Do religion and caste impact loan outcomes in India?

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2013-9-16

A recent study on Indian banking finds that social proximity in the form of religion or caste connections improves loan outcomes.

Discrimination is – for good reason – a word filled with negative connotation, associated with such social ills as gender inequality in the workplace; racial profiling by police; religious persecution; and unequal treatment in everything from buying a car to securing a loan.

At the same time, preferring to do business with those of one's own kind – whether in terms of gender, race or religion – sometimes happens with good reason. Often, it may be easier to assess the trustworthiness and reliability of those closer to you, and possibly also threaten retribution if they do not conduct themselves honourably. Which is more important, the pernicious impact of favouritism or the efficiency-enhancing effects of better information and 'social' enforcement? It is a question for the data to decide.

In a study on Indian banking, LSE's Daniel Paravisini, Reader in Finance, finds that social proximity is actually good for loan outcomes—that is, increased efficiency outweighs favouritism. In "Social Proximity and Loan Outcomes: Evidence from an Indian Bank," Paravisini and his co-authors, Raymond Fisman, Director of the Social Enterprise Program at Columbia Business School, and Vikrant Vig, an associate professor at the London Business School, assess whether loan officers lend more to those of their religion and caste, and also examine how religion and caste connections affect the probability of default.

Since bank personnel are rotated from branch to branch, some years borrowers will face a Hindu loan officer, and in others a Sikh or Muslim. By analysing how lending behaviour changes as a result, the researchers are able to tease out the effects of social ties on lending. Not only does lending go up when a loan officer of one's group arrives to head the local bank branch, but these larger loans are also less likely to go into default in subsequent years. Paravisini and co-authors argue that this is likely the result of officers making more loans to those from their own caste or religious background because they are better able to assess the likelihood of default, and also possibly apply social pressure to prevent default after a loan is made.

The research provides several policy-relevant insights into the role of social relationships in banking and other markets where it's hard to assess the reliability of trading partners. Most obviously, a bit of discrimination may not be a bad thing—it allows social connections to improve the quality of economic transactions. And it also provides some rationale for affirmative action policies. If underprivileged minorities – such as so-called 'backwards classes' in India – are afforded the opportunity to become loan officers, it has the potential to help their entire community gain access to much-needed credit, without exposing the bank to risky loans. Familiarity, after all, can breed good lending.