Cover Story

Microfinance, macro problems

By **INDRAJIT BASU** in KOLKATA

Indian activists protest in front of The Reserve Bank of India against micro finance institutions in Hyderabad. AFP

Until a few months ago, it was the poster child, a proven business apparatus to deliver financial services to millions of poor people and a lifeline to pull them out of the pits of ruin.

In more ways than one Indian microfinance set a model for developing nations, and raised huge expectations. Obviously, the other crucial aim was to stimulate greater growth of capital and credit for the world's microfinance sector.

But with more than 60 suicides in the past few months in India's southern state of Andhra Pradesh — the country's largest microfinance borrowing province, the sector finds itself mired in a messy collision of politics and borrowers' backlash.

The world of microfinance is mightily rattled as a result.

The widespread notion among the debt-trapped poor in India is: big or small, loans are a deadly trap. Many have vowed not to take up another loan again and investors now consider microfinance too risky. Global practitioners admit that the reputation and credibility of microfinance business is at stake.

Mainstream national and international banks funded India's microfinance with more than $4 billion of loans in 2010, while private-equity funds poured over $250 million that year.

Interest rates, however, are prohibitively high — from 25 percent to 100 percent a year. Lenders say this is due chiefly to the high costs of administering millions of small loans in remote areas.

Already there are debates on whether the India experience is an eye-opener, or worse, presages a doom for the business.

"For many people in the West, microfinance in India is microfinance," says Elisabeth Rhyne, managing director of the Washington-based Centre for Financial Inclusion.

"Global microfinance investors are focused on India because it is an important country. It is gigantic and has a huge number of poor people, and is also incredibly dynamic from the business and finance point of view. So anything happening in India would be seen and covered much more than anything that was to happen, let's say in Tanzania," she explains.

According to Alok Prasad, chief executive officer of Microfinance Institution Network, microfinance in India has been growing at a scorching rate over the past five years — more than 70 percent — reaching out to 35 million borrowers. "If you translate that growth, it means microfinance in India has touched the lives of about 100 million people," he says.

The concept originated decades ago. But it was the launch of Grameen Bank in Bangladesh (by Muhammed Yunus, who in 2006 won a Nobel Prize for his efforts) that spawned a social business wave.

According to Microfinance Information eXchange (MIX), one thousand-plus microfinance institutions in the organized sector have 88 million borrowers and 76 million savers worldwide.

Microfinance was considered a safe bet, because most borrowers comprise self-employed women, who were the least affected by the global market turmoil, and ensured repayment rates of 95-98 percent.

In India, microfinance emerged about five decades ago primarily as a government-sponsored model. It linked groups of village women to banks, and relied on grants or public funds for group mobilization.

According to industry expert, R. Balakrishnan, most companies began as "not-for-profit" organizations. But gradually, "the realization dawned that micro lending could also be hugely profitable and can bring massive riches".

Micro finance insitutions were not allowed to take deposits, in part because they would have become competitors to India's national banks.

That, experts say, was a big mistake. Deposit-taking, if properly supervised, would have let these companies raise funds locally, says Rhyne of Financial Inclusion. That would have created a balanced portfolio of products and revenue sources, she adds.

Consequently, Indian micro lenders came to depend either on their own capital, or banks, or private equity investors for funds. "In the process, the founders of these companies and their employees started rewarding themselves with higher-than-market salaries, huge stock options, etc. Private investors also wanted their share of super profits," says Balakrishnan.

With interest rates so high, many borrowers failed to honor repayment commitments. The fallouts were disastrous — mass defaults, and in worse, suicides.

The industry insists that the suicides are the result of a combination of reasons, the primary being business or crop failures.

With microfinance turning into a huge political issue, the government stepped in seeking to regulate the companies. It held lenders and the extortionate interest rates and questionable recovery practices responsible for the suicides. The Reserve Bank of India (RBI), the country's apex bank, imposed a fresh set of dos and don'ts. In Andhra Pradesh, too, the state government slapped a slew of restrictions.

Worse, local political leaders and religious clerics asked borrowers not to repay their loans.

"Scores of them have simply stopped paying, even if they are solvent, and as a result, lenders have stopped lending. There is also a huge pressure to bring interest rates down to below 24 percent a year, and following an RBI decree, Indian banks, the major source of funds for the sector, have become very selective in lending. Our business has come to a standstill, we are struggling for survival," an industry insider says on condition of anonymity.

Experts fear that capital flows to global microfinance will be severely hit.

Some are already considering whether they should continue investing, says Roshaneh Zafar, managing director of Kashf Foundation in Pakistan. Borrowers in other countries may go the India way and choose not to repay loans, he adds.

"Although Pakistan's microfinance sector is far more advanced and regulated than India, a populist movement has started here," adds Zafar. "We are facing questions: 'If people commit suicides in India, it can happen in Pakistan also.' They are questioning interest rates as well."

Bangladesh Rural Advancement Committee Director Shabbir Ahmed Choudhury echoes Zafar's views. "If Indian borrowers get away by not paying, borrowers in many countries may also get away without repaying. If that starts happening, it will be a big blow for global microfinance," he says.

According to the Consultative Group to Assist the Poor (CGAP), Morocco, Bosnia and Nicaragua are already experiencing the India ripples. To a minor extent, says Rhyne, the crisis in India has hit repayments in parts of Central Europe and the US.

However, Greg Chen, the South Asia-based director of CGAP, says, "The kind of microfinance that we see in South Asia has not been seen in any significant way in China."

"That's precisely why China needs to learn from the Indian experience," Rhyne says. "Microfinance is just getting started in China where the client market is quite different and state control is much stronger. Maybe the problems in India will make Chinese authorities think that they are not ready to experiment," she explains. "In a way, that's bad for China. There is a need for experimentation in this business," she says.

On the flip side, the current crisis that stifles the growth of microfinance across India could prove healthy for the sector in the long run. "There is an upside. The sector could use the crisis to recast into what may be called Microfinance 2.0," says Chen of CGAP.

"It's time to move beyond credit and embrace the real vision of financial inclusion that provides poor people with a full set of choices to manage their household finances," says Jeanette Thomas of CGAP from Washington DC.

Pros and cons

Microfinance is lending small amounts of money, normally less than $200, to business owners who use the loans to start or expand very small businesses like a grocery stand or a street-food shop.

It aims to lift the living standards of poor people by providing them a range of financial services to finance their earning activities, build assets, stabilize consumption, and protect them against risks. In practice, microfinance involves providing loans, insurance, as well as opening up avenues of savings.

One of the biggest downsides is that it charges very high interest rates that sometimes exceed 100 percent. But high interest rates also means very high returns, which is why, microfinance now attracts investments worth billions of dollars from global players. Critics, however, say it is more a commercial business than a social operation. The means are often dubious: Usurious interest rates, coercive collection methods, over indebtedness, pushing loans to borrowers, poaching of staff, weak lending practices and oversight, non-business related financing, for example, consumption lending, and diversion of funds to other ventures. Some these have certainly contributed to India's microfinance suicide epidemic and to a significant extent defeated the very purpose of microfinance.