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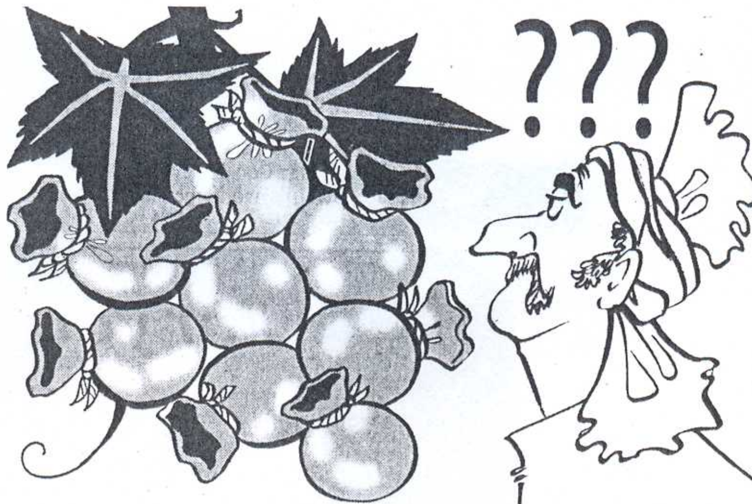
The year of microfinance bashing

Given that banks are unable to lend to the poor at socially acceptable interest rates, it is disingenuous to suggest that microfinance institutions are exploiting the poor, says **Sanjay Sinha**

LAST year (2005) was the International Year of Microcredit. It was celebrated in India as it was across the world. But, one year later, in 2006, we hear Andhra chief minister Y Rajasekhara Reddy describing institutions that provide microfinance services (MFIs) as "exploiters of the poor". In some districts of coastal Andhra, the district administration has told MFI clients not to repay their loans. The Orissa government has complained to the Reserve Bank of India about the level of interest charged by MFIs in that state. Even the Centre, on the verge of introducing legislation for providing a legitimate operating framework for microfinance, has turned cautious. Is 2006 turning into the Indian Year of Microfinance Bashing?

The International Year of Microcredit was a celebration of the growing availability of organised financial services for low income families — generally those families with incomes less than the national per capita GNP. In India, the average per capita GNP works out to $650 or Rs 30,000 a year, i.e., an annual family income of about Rs 1.5 lakh. In India and most developing countries, financial services such as credit and facilities to deposit savings are available to low income families largely through MFIs — not-for-profit NGOs or non-bank finance companies. This is because the commercial banking system has traditionally regarded this bottom-of-the-pyramid group as being not worthy of attention.

So, how do MFIs exploit the poor? Effective lending rates in the range of 20%-30% are deemed to be high and even exploitative on the grounds that the banking sector has traditionally provided tiny micro-loans (less than Rs 25,000) at around 12% interest and, even in this era of deregulation, the banks are not allowed to demand collateral or, even to charge more than their prime lending rate (PLR) on loans of less than Rs 2 lakh or to demand collateral on micro-loans. Since the PLR is currently around 11%, it follows that anyone who charges more must be exploiting the poor.



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But if we match the reality of the limited outreach of the banks with the restriction on the interest rates they are allowed to charge on small loans, the fundamental economics of financial service provision becomes clear. As in any activity, there are economies of scale in providing financial services; it takes banks nearly as much effort to provide a loan of Rs 10,000 as it does to provide one of Rs 5 lakh. And the bank usually charges some 15% interest on a Rs 5 lakh loan to a small entrepreneur and also expects collateral. How can we expect the banking system to reach large numbers of low income families if the banks lose money when making small micro-loans?

In a banking system dominated by the public sector, it is apparent that bankers cannot completely ignore the poor. Nevertheless, the practice of lending to the poor follows its own logic rooted in welfare rather than financial economics. Essentially, lending by banks to low-income clients takes place up to the point at which the marginal return curve for the bank management (in terms of political goodwill) crosses the marginal cost curve of the bank in terms of the financial losses incurred in lending to the poor. Not surprisingly, then, the RBI website shows credit in small borrowal accounts (<Rs2 lakh) is no more than 17% of overall bank portfolios. Credit of amounts less than Rs 25,000 — that might be described as micro-credit — is unlikely to exceed 5% of their portfolios.

SO WHAT is the solution? The logic of bank nationalisation was that the banks should lend to priority sectors, including the poor. This was also the logic for the establishment of a network of regional rural banks (RRBs) in the 1970s. Yet, by the mid-1990s, directed credit programmes like the IRDP had so ruined the RRBs required major recapitalisation. Small borrowers had become so discredited in the eyes of bankers that IRDP, the Integrated Rural Development Programme, became known to bankers as *Itna Rupya Dubona Padega* ("so much money must go down the drain"), and the borrowers themselves were unofficially classified as not-creditworthy. Clearly, this is one objective that bank nationalisation failed to achieve. The current withdrawal of banks, including the RRBs, from the rural sector is further confirmation that banks won't be able to serve large numbers of low-income families under the current risk-return profile.

Apart from direct credit lending by banks, the only alternative to the MFIs is the bank-SHG (self-help group) linking programme promoted by Nabard. By March 2006, around 1.6 million SHGs are reported to have been linked to banks. At an average of 15 members per SHG, this amounts to 24 million families. However, as with much official data, this information turns out to be overstated. The SHG linkage programme is also affected by complications such as the high costs of group development (rarely computed while calculating lending rates) and the fact that members charge each other 24-36% for intra-group lending.

A more careful assessment results in a liberal estimate of some 11 million families served — just 15% of the total of 192 million families in the country. Further, studies by the author's organisation show that the repayment rate of members to SHGs are no better than 70% and the real cost to the banks of lending to them can be conservatively estimated in the range 18%-21% of their portfolio. Let's not question the numbers here, instead focus on issues of costs of group formation, supply-driven credit amounts, subsidy seepage as the government gets involved, declining repayment rates as more credit is pushed to groups, and the fact that members themselves are charging 24-36% within the group, with part of the interest being used to defray costs.

Therefore it is disingenuous (or misinformed at best) to argue that even the best MFIs, charging 20-24%, exploit the poor. Indian microfinance has recorded substantial achievements over the past few years. India's leading MFIs are now highly regarded all over the world. Attempting to tar them with the brush of usury when they are providing a service the banks are unwilling or unable to provide is tantamount to throwing out the baby of microfinance with the bath water of limited and local management failures.

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