MicroSave India Focus Note 57

The Andhra Pradesh Crisis: What Should MFIs Do?

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India Focus Note 56 "The Andhra Pradesh Crisis: So What Next?" highlighted the problems Indian microfinance now faces. This note examines how the MFIs should respond to save their industry – denial is no longer an option.

Transparency Of Interest Rates

First and foremost, MFIs need to respond to the accusations that their pricing is not transparent – a common charge that is echoed around the world in microfinance, and points to a clear and present need to change. However, it is worth noting that the pricing of loans with fixed process or passbook fees, coupled with an interest rate that is usually expressed in terms of flat rate on principal, means that the Annualise Percentage Rate (APR) may vary with each loan. Furthermore, clients do not always understand APR, as typically informal sector interest rates are expressed as "X% of loan outstanding at the beginning of the month", or "Rs.X per Rs.100 outstanding". Often clients are above all interested in how much they have to repay each week. So pressing for expression of interest simply on an APR basis may add little real transparency for clients. Bangladesh has recently introduced a requirement that interest rates be expressed on a declining balance basis and that the upfront fees (which are also being capped at Tk.15) are clearly expressed separately from the core cost of the loan. But, of course, this masks the real effective interest rate.

Other elements of the typical MFI's loan package that obfuscate real effective interest rates include grace periods, the number of weeks over which the loan is to be repaid and requirements/"encouragement" to prepay the loan (most of which would be addressed by a move to declining balance-based interest rates). In addition, the commonly bundled loan-life insurance cover, compulsory savings or loan insurance funds will need to be unbundled to promote transparency in pricing. Clearly there is a need for an industry standard way of pricing, and a real commitment to helping clients to understand the real cost of their loans.

Transparency Of Operations And Governance

MFIs in India have a very real credibility problem when it comes to transparency of operations and governance – and continue to under-estimate how damaging this can be. The sudden and mysterious sacking of Managing Director and CEO Suresh Gurumani and his replacement with M. R. Rao, just two months after the IPO, resulted in a 6% dip in the organisation's share price. Discussions with bankers repeatedly show that the price of loans advanced to MFIs depend greatly on perceptions of their transparency and governance. However, MFIs, large and small, continue to ignore this sacred tenet.

But the challenges are in many ways more profound, India Focus Note 41 "Microfinance – Time to Get to Back to Basics?" highlighted concerns about the lack of transparency in transactions amongst many of the larger MFIs. Professor Sriram's analysis of the dealings of some of the leading MFIs confirmed concerns that many industry insiders had long since harboured.[1] Whether the dealings are strictly legal or not is unimportant; in a politically and social sensitive environment like microfinance, it is essential to be, and be seen to be, transparent and honest in all dealings … as Professor Yunus and Grameen Bank discovered amid a maelstrom of negative press in early December 2010.[2] However, the strong response that Professor Sriram's article elicited from some quarters just showed that months' before the crisis, the industry was still in denial.

MFIs in India, and indeed elsewhere in the world, need to establish outstanding levels of transparency and governance – in all parts of their business, financial and operational. They deal with a sensitive segment, the poor of the country, and should not only do good, but should also be seen to be doing so.

Improved Analysis And Dissemination Of Social Performance

MFIs often collect data about the nature of the clients they serve, but this typically remains on loan application forms, unanalysed, in branch offices. But this data could provide important insights into how MFIs are indeed reaching the very people that the Government of India is so keen to have served. Furthermore, very few MFIs are tracking their social impact – not least of all because of how difficult it is to do effectively without falling into attribution and selection biases. This problem is compounded because the tools available and currently being promoted focus on depth of outreach rather than how best to serve the poor. Analysing and acting on social performance analysed on the basis of client satisfaction and loyalty makes business sense – not just because it can be used to describe how the MFI is performing to external stakeholders, but also because it enhances the client responsiveness of the MFI.

Given the sensitivities involved and the vulnerability of MFIs' target customers, it is imperative that MFIs pay more attention to the basics of their business and the missions for

[1] **Sriram**, M.S., "Commercialisation of Microfinance in India: A Discussion on the Emperor's Apparel", W.P. No. 2010-03-04, IIM Ahmadabad, March 2010

[2] http://www.bbc.co.uk/news/world-south-asia-11899506 and http://www.bbc.co.uk/news/world-south-asia-11947902

which they exist: listening to and providing clients appropriate financial services. *MicroSave* has been concerned that the rate of growth of Indian MFIs and their loss of relationship with their clients for several years now.[3]

The concrete steps that MFIs can and should take are to:

- Follow stricter policies around *client protection* principles and do no harm. Maintaining transparent and fair pricing/interest rates, addressing multiple borrowing/ lending and ensuring appropriate collection practices is the starting point (and the bare minimum). Understanding clients' perspectives of what client protection actually entails is also essential.
- Take steps towards ensuring *client delight* through offering a range of high quality, client-centric and flexible financial products in a manner that is appropriate and suitable for clients.
- Develop a *strategy* that makes sense for the company, the management and the mission – not copy-paste from others.
- Improve *communication* with the stakeholders such as government officials, media about the social side of the microfinance, the nature of, and the benefits for, clients served.
- *Grow and expand*, but at rates that are manageable and enables human resources to be valued, well-treated and integral part of the institution, rather than becoming loan disbursal machines – and treating the clientele accordingly.

The points listed above seem clichéd. But despite repeating them on many occasions in the past, they have not been given enough attention, to the detriment of the entire fledgling industry. Meeting these challenges not only helps MFIs meet their mission and social performance needs, but also clearly makes business sense and enhances risk management (including strategic and reputation risks).

Establish a Credit Bureau?

The Indian MFIs that comprise the membership of MFIN are proposing to establish a credit bureau, which they believe, will allow them to mitigate the risk of over-indebtedness. However, even with the national unique identification number, a credit bureau may struggle to deliver information that is valuable in terms of reducing over-indebtedness for two important reasons. Firstly, MFIs effectively lend to a household not an individual … and it is from the household income and expenditure flows that the repayments will be managed. In the event of one member of the household being blacklisted on the credit bureau, another can easily step in and join another MFI(s). A second, related point, is that the informal sector will not participate in the credit bureau, and as the recent IFMR study[4] shows, the vast majority of poor households' loans come from informal sources. So the database will only show a small proportion of the debt burden of the households registered.

Move to 3rd Generation Microfinance[5]

Ultimately MFIs need to provide a suite of products to their clients to reduce their vulnerability and enhance their ability to earn income. This cannot be done by delivering mono-product, group-based lending. Poor people need a wide range of financial services – and many need considerably larger loans than group-based MFIs (or indeed SHGs) are typically offering them. This provides a tremendous opportunity to use banking correspondents to offer the full range of financial services (savings, credit, remittance and insurance) and thus real financial inclusion to the poor of India.

This range of financial services delivered by banking correspondents would deepen the relationship between the client and the financial service providers. High quality saving services, so often demanded by clients in focus groups held by *MicroSave* in the villages across India, would allow poor people to build financial assets to help manage their household budgets and loan repayments through the lean seasons and household crises. Remittance and payment services could remove the pain of spending both time and money getting to, and waiting in, the bank to access the cash, which could be delivered in the village by the banking correspondent instead.[6] Microinsurance products, to reduce households' risk, or provide a long-term savings mechanism, could also be accessed through the banking correspondent. Clients would repay loans to secure on-going access to wide range of valued financial services rather than because their group and a credit officer were pressurising them to do so – moving to a carrot- from a stick-based incentive.

MicroSave calculates that loans of Rs.20-25,000 are adequate to cover the costs of conducting a cashflow analysis of, and reference checks on, the borrower's business and household, and thus to offer a cashflow-based individual loan. Performed well, such analysis (while not perfect) may offer a better chance of assessing the risk of over-indebtedness than a credit bureau. Furthermore, if delivered on a mobile phone banking platform alongside other financial services, individual cashflow based lending could reinvent the way the MFIs' front-line staff interact with their clients. Mobile phone technology could take care of loan reminders, collections and initial follow-up; thus allowing staff to focus on origination, appraisal, monitoring/client relationships and the (hopefully) few cases of delinquency. Coupled with an agent based network, this could be the answer to a low cost model that India needs at the moment.

[3] See *MicroSave*'s India Focus Note 42 "Microfinance In India: Built On Sales Targets or Loyal Clients?"
[4] http://microfinance.cgap.org/2010/11/11/who%E2%80%99s-the-culprit-accessing-finance-in-andhra-pradesh/
[5] See *MicroSave*'s India Focus Note 26 "Market Strategy Development and 3rd Generation Microfinance in India"
[6] See *MicroSave*'s India Focus Note 29 "Potential for E-/M-Banking Enabled Migrant Remittances"