Microfinance: Lessons from a Crisis

The rural distress in Andhra Pradesh has been more than evident in reported incidents of farmers’ suicides and hunger deaths. The incidence of indebtedness, particularly among small and marginal farming households in the state, is the highest in India. By passively encouraging microfinance institutions to expand without limits in a policy and institutional vacuum, the state had created the conditions for a crisis. This is the time for finding out the pros and cons of completely trusting a credit-based poverty reduction strategy to the neglect of more critical structural and institutional solutions.

The recent crisis of microfinance in Andhra Pradesh has attracted a wide variety of responses, from both the critics and the enthusiastic supporters of microfinance. The former consider the crisis as a much-needed brake on the unhealthy and aggressive market growth of for-profit microfinance non-banking financial companies (NBFCs) without any coordination with the state government, while for the latter, the crisis is born of government intervention and not of flaws in microfinance itself.

By all accounts, the current stalemate is the continuation of the 2006 episode that broke out in Krishna district in Andhra Pradesh. It was alleged then that the strict and often “barbaric” debt recovery methods used by the microfinance institutions (MFIs), and the “explosive” growth rates of some MFI operations since the beginning of the decade, had led as many as 200 borrowers to end their lives (Kumar 2006). Several branches of MFIs were made to close operations in Krishna district. The reasons for the controversy were largely sought in the high level of competition among MFIs and the growing insecurity in the state bureaucracy and political leadership about the increasing popularity of MFIs. The state reacted quickly and sharply by putting in place helplines and constituting vigilance committees at the village and mandal levels to oversee the functioning of MFIs. The industry lobby, on its part, came to the rescue of MFIs by proposing a code of conduct for them, with a plea not to harm the prospects of the Rs 1,000 crore industry. The MFIs also offered to reduce their interest rates.

Apparently, the MFIs failed to put into practice many of their promises in the state, which reportedly led to a spate of borrower suicides during the last quarter of 2010. The state government came up with the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010, that tightly restricts the freedom of operation of the MFIs in the state. The ordinance, among other things, requires MFIs to register themselves, and prevents lending in cases where loans are already outstanding. It allows for only monthly repayments and demands the display of interest rates charged by the MFIs. Even as the Reserve Bank of India (RBI) constituted a committee to look into issues relating to MFIs, the Andhra Pradesh assembly ratified the ordinance on 15 December, thus, paving the way for a new law governing the functioning of MFIs in the state.

It is beyond doubt that the legislation casts a large shadow over the sustenance of multitude of initiatives outside the model that it hopes to deal with. The MFIs have been facing a sharp drop in repayments – reportedly 15% to 20% – across the state.

Solidarity and Social Capital

Many critical issues beg a clearer exposition in the context of the vast and diverse arena of Indian microfinance and the current models of microcredit delivery to the poor. The first one is regarding the simplistic assumption that the near-zero default rate observed in the Indian microfinance sector reflects the trust built over several years. Most of the MFIs maintain their repayment rates thanks to their close field monitoring mechanisms and not so much due to mutual trust and group solidarity. It is true that in the initial years when the MFIs were driven by the ideals of poverty alleviation and social capital formation and were more local in their orientation, strong groups and robust group dynamics were considered as virtues. Trust was the most critical resource during this phase. Ever since the gold rush began in the sector mid-way through the current decade, groups have become mere managerial categories and trust a redundant asset.

Alternative to Microcredit

The second issue is that of alternatives. If not microcredit, then what? The fear that the failure of microfinance would drive the poor back to the “failed” public sector or high-cost moneylenders is genuine. But then what evidence do we have to prove that the presence of microcredit has significantly altered the nature of local credit markets? Almost all the field studies even now show that the poor take recourse to...
moneymongers, especially to meet emergencies. This dependence cannot be snapped without making real investments in the pockets of poverty, and, thus, improving the livelihood opportunity structure.

The method of microfinancing implicit in the self-help group (SHG)-bank linkage programme had a clear focus on gradually building the poor households’ financial discipline and credit history by involving their own money saved over time – the “warm” money – in the lending operations. Once the groups attain the maturity to handle finances, the banks are encouraged to invest their “cold” money without any collateral and at market interest rates. Thus, SHGs evolve into credible and capable micro institutional structures that ensure their members access to regular loan and saving services without many hassles. More importantly, the terms of internal lending are decided by the groups and not imposed by external agencies. Unfortunately, this programme, the ideal counter to the for-profit model of microfinance intermediation, is also facing many challenges, mainly because of the gross neglect of savings and capacity-building of the groups and members. As some would argue, SHGs have become sheer credit management groups with excessive dependence on banks. A recent field study done in Rajasthan among SHGs that defaulted on bank loans showed that the savings role of these SHGs – the most significant role expected of them – has lost its primacy over the years. Between 2001 and 2010, the proportion of members with savings in SHGs declined from 93% to 42.5%. Other than the traditional collectives (rotating savings and credit associations (ROSCAS) or accumulated savings and credit associations (ASCAS) as we would like to call them like the marups of Manipur, vishis of western India or chits in almost all the south Indian villages) and the groups carefully formed and nurtured for long by NGOs, and in some cases by local cooperative banks, the SHGs have rarely shown the internal strength to fight it on their own. It is not without reason that all the success stories of the SHG movement are linked to promoter agencies – PRADAN’s federations, DHAN Foundation’s Kalanjiams and MYRADA’s credit management groups. That takes the issue squarely to the promotional agencies of SHGs – their type, role and the support they get from apex agencies like National Bank for Agriculture and Rural Development (NABARD).

Cost of Credit

The third issue is regarding the cost of credit. There is no evidence whatsoever that microcredit is a cheaper option for the poor. For a typical debt-funded MFI about half the total cost is accounted for by operational expenses, nearly 40% by financial costs and the rest by loan loss provision and margins. The only way to reduce the cost of lending is by reducing operational expenses or by accessing cheaper funds. Given the bottom heavy-structure of microcredit delivery (and the high professional salaries the sector is paying these days), it is very difficult to reign in operational expenses unless the portfolio volumes are phenomenally high. With bank interest rates in the range of 12%-14% on an average and no access to public savings, the for-profit microfinance companies are able to reduce the financial cost burden only with the help of equity support. But then equity funding does not necessarily ensure cheaper credit for the poor as the investors’ expected margins must be protected by the MFIs. All these have resulted in the microfinance sector getting deeply caught in a nexus which cannot lead to an evidently pro-poor inclusion outcome. That the large microfinance players in the market have not cared to reduce the interest rates closer to the bank rates over years of doing profitable business with the poor and realising phenomenal profitability margins, mostly through increased volumes, is evidence enough of this. This is the reason why many argue that equity-financed MFIs cannot serve as pro-poor institutional alternatives.

It may be said for the sake of the argument that the microcredit interest rates match the interest rate of credit cards or people without collateral referring mainly to the link between perception of risk and credit market imperfections. But then credit cards are used mainly for conspicuous consumption, whereas the poor need assistance for their survival. And they cannot offer collateral, because they are poor. Moreover, the group-based saving-lending model has been advocated as a pro-poor institutional arrangement as it rests on mutual trust as social collateral. The theoretical expositions of group-based microcredit stresses social collateral as this can help organisations effectively circumvent the problems of adverse selection and moral hazard that typically characterise imperfect credit markets and, thus, reduce the transaction cost.

The Ill of Overindebtedness

Overexposure to debt of poor households with fragile livelihood back-up, the other issue that needs attention, cannot be counted as just one of the benign demerits of microcredit. Many independent researchers with vast field exposure have been crying hoarse for sometime over the increasing incidence of multiple lending, resultant mainly from cut-throat competition among the expansionist MFIs. All the top line MFIs have been using collection agents (so much for social collateral and mutual trust built over years), who, for one, act more like the musclemen usually employed by private finance companies or as typical rent seekers who would maximise their returns by cross-selling microfinance clients. Many instances were reported from different parts of the country of loans going bad and clients acting defiant, but no one paid heed to these as the voices were not coming from the powerful lobby of sector leaders or intellectuals of repute.

A sector that has been hailed for its ability to deliver financial services locally using decentralised structures is now advocating

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setting up of credit bureaus to help MFIs avoid overlending. This definitely runs counter to the vision of microfinance institutions as “local” arrangements with a proper understanding of the risk profile of their potential borrowers which reduces the costs of screening as also the risk of default. Also, one is not sure how the credit bureau ensures that MFIs do not lend to already indebted households. The reported incidence of overlending is not a reflection of imperfect information on the part of the MFIs, but a smart business strategy to out-compete the rivals in markets with infinite demand for money.

The Larger Debates

And then there are the larger questions. Why did the state and the central bank encourage microfinance NBFCs to spread far and wide in the country just like the hire purchase companies? In this connection Fernandez argues that the RBI’s approach towards the fast growing MFI-NBFCs so far reflects a sense of urgency – as if it is urgent to integrate the poor into the international financial sector unlike its cautious, step by step approach towards the trade and financial sectors in general.

The RBI took actions – but they related to plans for extending financial services into the interior (Business Correspondents and Facilitators and use of technology), removal of caps on interest rates (banks could charge commercially viable rates for priority sector loans below Rs 2 lakh), etc. The RBI’s focus was on pushing the official financial system further into the interior on one hand and, on the other, a “hands off” approach as far as the MFI-NBFCs were concerned, encouraging them at most to “self regulate”! “Soft regulation” of MFIs was the policy that gained ground, because it was assumed the MFIs are local, community-based organisations which they are not. This lack of regulation/direction increased the risk of the marginalised who were “included” by the MFIs.

Ever since the MFIs embarked on their expansionist phase, they closed in on alien regions with the help of sophisticated strategic plans made by high profile consultants from the world of financial business; they gorged on local collectives to make their joint liability groups with the help of field staff often acquired from competitors by paying them a “competitive salary plus incentives”. In a remote north Rajasthan village that has a couple of failed SHGs as the women could not sustain their involvement in groups, I found poor women with large loans from a “south MFI”, whose name or address they had no clue of. They look up to them with the same eyes as they do to a local moneylender. Is this the development role of microfinance?

If microfinance is all about replacing moneylenders, then there is a merit in arguing that MFIs are able to offer credit at lower interest rates to the poor compared to the traditional players.10 But the relevance of microfinance in a developing country is that it helps the poor reduce their financial burden so that they can channelise their meagre resources productively to improve livelihood situation. Where is the evidence that the sector has been able to achieve this after close to 20 years of its existence?

Conclusions

There is no doubt that the last few years saw a gold rush in the Indian microfinance industry. This should necessarily be followed by a period of moderation, sound consultation and policy rationalisation not only on the pros and cons of microfinance, but also on the pros and cons of trusting so completely a credit-based poverty reduction strategy to the neglect of more critical structural and institutional solutions. It may be noted that the incidence of indebtedness, particularly among small and marginal farming households, in Andhra Pradesh is the highest in India. The “rural distress” in the state has been more than evident in reported incidents of farmers’ suicides and hunger deaths. This distress, argue Ghosh and Chandrasekhar (2004), cannot be seen as resulting from “leaving out” or “excluding” the rural poor from the process of liberalisation. Instead, they have been “forced into market relations that are intrinsically loaded against them”.11 They have not been marginalised and excluded; instead, they have been incorporated and integrated into market systems in which their lack of assets, poor protection through regulation and low bargaining power have operated to make their material conditions more adverse. The problems that plague the rural production system in Andhra Pradesh (as is elsewhere) are too complex to be handled only by a strong rural credit system. As Reddy and Galab (2006) point out, “the declining importance of agriculture and prolonged policy indifference towards finding appropriate technology and marketing solutions have contributed to the agrarian distress in the State”.

By passively encouraging MFIs to expand without limits in a policy and institutional vacuum, the state had created the conditions for a crisis. It is unfortunate that the sector had to falter finally before the wise manoeuvrings of provincial politics. But then in a democracy you cannot prevent collectives from political articulation of the problems and aspirations of the masses and build a managerially sound financial business using their resources.

This is perhaps the time to restart the older debates as to how to help the poor build and strengthen their resource base. This is also the time to ask under what circumstances and in what institutional form should microfinance figure in the list of anti-poverty strategies. And more importantly, it is high time that we carefully design a macro policy for financial inclusion by calibrating the relevant policies of commercial banking, cooperative credit and microfinance, rather than trying to patch together fragmented efforts like the financial inclusion project of RBI, cooperative reform efforts and the ever-evolving microfinance bill. The apparent divergence between the thinking of national policymakers and the local political administrative structures, the passivity of apex institutional agencies and the disturbing vacuum in the institutions that represent the indebted poor appear to make the last task a difficult one to achieve in the near future.

Postscript: Malegam Report

The sub-committee constituted by the RBI (under the chairmanship of Y H Malegam) in the aftermath of the AP crisis to study issues and concerns in the microfinance sector related to regulated MFIs submitted its report this month.

The Malegam Committee recommended the creation of a separate category of NBFC-MFIs. These NBFCs should hold more than 90% of their total assets (excluding cash, bank balance, and money market instruments) as qualifying assets. Loans for income generation purposes should cover 75% of the loans, individual loans should
not exceed Rs 25,000 and the borrowing household’s annual income must not be more than Rs 50,000. The recommendations also cover the loan tenure – should be less than 12 months for amounts less than Rs 15,000 and 24 months for others. Further, the NBFC-MFIs that do not qualify to be MFIs cannot extend micro loans beyond 10% of their total assets.

The committee also recommended interest rate and margin caps for NBFC-MFIs. While the interest cap is prescribed as 24% for all personal loans, the margin cap varies based on the outstanding loan portfolio of MFIs – for Rs 100 crore or more the margin cap is 10% and below that, 12%. The cost of loans will have only three components – processing fee (less than 1% of the loan amount), interest, and insurance premium.

It also responded to the anxieties regarding over-lending and multiple borrowing by prescribing a single membership norm for individual borrowers and by restricting the number of MFIs servicing the same client at two.13 Borrowers must be granted a minimum period of moratorium before repayment begins.

The committee recommended that NBFC-MFIs maintain a capital adequacy ratio of 15% (up from the current norm of 12%) and a minimum provisioning of 1% of the outstanding loan portfolio against loan losses. The other option will be to provide for 50% of the overdue instalments of between 90 and 180 days and 100% for those above 180 days as loan loss provision. While ensuring the onus of ensuring coercion-free recovery of loans on the MFIs, the committee suggested that a common client protection code, along with credit bureaus and the institution of an independent (and preferably mobile) ombudsman could constitute appropriate monitoring arrangements.

While the Malegam Committee report displays an overenthusiasm to regulate all the minute aspects of microfinance business – the loan size, interest rate, margins, borrower eligibility, etc – it has offered practically nothing towards curing some of the structural and systemic ills that dog the sector. The recommendations look more like a band-aid strategy to thwart an immediate crisis, without really hurting the interests of the large NBFCs with substantial stakes in the sector. The caps on interest rate and margin may look like a major corrective measure; but without a detailed diagnosis of the structure of the MFI sector and a systematic analysis of the availability, cost, and sources of loan funds across various size classes of MFIs, the prescription looks quite arbitrary and biased in favour of the big NBFC-MFIs, who have deep pockets and will be able to manage any drop in profitability on account of lower margins. The small and emerging ones will find it difficult to survive, given the size of their asset base and no assurance of affordable loan funds from the banking sector. A volume and profitability linked interest regulation would have ensured effective competition in the sector. The recommendation to raise minimum net worth to Rs 15 crore and capital adequacy ratio to 15% for an NBFC-MFI are also likely to help the big players who can attract more equity capital as they have already proven their mettle to private investors. And with their ability to leverage equity to secure subsidised bank loans, they have nothing much to worry about. It is clear that committee considers consolidation within the industry an inevitable eventuality and has aligned its recommendations to such a structure.

Again, the recommendations regarding an income ceiling on borrowers’ income and the extent of indebtedness as eligibility conditions are very slippery ones. In a country where personal income estimates are so notoriously imperfect, especially of those who are engaged in agriculture and unorganised economic activities, the impact of this condition on the conduct of the sector seems marginal.

Many recommendations are based on the seemingly arbitrary assumptions or conclusions of micro studies which can be generalised only in a limited fashion. For instance, while specifying the regulations the sub-committee observes: “Most MFIs consider a low-income borrower as a borrower who belongs to a household whose annual income does not exceed Rs 50,000. This is reasonable definition and can be accepted” (Section 5.2, p 6: emphasis ours). Similarly, the committee’s suggestion to limit non-income generation loans to 25% or less is informed by a single study done in Andhra Pradesh on a sample of close to 2,000 borrowers. One would expect a committee that is vested with the critical responsibility of defining the contours of a significant, yet contested sector, to apply more caution and wisdom while making recommendations. A clear lack of understanding about how microfinance interacts with the diverse contexts of livelihoods is evident here.

The assumption that the creation of a separate category of NBFCs in the MFI sector would solve the problems of unhealthy competition and over financialisation of micro lending is rather naive. Interestingly, the Malegam Committee, by its own admission, has abstained from expressing any opinion on the matter of the impact of private equity in microfinance, which, in fact, should have formed an important term of reference. By trying to regulate too much that can potentially have too little impact on the current conduct of the sector, the Malegam Committee has also created effective barriers to meaningful product and process innovation within the sector.

NOTES
4 Reddy, op cit.
5 Banerjee et al (op cit).
7 Reddy, op cit.
8 Banerjee et al (op cit).
10 “The MFIs, however, are less abusive, as well as far cheaper, than traditional moneylenders”, argues the Economist. See, “Under Water”, The Economist, 9 December 2009.
12 One is not sure how such contradictory conditions will be translated in practice.

REFERENCE