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COMPETITION IN MICROFINANCE INSTITUTION: A LITERATURE REVIEW

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Abstract: This research aims to investigate competition in Microfinance Institution (MFI). MFI is an institution that serves unbankable people through increasing access to finance. Though it faces a challenging situation, many organizations interested in investing in MFI, this condition builds a competitive situation among MFI. Meanwhile, MFI offers diversified products to increase their revenue because they are facing a more intense situation. This research uses a literature survey to find out a journey regarding competition in MFI.

Keywords: Competition, Microfinance Institution, Social Outreach, Sustainability

INTRODUCTION

For many years, microfinance turns into a commonly used instrument to reduce the poverty rate. The amount of microfinance borrower increases 21% yearly, while the average loan size rises 34% every year (González, 2009). Some well-known microfinance, for example, Grameen Bank and BancoSol, at first provide a simple loan without any need to give collateral, but today's microfinance also offers a variety of financial services such as microinsurance, payment point, and fund transfer. In terms of institutional profiles, microfinance also carries different goals and operational methodologies. Some microfinance does not offer any deposit product, while others only have group lending products to disburse their loan. Mersland (2011) stated that MFI is a new type of firm that delivers financial service to poor people. MFI has two main objectives, giving social impacts while still able to sustain financially.

MFI has some peculiar characteristics. They point on poor people and do not ask for assurance for their loans. Even if they need it, the requirements are usually very flexible. These institutions are micro in terms of daily financial activity measurement. One of the indicators is the average loan size. They offer loan sizes between \$50 and a maximum of \$500. MFI comes out with many institutional forms, which are cooperative, credit union, bank, non-bank financial institution, and non-government organization. Among the biggest MFI is in the form

of a bank. Grameen Bank, which locates in Bangladesh, provides financial services to almost 8 million individuals with a credit balance of around \$79 (Cull, Demirgüç-kunt, et al., 2009). While they can distribute this small loan, they also able to maintain the repayment rate. In December 2019, the repayment rate on Grameen achieved 98,2% of total loan due.

Not long ago, many MFI was the only actor in fair loan prices in their operational area. However, nowadays, the borrower usually elects among some lenders while they do not have any obligation to stick with only one financial institution. This condition led to difficulties in maintaining good lending quality (Vogelgesang, 2003). Some areas in Bangladesh and Bolivia show that the microfinance market has become saturated. Other sources of competitors are bank's consumer division or other non-banks financial institutions, which also propose small loans to the potential borrower.

For a long time, practitioner and policymaker do not pay much attention to micro-lending institution, especially regarding how they interact each other, up until the financial inclusion issue emerge as a concern by many central bankers (Cull, Demirgüç-Kunt, et al., 2009). Subsequent this event, the relation between loan to excluded communities and macroeconomic condition become a vital discussion. Many academicians believe that as microfinance emerges, there is a negative and positive effect on microfinancing as a whole (Baquero et al., 2018). Economists conclude that the balance comes from the interaction of positive effects, such as vigorous institutional development and adverse effect, which is the competition that may destroy dynamic incentive mechanisms; this mechanism itself is the heart of microfinance.

Besides, some parties believe that a competitive environment may lead MFI to move away from low-income people and targeted into higher-income communities. The competition and sustainability issue impact social performance since MFI change their profile into more profitable clients and neglect their primary goal, which is to provide service for unbankable people (Assefa et al., 2013). These issues are also known as mission drift, which forces a trade-off between social goals and financial sustainability. An understanding of how this thing happens will be a vital matter because many countries use MFI as the central tool to alleviate poverty. Therefore, it will be essential to figure out what the source is and the impact of competition on microlending and microfinancing (Shaffer, 2004) since this change will impact MFI's primary objective.

Numerous research shows empirical evidence on how the emerge of competition is still debatable. There is proof that the existence of competition induces efficiency while motivating firms to produce more products and reduce the price for the borrower (Berger & Hannan, 1989). There are possibilities that it may also happen in the microfinance industry. Nevertheless, McIntosh & Wydick (2005) stated that the competitive environment in providing access to poor people induce a negative effect. It possibly will ruin the borrower selection process. Besides, there also possibilities that clients will get multiple loans and risking the MFI repayment rate (McIntosh et al., 2005). If this happens, the double-dipping incident might happen (Navajas et al., 2003).

LITERATURE REVIEW

MFI AND COMPETITION

The SCP (Structure-Conduct-Performance) theory is one of the fundamental theories that explain about the competition using the relationship of market structure, conduct and

performance. Mason (1939) was the first researcher to introduce the SCP theory. Then Bain (1951) statistically measures how the relationship between concentration and performance in manufacturing companies in the United States. Only in the late 1960s, the banking industry uses this concept (Ajlouni, 2010).

Empirical evidence of the existence of SCP theory in the banking industry supports the application of antitrust laws in several countries (Shaffer, 2004). This conclusion comes up because there is a positive relationship between concentration and performance through high loan interest rates and low deposit interest rates (VanHoose, 2017). However, banking is different from other industries. The existence of economies of scale causes the number of loans small and large requires more or less the same effort because if the bank gives different efforts, it can increase bank risk. Forssbæck & Shehzad (2014) and Tabak et al. (2015) found a negative relationship between market power and the level of risk. While Azmi et al., (2019) and Kasman & Carvalho (2014) prove that low market power increases stability, but can only occur if the bank is efficient and diversifies its products.

Cyree & Spurlin (2012) analyzed competition in rural banks Cyree & Spurlin concluded that the ability of rural banks to exploit their proximity to the local population was able to increase profits even if there was a presence of commercial bank branches in the area. BPR (Bank Perkreditan Rakyat) is one form of rural banks in Indonesia in addition to cooperatives and Micro Finance Institutions (LKM). Rural banks themselves have different characteristics and designations in each country but have in common the small number of assets and limited operating licenses (FDIC, 2012). Whereas, from the perspective of regional conditions, BPR has close relation with the local factors where it stands. This close relation is partly as an impact of the Financial Services Authority (OJK) rules which require BPRs to only operate in one province.

Researchers in various countries have widely observed the role of rural banks or similar institutions in a country's economy. In general, research related to rural banks links their role in the regional sector. Burgess & Pande (2005) show that Indian banks must increase the number of banks in rural areas, which can reduce poverty levels significantly while Meslier-Crouzille et al. (2011) see the positive impact of rural banks on regional economic growth, especially in less developed and intermediate areas. The smaller the number of Cajas (institutions that function like microfinance institutions in developing countries) in Spain, the less accessible groups of people (Financial exclusion) (Martin-Oliver, 2018).

Competition in the banking industry is often an issue that has been a matter of debate. The debate is related to whether the banking industry should consist of only a few banks or consisting of many banks to enable consumers to benefit from alternative options available. Shaffer & Srinivasan (2002) and Martín-Oliver & Salas-Fumás (2008) concluded that the lower the level of competition, the more profitable consumers are in the form of cheaper loan interest rates and higher deposit rates. However, Flechsig (1965) and Meyer (1967) did not see a relationship between competition and interest rates, and instead, competition would increase the risks faced by financial institutions (Phan et al., 2019).

The debate about market structure also developed in the measurements used. Bikker & Haaf (2002) mentions two theories that model the relationship between market structure and competition and performance. In the first theory, the competition approach departs from the market structure. Because of these conditions, this approach is called the structural approach. Whereas in the second approach, competition is not measured by the market structure but by

how the bank behaves (Shaffer, 2004). The second approach is also called the New Empirical Industrial Organization (NEIO). Measurement of competition based on the NEIO is Lerner Index, Panzar-Rose (Bikker et al., 2012), and Boone Indicator (Boone, 2008). Because some tests with structural approaches show different results between competition and concentration (Berger et al., 2004; Claessens & Laeven, 2004), various recent studies use the NEIO concept to measure competition (Wibowo, 2017).

At the MFI level, commercialization encourages the increase of competition level. Most MFIs initially received donor support, but gradually the donors began to encourage them to become more independent and not dependent on donor assistance. As a result, many who initially relied on funding sources from donors had to divert it to third party funding from the community. In addition to seeking funding from third party deposits, the absence of donor agencies encouraged MFIs to obtain funding from commercial markets, including the capital market (Cull, Demirgüç-Kunt, et al., 2009). This condition indirectly raises concerns for many parties because of the increased risk faced by MFI. One of them is an increasingly diverse loan product that increases MFI credit risk, therefore, encouraging comprehensive oversight of the implementation of corporate governance at MFI (Benedetta et al., 2015). Besides, this transition causes concern for MFI incumbents because they tend not to be able to include the financing interest rate, the risk they face due to the absence of collateral and dynamic incentives to secure repayment rate (McIntosh et al., 2005).

MFI COMPETITION AND SOCIAL OUTREACH

Through a theoretical model, McIntosh & Wydick (2005) proved that the existence of competition caused the reach of MFI in carrying out its social mission to be reduced. An explanation of this condition is as follows. The behavior of MFIs in channeling financing, in general, is not prioritizing profits but rather prioritizing long term effects from lending such as drop out from the poverty line. As a result, MFI needs to cross-subsidize between "rich" debtors and "poor" debtors so that it is as if the "rich" debtors finance "poor" debtors through a pool of all MFI financing customers.

McIntosh et al., (2005) research has similarities with Navajas et al., (2003) where Navajas et al. uses a variety of Conning's models to show competition between borrowers who focus on individual loans and conduct high screening quality on loans given and borrowers who focus on group lending and conduct low screening quality on loans, which are in the same market. However, McIntosh & Wydick and Navajas et al., differ in terms of Navajas et al., emphasizing the process of sorting in competitive conditions while McIntosh & Wydick focus on the interaction between the borrower's strategic behavior and multiple contracting by borrowers when there are more than one institution lenders on the market.

Assefa et al., (2013) were the first researchers to use the Lerner Index approach, as well as the measurement of competition in commercial banks, to see the impact of competition on MFIs. In general, research on MFI competition uses an ad hoc approach. The results of his research indicate that there is competition in reducing the social performance of MFI. The decrease is shown by the reduction in the number of borrowers and the number of female borrowers, even though the relationship is weak.

COMPETITION AND FINANCIAL PERFORMANCE

McIntosh & Wydick (2005) explain another condition that explains the negative impact of competition on MFIs, which is related to financial performance and the ability of MFI to conduct daily operations. According to McIntosh & Wydick, with more competition, the asymmetric information will increase. As a result, MFI becomes challenging to get accurate information. Finally, borrowers who cannot wait get incentives to get more than one MFI loan. The next effect is an increase in the average value of loans from borrowers and a decline in expected repayment rates that end in deteriorating loan quality. This increase also has an impact on the deteriorating condition of patient customers and ultimately causes poor customers not to get loans due to these conditions.

The following studies investigate another impact of competition on MFI performance. Using the MFI sample in Uganda, McIntosh et al. (2005) observed that competition did not cause MFI to lose customers but instead encouraged double-dipping or one borrower to get more than one MFI loan. The impact, repayment rate tends to decrease as well as the level of savings. The decline in deposits occurs because in general, MFI requires borrowing customers to make mandatory savings with a particular composition based on the amount of the loan obtained. The existence of double-dipping where borrowers who can get it is a borrower with good enough quality shows that between credit officers often exchange information (symmetric information). Guha & Roy (2013) and Vogelgesang (2003) found the tendency for MFI competition to cause double-dipping.

However, Kar & Bali Swain (2018) found different results. By looking at the relationship between competition in MFI with the level of profitability, they found that competition can increase profitability. In his research, Kar & Bali Swain uses a Boone Indicator to measure competition. While the methodology used is GMM to prevent endogeneity. The sample used was 568 MFIs in 10 countries with a relatively large number of MFIs namely Bangladesh, Bolivia, Ecuador, India, Indonesia, Mexico, Nepal, Nicaragua, Peru and the Philippines.

CONCLUSION AND SUGGESTION

Various studies have shown that competition harms the repayment rate and quality of MFI loans. On the other hand, the competition will affect MFI's ability to reach poor and female borrowers. However, Cull, Demirgüç-kunt, et al. (2009) found that the penetration of commercial banks had a positive effect on the social outreach of MFIs, namely an increase in female borrowers and a decrease in average lending. This condition shows the existence of the target borrower shift when MFI has to compete with commercial banks. On the other hand, Iqbal et al. (2019) and Gupta & Mirchandani (2019) found that good corporate governance could support MFI in achieving the double bottom line. Thus, research by examining more deeply how all of these things can interact with each other so that MFI competition can healthily take place.

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