The Evolution of India's microfinance market – just a crack in the glass ceiling?

Schmidt, Oliver

1 December 2010

The Evolution of India's microfinance market – just a crack in the glass ceiling?

Reflections on the 2010-microfinance-crisis in Andhrah Pradesh (South India)

Abstract

A crisis of microfinance in Andhra Pradesh (AP) is of highest interest to microfinance practitioners and scholars and politicians around the world, because some of the world's largest microfinance institutions (MFIs) are based out of AP. The current crisis has shaken microfinance in India and beyond and fuelled a heated debate on the (de)merits of commercialization, going public and credit-drive of MFIs. However, regulators and politicians are liable for creating an adverse institutional set up (or 'choice architecture') – in many places but in India even more. The article shows which poor choices of MFIs flowed from the adverse choice architecture. In particular it highlights the failure of India's regulators to create formal space for micro-savings and the tendency of politicians to look at (rural) credit as a means of patronage. It concludes that the current crisis is an expression of changes in power relations within MFIs, among practitioners in the MF sector and between the MF sector and the polity/community it operates in.

1 Introduction

"[P]overty is not the result of rapacious financiers exploiting the poor. It has much to do with the lack of financial institutions, with the absence of banks, not their presence. Only when borrowers have access to efficient credit networks can they escape from the clutches of loan sharks, and only when savers can deposit their money in reliable banks can it be channeled from the idle rich to the industrious poor." (Ferguson 2008:13).

Microfinance has created opportunities for millions of people at the "Base of the pyramid (BoP)"; people who live on meager pay for hard, usually unhealthy and often dangerous work; pay that flows erratically and unpredictably. Most of those millions of people live in India, and the largest fraction of Indian microfinance customers live in the South Indian state of Andhra Pradesh. Moreover, Andhra Pradesh is the heart chamber of 'mega-trends' – meaning shapers of microfinance all around the world – of the microfinance industry: (i) credit-driven microfinance, (ii) scaling up and going public; (iii) self-help group methodology, (iv) inappropriate regulation, (v) political interference, (vi) market-based 'livelihood-services', that is roughly a combination of microfinance and agricultural extension.

Thus, a crisis of microfinance in Andhra Pradesh is of highest interest to microfinance practitioners and scholars and politicians around the world. After a brief on the microfinance crisis in Andhra Pradesh (section 2), this article discusses its effects on four of the six 'mega-trends' of microfinance (section 3-6). For reason of space, we shall neglect here a deeper discussion of the SHG-methodology, see e. g. Seibel (2005); latest data – NABARD (2010), on group-based microfinance - Schmidt (2010). It might be noteworthy that there is a spread of 'rediscovery' of this approach among development agencies and practitioners; which is influenced by the issues discussed below. We shall also neglect to look into the 'livelihood-services', because they do not constitute a 'mega-trend' presently; rather a 'mega-trend' hoped to be in the making, see exemplarily BASIX (2010). Section 10 offers a concluding outlook.

2 In a nutshell: The 2010-AP-crisis so far

The second crisis of microfinance in Andhra Pradesh (after 2006[1]) is the co-appearance of two events: On the one hand, cyclically surging suicide numbers among the desperately poor – usually at the end of a prolonged drought or in the aftermath of a poor harvest – receive local and national media coverage in India. On the other hand, Andhra Pradesh based SKS Microfinance, since 2010 the largest microfinance institution (MFI) in the world, had just successfully listed at the (Mumbai) stock market; in the aftermath of that listing, it went through some governance pains (see exemplarily Arunachalam 2010)

Hence, media intertwined the personalized stories of desperate poor people, some of which are customers of MFIs, maybe even of SKS Microfinance, and the personalized stories of a few inconceivably rich people who are busy engaging in fishy and narrow-minded quarrels. It might seem apparent to link these rich – who, judging by their quarrels, are of questionable characters and/or competence – to those poor who are so desperate suicide.

The state government of Andhra Pradesh responded by an "ordinance" – a government regulation meant to precede a legislative act – which stipulates that

- MFIs must register their activities (branches) at district level,
- any MFI executive who applies or orders coercive measures against borrowers or their families would be punishable by imprisonment of up to 3 years,

[1] "During a visit of the Chief Minister [head of the state government of Andhra Pradesh] to neighbouring Guntur district in April 2005, complaints by MFI borrowers were brought to his notice by local politicians and DRDA officials, the agency at the district level responsible for implementing Velugu […] In response to a demonstration involving stone-throwing by a group of irate borrowers led by a local politician outside a SHARE branch in Krishna district, demanding the return of house title deeds which had been retained as security for housing loans SHARE was making, […] on the night of March 8, 2006, the Collector (district officer) of [Andhra Pradesh] Krishna district seized the records and closed about 57 branches of Spandana and SHARE in the district, the two largest MFIs in the country, as well those of a few smaller MFIs.[…] The move received widespread publicity, especially in the local Telegu press, expressing support through wildly partisan news reports and editorials. […] Borrowers were given the impression that they need not repay MFI loans since the MFIs had violated a number of laws, including criminal laws. About 300 cases are reported to have been filed by the revenue authorities during the next few weeks. While many of the branches were soon reopened, field staff were reluctant to continue operations in view of the hostile atmosphere […]. It is widely reported that borrowers were informally told by government staff that they need not repay since their loans would be taken over by the government or other banks at the rate of interest charged by Velugu (popularly referred to SHG programme, which in AP is assisted by the World Bank. […T]he state government stands committed to subsidise whatever excess of interest over 3 per cent the SHGs have to pay […])." (Ghate 2006:61/62)

- MFIs are prohibited from charging interest in excess of the principal amount.

As part of the registration, MFIs are asked to report the effective interest rates they charge; which were found to range between 25 and 35% p. a. A state high court petition against the ordinance by MFIs was rejected; however ultimately the authority for regulating MFIs lies with the Reserve Bank of India (RBI) and the national government. The latter has announced to present a bill upon the report of the Malegam-committee, due in January 2011.[2]

3 Credit-driven microfinance

India is home to the largest credit-driven microfinance operations in the world. Among the 10 largest MFIs worldwide, by number of active borrowers, are 4 from India. 3 of them are based in Andhra Pradesh. 9 out the 10 – including all the Indian ones – 'replicate' a variety of the 'Grameen model': Borrowers form a joint liability group (JLG) of five. The five members receive loans in turns, all five are at any time jointly liable for timely repayment, should the borrowing members fail to pay. The MFI clusters four to six JLGs groups into a center (Schmidt 2010).

Among the majority of practitioners, it is now common understanding that savings are more important than credit in the sense that much more people – poor and less poor alike – desire a safe and reliable place for saving, and will use it if available, than people who desire to take on debt. Comparative effectiveness studies indicate that MFIs that offer both savings and credit tend to perform better than MFIs that are geared to one of the two. This is borne out by Collins et al (2009), who show that poor clients live rich financial lives – not rich in terms of amounts of money, but rich in terms of variety of financial instruments which encompass and permanently intertwine savings and credit.

Grameen Bank, founded by and jointly awarded a Nobel Peace Prize with Mohammed Yunus, fundamentally re-engineered its credit-driven business model. Under Grameen II, a flexible personal savings account has become one of the most popular products of the bank.

There are two fundamental differences between credit-only and savings-mobilizing MFIs:

- Operationally, building trust for mobilizing savings is a very different business from building a lending-organization (Schmidt 2008).
- Financially, a credit-only-MFI has a loan fund restraint. Either it is an intermediary lender – borrowing 'wholesale' and lending 'retail. In this case its borrowing is expensive and its 'retailing' narrowed to loans that have shorter tenures than the wholesale loan. Or it lends out of its own capital. In this case it has to attract equity by realizing high returns on the same and its credit operation has to have an over-proportional (as compared to lenders who intermediate savings) profit-mark-up in its interest rate. The third alternative is to

[2] In response to the crisis in Andhra Pradesh, RBI in October constituted a 3-month-committee under the chairmanship of Y.H. Malegam, a senior member of the central board of directors of the RBI, to look into ways of ensuring sound microfinance delivery, i. e. improved regulation.

operate on grants. SKS as well as Grameen Bank as well as nearly all the MFIs mentioned in this article started that way. There are those MFIs that opted for remaining small and local, all that opted for growth found that grants could not fuel it. They either went for savings mobilization, or for scaling up with the target of creating a stable combination of equity and debt sources for their loan funds.

4. Scaling up and going public

Large organizations promise economies of scale. That means services can be offered at a lower cost. The lion's share of microfinance worldwide is offered by about 300 large MFIs, and they have demonstrated not only the ability to provide micro-credit at lower costs than small MFIs, but they have also demonstrated higher ability to diversify services (Ramana/Schmidt 2010).

'The crown' of scaling up is embodied by listing an MFI at the stock market. So far, only 2 MFIs worldwide have gone public: The Mexican Banco Compartamos in 2007 and the Indian SKS Microfinance in July 2010. Both found their initial public offering (IPO) many times over-subscribed, both earned several hundreds of millions of US-dollars. SKS Microfinance attracted glamorous names from the world of finance, such as Citibank and Sequoia Investment funds, such as Warren Buffett and George Soros.

However, the quest for going public is a pressure to be quick, because earlier IPOs tend to pay off higher than later ones. Moreover, there is a pressure to be extremely profitable, because an IPO is, at its core, a public auction where bidders respond to double-digit profitability ratios.

Thus, the downside of a whole industry racing for going public is a strong systemic incentive to grow exponentially, to overstretch internal controls, to under-invest in HR, and thus to create a ground for all sorts of abominable operational practices which include

- multiple affiliation of groups, and group leaders, to several MFIs;
- regularly combined with lending-without-group training, and probably without appraisal, to customers who are members of another MFI's group,
- re-scheduling of loans to cover up delayed repayment; forging of group and/or customer identities ('ghost customers');
- 'sub-contracting' of lending agents.

All these bad practices lead to the same disastrous outcome: Over-indebtedness of the customer.

"As we are learning from a growing volume of research in the field of behavioural finance, money amplifies our tendency to overreact, to swing from exuberance when things are going well to deep depression when the go wrong. Booms and busts are products, at root, of our emotional volatility. […] The more integrated the world's financial markets become, the greater the opportunities for financially knowledgeable people wherever they live […] And the penalties for financial ignorance have never been so stiff." (Ferguson, 2008:13/14)

Over-indebtedness is a constant feature of raw poverty; it would probably be an early indicator of the same brewing up. Unfortunately, nobody has so far come up with a good idea how indebtedness levels of low income people could be tracked regularly. All studies on the topic are "flashlights", Collins et al (2009) is closer to a tracer study, but it by no means statistically representative – simply because observing a statistically representative sample with that methodology would be out of all financial boundaries.

This is a very disturbing fact particularly for lenders who care about the indebtedness levels of their customers. However, it is questionable if that motive has featured prominently among Indian MFIs that are in the above described race. E. g. those who attended forums organized by the sector umbrella Sa-Dhan found that specific accountability, let alone assessable standards, for any of the above mentioned operational issues were carefully avoided.

In any case, indebtedness of microfinance customers is not at all determined by MFIs. All robust studies show that indebtedness of poor customers is determined by borrowing from friends and relatives, from local shop owners and other traders and, ultimately, the traditional moneylender. A recent representative study from Andhra Pradesh finds that

"[w]hereas 82% of households have borrowed from informal sources, mainly village moneylenders and relatives or neighbours, only 11% have an MFI loan. On average, borrowers also owe over four times as much to informal lenders, which charge far higher rates, than they do to MFIs. The […] survey finds that a mere 3% of households in Andhra Pradesh have more than one [MFI] loan; in contrast, 70% of people have at least two informal loans. People with several MFI loans also tend to take them out simultaneously, rather than staggering them, as they would if they intended to use one to pay instalments on another." (Economist 2010b)

More unfortunately, in the absence of indebtedness data as early indicators there is, in India, a macabre too-late-indicator of brewing raw poverty: suicide. India does not rank anywhere near the top in a comparison of international suicide rates. But it cannot be denied that many poor Indians have taken their lives out of desperation. MFIs are only mildly relevant to most of the desperate poor – because most of India's poor are not MFI customers –, so they are usually not relevant for their desperate choices. Apparently, some of the people who committed suicide had been, at one point or another, customers of MFIs. So far, no case has been independently reported that would single out MFIs as the exclusive cause of suicide; one report says that MFI staff members were causal in 23 suicide cases (Rai 2010), but it did not say which MFIs, and the reporting agency is biased[3].

Obviously, flowing from the above named bad practices, there are strong-arm tactics – that is threatening, breach of privacy, illegal repossession of (declared or undeclared) collateral, public shaming – of MFI loan officers and/or of their subcontracted agents. The list of such incidents seems to be long; and they have in some cases lead to arrest of staff members by the police. It

[3] It is the same agency that is in charge of implementing Andhra Pradesh's state government microfinance program, see footnote 1.

is likely that such incidents have strongly added to people becoming desperate and committing suicide.

In summary, for organizations that operate by a mission of empowering poor customers and/or of improving their lives and/or of providing them with quality services, any involvement with such incidents is disastrous and, ultimately, non-excusable. India's MFIs had it coming: Several, not all, chose strategies for growth that put their missions at risk, and did practically nothing to manage that risk. That does not make them responsible for suicides. It makes them responsible for having made a mess of microfinance, and moreover for having failed their customers.

However, the 'choice architecture' has not been created by MFIs themselves, but by regulators and legislators (politicians). We shall look at their role presently.

5 Inappropriate regulation

If the largest MFIs are counted in terms of number of savers, only 3 MFIs from the largest MFIs by number of active borrowers feature among the top 10. These are Grameen Bank, BRAC and ASA from Bangladesh (Schmidt 2010). They make it to both lists because Bangladesh has a unique law for Grameen Bank and a regulatory framework that allows NGOs to mobilize savings. No large Indian MFI makes it to the list because they are legally prohibited from mobilizing savings. Different from other low-income countries, RBI has an effective grip of the formal financial sector to prohibit formal, large organizations from doing what they are legally prohibited to do. An exemplary case is the innovation of Ujjivan, to collect compulsory savings – that is, a fraction of the loan amount to be deposited as collateral *before* the loan is disbursed – in a more flexible manner, i. e. *parallel* to the loan. It was popular with the customers, but RBI found it to breach its regulation; it had to go (Gosh 2009).

Therefore, Indian MFIs operate amidst severely limited choices. They have few options to broaden and diversify their business model. Most of them have ventured into acting as insurance agents for registered insurance companies, and have probably extended insurance to more low income people than anybody else in the world. There have been different approaches to diversify, e. g. BASIX offers agricultural extension services, Spandana introduced an agricultural loan, Ujjivan has introduced a housing loan, SKS Microfinance plans for the same. But all of them are, at the core of their balance sheet, lenders. Their growth, their profitability hangs on borrowing more or to more people.

An important structural factor driving the priorities of regulators and legislators is India's nationalized banking sector. This is not the place to discuss its roots and implications; but it may be noted that the nationalized banking sector is bed on which fests inefficiency, costly self-compliancy and extremely low service quality (see Rajan [2008] for a detailed discussion and a long list of well thought through suggestions for policy change which would encompass microfinance).

Ultimately, it is to be noted that India's regulators and legislators

- have failed to be part of the worldwide quest for expanded savings services to the poor,
- have failed to come up with any workable innovation in that area,
- have, in consequence, forced the MFIs into a credit-driven business model, and
- have failed their largest constituency, low and very-low-income households who have to repair to expensive and/or high risk forms of savings (Wright 2008).

India's microfinance sector is in a mess; the regulators are to blame to have laid and to nurture its structural roots. The burgeoning, deeply inefficient bureaucracy of financial sector policy making, in conjunction with the body of nationalized banks, combines two terrible vices: It stifles innovation of BoP products and services; and it nurtures an informal sector reigned by corruption and nepotism and illegal exploitation – that is the word not for micro-credit but for charging people for services that the law stipulates a right to access transparently and/or freely.

6 Political interference

"Vicious as it often is, usury is linked to the collapse of formal rural credit. It fills a gap. In doing so, it devastates the lives of many. […] But don't lose sight of why and how it arises." (Sainath 1996:199)

In India, politicians argue vocally that rich MFI-entrepreneurs have gathered their wealth from lending money to the poor ones at usurious prices (interest rates) and through imprudent methods. This argument carries a bitter irony: Microfinance was started with the vision – and the story (!) – of 'driving out the moneylender' who charges usurious prices. The story of 'good microfinance' against 'bad moneylenders' appears to have taken a classically dramatic turn: Some of 'the good' have fallen to the 'dark side'.

But those politicians are in charge of creating institutions and choices that improve the wellbeing of their constituencies. Given that India is home to more poor households than any other country; given that the largest portion of poor living of 2 US$ or less per day are Indians, one may feel entitled to wonder if they lived up to their responsibilities.

The answer is not flatly no or yes – just as the explanation for the problems of India's microfinance, or of some of its large MFIs singled out, is not flatly 'good' or 'bad'. On the one hand, Indian politics – as well as many other countries' – have been marred by a tendency to attract dubious characters who look at it as a sort of business from which they make money. The sale of public offices, and the resulting extortion of illegal pay from people who come to those offices for service, is at the root of what is called "endemic corruption". It is paramount in India (see Guha 2007). On the other hand, well-meaning politicians – in India and all around the world – have seen credit programs as an efficient way to tangibly embody political platforms. In Andhra Pradesh, the party leading the state government has heavily relied on its own microfinance program – which is based on the self-help-group methodology – to mobilize political support and to advance its political objectives (see footnote 1; Ghate 2006 uses the term 'political investment').

Intertwining of these two strings of political motivation has often – not always – led to highly inefficient programs, that is, the 'government credit' suffered extremely low repayment rates and was ultimately waived. There has been an evolution in such programs over the decades. Andhra Pradesh's SHG-program is much better designed than some earlier government credit programs. But it still does not appreciate competition as has been brought in by MFIs. MFIs argue that they have some advantages over the SHGs – faster, more reliable disbursement of loans, higher loan amounts. The government and its implementing agency argue that MFIs distort and undermine the functioning of SHGs. The present crisis is, from that perspective, just a point in case. It is noteworthy here that India's SHG program has followed a comparable growth pattern in terms of groups and members as have the MFIs; and it has been faced by comparable problems; less on the side of coercive recollection, more on the side of poor repayment and inflated SHG-membership numbers. Economist (2010a) observes that "[t]he growth of microfinance has reduced local politicians' ability to use rural credit as a tool of patronage. That puts MFIs in the firing line."

Politics always lives of telling a compelling story. Embedding the storyline in the widest collective mindset; creating a 'hegemony' of ideas among constituents and thus consolidating power relations is the art of politics. Politicians in Andhra Pradesh and other parts of India today tell a story of MFIs being 'bad moneylenders against which action is taken in the name of the good. The story carries a bitter irony, because it absorbs and re-interprets the very story upon which microfinance operates: The story of being the 'good knight' who drives out the 'bad moneylender'. In India, this story also reminisces of the in the nationalization of the Indian banking sector by Indira Gandhi in 197? And 197?, which is one of India's sources of national identity and pride (Guha 2007).

However, one would expect that journalists would point out these hidden mechanisms; in particular one would expect that journalists would unveil the underlying power relations. Sadly, both the Indian and the international media have widely failed to do so (see the appalling example of Kazim [2010], positive examples are Rai [2010] and Economist [2010a, b]).

Last but not least, it must be recorded that there are also politics within the 'community' of microfinance practitioners. These are more pronounced in a huge and varied country like India. Indeed, microfinance practitioners from NGO-backgrounds have been suspicious and at times openly hostile to the 'commercial MFIs'. These tensions have deterred India's microfinance sector from 'speaking with one voice', e. g. visible in the reduction of the sector's national platform Sa-Dhan by the entry of various networks and groupings. Some of these are not too unhappy about the crisis – they have been weaving the same story line that is now proposed by the state government of Andhra Pradesh, and they count that 'driving out the bad MFIs' would give them opportunity to shine as 'good MFIs'. It remains to be seen if these grant-oriented MFIs can veil the fact that they have remained insignificant to the vast majority of low-income-people.

7 Concluding Outlook

Microfinance has come to another crossroad, or, to use a popular term, 'the microfinance revolution eats its children'. Microfinance and its providers need to re-invent themselves to reach more poor households with more relevant products. They also need to develop strategies to fend of the 'slashback' from the powers that be – within themselves as well as among their 'community' as well as in their policy/politics environment – and to engage regulators more intensively.

Hopefully, these might be the learning from the latest AP-crisis; learning that might help to avoid likewise crisis in other countries. But then, there is nothing like a free lunch. The change that microfinance has come to bring – to its entrepreneurs and staff and now also investors, to the wellbeing and power relations of the polities and communities it operates in – will continue to create pains. The biggest hope is that these pains are not, as they usually are, bulked at those who are too weak to escape them. After all, this crisis has brought to the spotlight that such is happening; it might also bring to the spotlight how regulators and politicians are and continue to be strongly liable for it.

References

Arunachalam, R. (2010): http://microfinance-in-india.blogspot.com/, [1.12.2010].

BASIX (2010): Livelihood triad, under: http://69.89.31.196/~basixind/index.php?option=com_content&task=view&id=47&Itemid=61 [1.12.2010].

Collins, D. et al (2009): Portfolios of the Poor, Princeton and Oxford.

Economist (2010a): Discredited - A string of suicides puts microlending under the spotlight, 4th Nov. 2010.

Economist (2010b): Overcharging - Microlending is under attack, unfairly, 18th Nov. 2010.

Ferguson, N. (2008): The Ascent of Money, London.

Ghate, P. (2006): India Microfinance – A State of the Sector Report 2006, New Delhi.

Gosh, S. (2009): Savings - the Beginning and the End of Microfinance Relationship, in: Sa-Dhan Patrika, Vol. 10/1, p. 3-5.

Guha, R. (2007): India after Gandhi, London.

Kazim, H. (2010): Wucherer treiben Tausende Inder in den Ruin, in: Spiegel Online, 28th Nov. 2010, www.spiegel.de/wirtschaft/unternehmen/0,1518,730952,00.html [1.12.2010].

NABARD (2010): Status of Microfinance in India 2008/9, Mumbai, under: http://www.nabard.org/pdf/Status%20of%20Microfinance%20in%20India%202008-09_131109.pdf [1.12.2010].

Rai, V. (2010): India's Microfinance Crisis is a Battle to Monopolize the Poor, Harvard Business Review, 4th Nov. 2010, under: http://blogs.hbr.org/cs/2010/11 /indias_microfinance_crisis_is.html [1.12.2010].

Rajan, R. (2008): A Hundred Small Steps, Report of the High Level Commission on Financial Sector Reform, New Delhi.

Ramana, N. V. / Schmidt, O. (2010): Size Matters, in: Development and Cooperation, Vol. 51, 2010:2, p. 60/61.

Sainath, P. (1996): Everbody loves a good drought, New Delhi.

Schmidt, O. (2008): Considering micro-savings — A brief on International and Indian experiences and approaches, in: Sa-Dhan Patrika, Vol 9/Special Issue, p. 8-10.

Schmidt, O. (2010): Who uses microfinance, and where do they get it?, in: Digital Development Debates, issue 02, under: www.digital-development-debates.org/ (forth coming).

Seibel, H. D. (2005): SHG Banking in India: The evolution of a rural financial innovation, Working Paper, University of Cologne – Development Research Centre, under: www.econstor.eu/handle/10419/23653 [1.12.2010].

Wright, G. (2008): Savings protection by prevention? – For a new paradigm for micro-savings in India, in: Sa-Dhan Patrika, Vol. 9/Special Issue on Savings, p. 2-4.