

## **THE IMPACTS OF SMALL DEPOSITS ON MICROFINANCE DEBT CONTRACT**

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The paper objective is to theoretically model the effects of micro-savings on MFI Outreach, Sustainability and Impact in a debt contract. Drawing upon theories of lending relationship and monitoring costs, the effects of micro deposits are considered both in the short term and the long term. Basically, when deciding whether or not to mobilize deposits from poor households, an MFI compares the profit it brings to its client with and without deposit funds. By mobilizing deposits, the MFI obtains 2 opposite effects: one is the information benefit created by the depositor-lender relationship and the other is cost effect generated by deposit operating cost. The MFI will refuse to collect deposit if this fund does not provide it any surplus. Gain/loss in the MFI client's profit arises when the information benefit surpasses/lowers the cost. The MFI is confronted with an adverse selection problem due to the private information about the type of borrowers. Given that low quality borrowers are not profitable in productive activity, the MFI wants to channel its funds only to high quality borrowers. Although it undertakes creditworthiness test for each borrower to reveal his type, this test is imperfect; therefore some credits will be misallocated to low quality borrowers. The information reaped from the depositor-lender relationship helps reduce the error of the test and increase the probability for the MFI's credits to come with a right person, thus increasing the MFI lending impact. This information effect of deposit may be offset by its cost. The MFI will calculate its borrower's expected profit with deposit funds and compares this to the expected profit without deposit funds to decide if it should enter the deposit market. With this framework, the model brings to light the trade-off between Outreach, Sustainability and Impact of an MFI when deposits are introduced and help answer the question "which kind of MFIs should be involved in deposit mobilization?" Furthermore, it provides some strategic implications to MFIs benefit from deposit funds.