Microfinance: A Fairy Tale Turns into a Nightmare

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It was inevitable that the commercial model of microfinance in India, with its minimalist and standardised model of lending, would grow into a bubble and run into trouble. Many microfinance commercial organisations have entered the market in search of profits and are competing to lend to the poor. In the process they have put the "understanding" of the needs of the poor aside and have started chasing targets and numbers. For these institutions, the poor are not seen as human beings having individual identities and needs. Instead they are seen as data points that add up in their profit statements. The anxiety for growth is dictated by the fact that the investors in the market-based models are impatient and look for high returns – and then exit!

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There is a new intensity in the discussion on microfinance – about multiple lending, interest rates and on whether a bubble is being built around lending to the poor. There is a heated debate about the interest rates of microfinance institutions (MFIs) and whether they could be termed usurious. There has also been a boardroom fracas at SKS Microfinance – an event unrelated to the larger one about the delicate relationship between MFIs and their clients, but it is nevertheless hogging equal headline space in the press. The commercial section of the industry has reacted with the industry association – the Microfinance Institutions Network (MFIN) – coming out with a code of conduct. The State has indicated its displeasure about the level of interest rates and it has sent an advisory to the commercial banks. The Government of Andhra Pradesh, facing a lot of flak from the local press and the opposition parties, has promulgated an ordinance in order to "rein in" MFIs.

There is indeed a sense of déjà vu to the entire episode – of a crisis following heady success. The success had culminated in the oversubscription of the SKS Microfinance initial public offering, allotment of shares at the upper end of the indicative price band, listing of the scrip at a premium, and its continuous rise thereafter. As this was sinking into the minds of the players in the microfinance market – and with the next rung of institutions ready to harvest the gold rush – the same SKS Microfinance was in the news for all the wrong reasons.

Three Models

This article looks at the growth in microfinance, keeping the current developments in perspective. But before looking at the current episode, it is important to have a perspective on how the microfinance space is organised and who the different of players in the market are.

At this point of time there are three significant interventions in the provision of universal access to financial services.

(1) The people's movement which has existed outside of the government schemes, banks and other interventions by entrepreneurs. This is led by non-governmental organisations (NGOs) that have remained true to the community-based model and have emerged by organising people to sort out their financial mismatches without the intervention of the external world, and if there is an intervention it is a conscious choice collectively exercised by the people.

(2) The intervention by the government pre-existed the people's movement and was expressed in the form of the self-help groups (SHGs). This has usually been supply-driven, addressing the institutional and physical infrastructure needs and offering standardised supply-side solutions or "schemes". In Andhra Pradesh the State has almost usurped the community model through the Indira Kranti Patham scheme (earlier known as Velugu). Clearly the role of the government in Andhra Pradesh has moved beyond being an independent observer. In this case the State is in a peculiar position of being a player as well as an arbiter of microfinance practices.

(3) The market forces, which look at the poor as a market, have found a mechanism to deliver credit through an efficient delivery model. This approach is more than a decade old and has made rapid growth. This growth has encouraged us to look at the business through a different lens.

Each of these interventions has a different approach and uses a different methodology to reach out to the poor. These methodologies have an important bearing on the process and packaging of financial services.

The SHG model was promoted as an alternative to the available options of financial intermediation. It was at one level rooted in the community and at another level was integrated with the larger banking system. The dealings were on the basis of mutuality, thus providing

the power of a collective. The approach, by definition, was a slow one because there had to be a good understanding on how a collective based on the principles of mutuality worked. It required patience, tolerance and an appreciation of the constraints that the fellow SHG members faced. It made members think about their financial services needs of their households, and also those of their neighbours who were members of the collective. This helped the members think responsibly because they were dealing with their own money or the money of the members of the collective. This methodology ensured that people were together to narrate a growth story, a story of their confidence and how they were taking charge of their own lives.

This movement is very time-consuming. The collective has to go through the many phases of forming, storming, norming and performing.[1] Even if the process is slow, the edifice will be strong and lasting. This edifice can continue to serve the poor and the marginalised on an autopilot basis once it stabilises. Once this happens, it shows that the poor can not only take control of their resources, but as these resources grow they can hire professional help to manage their resources. This transformation does not happen overnight, but through a long process of community intervention.

Unfortunately, there is impatience, and then there is the State. If the groups succeed, there is an urge to replicate the model quickly across the country. The success of community-centred microfinance has attracted the government. The State deals with large numbers and its anxiety to deliver development at a pace that can do justice to the incumbent combination is understandable. The State learnt quickly from the SHG movement and decided to adopt it as one of its "schemes". The bank linkage programme has been going on for years, and each year the government increases the targets to the banks for linkage and ports several other welfare schemes on to the groups.

Market for Inclusion

The last type of player in the inclusion market is a product of market forces. In the last decade there have been several people who for years worked in the development sector with communities and became impatient for growth. They embraced a market-based model of inclusive finance. The idea was that if we are able to make this activity of inclusive finance inherently profitable, then more and more people (who work for profits) will see merit in operating in this market. And with a good number of players, the market will not only expand, but because of competition the poor customers would eventually get a good deal.

Unfortunately there have been numerous instances where our belief in the market has been belied and microfinance adds to the scepticism about the school that believes only in markets. During the initial phases of the intervention by the market model of MFIs, most of us looked at the growth of these organisations with a sense of awe. These organisations brought efficiency to their operations. But gains in efficiency are usually a function of standardisation.

Standardisation worked at two levels: (a) The organisations themselves offered standardised products, that allowed them to reduce operating costs. (b) The individual identity of each organisation and what it stood for vanished. In the field one could therefore see little difference between one MFI and the other.[2]

Rhyne (2001)[3] writing about MFIs in Bolivia has said that the institutions tend to converge operationally to the dominant microfinance paradigm. The paradigm of commercial microfinance is that of minimalism. That credit should be provided efficiently and quickly and a sharpening of financial viability have influenced institutions operating in this space.

Bolivian Experience

In microfinance itself, there were significant lessons to be learnt from Bolivia. For instance, Rhyne indicates that the number of institutions that had a subsidy drastically fell in about four years, and each of these institutions lost its core identity. FIE, an MFI known for technical assistance to a single community-based enterprise, Fades, which used to focus on lending for community infrastructure projects, and ProMujer, which specialised in empowerment training; all dropped most of the operational practices that differentiated them from the dominant paradigm.

This "convergence" is happening in India as well. The minimalist model disburses credit in as efficient a manner as selling soaps and shampoos. It has its merits. For instance, in a largely agrarian society where large cash inflows take place only during the harvest season and

the local economy operates on peaking of financial activity in this season, forcing a weekly repayment is by definition defying the logic of agrarian cash flows. However, by forcing this weekly discipline these institutions have possibly expanded the market for credit – persuading people to think about activities that give a weekly cash flow that can service their loan. This could thereby have made more cash move through the hands of people and reduced their vulnerability.

However, the downside of a standardised model is that unless the cultural and economic nuances of each location are understood,[4] there could be cracks. A standardised model closes innovation, reduces responsiveness and prevents customisation and once it reaches stability it expects to grow at a scorching pace. When something – particularly in financial services – grows at an unnatural pace, it is going to build into a bubble sooner or later. Such a process in the market-based microfinance sector may be happening now.

The hope that the demonstration of one market-based experiment will attract more players has come true. Many more organisations have entered the market and are competing to lend to the poor. In the process they have put the "understanding" of the needs of the poor aside and have started chasing targets and numbers. For these institutions, the poor are not seen as human beings having an individual identity, characteristic and need. Instead they are seen as data points that add up to their profit statements.

This anxiety for growth is dictated by the fact that the investors in the market-based models are impatient and look for returns (and then exit!). The evidence from Bolivia is available before us. Microfinance in that country went through a phase of intense competition, leading to over-indebtedness and even the collapse of a few institutions. A reading of the microfinance movement of Bolivia in the 1990s looks like a contemporary Indian commentary. All the elements – client poaching, competition, reckless lending, over-indebtedness of the client – that eventually caused cracks in the efficient credit delivery mechanisms were present in Bolivia.

Effects of Rapid Growth

One of the visible indicators of the standardised model is its religious belief in zero tolerance of default. The organisations following the market model have possibly seen too much of indiscipline in the delivery of credit to the poor and have realised that this is one variable that has to be controlled at all cost. The story of organisations having a near 100% recovery rate for years is a fable difficult to believe, given that no household or economy can be insular to shocks all the time. Yes, the commercial models have been able to control one cause of default – intent. But it is well known that default also happens when the ability to repay is impaired. The new generation of MFIs has possibly not learnt to deal with this aspect. For a long time, while the MFIs were growing at an unnatural pace through geographic diversification, the borrowers were probably growing at a normal pace. With competition setting in, more and more MFIs concentrated on the same geographies. With the client getting multiple choices and the anxiety of the client to get as much of finance as possible from multiple institutions and this coupled with the overzealous suppliers of credit meant that the client herself was trying to grow at an unnatural pace, or that the client had begun to resort to adverse usage of credit. Unfortunately the standardised models

do not have the patience to engage with the client.

It is one thing to justify the high cost of credit at lower levels, but we also have to realise that at higher levels of indebtedness, interest rates become onerous from the point of view of the poor households. Servicing five MFI loans of Rs 10,000 each at 28% is not the same as servicing one such loan. And since the MFIs have not provided themselves with a mechanism of coping with default, the pressure on the borrower turns out to be intense. And this pressure could potentially lead to suicides.

We do not know whether the current spate of suicides in Andhra Pradesh is a result of the MFI loans and the intense repayment pressure on the clients. These are claims made by the state government. Vikram Akula, the chairman of SKS Microfinance acknowledged that 17 of the 30 suicide cases were related to borrowers of SKS (*Indian Express*, 15 October 2010). However he is not helping the cause of the MFIs by stating that "the deceased borrowers were not defaulters of SKS and they would have been driven to suicides by other factors such as pressure for repayment of dues by other MFIs that lent money to the same borrowers" (*Mint*, 15 October 2010). The collective response of the microfinance institutions has also been found wanting. All that they have offered is a code of conduct, which is observed in violation! A meta level credit bureau makes a mockery of what is clearly acknowledged on the field. You do not need a database of clients and loans. The clients themselves are openly talking of multiple borrowings.

Governance Issues

Unfortunately, the celebration of the market endorsement of this business at the "bottom of the pyramid" could not have been more ill-timed. At the ground level, the stress was showing. Clients (for whatever reasons) were committing suicides. At the institutional level, it appeared that the boardroom battles were all about stock options, cashing in, cashing out and severance packages, when each of the boards should have been discussing whether their business model was showing cracks. Instead of being introspective, the response of the MFIs has been stubborn and defensive.

State Response

The response of the State has also not been in the desirable direction. Obviously, all the action is centred around Andhra Pradesh which has the highest concentration of MFIs and the largest exposure through the SHG-Bank linkage model. The government has responded with a heavy hand by passing an ordinance that has shifted the discourse from the basic problem to a legal frame. This almost appears like the government taking revenge on the competition with its monopolistic regulatory power.

While there are nuances in whether the Government of Andhra Pradesh has the ability and the inclination to digest the administrative implications of the ordinance, it has once again shown its inability to target the errant microfinance institutions, and has instead come down heavily on the entire market. Given that the State itself is a dominant player in this market, this heavy-handedness creates an undesirable competitive barrier to an alternative model of credit delivery.

Instead of harping on caps on interest rates and threatening to remove microfinance from the priority sector list, it is necessary for the State/Reserve Bank of India to look at specific instances and pull up the delinquent organisations. The RBI has set up a committee to look into the issues pertaining to MFIs and has asked the committee to submit a report within three months. But what is not clear is why the RBI is not carrying out a routine inspection of the portfolio of some MFIs that are under its purview in order to understand the issues of ghost clients and multiple borrowings and take action to discipline the erring organisations.

Some of these organisations have serious governance issues that are not being investigated. The institutional representatives on the boards of these MFIs have not exercised their independence. The promoters have gotten away with significant instances of skimming and there seems to be no dissent voiced on the greedy executive compensations and short-sighted behaviour of the management of the top MFIs.

So on the one hand, while the larger directional of the movement of the State/RBI in terms of financial inclusion seems to be good – directing payments through banks, calling for financial inclusion plans, opening up branch licencing, removing the cap on end use interest rates and so on – its response to the rapid growth of microfinance has been somewhat alarmist. Hopefully the State and the RBI would do what is well within their mandate in specific cases. This would be a superior approach compared to the policy-level clampdown that they have been talking about.

NOTES

1 See Kanitkar (2002), "Exploring Empowerment and Leadership at the Grassroots: Social Entrepreneurship in the SHG Movement in India" in Fisher and Sriram, *Beyond Microcredit, Putting Development Back into Microfinance* (Delhi: Vistaar).

2 As an aside, during a recent trip to Bhopal, I found that in one of the interactions with the women borrowers of microfinance a lady started introducing herself as "a member of Spandana for three years" while the meeting was of the group Samhita. She was nudged by her co-members to remember the right group.

3 Elisabeth Rhyne (2001), *Mainstreaming Microfinance* (Connecticut: Kumarian Press).

4 This is another instance from Bhopal: The women borrow from three to four MFIs. Each have weekly meetings on a specified day of the week. They said that if in a month there were five Mondays, it would increase their instalment payments by another 25%.