TIME TO GET BACK TO BASICS?

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→| OUTLOOK

> **"We may become the makers of our fate when we have ceased to pose as its prophets."**
>
> KARL POPPER

THE RAPID GROWTH OF THE MICROFINANCE sector in the last few years has completely changed its complexion and nature. The growth has transformed microfinance: from being a sub-set of the development sector it has become a sub-set of the financial services industry. Microfinance is already pushing towards recognition as an 'industry' with a separate Act for regulation of microfinance institutions in the offing. This growth has put many issues and challenges before the sector and one of the major concerns voiced about the sector has been that of 'mission drift'. Detractors of typical 'Grameen' replicators have been saying for a while that high rates of growth have led to mono-products and multiple lending to a vulnerable section of the population.

Similar sentiments have been voiced by other stakeholders, and also the media. Various issues have been brought out to highlight the problems in the microfinance sector and the main concerns are as follows:

"In Karnataka or AP, it appears there is aggressive pushing of loans without ascertaining repayment capacity. In the event of distress, there could be defaults and the MFIs will take a hit. If the defaults are widespread, MFIs may find it difficult to repay their bank loans. But, this is not a systemic problem. The MFIs are too small for that. The real concern is rural women. Irresponsible lending can push them into distress and impoverishment. And make banks wary of microfinance itself." *The Economic Times*, March 8, 2010 quoting the Deputy Governor of the Reserve Bank of India, Mrs. Usha Thorat.

LACK OF TRANSPARENCY

The microfinance industry has evolved from NGO[1] roots. The push towards a 'for-profit' status to the industry was primarily at the behest of banks. The thinking in the early part of the decade of 2000 was that a Non-Banking Finance Company[2] format would usher in transparency and bring the institutions under the ambit of the Reserve Bank of India making them 'supervised' entities and in the process, giving them some regulatory legitimacy. However, NBFCs needed to fulfil capital adequacy norms and most promoters from humble NGO roots did not have the wherewithal to bring in equity capital. (In those days, a CRAR of 10% had been stipulated by RBI for NBFCs).

Working with a leading accounting firm, MFIs came up with an innovative idea and for-profit trusts were constituted which took in money as 'contributions' from a large base of 'clients' or 'members'. The corpus thus created with the trusts was invested as capital in the NBFCs. It was widely believed at that time that the clients putting money in the trusts were unaware that this was actually an equity investment. Over a period of time these trusts disappeared or reduced in size with the promoters or investors buying out the community without, and at least in some cases, sharing with them the growth and returns. Hence, while the route of forming trusts was not illegal, and was perhaps dictated by the need to bring in the much-needed equity, the sectoral grapevine was abused with tales of unethical, and in some cases illegal behaviour from MFI promoters. The way the issues were handled by the concerned MFIs and by other sectoral stakeholders, in terms of transparency and ethical/legal issues, left a lot to be desired.

While the merits of the move to a for-profit status can be debated, it is apparent that the manner in which this occurred was not always above board. "Thus the privatisation of the community owned entity was thus well on its way. The transformation of microfinance as a vehicle for personal enrichment clearly was visible"[3].

PRIVATE EQUITY PUSH

The transformation of microfinance institutions to an NBFC format, largely pushed forward by banks and supported by the Small Industries Development Bank of India through its 'Transformation Loan', helped a for-profit orientation to emerge. Large institutions were able to bring down operating costs, and the operating cost ratio[4] reduced to 8.5% in 2008 from 15.4% in 2006. Total cost ratio[5] also came down drastically to 17.6% from 23.4% in the same period. As against this, interest rates for ultimate clients continued to hover at around 30%, and the industry margins were quite attractive. The high margins and the seemingly limitless market, considering the poverty levels in India brought private equity (PE) players to the sector. The industry stakeholders and banks welcomed this move as it was seen as a coming of age of the sector. A few voices expressed their concern that the entry of PE players would lead to rapid growth and commercialisation at a scale not seen before, but these were quickly brushed aside in the initial euphoria.

"We also find that by 2006, the individuals were gradually replaced by a substantial holding by mutual benefit trusts [MBTs] – a new special purpose vehicle discovered by the microfinance sector. These for-profit MBTs – the creation of an intelligent legal brain – were actually special purpose vehicles that would aggregate the borrower-members of the microfinance organisations as members. The grant money in the not-for-profit society would find place in the MBT and this MBT in turn would contribute to the share capital in the NBFC. This had two advantages – the companies did not have to deal with a large number of retail share holders on their books – but would be dealing with blocks of shareholders in the form of MBTs. Two, the trust deed would be drawn in a way that an employee of the for-profit entity would act as a representative of these trusts in participating in the general bodies of the companies – thereby retaining complete control over the so called 'community investment' in the NBFC. Thus, by the time we come to the middle of the decade, the charade of the community participation in the capital structure of the company is also shed"[6].

The entry of PE players changed the game quite comprehensively. The money brought in was short-term and needed high returns of the order of 24-30%[7]. The only way such returns could be realised was through rapid growth. The more money that was leveraged on account of equity, and the faster it was turned around, the more profit would be gained. Growth, which till then was being supported by all stakeholders, became an end in itself and was driven by profit – the client and her needs scarcely factored. The hard capitalists and stakeholders from other industries might feel that there is nothing wrong with this, as profits are the drivers of growth. In addition, especially in a sector

where clients are not getting enough services, growth is inextricably linked to clients' needs, and hence to client satisfaction.

However, this may not be the complete picture in the case of the microfinance industry as it continues to be a 'sellers-market'. As one expert repeatedly points out, "Microfinance is one of the last remaining supply led industries in the world." In this situation, the direct fall out of rapid growth has been the insular growth of the microfinance in India. Despite the presence of the plethora of institutions, most offer the same product, typically with a first cycle loan of Rs.10,000 to be repaid over a period of fifty weeks. Thus, despite all the 'we are different' postures that may be adopted, the race to 'capture' clients is very clearly visible. This race has stifled innovation and has ensured that the customer's needs are simply not the basis for the products and services offered by MFIs. It is for this reason that from the villages of Andhra Pradesh to the Gangetic belt of UP, and whether clients are in remote rural villages, urban settlements or metros, everyone is being offered the same product irrespective of his or her needs.

However, one might ask how growth could have stifled product innovation? The answer perhaps lies in the operations of the microfinance industry. One of the reasons for the rapid growth of microfinance has been its simplicity in terms of products and systems. The moment multi-product offerings are made, the systems become more complicated. Then the MIS has to be more robust, and risk in operations grows disproportionately, as does the complexity of HR, which requires better-qualified staff and more involved training. Hence, sectoral growth has been at the cost of innovation and has not factored the clients' needs.

MEANINGLESS GROWTH

The growth in coverage of microfinance is limited to pockets, and MFIs across the country have developed a tendency to congregate in specific areas. It is very common to find urban and peri-urban settlements to have between 10-20 microfinance institutions operating within a small geography. This has lead to the problem of multiple lending, which has raised the issue of client over indebtedness, default and strong-arm recovery tactics. On occasions, charges have also been made of client suicide due to repayment pressures, but this appears to be more a figment of the imagination of the vernacular press than corroborated by any evidence. Hence, multiple lending is a well-known phenomenon and the sector has continued with an ostrich-like attitude to the problem. Despite evidence from across the globe, no efforts have been made to address the shortcomings of the group-based lending product and collection methodology, which remains almost exactly as it was when imported in the late 1980s.

CONCLUSION

Overall, the need for microfinance in India cannot be understated. The government and its programmes aimed at bringing about financial inclusion, can never hope to address the needs of the large number of poor in the country. Hence, the role of private sector microfinance whether in 'for-profit' or 'not-for-profit' formats will remain. However, any business which forgets its client cannot have a bright future. In the desire to grow at double digit (and even triple digit!) rates, the microfinance sector may have forgotten the *raison d'être* for its existence – its clients. Adopting a client-responsive approach, coupled with ethics-based transparency, could take this sector to greater heights and fulfil the very strong needs of poor people in India. ▣

[1] The early 1990 saw NGOs beginning to offer credit services in addition to other social development programmes that were already in their repertoire such as education, women empowerment, water and sanitation etc.

[2] The non-banking company format provides oversight of the Company Law Board as also the Reserve Bank of India.

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

[4] State of the Sector Report 2009.

[5] State of the Sector Report 2009.

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

[7] The Bharat Microfinance Report, Side by Side 2009 reports an average return on equity of 25.88% (Table 4: Operating and Financial Summary of 69 MFIs: 11).