, and Place: The Geography of Economic Development" (1999) 36 *San Diego L. Rev.* 295.

[59] Conning, *supra*, note 29, 53.

[60] It should be recognise that conventional commercial creditors pass on investigation and screening costs to debtors, but these costs are shared among a much larger number of debtors.

all group members while *any loan* to a group member is in arrears.[61] A rich microeconomic literature on these transactions predicts that peer lending improves repayment rates relative to the expected repayment rates of unsecured individual loans without joint responsibility. Better repayment rates, in turn, are assumed to encourage creditors to lend to individuals who otherwise would be excluded from credit markets. In this way, peer lending is expected to negate the exclusionary effects of information constraints and thus remedy the problem of credit rationing.

The incentive scheme embedded in peer lending has several elements. From the perspective of the creditor, the simple device of widening the sphere of responsibility may in some circumstances increase repayment rates above those expected from individual responsibility. Besley and Coate model a 'repayment game', in which successful debtors have an incentive to pay the loans of an unsuccessful or opportunistic peer when the benefit to them from the original loan and the expectation of refinancing outweighs the cost of making up a shortfall. Under these conditions, the very fact of grouping borrowers together and holding them jointly responsible will result in a higher total repayment than if the same persons had received unsecured individual loans and the unsuccessful person had defaulted.[62]

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[61] Even in countries of the North where the legal and administrative infrastructure exists to routinise debt collection, microcreditors seldom resort to legal processes of debt recovery except in cases of fraud, preferring to rely on exhortation, repeated contacts, and offers to assist in dealing with financial problems. A UK study of micro-lenders concluded that: "*'Honourable debts'* incurred where clients had done their best but been unable to make the business a success, would be written off." The Personal Finance Research Centre, *Benchmarking in Micro-Lending: Country Report* (Bristol, U.K.: PFRC, 1998), 40.

[62] Timothy Besley and Stephen Coate, "Group Lending, Repayment Incentives and Social Collateral," *Journal of Development Economics* 46 (1995): 1-18.

This positive ‘surety effect’, however, is not inherent in the structure of peer lending transactions. Under other configurations of costs and benefits among the peer borrowers, joint responsibility could produce lower repayment rates than individual credit transactions. Consider, for example, the case where the benefit of microcredit to a successful debtor exceeds the debtor’s costs of repaying her own loan, but is insufficient to cover also her share of a delinquent group member’s payments. In this scenario, successful debtors have no incentive to repay the loan of the defaulting peer because the costs of so doing exceed the benefits. Moreover, since failure of the group to pay for the delinquent peer disqualifies all group members from refinancing, a successful debtor who would have repaid a loan under conditions of individual liability may choose not to repay her own loan. Joint responsibility erodes repayment incentives in this case because the transaction penalises the individual who repays only her own debt to the same extent as her peers who default.[63]

The indeterminacy of the surety effect, however, does not defeat the argument for peer lending because creditors expect peer debtors to do much more than simply make up the missing payments of peers. Peer debtors’ interests in securing ongoing finance are intended to breed practices that make repayment more likely to occur, such as vetting of group members, monitoring of repayment records and imposing social sanctions to pressure defaulting peers into timely payment.[64] Economic analysis characterises peer pressure as a method of increasing the costs of breach to a debtor who contemplates

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[63] *Ibid.*

[64] *Ibid*., see also, Joseph E. Stiglitz, "Peer Monitoring and Credit Markets," *World Bank Economic Review* 4, (1990): 351-66; Hal R. Varian, "Monitoring Agents with Other Agents," *Journal of Institutional And Theoretical Economics* 146 (1990): 153-74; Beatriz Armandáriz de Aghion, "On the Design of a Credit Agreement with Peer Monitoring," *Journal of Development Economics* 60, (1999): 79-104.

default. If the consequences of penalties such as ostracism and denunciation are so severe that the costs of default exceed the benefits from failure to pay, a debtor has an incentive to choose repayment rather than to breach. While peer pressure may not affect overall repayment rates when the peer debtors would have chosen to pay the loan of a defaulting group member to protect their interests in refinancing, the analysis predicts better repayment rates when the surety effect fails. [65]

In addition to its impact on repayment rates, peer pressure may enhance the stability of peer lending groups, making them more sustainable. This stabilising effect occurs when peer pressure reduces the risk that successful group members will face demands to pay the loan of a failing peer. Although in some circumstances it may be rational for successful debtors to repay the loan of an unsuccessful peer, such payments alter the distribution of gains within the group, causing the peer lending arrangement to become less valuable to performing debtors than they had expected. Redistribution within the group has no social value and the risk of its occurrence may cause group members to incur transaction costs of attempting to protect themselves against the free riders. Furthermore, where redistribution transgresses strongly held norms of fairness, potential borrowers who could benefit from microloans may choose not to participate in group lending rather than to incur the risk of redistributional loss. Peer pressure offers a possible solution to the costs of redistribution if its social penalties can be levied at lower cost than either individualised protections or withdrawal.

Peer pressure may promise to enhance the security of lending transactions in ways that mimic the effect of collateral on information asymmetry, but its implementation

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[65] Besley & Coate, *supra,* note 62.

entails costly, information intensive processes. Debtors who rely on social sanctions must find ways of monitoring their peers' performances and interpreting signs of imminent default. Group members may wish to make sure that peers invest sufficient effort to grow their business, so that increased revenues will ensure ability to pay. They will want to watch for signs of opportunistic decisions to free ride on other group members, so that sanctions may be imposed where necessary to enhance willingness to pay. Obtaining and processing the relevant information requires group members to interpret reports of activity and to test and assess each other's claims. They also must find effective ways to share information about failing loans to enable the collective application of sanctions; they need, in addition, information about the range of available sanctions as well as processes for deciding when to apply which sanctions.

Given these non-trivial costs of information acquisition, processing and communication, costs that reportedly deter mainstream creditors from selling small loans to poor microentrepreneurs, the question arises of how peer groups manage to offset information imperfections at lower costs than creditors. Do peer group members have a comparative advantage in information processing and enforcement such that shifting responsibility for precautionary and protective measures from creditor to debtors results in lower transaction costs?

Economic analysis of microcredit in Countries of the South locates peer debtors' comparative advantage in local knowledge derived from the relative immobility of populations; frequent opportunities for interactions that produce insights into character and skills; and the routine sharing of information about the circumstances of friends and family. Local knowledge may produce the information required to vet potential group members and to observe how much skill and effort they put into building their businesses and meeting repayment obligations.[66] When default threatens, local knowledge may assist peer group members to decide whether to make up the shortfall or to apply pressure, to determine suitable sanctions and to calibrate how intensely to apply them. Rich social networks that share context and location also constitute the setting for social penalties to 'bite'. [67] Sanctions based on shaming and reputation effects, such as denunciation, ostracism and opprobrium, depend on relationships established outside the lending transaction. They presuppose that persons at risk of disgrace care what others think about them and will take steps to preserve honour and avoid stigma; they gain strength from proximity, social relationships and interdependence.

If local knowledge secured costless, transparent access to relevant information about debtors then it might be plausible to treat peer lending as a powerful response to information asymmetry, at least among the peers.[68] In practice, however, the processes of

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[66] Maitreesh Ghatak and Timothy W. Guinnane, "The Economics of Lending with Joint Liability: Theory and Practice," *Journal of Development Economics* 60, (1999): 195-228; Conlin, *supra,* note 13; Eric Van Tassel, "Group Lending Under Asymmetric Information," *Journal of Development Economics* 60, (1999): 3-25.

[67] Stewart Macaulay's work on the non-use of legal norms and institutions by business people has provoked considerable interest in the normative regimes that govern commercial life: Stewart Macaulay "Non-Contractual Relations in Business: A Preliminary Study" (1963) 28 *American Sociological Review* 55. For recent examples of the legal literature on the role of social norms and sanctions as alternatives to legal enforcement, see, Posner, *supra* note 43; Lisa Bernstein, "Opting out of the legal system: Extralegal contractual relations in the Diamond Industry" (1992) 21 *Journal of Legal Studies;* Robert Cooter, "Decentralized Law for a Complex Economy: The Structural approach to Adjudicating the New Law Merchant" (1996) 144 *University of Pennsylvania Law Review* 1644"; Eric A. Posner, *Law and Social Norms* (Cambridge, Mass.: Harvard University Press, 2000); Cao, *supra* note 43; Kornhauser, *supra* note 55. For analysis of the power of shaming as a social sanction, see John Braithwaite, *Crime, Shame and Reintegration* (Cambridge: Cambridge University Press, 1989); for discussion of the role of shaming penalities in corporate law, see, David A. Skeel Jr. "Shaming in Corporate Law", (2001) 149 *University of Pennsylvania. Law Review,* 1811-1868; Jayne W. Barnard "Reintegrative Shaming in Corporate Sentencing" (1999) 72 *Southern California Law Review* 959-1007.

[68] Some research suggests that this situation is hazardous for creditors since the close relationships that protect informed debtors against adverse selection of an individual peer might enable adverse selection of an entire group that acts against the interests of the lender. When this effect occurs, debtors with strong attachments to each other who do not care about – or do not trust in – the prospect of refinancing may collude

translating knowledge gleaned from daily social interactions into information relevant to the operation of peer lending may be quite costly. Peer group formation, for example, may require multiple meetings to explain the microlending programme, consider the business plans and aspirations of potential participants and to select peer group members. Early adopters may need to market the peer loans to persuade members of their social networks to join a group. Where programmes are over-subscribed, by contrast, peer group members may have to spend considerable time and energy justifying decisions to reject their friends and neighbours, diffusing anger and dealing with resentment. However rich the local knowledge, strong the social bonds, or deep the kinship networks, such vetting and selection activities may prove to be complicated, time-consuming and divisive.

The deployment of local knowledge in monitoring and sanctioning group members also incurs costs, particularly when these processes strain the bonds of solidarity on which peer lending depends. These bonds are intended to encourage peer groups to care about why a member cannot meet her commitment to pay on time and to adapt their responses according to whether default is due to unanticipated events or strategic behaviour. Confronted with a faltering peer, successful group members who wish to maintain access to credit face the hard choice of whether to provide support by increasing their own payments or to impose sanctions. Although familiarity might help group members to observe and interpret each other's behaviour, peer-lending arrangements require them also to distinguish between opportunism and misfortune, and to penalise those who fail because

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to obtain loans they do not intend to repay: Ashok S. Rai and Tomas Sjöstrom, "Is Grameen Lending Efficient?" http://www.cid.harvard.edu/cidwp/revised40.pdf, CID Working Paper, No. 40 (Review of Economic Studies: Center for International Development, Harvard College, December 2001); Ashok S. Rai and Philip Bond, "Collateral Substitutes in Microfinance," http://www.cid.harvard.edu/cidpublications/limits-july2.pdf (Center for International Development, Harvard College, July, 2002).

of strategic behaviour or incompetence. Close personal relationships may obscure the extent to which a microentrepreneur's failure is due to lack of skill or effort; intimate knowledge of a peer's adverse circumstances may cause dissension about whether to offer support or apply pressure. Local knowledge of the impact of sanctions such as ostracism and negative publicity may cause some group members to refuse to align themselves with the creditors by participating in disciplinary control of family and friends.[69]

The limitations of local knowledge may be controlled to some extent by characteristic features of microcredit programmes, such as limiting the size of peer groups,[70] mandating training before individuals join a peer group, [71] requiring debtors to participate in group development activities[72] and to meet regularly to monitor and report progress, and insisting on frequent instalment payments.[73] These features may have particular value for microlending programmes in urban areas of the North where people are mobile, relationships may be shallow and fleeting, and strong privacy norms exist in relation to money.[74] In such environments the process of forming peer groups capable of

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[69] Some studies show peer group members refusing to impose strong sanctions because of the harm they cause to the disciplined peer member: Ghatak & Guinnane, *supra,* note 66, 221, citing to Kevane, (1996) *Qualitative Impact Study of 'Credit with Education' in Burkina Faso*.

[70] Ghatak & Guinnane, *supra,* note 66 at 219.

[71] Conlin models pre-qualification exercises, such as course completion requirements, as fixed costs that potential group members must incur to prove their seriousness and good faith, arguing that these costs may have the vetting effect of screening out opportunistic and undisciplined individuals: Conlin, *supra,* note 13.

[72] Mandatory participation in networking and group development programmes may be intended to build or strengthen 'fictive friendships'among peers, with the twin goals of improving group solidarity and creating a foundation for the application of peer sanctions if necessary. On the role of "fictive friendships" in transactions, see Yoram Ben-Porath, "The F-Connection: Families, Friends and Firms and the Organization of Exchange," *Population and Development Review* 6, (1980): 1-30

[73] Armandáriz de Aghion & Morduch describe this repayment procedure as "one of the least remarked upon – but most unusual – features of most microfinance credit contract" and argue that it helps to screen out "undisciplined borrowers"Amandáriz de Aghion & Morduch, *supra,* note 24, 414.

[74] A recent Canadian study on the financing of small and medium sized enterprises notes that: "it is well known that entrepreneurs are discinclined to discuss their financing with other parties". The Research Institute for SMEs, Université du Québec à Trois-Rivières, *Financing Small- and Medium-Sized*

imposing social sanctions on individuals connected only by their shared debtor status in relation to a microcreditor is likely to be challenging.[75] Given the costs of interpreting and applying local knowledge, even in the closely-knit societies of the South, these features of peer loans may help groups to avoid failure in these societies also.

Even if local knowledge and the structuring of peer groups as small numbers of qualifed microentrepreneurs help to strengthen peer lending, this risk-management technology remains a costly practice for debtors. Unlike collateral, which may substantially replace investigation and monitoring as protection against information asymmetry, peer lending encourages debtors to engage in these information intensive activities, offloading onto debtors the costs of protecting creditors' interests in repayment. Compliant peer group members in effect align their interests and incentives with lenders, not with other debtors.[76]

In sum, economic analysis of the peer lending transaction shows that debtors may incur substantial debt servicing costs as well as the interest and fees they pay for credit. These costs arise from the demands of managing a complex relationship that

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Enterprises: Satisfaction, Access, Knowledge and Needs (Small Busines Policy Branch, Industry Canada: February 2002) 25; see also Merrill, *supra* note 13. For dicussion of the power of such privacy norms even in communities defined by a strong sense of common interests and solidarity, see Kathryn Marie Dudley, *Debt and Dispossession: Farm Loss in America's Heartland*, (Chicago: University of Chicago Press, 2000).

[75] Balkin describes group formation at a Chicago microlending programme that could take as long as 6 – 8 months, which he attributes to members lack of prior knowledge of each other and their discomfort in assuming joint responsibility until they had developed a basis for assessing the trustworthiness of peers. Steven Balkin, "A Grameen Bank Replication: The Full Circle Fund of the Women's Self-Employment Project of Chicago," in *The Grameen Bank: Poverty Relief in Bangladesh*, ed. Abu N M. Wahid (Boulder: Westview Press, 1993), 234-66; see also Wali I. Mondal and Ruth Anne Tune, "Replicating the Grameen Bank in North America: The Good Faith Fund Experience," in *The Grameen Bank:Poverty Relief in Bangladesh*, ed. Abu N M. Wahid (Boulder: Westview Press, 1993), 223-34; Copisarow, *supra*, note 5; Merrill, *supra* note 13.

[76] Matin, *supra,* note 44, makes a similar point when questioning the nature of 'solidarity' in microlending.

simultaneously serves facilitative, supportive and disciplinary purposes.[77] To manage the relationship effectively, debtors must participate in the information intensive processes of screening and monitoring their peers and, where necessary, find ways to enforce repayment obligations without recourse to the traditional "stick" of the legal process. To ensure the survival of the peer group, its members must engage in these processes while maintaining the confidence, commitment and support of other group members.

By unpacking the dynamics of the peer lending transaction, economic analysis reveals some of the challenges posed by this lending technology. In particular, the analysis sugests that the benefits of participating in peer groups are unlikely to exceed the total implicit and explicit costs unless a microenterprise receives a substantial income boost from obtaining a peer supported loan. Recognising the nature and extent of these costs, many microentrepreneurs may reject the peer loan as a rational solution to their credit needs.

III. Microcredit in Canada: the Calmeadow experience

A. The Emergence of microcredit in Canada

Modern microcredit in Canada is almost synonymous with the work of Calmeadow, a non-profit organisation founded in 1983. While other Canadian NGOs and credit unions experimented with microcredit projects during the 1990s, a few of which survive today, only Calmeadow attempted to build a large-scale programme of microlending. When the domestic loan funds closed at the end of 2000, Calmeadow had

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[77] Richard Montgomery, "Disciplining or Protecting the Poor? Avoiding the Social Costs of Peer Pressure in Micro-Credit Schemes," *Journal of International Development* 8, (1996): 289-305.

disbursed more loans (2558) than all of the other Canadian peer lending projects combined.[78]

Calmeadow's initial forays into microcredit took the form of partnership with organisations promoting women's economic self-reliance in countries of the South.[79] Some of these organisations reported considerable early success in terms of numbers served, repayment rates and the potential to become self-financing. Their achievements suggested that microcredit could turn into a significant tool of development in the South and stimulated interest in its capacity to contribute to economic development in Canada.

With its domestic operations, Calmeadow sought both to respond to and to encourage the growth of microenterprise. At the end of the 20th century Canada experienced a dramatic resurgence of self-employment, driven by the corporate restructuring of late capitalist development. Between 1970 and 1992 Canada reversed "the… pattern of corporatization of employment, increas[ing] the proportion of self-employed in its population from 8.4% to 9.7%."[80] By 1998, self-employment accounted for about 17% of the entire labour force, and small business contributed 24% of Canada's GDP.[81] Distinctive patterns appeared within this general trend. Until the end of the 1980s, small businesses that employed persons in addition to the owner grew much faster than one-person businesses but since 1990 the growth of businesses that employ only the owner

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[78] Frankiewicz, *supra*, note 8.

[79] Calmeadow developed relationships with local and international Non-governmental organisations (NGOs) and raised funds that received matching grants from the Canadian International Development Agency (CIDA). Between 1985 and 1991, Calmeadow established partnerships with microlending programmes in Columbia, Brazil, Bolivia, Mexico, Peru, Bangladesh and South Africa: Frankiewicz, *supra*, note 8.

[80] Manuel Castells, *The Rise of the Network Society*, The Information Age: Economy, Society and Culture, vol. 1 (Oxford: Blackwell Publishers, 1996).

[81] James Gauthier and Richard Roy, *Diverging Trends in Self-Employment in Canada*, Applied Research Branch Strategic Policy no. R-97-13E (Hull, Que: Human Resources Development Canada, 1997) 1.

(own-account self-employment) has far outstripped employer businesses.[82] In addition, women are significantly represented amongst owners of microenterprises, comprising 40 percent of those in own account self-employment.[83]

Self-employment rates rose in response to the economic crises of the 1970s and 1980s when profits fell, interest rates increased and manufacturing industries retrenched, destroying millions of jobs in Western Europe and North America and reducing the real value of wages.[84] To reduce costs, particularly the costs of labour, corporations looked for new ways to organize production, adopting strategies such as "contracting-out" that forcedworkers to create their own jobs. The corporate shift from in-house to outsourced supplies produced "opportunities" to work as "independent" contractors; lower wages spurred households and individuals to seek sources of additional income.

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[82] I*bid.*; Calmeadow Research, *supra*, note 5; Karen D. Hughes, *Gender and Self-Employment in Canada: Assessing Trends and Policy Implications*, CPRN study no. W|04 (Ottawa: Renouf Publishing Co. Ltd., 1999).

[83] Hughes, *supra*, note 82. Studies in the U.S. and the U.K. also document dramatic increases in self-employment during the 1980s and 1990s, with the number of women-owned businesses growing much faster than businesses owned by men: Eileen Green and Laurie Cohen, "'Women's Business': Are Women Entrepreneurs Breaking New Ground or Simply Balancing the Demands of Women's Work in a New Way?" *Journal of Gender Studies* 4, (1995): 297-314; Dorothy P Moore and E. Holly Buttner, *Women Entrepreneurs: Moving Beyond the Glass Ceiling*, cited in Hughes. Racial minorities in both jurisdictions also have contributed substantially to the growth of small and microenterprises: Bank of England, *The Financing of Ethnic Minority Firms in the United Kingdom: A Special Report* (London: Bank of England, 1999); Office of Advocacy, *Minorities in Business* (Washington, D.C.: US Small Business Administration Office of Advocacy, 1999).

[84] Statistics Canada, *Perspectives on Labour and Income* Vol. 3 No. 11, November 2002; Ken Battle, *Minimum Wages in Canada: A Statistical Portrait with Policy Implications*, Caledon Institute of Social Policy, Ottawa, 2003. For discussion of these economic trends from a feminist political economy perspective, see Brenda Cossman and Judy Fudge (eds.) *Privatization, Law, and the Challenge to Feminism* (Toronto: University of Toronto Press, 2002); see also Wallace Clement and Leah F. Vosko (eds.) *Changing Canada: Political Economy as Transformation* (Montreal & Kingston: McGill-Queen's University Press, 2003); Castells, *supra*, note 80.

These trends were fostered by policy initiatives of the Canadian state, which refashioned income support programmes as self-employment incentive schemes;[85] shifted the focus of regional development from relocation incentives in search of new manufacturing industries to the stimulation of local small business development;[86] and revitalised an array of public sector financing programmes that mediate the often difficult relationships between small businesses and the Canadian banks.[87] Making a virtue out of these strategic political choices, such measures were promoted as liberating a dynamic microentrepreneurial spirit from the stasis of public and private bureaucracy.[88]

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[85] In 1987 Human Resources Development Canada (HRDC) the federal ministry that oversees labour markets, developed a Self-Employment Incentive programme to support business development in rural areas In 1990, access to self-employment assistance was extended across Canada and funding was transferred from the Consolidated Revenue Funds to the Unemployment Insurance Funds. Changes in the mid 1990s saw the transfer of responsibility for regional economic development initially from HRDC to Industry Canada, and subsequently to provinces that entered into a Labour Market Development Agreement with the federal government. Services in support of self-employment such as loans, grants and technical training may be delivered through the Community Futures Development Centres, which are regional economic development agencies: see generally, Frank Graves and Benoît Gauthier (1996), "Evaluation of the Self-Employment Assistance Program," Human Resources Development Canada, available at <http://www11.hrdc-drhc.gc.ca/pls/edd/SEAP_123000.htm>.

[86] J.D. McNiven and J.E. Plumstead, "Comparative Perspectives on Regional Development," in Comparative Perspectives on Regional Development, North American Policy Group, (Halifax, Nova Scotia: Atlantic Canada Opportunities Agency, 1998).

[87] David Berger (Chair), *Taking Care of Small Business: Report of the Standing Committee on Industry* 35th Parliament-27, First Sess. (Canada 1994); Canada, *Financing Growth: For 37 Years with the Small Business Loans Act*, Industry Canada (Ottawa: Industry Canada, 1998); Angus Reid Group, *Financing Services to Canadian Small and Medium Size Enterprises: Report on Focus Group Research*, Business Development Bank of Canada (Business Development Bank of Canada, 2000); Heather Scoffield, "Banks Warned to Keep Cash Flowing Parliamentarians Threaten Grudge During Mergers If Banks Hinder Small Business," *The Globe and Mail* 2 March 2001, Toronto, Report on Business: B5.

[88] See, generally, Atlantic Canada Opportunities Agency, *supra,* note 37; Government of Ontario, "Opportunity Knocks -- Ontario Launches Small Business Month: Backgrounder," <http://www.2.ontario-canada.com/English/about/news_releases_2001/01-10-2001.htm>, 2 October 2001; Government of Ontario, "Opportunity Knocks -- Ontario Launches Small Business Month: Backgrounder," <http://www.ontariocanada.com/English/about/news_releases_2002/10-04-2002_backgrounder.htm>, 04 October 2002.

Calmeadow situated itself as an enthusiastic advocate of microenterprise in Canada through position papers, conferences and engagement in policy debates,[89] as well as its material support for the delivery of microloans. Its early Canadian initiatives mimicked the 'partnership' form of its support for overseas programmes. Rather than deliver loans directly, Calmeadow secured financing, through grants and loan guarantees, and sponsored local organizations in the targeted areas to adopt peer lending. Its first project, the First People's Fund (FPF), worked with established organizations in First Nations Communities across Canada; its second, the Peer Assistance for Rural Development (PARD) programme, funded the creation of autonomous, dedicated peer lending institutions in Nova Scotia.[90]

From the beginning Calmeadow intended to act as a catalyst rather than as a long-term financial intermediary, projecting that within five years the the FPF and the PARD would significantly reduce reliance on its financial intermediation and be close to self-sufficiency. Based on the example of successful microcredit intermediaries in the South, Calmeadow envisaged rapid expansion in the numbers of debtors - the achievement of scale - as the primary strategy for attaining this goal. Despite preliminary research

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[89] Calmeadow Research, *supra*, note 5; Frankiewicz, *supra* note 8. According to Mary Coyle, a former Calmeadow executive director, Calmeadow first tried to instigate microlending by other Canadian non-profit organisations. Reporting on a conference Calmeadow convened to generate interest in microcredit, Coyle states that: "The Canadian NGOs did not embrace the concept. On the contrary, many expressed concerns, based on ideological grounds, that microcredit and microenterprise development were counter developmental because they were supporting petty capitalism and perpetuating the marginalization of poor people. Calmeadow's response was to get into the business directly by transforming itself from a funding organization into an operational one." Coyle, *supra,* note 8.

[90] Frankiewicz, *supra*, note 8; Nic Friendly and Robert Wright, *Calmeadow Nova Scotia*, (Nova Scotia: Calmeadow, 2001). This section relies heavily on Frankiewicz's assessment of Calmeadow Metrofund. All factual information is taken from her report unless otherwise noted.

documenting a significant "need" for credit to support microentrepreneurship in the target localities, the FPF and the PARD never approached scale required for self-sufficiency.[91]

Although the performance of these early initiatives clearly did not meet expectations that peerlending would stimulate large-scale microentrepreneurship, neither did the experience provide an unambiguous explanation of what had gone wrong. One could infer that the "social objective" of supporting self-employment of poor and marginalized individuals was inappropriate or that the business objective of sustainable microlending was unattainable, but the problems also could be attributed to the sparsely populated locations of these rural initiatives. The poor performances of the FPF and the PARD programmes might evidence rejection of peer lending methodology or they might signify a need for better marketing and management of peer loans.[92]

After these sobering experiences with decentralised delivery of microcredit in rural areas, Calmeadow focused its efforts on densely populated urban areas and assumed a direct role in supplying funds. Its boldest initiative was the creation of Metrofund, a microcredit programme in Toronto, Ontario.[93] Metrofund's April 1994 launch was widely publicized amid high expectations. Its ten-year plan forecast that in 2003, it would manage a loan portfolio of almost C$7 million and have achieved a sustainable active client base of

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[91] The FPF aimed to launch at least 60 viable microloan funds in First Nations communities across Canada, but at the end of five years, it had created only 20 funds, serving about 300 microentrepreneurs, Frankiewicz, *supra.,* note 8. The PARD in Nova Scotia also fell short of its goals, creating only six microloan funds and reaching fewer than 100 borrowers in its first 5 years, Friendly and Wright, *supra,* note 90.

[92] As might be expected, evaluations of the FPF and the PARD suggested that their problems could be attributed to a variety of factors, including over-ambitious goals, difficulties in attracting the "right" clients, and local economies that provided an inhospitable climate for microenterprise development. The evaluations also pointed to weaknesses in the structuring of credit delivery through autonomous local loan funds: Frankiewicz, *supra*, note 8, Friendly and Wright, *ibid*.

[93] Calmeadow also refashioned its microlending projects in Nova Scotia and B.C., as direct delivery programmes in urban centres: Frankiewicz, *supra*, note 8.

more than 1400. Once again, experience fell well short of expectations. By the end of 1999, when Calmeadow decided that Metrofund would become sustainable, it had fewer than 500 active clients and the loan portfolio stood at about C$1.5 million, each datapoint amounting to less than one-third of the forecasted figures.[94]

B. The Goals of Calmeadow's Metrofund

Metrofund aimed to "provid[e] credit to self-employed entrepreneurs who are marginalized from formal credit markets, using a sustainable model of lending".[95] This goal had both social and business components. Its "social objective" was to support job creation among "the least-advantaged" by supplying credit in aid of microenterprise to low-income individuals;[96] the business goal was to develop a sustainable model of lending to low income microentrepreneurs, by which it meant that revenues must cover costs, without the need for subsidies from the public or private sectors. Within the general category of "the least advantaged", Metrofund chose to focus on serving women and recent immigrants, two populations that consistently reported systemic barriers to access to financial services and featured prominently in the emerging microenterprise sector. The targeting of these groups served a strategic purpose also in relation to its goal of sustainability. Metrofund assumed that women and immigrants would adapt relatively easily to its core lending methodology, the peer loan. Women because they were assumed to be better attuned than men to the demands of sociability and hence more comfortable

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[94] *Ibid.*

[95] *Ibid.* 8.

[96] *Ibid.* 8.

working with and within the complex web of social ties required of successful peer groups. Recent immigrants were thought likely to succeed because of their presumed familiarity with arrangements that resembled the peer group dynamics.[97]

In pursuit of its sustainability goal, Metrofund attempted to limit its services to the supply of credit. This approach rejected the strategy, increasingly favoured by other North American microlenders, of providing ancillary business development services, funded by grants, to subsidise the administrative infrastructure of microlending.[98] Experience working with microentrepreneurs, however, led Metrofund to revisit its original 'minimalist' design and to begin offering business development services to meet debtors' needs, particularly in the areas of networking and marketing.

Like Calmeadow's other Canadian microlending projects, Metrofund began with the peer loan as its primary credit technology. Unlike the earlier initiatives, however, Metrofund planned to introduce individual loans, backed by collateral and personal guarantees, once it had established the peer lending programme and it anticipated significant demand for this service.[99] Metrofund intended the individual loan service to help it retain successful "graduates" of peer lending who needed larger loans and to attract as new clients more established microentrepreneurs whose credit needs lay between the tiny loans of the peer groups and the standard products of mainstream financial services providers. To meet the perceived needs of this clientele, the individual lending service

[97] *Ibid.* 11.

[98] Johnson, *supra*, note 38.

[99] Its financial forecast projected that at the end of ten years, these loans would exceed 70 per cent of the total portfolio value: Frankiewicz, *supra*, note 8.

offered much larger loans, with significantly longer repayment periods, and intensive support from Metrofund staff.[100]

Metrofund modelled its peer loan on practice in Countries of the South. It required small, self-selected peer groups to assess loan applications, and to monitor and enforce timely repayment. Non-payment by any group member resulted in denial of future loans to everyone in the group, including those who had yet to receive their first loans, unless group members coerced a non-paying peer into performance or made up the shortfall themselves. The peer lending programme capped first loans at $500 repayable by direct deposit[101] in monthly instalments over periods of three to twelve months, for which Metrofund charged 12 percent interest and an administrative fee of 3 percent of the loan, which it raised to 6.5 percent in 1998.[102]

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[100] Under the individual loan programme, debtors could borrow up to $15,000, repayable over 3 to 60 months, for which they paid annually 12 percent interest and a 6.5 percent 'administrative fee'. To obtain a loan, a microentrepreneur had to have at least 1 year's experience in operating the business and to have created a plan for its development; provide guarantees and collateral; and permit the checking of references and credit bureax reports. These requirements attached similar importance to experience, security, and information about character and credit history as the small business lending programmes of conventional financial institutions. Unlike such institutions, however, Metrofund made available relatively small amounts on term loans, which the banks reputedly found too costly too offer. In addition, Metrofund offered individual borrowers a substantial amount of personalized support, including business advice, technical assistance, referrals, encouragement, and counselling: Frankiewicz, *supra*, note 8.

[101] An unintended consequence of direct withdrawal was the undermining of the disciplinary power of peer groups. The groups often lacked timely information about members' performance of the repayment obligation, which impaired their capacity for prompt response to a missing payment. Without early knowledge of missed payments group members would not appreciate the threat to their own access to future loans, which weakened their capacity to apply peer pressure: Frankiewicz, *supra*, note 8.

[102] Originally the first loan could be as high as $1000, but after experiencing high arrears, this was scaled back. Subsequent loans to successful borrowers could be as high as $5000.00: Frankiewicz, *supra*, note 8.

III. C. Debtor distaste for peer lending and the demise of Metrofund

Calmeadow's peer lending projects encountered three related difficulties, which ultimately defeated their attempts to reach scale and sustainability: low rates of debtor recruitment; weak rates of debtor retention and high rates of debtor default. These problems conform to the predictions of economic analysis that debtors may reject peer lending as too costly a solution to the information costs of credit transactions.

1 Debtor Recruitment

In terms of its clients' demographic characteristics and economic circumstances, Metrofund seems to have reached its target populations. Women comprised a majority of Metrofund clients (55.6 percent) and just over half of all debtors (52.8 percent) were immigrants. Peer debtors were poor, reporting an average monthly income of just $1600 and only $6,800 worth of net assets; and a sizeable minority relied heavily on self-employment income. Twenty-five percent of peer debtors reported self-employment as their "only source" of income, and another 15 percent described it as a "major source" of income. The microenterprises run by these debtors were "young", tiny, service-providers, mostly operated from the home. Finally, Metrofund's peer debtors experienced severe credit constraints, with 40 per cent reporting no other source of credit and only 3 per cent holding a bank loan. Less than half of the peer debtors held credit cards, which were often drawn to their limits.[103]

Contrary to expectations, however, these clients did not embrace peer lending. Although Metrofund's well-publicized launch stimulated a dramatic early response,

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[103] All data in this paragraph are reported by Gomez & Santor, *supra*, note 13, in tables at 952.

demand dried up almost as quickly as it had started. At the end of its first year, Metrofund had recruited a total of 123 debtors, already notably short of its target of 150. Anemic growth continued. During its second year, Metrofund recruited fewer than 100 new clients instead of the 250 it had projected. Client recruitment received a boost from outreach initiatives taken to increase interest in the peer loans and from the introduction of individual loans, which in Metrofund's final year were sold at twice the rate of peer loans. At no point after the programme launch, however, did the recruitment of new clients match the original expectations.[104]

Metrofund's inability to drum up enthusiasm for its peer loan service illustrates some of the difficulties of peer group formation.[105] While staff tried to help peer groups to form by holding information sessions and establishing qualifications, the programme insisted on debtor autonomy in the selection of peers, expecting microentrepreneurs "to assess each other's character, personality, trustworthiness and business ideas to form a group upon which they believed they could depend."[106] Rarely, however, would a promising candidate for peer lending approach a microcreditor with four or five close friends in tow who also want loan capital. Absent existing relationships among budding microentrepreneurs, Metrofund asked them to bond with strangers, to judge and be judged

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[104] Frankiewicz, *supra,* note 8.

[105] Overcoming borrowers' reluctance to assume the responsibilities of peer group membership for people they do not know may prove quite costly for both lender and borrowers. Suzanne Merrill describes one peer-lender in Montreal, which interviewed and pre-selected women for its programme. It then required the women to complete a 16 week, 160 hour training course, which included orientation to the peer lending model, as well as business development skills. Only those who completed the training course were eligible for loans. Mandatory training offered participants' opportunities to form relationships with one another before joining loan circles, and assurances that all "graduates" had at least shown sufficient commitment and skills to complete the training. Nevertheless peer group formation still encountered difficulties of group cohesion and low take up rates for loans. Merrill, *supra*, note 13.

[106] Frankiewicz, *supra note* 8, 10.

on "character, personality, trustworthiness and business ideas". Such demands were likely to encounter predictable resistance, particularly when judgments relate to financial affairs, conventionally governed by strong norms of privacy. As Merrill found in her study of peer lending in Montreal, an individual's history of bad experiences with debt may joins with cultural norms of privacy to discourage her from seeking credit on her own behalf. Such potential clients are unlikely to find appealing either the group discussion of their credit histories or the prospect of assuming responsibility for other people's debts that peer lending demands.[107]

2 Debtor Retention

Satisfactory debtor retention rates proved just as elusive as the recruitment targets. Metrofund had counted on a brisk rate of loan renewal to generate revenue and a strong level of peer debtor retention as a foundation from which to build its active client base. It had projected, for example, an average of two loans per year per client in a peer lending group and had assumed that most peer debtors would renew their loans. From the beginning, however, loan renewal targets were missed, partly because debtors took out longer term loans than estimated, partly because they left the programme in larger numbers than had been anticipated, and partly because higher than expected delinquency rates disqualified many debtors and their peer guarantors from refinancing. Debtor drop out rates became a particular focus of concern when, four years after its launch, Metrofund found that it had retained only 48 percent of its borrowers.[108]

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107 Merrill, *supra,* note,13.

108 Frankiewicz, *supra*, note 8.

The failure to retain debtors and renew loans hampered the drive for sustainability. Metrofund never developed a stable base of active borrowers from which to build its lending portfolio and the constant turnover hindered its efforts to reduce lending and administrative costs. New debtors were more costly to recruit and support than returning borrowers who understood the programme and whose repayment of earlier loans had produced information which fed into assessments of requests for subsequent credit. Low retention rates also resulted in lower than expected revenues. Metrofund had anticipated that refinancing debtors would assume larger loans than new debtors and had counted on loan renewals to generate higher revenues from fees and interest.[109]

Finally, desertion diluted the incentive effect of refinancing. Debtors who did not intend to renew loans had less reason to repay an existing loan than debtors who wished to continue and the decision to leave rendered them less vulnerable to peer pressure from other group members. Debtor exit, however, had broader consequences for retention of individuals who wished to stay because it contributed to a destabilizing cycle for the peer groups. The marginal economic position of Metrofund clients suggested that few of them could comply with the requirement that other group members make up missing payments or be disqualified from access to future loans; the unfairness of being penalised for another person's default suggested that few would want to make such payments.[110] Thus the departure of a single non-paying debtor could prevent the retention of three to nine other

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[109] *Ibid.*

[110] This problem resembles that of the uncompensated guarantor who acts as a surety, generally for a family member or a friend, with the difference being that the peer debtor does not pay out in the event of default. However, she does lose a real benefit, which is the access to credit in the future. On spousal guarantors, see, Belinda Fehlberg, *Sexually Transmitted Debt: Surety Experience and English Law* (Oxford: Clarendon Press, 1997). For a helpful overview of legal responses to the uncompensated guarantor, see New South Wales Law Reform Commission, *Guaranteeing Someone Else's Debts* (2000).

individuals in the peer group, even if those other individuals wanted to continue to borrow and repaid their loans. Aware that the arrears of one individual, which could occur at any time, would harm everyone in the group, those who paid regularly could never be certain that they would reap the reward of future refinancing. This lack of confidence in the ability to realise the benefits of peer lending, stemming from a sense of powerlessness in relation to the decisions of peer group members, likely contributed to debtors' abandonment of peer loans and the much greater enthusiasm they showed for the individual loans service introduced in 1997.

Metrofund attempted to improve the retention rates through measures such as cheaper prices for subsequent loans to good payers,[111] increasing ancillary non-financial services and tempering the collective responsibility regime of the peer loans. Instead of denying new loans to all group members if any loan was in arrears, Metrofund permitted refinancing of a peer group member who paid a share of the arrears.[112] This concession allowed individuals to overcome the collective action problem, which occurred when some peers of a defaulting debtor were willing to pay the arrears but others were not. Under the new scheme, payment of a portion of the arrears by willing peers preserved each paying individual's access to refinancing, while those unable or unwilling to pay their shares remained ineligible for new loans. These measures met with some success, improving client retention rates from a low of 32 percent to 59 percent in December 1999.[113] But even with this gain, the rate fell short of the 70 percent that Metrofund had estimated it needed

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[111] Frankiewicz, *supra*, note 8.

[112] Conlin *supra,* note 13 at 257, describes the formula for calculating the payment required to preserve eligibility for future loans.

[113] Frankiewicz, *supra*, note 8.

to build a sustainable active client base and to offset the threats to sustainability caused by low recruitment and high delinquency rates.[114]

3. Delinquency rates

Higher than expected rates of delinquency plagued the Metrofund from its inception until closure. Frankiewicz reports that within 9 months of the launch, 18 out of 68 groups were "in serious default" and that by the end of the first fiscal year, "30 percent of [the Metrofund's] client base was delinquent and only one group had agreed to pay the loan of its defaulting member".[115]

Initial responses, which centred on attempts to "recruit the right kind of clients", "motivate clients to be more serious about their relationship with the fund", and improve peer groups' capacity to screen new members and monitor each other effectively, had some impact, but delinquency rates remained high.[116] By the summer of 1996, Metrofund had reached the limits of what it could achieve through education and motivation; its subsequent efforts to reduce default involved changes to the structure of the programme. It changed the rules about peer group composition to ensure that no more than one person per group could be a startup microentrepreneur who lacked business experience or self-

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[114] *Ibid*.

[115] Frankiewicz, *supra*, note 8. 14. Frankiewicz reports that while Metrofund had difficulty discerning relationships between default and repayment records or business circumstances, some demographic characteristics had predictive power: "borrowers were more likely to default if they were young, male, born in Canada, single, or had less than a high school education. They were less likely to default if they were older, married, or had self-employment training." *ibid.*, at 39.

[116] *Ibid*. 20.

employment training.[117] In addition, it experimented with pricing and incentive strategies, such as late payment fees and offering access to the much sought after individual loans to members of groups in good standing. More radically, Metrofund staff assumed some of the responsibility for verifying information in loan applications, a responsibility which had previously been borne exclusively by the peer groups.[118] Over time, the default rates on peer supported loans declined significantly,[119] which shows that after several years of experimentation, including changes to membership criteria and group member responsibilities, the peer supported loans stabilised, albeit at a much lower volume of lending than had been anticipated.

Excessive arrears and delinquency rates recurred, however, when individual lending started. Launched in 1997, individual loans proved extremely popular with debtors and Metrofund staff, but as this part of the loan portfolio grew, the rate of arrears began to climb. Between December 1998 and August 1999, a period that coincided with significant growth of individual lending, the percentage of loans more than 30 days in arrears, doubled, rising from 6 to 12 percent of the loan portfolio.[120]

D. Summary of the Calmeadow experience

Ultimately, Metrofund, despite its location in a dense urban environment, fared no better than Calmeadow's earlier rural initiatives. Its peer groups formed slowly, and once

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[117] Conlin reports that between April 1996 and September 1997, "the ratio of loan amount defaulted to repaid" fell from 0.24 to 0.04, which he attributes to changes in the composition of peer groups and the verification procedures. Conlin, *supra*, note 13.

[118] *Ibid*.

[119] *Ibid*., 258.

[120] Interestingly, the data also showed specifically that individual borrowers (22 percent) were more likely to default than peer loan debtors (18 percent), Frankiewicz, *supra*, note 8.

formed, they struggled with both monitoring and the imposition of social sanctions. Economic analysis would explain these results in terms of distinct problems that might occur in groups that do and do not build on prior relationships among participants. In both cases, however, it identifies reasons for non-trivial levels of delinquency.

Without pre-existing social relationships and access to local knowledge, peer groups may have difficulty obtaining information about the risk of strategic behaviour and assessing reasons for a member's inability to pay instalments on time. Information asymmetry creates abundant opportunities for individuals to mask dishonesty and lack of commitment to the peer lending project or to the development of their businesses. While the regular meetings that Metrofund demanded allowed for the raising of concerns, meetings do not guarantee truthful reports of activity or honest answers to questions.

Groups formed among strangers also lack the necessary information to apply social sanctions to an opportunistic or recalcitrant peer. People who do not know each other well may reach different conclusions about whether a non-paying peer warrants sanctions and the dissension may dilute the impact of sanctions. Group members may not know what sanctions will pressure a peer to perform in order to avoid disgrace. An opportunistic group member might not care at all about the opinions of peers to whom the only connection is the loan arrangement. In this case, opprobrium is simply ineffective. Without additional safeguards against information imperfections, therefore, the conditions of peer groups formed among strangers may create ample opportunities for – and weak protection against -- strategic behaviour that undermines the security of the peer lending transaction. Calmeadow's experience of debtors' reluctance to participate, as evidenced by low loan takeup and retention rates are predictable responses to this risk.

Peer lending methodology poses different challenges for groups that include peers who have social ties outside the loan transaction. Since local knowledge counteracts some aspects of information asymmetry, peer group members who interact socially may have more confidence in the screening and monitoring processes of peer lending. Even when embedded in relationships of trust, however, screening and monitoring do not reliably generate complete information about character and conduct, and changed circumstances may always threaten repayment intentions. Since information is never complete and the future is not certain, even groups formed among friends may experience ambiguous missed payments, for which the reason is open to varying interpretations. Ambiguity may cause significant problems among peer-acquaintances. Those who do pay may feel let down by a friend who does not. Someone who claims inability to pay because of changed circumstances may resent the suspicion of his or her peer friends, with its implications of dishonesty or betrayal. In sum, peer lending's demands for judgment and sanctions may exact a heavy toll on prior social relationships, which may deter participation in microcredit programmes.

Beyond the specific challenges of recruitment, retention and delinquency, Metrofund found that its debtors required more care and attention from staff than it had anticipated. Clients looked to staff for counselling about their debts and their businesses; they sought advice, support and reassurance.[121] Peer debtors apparently found their relationships with Metrofund far more empowering than those with their peers, presumably because staff represented the organisation that controlled the sources of credit. Moreover, relationships with the staff were far less demanding for peer debtors than peer groups that

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[121] Frankiewicz, *supra*, note 8.

required commitment to the development of affinity group norms. From the perspective of Metrofund, however, debtors' unmediated access to its staff shifted back to the organization the costs it had sought to avoid by adopting peer lending technology.

Calmeadow wanted to develop a sustainable model of microcredit provision to low income self-employed persons who had difficulty obtaining credit from conventional sources. Over time it tested different kinds of loans, variations in administrative structures for selecting and monitoring borrowers, different target groups, and the receptiveness of different locales to its interventions. Calmeadow consistently witnessed significant "need" for small loans that were not offered by other credit providers in the markets it served, but neither in rural nor in urban settings could it meet the need within the constraints of its business goal of "sustainability".

IV. Reflections on the lure and the limits of microcredit

Canadian policy makers welcomed the emergence of microcredit, suggesting that it had "enormous potential"[122] to contribute to community economic development by fostering the growth of a microenterprise sector. Even within microcredit's 'home' environment, however, experience has raised questions about its capacity to deliver the anticipated benefits. For every example of success, such as The Grameen Bank, or BancoSol, multiple examples of failed programmes exist. Moreover, a growing critical literature questions some of the claims of 'successful' microcredit providers, including the Grameen Bank.[123]

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[122] Bevilacqua, *supra*, note 2.

[123] See sources cited above, especially at notes 6-7.

In the less hospitable environment of Countries of the North, microcredit intermediaries have encountered significant difficulties, and many report anemic performance in relation to outreach, repayment rates and expanded access to credit.[124] Mirroring the experience of Grameen, microlenders in the US and Canada recount low take up rates and high delinquency rates[125]. Rapid programme growth of the early 1990s has been followed by 21st century retrenchment, especially of programmes that initially specialised in peer supported loans. Many intermediaries have redirected their resources to promote microenterprise development generally – rather than lending specifically – and diversified their services to include training, business development and technical assistance services, and asset-building products. Some micro*credit* organisations have abandoned peer lending, others have shifted their focus to target less poor and more established microenterprises.[126]

The allure of microcredit in societies such as Canada lies in its promise of symbolic and material benefits to key political actors. It offers banks some relief from continuing social pressure to deliver more services to low-income people. By lending to a safe microcredit intermediary who bears the marketing and management costs of lending, financial institutions may report investment in disadvantaged localities, responding to political – and legal – demands at low cost and minimal risk.

Microcredit also suggests the possibility of benefits to state actors. Through its material aid to self-employment, microcredit contributes to the myth that the

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124 Richard P. Taub, "Making the Adaptation across Cultures and Societies: A Report on an Attempt to Clone the Grameen Bank in Southern Arkansas," *Journal of Developmental Entrepreneurship* 3, no. 1 (1998): see generally; James H. Carr and Zhong Yi Tong, eds., *supra*, note 6; Bhatt, *supra,* note 8.

125 Frankiewicz, *supra*, note 8; Bhatt, *supra,* note 8.

126 Bornstein, *supra*, note 18; Bhatt, *supra,* note 8.

entrepreneurial instincts of the poor will solve the dilemma posed by the economic restructuring processes at the end of the twentieth century. Neoliberal responses in Countries of the North, manifested in state programmes of privatization and welfare state retrenchment, severely curtailed income maintenance and redistributional policies, at the same time as they intensified the structural conditions that produce poverty. While microcredit cannot change these structural conditions, its promotion as support for a spontaneous revival of the entrepreneurial spirit contributes to the recasting of the state's withdrawal from the delivery of social and economic security. The ideology of entrepreneurialism portrays microenterprises as embryonic small businesses that are innovative and ambitious to grow. From this perspective, credit accessibility programmes may be represented as "leveraging" funds – including state subsidies -- into wealth creating microenterprise as opposed to their deployment in unproductive wealth-transfers (for which read "handouts").

The experience of microenterprise, however, challenges this portrayal, and with it the potential role for microcredit. Far from a catalyst of the new economy, much of the microenterprise sector consists of part-time service occupations, often low income and usually insecure.[127] In many instances, self-employment supplements the individual's main job(s).[128] Contrary to the assumption that very tiny businesses seek credit to grow into larger ones, microenterprise may be adopted as a necessary response to increasingly volatile and precarious income streams. Self-employed micro"entrepreneurs" may wish no

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[127] Alejandro Portes, Manuel Castells and Lauren A. Benton, (eds)*The Informal Economy: Studies in Advanced and Less Developed Countries*, (Baltimore, The John Hopkins University Press, 1989).

[128] *ibid;* Judy Fudge and Leah F. Vosko, "Gender Paradoxes and the Rise of Contingent Work: Towards a Transformative Political Economy of the Labour Market" in Clement & Vosko (eds)*, supra*, note 84.

more than to smooth their incomes, protecting themselves against risk; they may have little interest in growth and indeed may prefer to abandon the 'business' once better opportunities are available. Credit may play a very modest role in this context, sought only to achieve or maintain a level of sustainable self-employment. This divergence between the assumptions of entrepreneurialism and the circumstances of many microenterprises may partly account for the persistent failure of the demand for microcredit to match expectations derived from the significant growth in self-employment during the 1990s.

Another reason for divergence between expected and realised demand for microcredit may be the capacity of conventional credit markets to supply more convenient forms of credit to self-employed microentrepreneurs. At first sight, this claim seems implausible. Inadequate access to credit even for established small businesses is a repeated criticism levied against financial institutions in Canada, the US and Europe, and reports frequently comment that banks do not extend term loans in small amounts to microenterprise startups. But in countries of the North, microentrepreneurs are also consumers, and in that aspect of their economic lives they may have access to numerous sources of credit. Thus, many microentrepreneurs unable to find cheap small loans from banks may yet finance their businesses through their personal credit cards.

In North America, this practice, which began at the initiative of microentrepreneurs drawing on their consumer credit cards, was facilitated by "numerous deregulatory policies of the 1980s and 1990s that made credit card loans enormously profitable to member banks".[129] It has gathered steam as credit card providers sought to expand beyond their

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[129] Robert D. Manning, *Credit Card Nation: The Consequences of America's Addiction to Credit* (New York: Basic Books, 2000) 248.

traditional saturated consumer markets.[130] By the late 1990s, it had led to aggressive marketing of corporate credit cards, including their promotion as a means of "democratizing" access to credit.[131] Its practical effect is that: "the same banks that consider a [micro-entrepreneur] an unacceptable risk for an 8 percent small business loan routinely offer her a credit card for the same purpose at 18 percent APR".[132] Clearly, as this comment suggests, credit card financing is expensive, but so also are microloans. Microcredit intermediaries charge administration fees and high interest rates and debtors in peer lending programmes incur ancillary costs of screening, meeting attendance, monitoring, and peer discipline as well as foregoing the benefits of flexibility and privacy that credit cards offer.

The modest "business" aspirations of many self-employed microentrepreneurs and the availability of credit cards may have diminished the potential market for microcredit in the North, but many of the broader problems microcredit sought to address remain. Significant levels of economic hardship exist in cities that have undergone massive disinvestment and lost "good jobs" in semi-skilled occupations, and in rural areas that have historically failed to attract capital. Employed and unemployed people have experienced declining levels of income and rising economic insecurity in the last 20 years. While North America might be awash with credit, there continue to be concerns that opportunities to borrow are unevenly distributed. New entrants to credit markets, particularly immigrants and recently-separated women, may have difficulty obtaining access to credit. Individuals

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[130] *Ibid.,* 231.

[131] *Ibid*.

[132] *Ibid.,* 255.

from racialized communities frequently report similar problems.[133] Though microcredit may not solve these problems, its advocates have played the valuable role of drawing attention to ways that conventional credit markets fail to serve the needs of people from marginalised communities. In addition, microcreditors appear to have played the rather more limited roles of helping some individuals establish or rehabilitate their credit records. While these credit probation and credit repair services may have faciliated entry into the mainstream credit markets, it seems likely that they could be delivered at lower cost than through the complicated peer loan transaction.

CONCLUSION

This analysis of the traditional core of microcredit – the peer lending arrangement – has argued that it is unable to fulfill the objective of faciliating large scale microenterprise development or even to meet a more modest goal of enhancing access to credit. The promise of peer lending lies in its apparent capacity to reduce the costs to creditors of lending small amounts of money to tiny businesses, but in practice, this capacity has proven illusory. There is little evidence to suggest that peer supported loans are less costly for creditors to deliver than other debt instruments. In addition, the peer supported loan imposes substantial costs on debtors, a significant proportion of which are not included in the explicit price paid for the loan.

The experience of peer supported lending in Canada has consistently generated low participation rates and those debtors who joined the programmes generally did not stay for very long. This rejection of peer lending may reflect debtors' recognition of the substantial

[133] Bank of England, *supra* note 83; Office of Small Business Advocacy, *supra* note 83; The Personal

costs they likely will incur in screening, monitoring and enforcing a loan, and of the implausibility that a loan will generate sufficient additional income to cover these costs. The increasing "consumerization" of small business lending, where many individuals may obtain substantial credit without much investigation of their circumstances or plans, may result in many individuals choosing this option rather than a micro lender for financing their small business.

Although microlending in Canada may not fill gaps in the market for credit, or meet the ambitious purposes that were initially articulated, it has contributed to the identification of very tiny businesses as a distinctive sector of the financial services market. Microenterprises appear to straddle the boundary between consumers and the conventional category of "small business". While law reform has traditionally proceeded in terms of a dichotomy, adopting the mandates of protecting consumers and facilitating small business development, the emergence of microenterprise may suggest a need to combine these approaches.

If microlending has failed to expand access to credit, then the issue must be raised of the role and responsibility of mainstream financial services providers. Recent amendments to the Bank Act created the office of the Financial Consumers Agency of Canada to oversee compliance by financial services institutions with federal consumer protection measures. The amendments also require financial institutions to report on their contributions to the community, to warn of potential branch closures and to simplify the

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Finance Research Centre, *supra*, note 61.

process of opening bank accounts.[134] These reforms offer the appearance of greater accountability, but the limited duties they impose suggest they will do little to enhance accessibility for tiny businesses. Another interesting development, following the recommendations of the Task Force on Financial Services, is Industry Canada's assumption of responsibility for reporting on small business financing by banks and other financial services providers. This initiative has the potential to draw attention to credit accessibility problems but it lacks a simple mechanism to translate information into action.[135]

The imposition on financial institutions of strictly regulated duties to serve disadvantaged communities might have more potential to increase the supply of affordable credit to microenterprises. But strict regulation of these institutions is unlikely to happen in Canada given the political economy of the financial services sector and the longstanding tradition of 'soft law', codes of practice and other voluntary initiatives. Given this tradition, future developments in relation to debt financing of microenterprise likely will result from the interests of financial services suppliers in the further "consumerization" of the lending process. The potential benefits, costs and risks of consumerization for microenterprises warrant a prominent position on future research agenda.

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[134] Bill C-8, *supra*, note 50, received Royal Assent on June 14, 2001, and was proclaimed on October 24, 2001.

[135] Reports are submitted to the House of Commons Standing Committee on Industry, Science and Technology and are intended to be advisory: Industry Canada Small Business Policy Branch, *Small and Medium-sized Enterprise (SME) Financing in Canada*, *2002*, (Ottawa: Government of Canada, 2002), available at: http://strategis.ic.gc.ca/fdi.