Economists find kinship networks play key role to access credit

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In times of financial hardship, or when opportunities arise, the ability to borrow can be critical. Some people rely on commercial lenders, while others depend on relatives, especially in developing countries. But a new study shows that the presence of banks and relatives together are better than any one source individually.

The research, funded by the Consortium on Financial Services and Poverty (CFSP), suggests that not every household in a village needs to use the banking system directly in order to benefit in terms of buffering consumption, if interpersonal gifts and lending are widespread.

"Strikingly, an indirect connection [to a bank] is as effective as a direct connection," economists Cynthia Kinnan and Robert Townsend wrote in a paper published in the American Economic Review, "suggesting that borrowing and lending among households acts to distribute capital from formal financial institutions."

In their study "Kinship and Financial Networks, Formal Financial Access and Risk Reduction," Kinnan and Townsend used unique data from rural Thai households to examine the relationship between kinship networks and the access to formal financial institutions. Their findings show that most people smooth over short-term income shocks either by borrowing directly from a financial institution, or borrowing from someone in the village who in turn had access to bank credit.

These findings caution against evaluating financial access by comparing those who directly use the banking system to those who do not. This is likely to yield significant mis-estimates of the effect of financial access. Such comparisons may underestimate the gains from financial development in terms of smoothing consumption, because part of the "unbanked" group is actually benefitting through indirect connections to banks.

As well as examining how households smooth consumption, the authors also studied how the households finance large investments for their businesses, farms or homes. Without the ability to borrow, such investments will only be possible when a household's cash flow is high, but this may not be the ideal time to make investments. Therefore, Kinnan and Townsend examined whether connections to banks or the presence of relatives helped households to finance investments when cash flow was low. They found that to finance large investments, the presence of a kinship network was vital: those who have kin manage to finance investments even when cash flow is low. Those who are connected to banks, but lack a kinship network, could only undertake investment when cash flow was high.

Kinnan and Townsend argue that borrowing and lending from banks typically uses tangible collateral as a guarantee for the loan and without this some other guarantee is needed. The importance of kinship networks in facilitating investment is found primarily for those in occupations, such as business owners, where investments tend to be large relative to a household's net worth. In these situations, households need to borrow a large amount for investment, but may be tempted to not repay and cannot guarantee the loan with their own initial wealth. The relationships among kin guarantee the loan. "If your grandmother and other kin are keeping an eye on you, you'll do your best to repay the loan no matter what—no collateral is needed," Kinnan said.

The study relies on data from the Townsend Thai Monthly Survey, which observed a total of 531 households in 16 villages over 84 months from 1999 to 2005. Data on loans and transfers among households were matched with census data to construct a financial network of each village. The authors note that the importance of kinship networks and financial access are each well-documented, but the channels through which these effects occur and the relationship between them were not yet well understood. The unique data from the Thai survey has enabled researchers to examine the interplay between the two for the first time.

These findings illustrate that, even within poor villages, some households are much more vulnerable than others. Those without direct or indirect access to banks still rely on kinship networks to imperfectly smooth out short-term income fluctuations, and those with neither bank access nor kin remain the most vulnerable to financial disruptions. This suggests that efforts to provide a social safety net should focus especially on those who lack bank access and kin networks, such as recent migrants.

Provided by Consortium on Financial Systems & Poverty

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