REPAYMENT TROUBLE

The rising threat of microfinance defaults

Loan-takers may find it difficult to repay debt with the industry likely to tighten norms to avoid bad loans

By Ruth David
feedback@livemint.com

MUMBAI

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Savita Ramesh Rathore stood at the door to her dimly lit workshop in Mumbai's Dharavi slum, filled floor-to-ceiling with bundles of old clothes, and tallied up the cost of her son's wedding last year.

"Jewels, clothes, food, the town hall," said Rathore, 50, who makes towels from discarded clothes. She borrowed Rs30,000 from moneylenders charging 60% interest and took additional loans from friends to pay for the wedding. Three months ago, she got a Rs10,000 loan from urban lender **Hindusthan Microfinance Pvt. Ltd** to repay some of that debt.

Rathore is one of 25 million Indians who have taken so-called microfinance loans, often without adequate documentation or collateral, according to **Micro-Credit Ratings International Ltd**.

As Hyderabad-based **SKS Microfinance Pvt. Ltd** plans to become the first such lender to go public in the country, an industry credited with helping alleviate poverty may come under pressure to tighten loan standards to avoid a pile-up of bad debts.

"Globally, microfinance is showing characteristics of the Western financial markets before the collapse," said Sanjay Sinha, managing director at Micro-Credit Ratings in New Delhi. "In the US, homeowners were given loans at 120% of the value of their properties. In rural India, people are being lent to at 150% of the value of their enterprises."

The implosion of the US market for subprime mortgages to people with poor credit histories helped trigger a financial panic and almost $1.8 trillion (Rs84.06 trillion) in losses and write-downs at financial institutions worldwide.

Microfinance, which focuses on loans in poor areas largely shut out from traditional banking services, gained prominence globally when Muhammad Yunus won the Nobel Peace Prize in 2006 for his role in founding Bangladesh's Grameen Bank. Yet the past two years have been marked by surging defaults in some countries.

Microfinance markets in Nicaragua, Morocco and Pakistan have seen default levels climb to more than 10%, the threshold that marks a "serious repayment crisis," according to a February report from Washington, DC-based policy and research firm Consultative Group to Assist the Poor (CGAP). Delinquencies in Bosnia and Herzegovina stayed below that level only because of "aggressive loan write-offs," the report said.

While there has been no evidence of a "widespread repayment crisis" in India, "a number of industry analysts have highlighted industry vulnerabilities," the report said.

Indian microfinance firms have reported bad-loan ratios of about 2.5% on average, Micro-Credit's Sinha estimated. Actual levels may be higher, in part because some lenders roll over loans to struggling borrowers to avoid defaults, he said.

Most microfinance loans in India range between Rs5,000-20,000, according to an October 2009 report by Crisil ratings, the local unit of Standard and Poor's. The country, where more than 600 million people live on less than $1.50 a day, is the world's largest microfinance market, according to a March report by CGAP and **JPMorgan Chase and Co.**

Interest rates range from 18-33%, according to Vijay Mahajan, chairman of Hyderabad-based Basix Group and president of the Microfinance Institutions Network, an industry lobbying organization. Indian banks typically don't lend directly to microfinance customers.

Microfinance lending in India may surge by about 40% annually over the next few years, said Sinha, whose company provides ratings services to potential investors.

SKS, betting that the potential for growth will attract investors, sought approval from India's capital markets regulator in March for an initial public offering and picked **Kotak Mahindra Capital Co.**, **Citigroup Inc.** and **Credit Suisse Group AG** to manage the offering. The company hasn't said when it will sell stock.

Sequoia Capital, one of **Google Inc.**'s and **Yahoo Inc.**'s early investors, began buying shares in SKS in March 2007. It plans to sell less than one-third of its holding in the IPO, according to the filing SKS made in March.

"The market is only 15-20% penetrated today," Sumir Chadha, managing director of Sequoia Capital India, said in a 6 May interview. "So even though microfinance has been growing at stupendously high growth rates for the last four-five years since we first invested in the sector, we expect it to continue to grow at very high rates for the foreseeable future."

SKS, which mainly provides loans to poor women in rural areas, said its borrowers climbed almost 20-fold to 3.95 million in the three years ended 31 March 2009. Loans outstanding increased more than 18 times in the period, to Rs1,420 crore, and profit jumped almost 49 times to about Rs80.2 crore, SKS said in the March filing.

Vikram Akula, SKS founder and chairman, sold all his shares to **Tree Line Asia Master Fund (Singapore) Pte** for $12.9 million on 10 February, according to the filing. Akula, a US citizen, was paid Rs70 lakh in salary for the fiscal through March 2009 and holds 2.68 million stock options that he agreed not to sell within three years from the listing.

Stricter norms: *(top) A glove-making workshop in Dharavi in Mumbai, and (above) employees at Hindusthan Microfinance's office. Microfinance lending in India may surge by about 40% over the next few years.*

"While there is nothing legally wrong in the encashment process, it does raise a larger question" about executives' commitment, M.S. Sriram, a former professor at the Indian Institute of Management, Ahmedabad, wrote in a working paper published in April.

Akula and senior SKS executives who have sold their holdings declined requests for interviews, spokesman Atul Takle said, citing a quiet period before the IPO.

Runaway growth at microfinance firms masks an erosion of lending standards and a lack of regulation that may help spark rising defaults, said Micro-Credit's Sinha. India doesn't have a nationwide system for tracking borrowers' credit histories, making it hard for lenders to check whether clients have multiple loans.

Increased regulation may force lenders to boost provisions, hurting profits, said Sandip Sabharwal, head of portfolio management services at Mumbai-based **Prabhudas Lilladher Pvt. Ltd**.

If "there is more transparency, whether profitability will be the same remains to be seen," he said. "From an investor standpoint, the risk is that the huge profitability we see today may not remain going forward."

More microlenders will likely tap equity markets, said Basix Group's Mahajan. Until now, they have relied on loans and grants from banks, insurers and foundations for funding, he said.

"An IPO is inevitable for any microfinance company that has crossed a certain size," Mahajan said. "The money needed to maintain capital adequacy standards and finance future growth at that point is too much to expect from just the banks or private equity investors."

Basix, which focuses on poor households in rural areas and provides loans averaging about Rs3,000, may sell shares in an IPO next year, he said.

Spandana Sphoorty Financial Ltd, **Share Microfin Ltd**, **Bandhan Financial Services Pvt. Ltd** and **Asmitha Microfin Ltd** are among rivals likely to consider selling stock this year because of their size, Mahajan said.

While raising money from private equity investors is an option, "we are also keen to tap the stock markets by listing shares," Padmaja Reddy, managing director of Spandana, said in an email. Vidya Sravanthi, managing director of Asmitha Microfin, said in an email that the firm may seek a listing, "but not this year".

Udaia Kumar, managing director of Share Microfin, and Bandhan managing director Chandra Shekhar Ghosh didn't return calls seeking comment.

"There is significant investor interest in microfinance companies' public issues, but it's being driven by irrational exuberance," said Sinha. "Investors aren't fully factoring in the risks involved in unsecured lending to an over-marketed segment that also becomes politically charged at election time."

Former finance minister P. Chidambaram had in February 2008 announced a $15 billion waiver for farmers' debts, seeking to shore up rural support before general elections. The move was partly in response to almost 200,000 suicides among Indian farmers since 1998.

"Rural lending is more difficult than urban lending," said Amit Kalokhe, a loan officer at Mumbai-based Hindusthan Microfinance. "If there's a bad monsoon and the farmers lose their crops, our money can go along with it that year."

Hindusthan Microfinance tries to reduce risk by making borrowers pay an 8% deposit and lending to groups of people rather than to individuals, founder Anil Jadhav said in an interview in Mumbai. "That way, if one person defaults, others can pay the amount," he said.

The Rs10,000 advance to towel maker Rathore in Mumbai was part of a loan to a group of women, according to the company.

Another proposed safeguard is the Microfinance Institutions Network, which was set up by the largest microlenders in India and represents almost 80% of the industry, according to a 9 March statement from the organization.

The entity, whose board includes Basix's Mahajan and SKS Microfinance chief executive officer Suresh Gurumani, created a credit bureau to improve risk management and "ensure multiple borrowing and over indebtedness is checked", the release said.

Lenders' efforts at self-regulation may not be enough, said Ramraj Pai, a director at Crisil.

"Central regulation is critical for the continued growth of the industry and to open new doors for funding," Pai said.

In March 2007, the government proposed the Micro Financial Sector (Development and Regulation) Bill in the lower house of Parliament, seeking to strengthen oversight.

Under the Bill, the National Bank for Agriculture and Rural Development would oversee the industry, and microfinance companies would be forced to set aside 15% of profit each year as reserves. The legislation lapsed when Parliament was dissolved before the 2009 general election.

As the push for greater state oversight stalls, Rathore is already mulling how to finance the next major outlay: her 19-year-old daughter's wedding.

"Once my present loans are paid off, I know there will be more," Rathore said from the doorstep of her workshop, looking past the open sewage drains at the two-room home with a tin-sheet roof that she shares with four family members. "The cycle doesn't end."

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