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Title: Social Capital and Lending Methodology in Microfinance Industry

Microfinance institutions (MFIs) help to alleviate the poverty level by providing loans to the poorest clients who are viewed to be risky by regular financial institutions. There are two types of lending methodology employed by MFIs: group and individual. Like any financial institution MFI is a subject to adverse selection and moral hazard from customers, and group liability claims to overcome these information asymmetries. Still, despite this claim, group lending is generally employed only in developing regions. This research is undertaken in an attempt to answer the question of what factors drive the choice of lending methodology by MFI in different regions. Using data for 450 MFIs from 71 countries over period 2006- 2010 we show that there are two important determinants which are essential for the existence of group lending. First, the contract enforcement by MFIs which guarantees borrowers' compliance with contract terms. Second, social connections among group members determine the strength of peer pressure among borrowers, thus allowing groups to effectively monitor group members. Our finding imply that group lending is more likely to be employed in countries with low contract enforcement and high social connections. This combination is usually found in less developed countries, while in more advanced countries individual lending is more prevalent.