

**MICROFINANCE IN INDIA – AN ANALYSIS OF SUPPLY SIDE  
CONSTRAINTS**

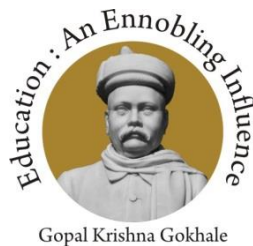
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“The test of our progress is not whether we add more to the abundance of those who have much; it is whether we provide enough for those who have too little.” - Franklin D. Roosevelt.

## **I. Introduction**

The World Bank defines poverty as “The inability to attain a minimum standard of living”, which was “consumption-based” and comprised of two elements: “the expenditure necessary to buy a minimum standard of nutrition and other basic necessities and a further amount that varies from country to country, reflecting the cost of participating in everyday life of society”.

India has housed so many civilizations and endured so many invasions. It is filled with both, tremendous wealth and extreme poverty. Poverty in India is widespread and is prevalent in nearly every city and village, and bolstered by significant income disparity between the rich and poor.

This thesis deals with microfinance and various methods employed for poverty reduction. There is enormous literature stating that demand for microfinance is too huge. Globally as of 2008, 1.3 billion people (22.4 per cent) live on less than \$1.25 a day. Increasing the income poverty line to \$2.50 a day raises the global income poverty rate to about 43 per cent, or 2.5 billion people (World Bank Group, 2012). Now the world population stands about 7.2 billion. Helping such a huge population count is a daunting task.

With all praises, criticism and discussions about microfinance, microfinance has reached one hundred and ninety million individuals worldwide in 2009 (Reed, 2011). This shows that microfinance is able to serve a very small percentage of the demand. Hence this research topic is relevant to address how the microfinance can be used to meet the demand. We try to understand what are the hurdles to meet the goals and how there can be innovation in terms of microfinance delivery.

There were active microfinance systems in India more than 3,000 years ago (Young, 2006) and various rotating savings systems and credit associations have been in existence for more than 500 years in Africa and South America under the names of Susus (Ghana), Pasanaku (Bolivia) or Tandas (Mexico).

Since independence of India, all the governments have been planning to reduce poverty and enhance the living conditions of the population. There were several initiatives in place by government to aid its poverty alleviation plans.

Many initiatives and methods have been adopted across globe. Every year, several conferences and summits discuss about poverty reduction. World Bank has initiated Millennium development goals, several governments maintaining separate budget for poverty reduction. It might be unwise to not acknowledge the efforts put in world wide. In India, Government initiatives dominated the microfinance space till 1970s, post which microfinance revolution picked up. Over a 30-year period,

microfinance has transformed itself drastically. Thanks to field practitioners, microfinance innovations have grown exponentially. Started initially by what is often referred to as a “civil society”, microfinance was largely built upon initiatives from non-governmental organizations (NGOs), and cooperatives. We have many success stories for microfinance. Well-known example is Grameen Bank. It started as a small pilot project with NGO-features in Chittagong, Bangladesh, in 1976. The Grameen Bank is now a well-established financial institution under the legal status of a cooperative, serving over six million clients in Bangladesh, with hundreds of replications worldwide. Such initiatives, alongside a thousand more, were fairly disconnected. Things have improved a lot now, with a lot of information flow and best ideas are being adopted by many.

Armendariz & Labie (2011) has classified microfinance trends as follows:

- *Change in lending methodology:* microfinance gained popularity for having introduced solidarity groups and village banking. Now it has many more approaches.
- With joint liability, mostly among women borrowers.
- *Change in the supply of financial products:* Microfinance has changed from regular micro credit to supply of other financial services.
- *A larger and a more diverse pool of suppliers:* There are many more providers of microfinance other than NGOs, cooperatives. There are newer social investors coming in along with profit motivated investors giving rise to Microfinance Investment Vehicles (MIVs).
- *A radical transformation in supervision and regulation:* stringent supervision for fully regulated suppliers is being set-up in many countries
- *Fundamental change in financial priorities:* Microfinance providers are moving from self-sustenance to profit generation.

The objectives of the thesis are as follows:

1. To understand the characteristics of Indian MFIs like profitability, interest rates, size, etc.
2. To gain understanding of other methods of microfinance funding other than borrowing from banks/donors and then lending it to poor.
3. Understanding any financial innovations in microfinance sector.
4. Understanding the conventional methods of microfinance like Credit unions, Regional rural banks, etc. and practices adopted by these institutions.

## **II. Findings**

This thesis touched upon centuries of poverty theory and almost 60 years of microfinance research.

This thesis studies research done by many practitioners and academicians, and analyse various data to arrive at the following insights.

*Chapter one* is mainly concerned with the basic foundational concepts in microfinance. Though Yunus popularized microfinance concept through his Grameen Bank, it was in existence since 1700 when an Irish man setup a bank to help poor, by lending money to poor who were not under the commercial bank purview. In terms of Indian side of microfinance story, non-institutional lenders contributed about 93% of complete lending in 1951 which dipped to 36% in 1991 and moved up to 43% in 2002. The initiatives by Indian Government were working fine barring 2002 figure. Interestingly, before 2002, there were numerous initiatives like IRDP, SGSY, RRBs, Credit cooperative societies, etc., and it started with formal microfinance after that. This is completely paradoxical to the research literature which states that the government initiatives were not efficient hence microfinance was launched. The analysis of delivery models of microfinance shows that there was constant increase in borrower base in Bank-SHG model and MFI model, showing that there is a constant increase in microfinance activities. MFIs have an important place in microfinance activities in India.

The analysis shows that microfinance sector started with donor funds but gradually they were expected to be self-sufficient after a few years of its operation. Hence MFIs started exploring capital raising methods and that's how commercial microfinance was born. Innovative financing methods like raising money from capital markets as done by SKS or using structured finance approach of securitizing loans emerged in the sector.

Without understanding poverty concepts, this thesis is incomplete. That's what *chapter two* analyses, where poverty theories and its relation with microfinance are examined. We have looked at seven approaches to poverty and conclude that access to credit is important element in economic stability of an individual. If there is a discussion about poverty, it is important to understand the measurement of poverty. None of the poverty measures work accurately and it is important for any practitioner or researcher to study multiple measures before arriving at any conclusion. For example, head count index for India is reducing implying that number of poor people below poverty line is reducing during the last decade. However, the Gini coefficient of India for the last decade is showing an increase implying that the inequality has increased. Poverty has been studied for centuries and there is an exhaustive literature on it. Understanding various aspects of poverty is essential foundation for microfinance sector.

*Chapter three* is concerned about India's MFIs' characteristics. M-CRIL has developed an index CRILEX to study Indian MFIS. There has been a substantial dip, almost 22%, post AP crisis pointing to the deep rooted trouble of one Indian state. In comparison with the peer countries, India stands with the highest GLP of about \$4.2bn and 96 per cent of female borrowers. 60 per cent of this \$4.2bn is divided among six MFIs which mean that larger players hold the grip of the microfinance sector. Cost is an important component of any organization and is a major driver for its sustainability

and profits. Indian MFIs have advantage of India's population density and this is how they are minimizing the cost per loan or per borrower. Indian MFIs costs are at significantly lower levels than its peers. If any MFI is profitable it does not mean it is for-profit, but it can mean that it does not distribute its profit to shareholders but prefer reinvesting in its activities. The positive picture that cost figures have given does not stay the same in case of profitability. AP crisis have seriously crippled the Indian MFIs profitability as shown by negative ROE and ROA. So, despite having good control over cost, it is not able to generate profits. This can be mainly attributed to write-offs on account of the AP crisis. The same view is bolstered by negative profit margins.

Despite these drawbacks, OSS has been high for most of MFIs, and around 73 per cent MFIs are self-sufficient. PAR for India has been on the rise, but it is still at 20 per cent. Interest rates charged by MFIs are higher than the prime lending rate in any country. But the spread between them is narrower than its peer contradicting the theory that Indian MFIs are not charging usurious rates. Even though they have reduced the rates from 2010 after AP crisis, they were already below their peers.

*Chapter four* discusses the AP crisis in depth, along with analysing SKS fiasco by comparing it with cases of crisis across the world. SKS has been under discussion for multiple reasons like raising money from capital markets, reporting 87% CAGR in its annual report 2010-11. Its IPO was oversubscribed by 13.69 times supporting the investors' enthusiasm in commercial form of microfinance. SKS was innovative in its methods and well ahead of its peers in monitoring and processing of loans. It was better in controlling costs and efficient in delivering. SKS was also involved in non-profit or social mandates which were not governed by profit motives. The question that comes up after looking at this is how AP crisis hit SKS functionality so badly that it had to write down 45% of its loan book. AP crisis, widely discussed by academia and practitioners, had affected not only MFIs operating in AP but across India. The AP government ordinance had put restriction on MFIs operations, putting them in a situation where there were restrictions on repayment collections. This triggered delinquency in loans as people were not repaying the money borrowed.

We analyse a number of crisis all across world involving microfinance organizations. These crisis points to one common theme, wherein the borrowers were under debt from multiple lenders leading to a debt trap. A point came where this was not sustainable and whole system collapsed causing widespread defaults in so called historic low default rate industry. This phenomenon of over-indebtedness means the family expenses goes beyond its income. This is caused because poor buy from multiple lenders to meet their expenses and pay off old loans; this is not a sustainable model. Parameters like PAR, collection rate, etc. are lagging indicators and cannot help if a country/region is going towards over-indebtedness. This index was developed for 13 countries and consists of 14 leading indicators that can potentially signal a growing risk for over-indebtedness in any given

microfinance market. Over-Indebtedness early warning Index (OID Index) developed by Kappel et al. (2010) can potentially signal a growing risk for over-indebtedness in any given microfinance market, but unless the data for each household is collected, it is difficult to predict the over-indebtedness.

SKS' capital raising method through capital markets was an innovative technique. Similarly, securitization of microloans is also an innovation in microfinance industry as discussed in *chapter five*. The restrictions on MFIs for not accepting deposits and higher cost of raising capital pushed securitization to come into force. Also MFIs receive loans from banks under priority sector lending which happens only at the end of financial year. So MFIs do not have funds to disburse throughout the year. Securitization is an asset backed transaction, wherein microloans receivables are pooled and repackaged to sell them to investors (banks/funds/investors).

Securitization involves selling loans from MFIs to Special Purpose Vehicle (SPV) which is setup for this purpose. SPV then in turn repackages these loans along with receivable into various tranches (Senior, Mezzanine, Junior, Equity, etc.). These tranches are sold to the various investors depending on their risk appetite. In this way investors are funding the micro borrowers of MFIs who remain to be the servicer of these loans. SPV ceases to exist when the principal and interest is paid to the investors. The senior tranches are protected by junior tranches and first loss guarantee is taken up by originator by maintaining cash collateral. RBI also has put conditions on originators to retain certain amount of loans on their balance sheet. This condition is adopted from popular term 'skin in the game' in Dodd-Frank Act<sup>1</sup>. The structure of securitization has early warnings in built. If there are losses to cash collateral or junior tranches, it will give signal to monitor closely the performances of the loans. The funds/investors can get an early warning about the portfolio deterioration. The securitization has created a link between MFIs and private investors in capital market helping even rural MFIs to tap the funding.

The thesis has discussed MFIs, innovations in MFIs, but its roots are in earlier ways of supporting poor, *chapter six* discusses the alternative form of microfinance. The new age microfinance was considered to be panacea for poverty alleviation, before all the crisis and discussion around their mission drifts. Historically, government initiatives and microfinance helped to eradicate poverty by reducing money lenders' involvement in this sector. They were partially successful, but all the efforts could not remove money lenders from the system. This calls for a deeper analysis of alternative ways of microfinance and understand the historical changes of these initiatives. Many of

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<sup>1</sup> This act was designed to prevent the recurrence of events that caused the 2008 financial crisis. The Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly referred to as simply "Dodd-Frank",

the government's five year plans had poverty eradication as one of its motives. It started even before this with Primary Agricultural Cooperative Credit Societies (PACS) during 1900s. Around 1930, Land Development Banks (LDB) was established. It is quasi-commercial type that provides services such as accepting deposits, making business loans, and offering basic investment products. The main objective of the LDB is to promote the development of land, agriculture and increase the agricultural production. A co-operative is generally viewed as an autonomous association of persons united voluntarily to meet their common social and economic needs and/or objectives. Thus, a co-operative is a socio-economic organisation that is expected to have its members' interest truly at heart. After India attained Independence in August 1947, co-operatives assumed greater significance as an instrument of socio-economic development and became an integral part of India's Five Year Plans. The All India Rural Credit Survey Committee Report, 1954 recommended an integrated approach to cooperative credit and emphasised the need for viable credit co-operative societies by enlarging their area of operation, encouraging rural savings, and diversifying their business. 1950s and 1960s found tremendous push for cooperative banks. But RBI (1969) stated that cooperatives had short comings and there was a need for them to be strengthened. This led to formation of Regional Rural Banks (RRBs). RRBs also went through various reforms mainly through three phases for improving its functionality. RRBs performance was not impressive all along and government had to float reforms from time to time. The reforms made RRBs similar to any commercial bank and caused mission drift. These reforms raised their profitability power but by transferring resources from rural poor to urban rich (Bose, 2005).

Formal or semi-formal finance is not able to meet the needs and demands of rural finance completely. Even if the demands are met it does not serve its intended purpose because of local factors involved. Despite multi-faceted initiatives of government to reduce dependence on informal finance, contribution of informal finance went up from 36% to 42% from 1991 to 2002 (Table 6.2). This calls for deeper analysis of informal finance. Of 20 states 15 states saw fall in institutional lending. Informal financial institutions rely on relationships and reputation and can more efficiently monitor and enforce repayment from a class of firms than commercial banks and similar formal financial institutions. Informal finance are not strict on reasons for lending, punctual repayment, are available anytime and everywhere in village like shops, etc. There are many things that formal and semi-formal finance can learn from informal lenders.

A definitive claim cannot be made that supply of micro credit is done better by microfinance institution or other formal/semi-formal finance. MFIs in India are no doubt cost effective and have lower rate of interest than peers. But this cannot guarantee a success in poverty alleviation because policies and robust regulations are also important. MFIs or banks should also look at the flexibility provided by informal finance. This research convincing makes a point that there cannot be one

solution to poverty, but we should have multiple options open and adopt best practices to make it efficient. Microfinance is a great system for supporting income generating activities of poor and get them out of poverty. We conclude that microfinance provide meaningful support to the poverty alleviation and women empowerment initiatives, it needs support in terms of better and stable regulatory framework, and higher level of easier funding possibilities.

### **Recommendations:**

The thesis points out some of the recommendation driven towards improving the supply of microfinance in India.

- It might be better for government to avoid focussing on profitability in such cases and focus only on its mission. Like RRBs accepting foreign deposits is not required at all.
- Government needs to emphasize more on the regulations for MFIs accessing capital markets, so that there is no predatory lending or coercive techniques used with the borrowers. RBI or any other apex organization can be the sole regulator and oversee the India's MFIs' working.
- Any innovative proposal needs to be studied thoroughly before implementation. Even if there is a caution on progressing, the government has to inculcate confidence in everyone that Government will do all the things necessary for protecting the investors/bankers/tax payers' money. Andhra kind of crisis will just evaporate the confidence in the sector and the poor will not get the help required.
- Government needs to understand why moneylenders still exists and try to adopt their best practices. They can have RRBs/cooperatives/MFIs open on weekend and have flexible loan structures.

### **Limitations of Data and Design:**

This research has identified that there is more scope for in depth analysis of microfinance. In terms of quantitative data, we have limited our study to only individual MFIs in India that reported to mix database. Though, there is reference to a few peer countries at country level analysis, this analysis can be completed only when we collect grass root level data from individual MFIs additionally to those reported to mix database.

In terms of qualitative data, the events were unfolding as the research is completed. Microfinance being in nascent stage, lot of developments kept on happening in regulatory front. In terms of securitization of micro-loans, the famous regulatory Dodd-Frank act can be comprehended and can lay down the probable future regulations in securitization in India. India is still closed country in terms of innovations e.g. revolving securitization structures are yet to be launched in India, but it might be a matter of time. Studying Dodd-Frank act can give a better picture on regulatory front for securitization as a whole.



### Further Research:

This research has identified that there is more scope for deeper understanding of microfinance and people. It calls for an open discussion from practitioners, academia and experts, wherein the open areas are revalidated.

Microfinance in India has gone through lot of reforms and innovations. It has been in troubled waters after Andhra crisis. Competition amongst MFIs is benefitting borrowers, as they are offered competitive rates, flexibility and various products. But disadvantage of this is MFIs going towards predatory lending or borrowers borrowing from multiple MFIs. One of the major reasons for the crisis was over-indebtedness; we cannot predict level of indebtedness unless we have household data for financial resources and shocks in the families. This is where the functioning of credit bureau will help in tackling this issue of over-indebtedness. This way there will be a central repository where information is shared on institutional and individual level. In India credit information system (CIS) is still immature even for commercial borrowing.

Finally, it is important not to restrict ourselves to only one type of microfinance successful in some countries. That might not be in best interest of India, which is diverse in culture. It is better to study any form of microfinance to understand its best practices and adopt into mainstream microfinance.

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