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Big concerns over small loans

Microfinance is an effective tool for financial inclusion. Here are some elements of the recently embattled sector

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Bindu Ananth and Nachiket Mor

The recent controversy surrounding the microfinance sector has entirely eclipsed the fact that it is the first effort in India to have delivered financial services to remote corners of the country in a self-sustaining manner. The stakes are high for India's poor, and we have to pave the way for orderly growth in the sector. Here is our view on some key issues that have featured in the current debate.

- **High interest rates:** The effective interest rate charged by microfinance institutions (MFIs) to their clients has varied between 24% and 40% per annum. Given that default rates on microfinance loans are extremely low, these rates seem "usurious". MFIs justify them, citing high operating costs involved in serving remote areas with small loans. However, recent equity market valuations suggest that in reality, stable return on assets are 8-10% for an efficient MFI charging 28%—much higher than that of banks and other non-banking financial companies. So, even while it is true that these rates are lower than those charged by informal lenders and within the envelope of returns earned by clients from micro-enterprises, there is clearly massive room for lower rates. But the big question is: How will these lower rates come about?

If economic history is anything to go by, definitely not through regulation that caps rates and shrinks supply. One alternative could have been a benevolent public sector that charges "fair price" for the same service and puts pressure on the private sector. Let's examine the self-help group (SHG) programme. Banks lend to an SHG typically at 12%. This is, according to the Rangarajan committee, 10-20% lower than the true total costs of a bank even after fully accounting for implicit subsidies from the government by way of cheap refinance and privileged access to low-cost current account and savings account funding. SHGs acting as quasi-banks, in turn, lend this money (and internally raise deposits from a few members) to the end client at around 24-48% per annum. These rates are comparable to those charged by MFIs and mean that there is no pressure on rates from public sector alternatives.

Therefore, the only way out is to aggressively promote competition between entities and facilitate entry of disruptive new models. However, any mention of competition is met with grave concerns regarding multiple borrowing and evergreening.

- **Multiple borrowing and excessive client leverage:** Talk of unfettered competition prompts images of borrowers collapsing under a mountain of credit card debt in South Korea. When educated and disciplined South Koreans could not escape this debt trap, how can we expect the hapless illiterate rural Indian borrower to do so? Facile comparison, we think. The low-income borrower is in fact a careful money manager and is not easily enticed by promises of more "easy" money—more so when she knows that it needs to be compulsorily repaid. In addition, the group structure

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and the threat of credit denial upon default puts enormous pressure on members to be conservative on amounts and purposes. Researchers, on the contrary, rue that microfinance does not help entrepreneurship, given the small amounts and extreme risk aversion created by the group model.

• **Evergreening:** A related concern with competition is that new loans service old loans. From our experience, the near-zero default rates are a fact. The Grameen Bank methodology requires people to borrow in groups, guarantee each other and make repayments of principal and interest in weekly instalments. Eligibility limits start at R 5,000, rise gradually, and cap out at Rs25,000 per member. These limits have remained intact in nominal terms for over two decades, and have thus halved in real terms. This approach results in clients borrowing conservatively and relying on current income for repayments. Research shows that the closest parallel to a microloan is a mandatory/disciplined savings programme. Clients view the loan as a disciplining device to create assets for the household, rather than leverage in the commonly understood sense. The weekly instalments, combined with low default experienced by all players, make evergreening a technical impossibility and fit more neatly with the desired savings patterns of rural households.

• **Excessive credit discipline and coercion:** When times are good in microfinance, the coercion by groups to repay is applauded as the beneficial power of "social capital". Maintaining a high degree of credit discipline is at the heart of the microfinance success. However, in the case of group-based microfinance, this credit discipline is principally enforced by members of the group on each other because they are desirous of maintaining a good track record with the lender. The key here would be to not weaken overall credit discipline, but to protect clients in events where there is genuine inability to pay; emphasize process discipline at the time that the loan is made; and not rely on high-powered incentives for loan officers linked to collections. Industry participants such as Basix chairman Vijay Mahajan have repeatedly emphasized the role of insurance in providing a safety net to clients during bad times. These are useful directions for MFIs to pursue without losing focus on credit discipline.

It is critical that we don't let years of hard work and innovation come to naught over imagined concerns or organization-specific episodes. The large, systemically important MFIs are routinely audited by the Reserve Bank of India (RBI). Boards, top management and investors have to be stewards of orderly growth and market discipline in any financial institution. Microfinance is no different. MFIs and lenders to these entities urgently need the certainty and the reassurance from RBI that they will be held accountable to the same standards.

Bindu Ananth and Nachiket Mor are president and chairman, respectively, of IFMR Trust.

Comments are welcome at theirview@livemint.com

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Interest rates: The Poisonous Fangs of MFIs

MFIs were touted to provide the poor access to affordable credit, reduce poor people's need to use moneylenders and indebtedness. In short, provide a much kinder, cheaper alternative to the village loan shark. Instead, they evolved as the new class of institutionalized loan sharks which neo-liberals gave respectability to. MFIs did improve access to micro loans but failed in their touted mission to provide affordable and gentler credit and above all, one that lifted people from the clutches of poverty. Objects of institutional financial sustainability exhort them to charge interest rates and fees high enough to cover the costs of their lending and other services.

MFIs argue that they need a spread apart from all costs to provide for contingencies and growth. Fine but the moot question is how much should be this spread.

MFIs argue that economies of scale and competition will drive interest rates down. This remains only a theoretical argument. "Mexican micro-finance institutions charge such high rates simply because they can get away with it", said Emmanuelle Javoy, the managing director of Planet Rating, an independent Paris-based firm that evaluates micro lenders!!

If at all, the average Indian MFI interests rates appear more benign than in Latin America or Nigeria, then it simply because other than factors internal to the MFI industry, the sector faces strong competition from governmental and NGO SHG micro-saving programmes in the absence of which, these MFIs would have formed a cartel. Past angry public and government reactions that resulted in a backlash against them, which included the arrests of MFI top leaders, like Uday Kumar of Share Microfinance Ltd as in 2007, keeps their profiteering impulses under check.

The sooner MFIs are seen as profit enterprises, the better. The longer they pretend they are pro-poor, the longer they discredit the NGO sector that gave birth to a Frankenstein. By 2014, they target to reach 110 million borrowers. Remarkably, despite two decades of operations, if statistics are to be believed, these MFIs only reach just 20 million people in the country, a good proportionate of them, multiple counted. Yet, they succeed in gaining an attention, so disproportionate to this minuscule reach. Act now to prevent they becoming an epidemic in the country. Act now, when they are most vulnerable.

And how do know they are vulnerable? Because Vijay Mahajan, the father of MFIs in India tells us so:

"We are facing collapse. Unless something changes on the ground, the industry as we know it is basically gone. "

Mahajan, we have news for you. The day when the likes of you are gone, that will be the turning point for the fight against poverty!

What's wrong with Micro-finance Institutions? Practically everything as the case of SKS illustrates.

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Sasi Thumuluri 11/02/2010 12:03 AM

Very well written and insightful peice. I totally agree that MFIs particularly large ones have enough room to reduce rates but right incentives to do so are missing. Competition is not helping since cleints have so far been less price-sensitive. High valuations have raised many eyebrows and questions are being raised about intentions.

One thing that seem to have been left out is mono-product and herd mentality. New and diversified products would help reduce the need for multiple lending but there is a tendency of staying in comfort zone and wait for someone else to innovate and standardize before embarking on it. Credit-linked insurance is a good example of an innovation that is widely replicated but of little use to the client on most cases.

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