MicroSave India Focus Note 56

The Andhra Pradesh Crisis: So What Next?

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So What is Likely to Happen in the Long Term?

India Focus Note 55 "The Andhra Pradesh Crisis: Three Dress Rehearsals … and then the Full Drama" highlighted the predictability of the current crisis in Indian microfinance, and indeed how its constituent parts were played out in the years that preceded 2010. This note looks at what is likely to happen next ….

Clearly the microfinance, or better said "microcredit", industry in India is undergoing a major shake-up. MFIs are busy trying to reorganise their operations to comply with the Ordinance in Andhra Pradesh, and this is likely to accelerate a trend that has occurred throughout Latin America and Africa already. *MicroSave* has been suggesting that the long-term future of mono-product group-based microcredit is questionable – and that there is a pressing need to reinvent it as individual-based microfinance that leverages m-banking platforms to offer a wide range of financial services.[1] Furthermore, it is clear that the Reserve Bank of India would like the banks to be more directly involved in lending into the villages through banking correspondent-based systems offering a range of services … and is likely to keep refining the regulations until this is commercially viable for the banks. This being the case, it is possible that MFIs eventually end up as the agents of banks in rural areas, selling products and managing clients/repayments etc.

Interest Rate Cap

An interest rate cap of 24% (even though being pushed informally) is likely to the lead to demise of many smaller MFIs without the capital base to build the scale to breakeven at that rate. Remote areas, particularly in the north east, where some fledgling microfinance activities had been initiated will be the worst hit. It will also lead to large scale financial exclusion for the poor in remote rural areas, or indeed in expensive-to-serve metros like Delhi and Mumbai where salary and rental expenses are so much higher. One of the fall-outs of interest rate caps would also be that MFIs would tend to focus on higher ticket-size loans. This could lead to the poorer amongst the existing clients being excluded from the provision of microfinance (or microcredit as it is presently) and will have to go back to informal sources of credit at much higher interest rates.

Another potential negative fall-out of a ceiling in interest rates would be the propensity of MFIs to push consumer products with the loans. It is well known that products such as water-purifiers, currently being marketed through MFI channels, enable direct cash inflows to the MFIs in terms of commissions. In the case of some products, this can be a significant percentage of the loan amount. While the propensity of MFIs to load consumer products onto their systems is low, the interest rate ceiling could encourage such behaviour to the detriment of the client, and would circumvent any interest rate ceilings. All the above said, some banks seem to be focusing on 24 - 30% as the maximum acceptable interest rate, reflecting important pragmatism. For example on December 12th the Hindustan Times reported T.M. Bhasin, CMD, Indian Bank saying, "There is no bar in lending to MFIs, but we have decided to sign a contract before lending to them, ensuring that they cannot charge interest above 30%". Similarly, SIDBI has written to MFIs asking for plans to reduce rate of interest to 24%. In the current crisis, the role of players like Dia Vikas Capital, Maanveeya Holding (Oiko Credit) etc. will enhance as their capital supply lines are independent of Indian banks.

The Worst Case Scenario

The worst case scenario is that the microfinance industry may continue its downward spiral. In early December MFIN, the network of larger NBFC-MFIs reported that MFIs were not in a position to collect about Rs 7,200 crore outstanding loans in Andhra Pradesh, and had missed the opportunity to lend about Rs 1,200 crore since October when the Ordinance was introduced. In case recoveries in Andhra Pradesh do not improve in December 2010 and January 2011, MFIs run the risk of defaulting to banks (large MFIs claim to have enough liquidity to continue repaying banks till February/March 2011). Defaults would make it impossible for banks to extend any further financial support to the very institutions that they helped to reach such gigantic proportions. Microfinance is essentially working capital finance; it is easy to get into the financial cycle of a household, but quite difficult to get out. Clients repay their current loans in order to get their next loan. Thus exit can only be a slow and gradual process; any knee-jerk reactions will only lead to massive defaults for the MFIs, and thus in turn for banks, and the spiral would then become a black hole. If recoveries do indeed pick up in the next two months, some order may be restored. MFIs will still take a hit as banks will reduce the flow of funds; and the higher risk rating of the business, and individual institutions within it, may also mean higher cost of funds with lower onward lending rates – a

[1] See *MicroSave* India Focus Note 26 "Market Strategy Development and 3rd Generation Microfinance in India"

classic double whammy. The future for microfinance does not appear to be as projected just a couple of months ago.

The lower fund flow in the sector will mean that leveraging will go down, and higher equity inflows will be needed. The higher equity requirements is unlikely to be met by conventional private equity players as commercial equity seeking 25-30% return will not find the sector attractive enough. Long term, patient social equity will be needed but at present, this is scarce in India. The potential withdrawal of priority sector status for debt funds extended to MFIs would also lead to higher cost of funds and, at least in the short run, the myriad financial instruments[2] that had grown up to service the fledgling microfinance sector will reduce drastically, if not vanish completely.

Equity and Valuations

Large MFIs waiting to tap the capital markets will be unable to do so in the near future and get any decent valuations. The sector which prided itself on the potential in the field and the limitless market will have to settle for lower value and book multiples. The Microfinance Bill, which had been forgotten by the Government and the sector, is back under development on a high priority basis. The Government is on record that it will consider tabling the bill after taking into consideration the recommendations of the Malegam Committee constituted by the Reserve Bank of India. The Malegam Committee is set to report in February … until then the Indian microfinance industry looks set to remain in flux and chaos.

The Up-side

On the positive side, capping of interest rates (informally) lead to a relook at the whole model of microfinance and will, in the long run, enhance the use of technology to reduce operating costs. MFIs and banks will experiment with different forms of agent models and these could form the basis of reducing costs and cross-selling products such as savings and insurance – enabling delivery costs to be shared across different products. Risk management will be given the importance that it deserves, especially in the larger MFIs, which studiously ignored the political and reputation risks that were so clear and present for several years before October 2010.

The current crisis will also lead to some emphasis on brand building and differentiation, in order to allow MFIs to compete to meet clients' needs for financial services on a more comprehensive and holistic basis. The joke in the field (not far from truth) at the moment is that clients know MFIs only by the day on which they make collections viz. "Monday MFI", "Tuesday MFI" etc. As part of their response to the crisis MFIs are likely to have to move closer to what *MicroSave* has been calling 3rd generation microfinance,[3] harnessing technology and collaborative arrangements to offer a range of financial services to their clients. This would provide an opportunity to reconnect and rebuild relationships with their clients and to move the incentives for repayment away from group liability-based "sticks" to the "carrots" of maintaining on-going access to a broad range of valued financial services. To do this effectively MFIs will need to choose their position on the basic perceptual map or positioning triangle, and choose combinations of price, quality products and customer service on which to differentiate themselves in competitive markets.[4]

This type of differentiation will also likely mean a move to individual cashflow-based lending for many MFIs. Such a move would have the advantage of giving the MFIs a better chance of understanding the levels of debt in the households to which they are lending, rather than relying on group liability to overcome information asymmetry and tolerating multiple borrowing.[5]

The diversified bouquet of products with higher levels of technology will call for better quality manpower and more emphasis on HR systems. This will also ensure that client relationships are better managed and the brand name of MFIs is not compromised. All this will lead to reduced profitability and lesser margins, and the future will also see more discerning capital markets.

Finally, this enforced slow-down period should allow MFIs to consolidate, and modify their systems to catch up with their scale, thus reducing their risk profile.

Conclusion

Long-term the current turmoil in Indian microfinance may result in improved financial services for the poor – so long as they are easily accessible and not in high cost to operate areas. In the short run the options for poor people will shrink significantly – much to their detriment.

The next two India Focus Notes look at what MFIs should do to reorient their services and rebuild their credibility, and what the government should do to optimise the functioning of the microfinance industry and thus the financial inclusion of the around 400 million financially excluded poor in the country.

[2] See *MicroSave* India Focus Note 30 "Alternative Financing for Indian MFIs"
[3] See *MicroSave* India Focus Note 26 "Market Strategy Development and 3rd Generation Microfinance in India"
[4] See *MicroSave* Briefing Note #27 "Corporate Branding and Identity – Why They Are Important For MFIs?"
[5] See *MicroSave* India Focus Note 33 "Why Do Microfinance Clients Take Multiple Loans?"