MicroSave India Focus Note 5

Microfinance Is Not An Easy Business!

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The world's attention turned towards microfinance with United Nations proclaiming 2005 as the Year of Microcredit. It reached a crescendo with the award of Nobel Peace Prize to Grameen Bank of Bangladesh and its Founder, Professor Md. Yunus in 2006. Riding the wave of the new found popularity of microfinance, mainstream investors like Sequoia and Legatum suddenly discovered a new asset class in the fast growing Microfinance Institutions (MFIs) of India. The infamous Krishna District episode of March 2006, that appeared to threaten the very survival of the microfinance sector became a distant memory, all but erased. The MFIs of India are suddenly the toast of shrewdest investors, boasting of valuations almost reminiscent of the dot com boom. It is at such apparently giddy times that are opportune to take stock of where the journey of microfinance began so as not to lose sight of where it needs to go. And that it can do so, armed adequately with the lessons learnt along the way.

For those who came in late, microfinance essentially entails the provision of financial services for the poor, involving transactions of small sizes, be it credit or savings and hence the self-explanatory prefix. In India, beginning essentially in the early eighties as an NGO movement, whether through the (later) Government supported, Self Help Group (SHG) movement or the Grameen replicating MFIs, microfinance emerged as an answer to the inequitable access to finance provided by the mainstream banks, with the aim of poverty reduction at its very heart. Initially funded mostly by grants and donors, the first phase of growth, even if limited in scale, suggested at least to the more daring amongst the banks that an interesting and viable model of delivery was taking shape. Targeted mostly at poor women in rural households, the peer selection model of client acceptance, door step delivery of services, small repayment amounts through frequent collections (aided somewhat by peer pressure) and above all, the promise of a repeat higher loan to reward impeccable credit record, produced almost hundred percent recovery rates and an astounding asset quality.

The only trouble was that to deliver financial services (mostly credit) in such manner, with small frequent transactions and doorstep delivery, cost a lot of money. The high costs of transactions (between 10% to 15%) translated into high borrowing costs for the poor (between 24% to 40%), which even seemed ethically acceptable, albeit as a temporary solution where none other existed (and as is the case across the globe). Besides, it was quite clear that an optimum scale would certainly cut down the costs. That began to happen soon enough as the next phase of growth saw funds from commercial banks, first trickling and soon pouring, many accuse, somewhat indiscriminately. But the results were clearly for all to see. Most MFIs hitherto in the red, grew rapidly and turned profitable, some modestly and a few not so modestly.

Most MFIs however, including those amongst the latter, continued to charge their borrowers, at seemingly high rates. Uncertain perhaps, of how long the abundance of funds would last, these MFI continued zealously on their path to build up large reserves.

In hindsight, it was only natural perhaps that the bounty tucked away in the balance sheets of organisations, ostensibly providing credit to the poor for alleviating their poverty, would attract the attention of authorities keen on securing a “fair deal” for the poor. As the bureaucrats of Andhra Pradesh’s Krishna district were grappling with low repayment of the Government supported SHGs, their focus naturally turned on those MFIs whose higher priced loans were causing multiple indebtedness and (possibly) debt traps. These authorities saw that MFIs continued, rather unfairly according to them, to enjoy perfect repayment, arguably at the cost of those loans offered at a subsidised rate through the SHG-based systems.

The much debated crisis that followed the pronouncement of the District Collector prohibiting borrowers from repaying their loans to the MFIs, was the first big road bump, which at its peak, appeared close to derailing the entire sector, even beyond the borders of Andhra Pradesh.

But eventually good sense prevailed in all quarters. The erring MFIs reduced their lending rates, the District Collector recalled his orders banning repayment and with RBI’s active intervention, the sector survived, one hoped, strengthened and mellowed by this rude shock.

Well wishers of the sector, attributed the super profit motive of the biggest MFIs in India, to their desperate need for building reserves, crucial for leveraging debt and growth (to further financial inclusion) particularly as equity for this sector was virtually non-existent. It’s logical therefore, to be highly enthusiastic of this exciting trend of private equity coming the way of this deserving sector. Visions of a public listing and wealth creation by the MFIs begin to look distinctly achievable.

And there lies the danger. The Krishna lesson is barely a year old and too valuable to be forgotten yet. One wonders if the MFIs can afford investors seeking internal rates of return of 30%; and what may be the cost of doing so? The jury may still be out, but the need for capital is very much in. And there is far too much at stake to risk another mistake. Will the Social Investors of India (not just Vinod Khosla, the lone torch bearer of 1.1 billion Indians) please stand up and be counted?

And will the MFIs rise to the occasion and respond to challenges as well as the opportunities? Managing a compounded growth rate of 100%, year on year, is a daunting task even for those with very deep pockets. For the still largely resource challenged MFIs of India, the danger is far greater. The ability of these increasingly hugely staffed organisations, to handle ever changing external dynamics, internal complexity, and the consequent stress on human resources, will not only determine the fate of these MFIs but also that of hundreds of thousands clients they serve. To rise to this challenge, the MFIs must be constantly vigilant and react with agility. Even as many of them need to raise the bar on governance and transparency, running tight and efficient operations across ever larger and disparate geographies will call for even stronger management and information systems. And all this without losing touch with the local realities and client needs.

A tall order indeed! But only this way can we hope to bring cost-efficient, quality financial services to the millions of poor in India who are still without access to the formal financial system.

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