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Is micro-credit too costly?

FACE-OFF

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But is there a cheaper alternative?

A FELLOW airline passenger recently told me "MFIs loot the poor". A common middle class perception. We have become socialised to the idea that the poor need subsidies.

Consider the alternatives for a poor woman in a village. The most obvious, for a man at any rate, would seem to be to go to the local bank and take your chances getting past the armed guard and then the chaprasi. The manager will probably ask you which scheme you are applying under and ask for a recommendation from a government functionary. If you are lucky, a month or two of running around will yield a loan of Rs 5,000 at the bank's PLR of 11.5%. "Cheap" loan for which you spent Rs 500 in cash completing all the requirements and another Rs 500 in lost wages. Effective interest rate, 47% per annum; chances of getting a loan in a month, 5%.

Second possibility, go to a moneylender; not any moneylender but one who knows you since he is the only one who will lend you anything. If you happen to live in some parts of south India the moneylender will let you have a loan at Rs 3 per hundred per month (36% per year) but usually against security of some form of jewellery or other valuables — even utensils are mortgaged in this way. If you are less fortunate and happen to live in north Bihar or the tribal areas of Orissa, Chhattisgarh or Assam, it will cost you 10% per month. Effective interest rate, 120%, chances of getting a loan, 70%.

Third possibility, become a member of an MFI if there is one near you, participate in their programmes (half an hour's meeting a week) and get a loan at 30-40% effective interest rate; chances of getting a loan, 90%.

Is microfinance too expensive? Let the market decide. Anyone with a genuinely cheaper alternative will not come to MFIs for a loan. If the MFIs flourish, competition will force efficiency and bring down costs. Ask the cellphone service providers, ask the airlines. Is microfinance too expensive? Ask the MFI clients. The poor need competitive service providers.

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Balance financial and social objectives

SEVERAL factors have led to the current tense situation vis-a-vis microfinance in India. Firstly, the interest rate. The stated interest rate ranges from 10 to 25% per annum. But the effective interest rate is anywhere between 20 to 45% per annum, which includes various factors such as processing fees, the repayment frequency, number of instalments, etc. This explains how a flat interest rate of, say, 15% per annum, can amount to an effective interest rate of 38% per annum.

Secondly, as with most issues, when the government becomes an active player, the issue becomes politicised. In Andhra Pradesh, which accounts for 40% of all microfinance activities in India, the government has its own microfinance model. This is the 'self-help group' banking model. So the state is not a neutral umpire and faces competition from existing MFIs.

Thirdly, the objective of MFIs to serve the poor while aiming for financial sustainability calls for a fine balance. They face high transaction costs as their business involves making small loans to a large number of clients. One way to reduce these costs and take advantage of economies of scale is by standardising products and operations. Uniform treatment of clients and greater professionalism translates into persistent efforts to collect repayment. The trade-off in this case is reduced flexibility in contracts which may lead to debt spirals when customers turn to moneylenders for help.

Lastly, microfinance has grown at an alarming rate over the years when financial products offered to clients have increased in number, range and sophistication. In such a scenario, concerns for consumer protection will naturally intensify and expand to address issues relevant to the marketing and sale of microfinance products. However, regulation such as capping interest rate might be akin to "throwing the baby out with the bath water". It might exacerbate the situation by putting several MFIs out of business and by driving clients back to informal lenders who charge significantly higher interest rates. Another likely drawback would be higher effective interest rates, reflecting the new riskier political climate.