Interactive Session on Developments in Micro Finance (MF) Sector
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MF Sector in India: Few Observations

Developments in MF Sector

Till couple of decades back, barring crop loans from state supported cooperative institutions in the rural areas, poor in our country were not availing any noteworthy credit product from the formal financial sector. That situation partially changed when GOI launched twin initiatives in mid 90s, e.g. NABARD sponsored Bank-SHG Link (BSL) program and permitting diverse types of Micro Finance Institutions (MFIs) to penetrate into then un-banked sections of society. With this, poor, particularly women among them, started getting unsecured micro credit. Over the years, annual credit disbursements under both the modes increased substantially, though much less if the total credit requirement of the poor in our country is taken into account.

This "micro-credit" centric financial inclusion program is being further diversified in last few years. GOI, with the help of regulators like RBI, IRDA, PFRDA, has taken lead to include millions of poor people in formal financial sector. There are schemes (e.g. PMJDY, MUDRA, Atal Pension Yojana etc.), revisions in extant policies (e.g. relaxing KYC norms), licensing new financial institutions (e.g. Small Finance Banks, Payment Banks etc.) and directing financial entities to launch special products aimed at poor people (e.g. Micro Insurance, Micro Pension etc.).

These developments need to be welcomed, unreservedly.

Though each above-mentioned initiatives is a candidate for serious discussions, we propose to confine our present discussions only on Micro-Credit for quite a few reasons.

Focus on Micro Credit

The term Micro Finance(MF) connotes all the financial products and services being served to poor. However, none of them invokes kind of social political response like "Micro Credit". There are reasons. Accessing "credit" enhances cash-inflows of the borrower family, whereas availing other products (e.g. micro –savings, insurance and pension) entails cash-outflows. Poor, being cash starved most part of the year, avails "credit" number of times in a year compared to other MF products. This is reflected in exponential growth of "micro-credit" sector. Both the credit delivery models, viz., BSL and MFI have registered impressive growth rates in terms of both the parameters, viz., number of clients and amount of loan outstanding. This trend is likely to remain unabated in foreseeable future. No other micro finance product can match these numbers and trend.

Further, interest rates charged and the methods adopted for recovery of loans from the defaulting poor borrowers are always seen with hawkish eyes by society at large; and rightly so in a democracy like ours. Third reason why issues in micro credit sector need to be discussed seriously is the profile of the clients. For example, both modes of micro credit, viz., BSL and MFI, serve around 4 Crores borrowers each. Many borrowers borrow from both the channels. Hence must have been double-counted. Nonetheless, the number is huge. Out of these borrowers, around 97% are women. The borrowers belonging to SC/STs and minorities are reported to be 30% and 27% respectively (Ref: SADHAN 2016).

There may not be great changes taking place in near future as far as poor borrowers are concerned, e.g., their perennial need for credit, their tendency to divert credit purportedly taken for income generation towards consumption, their weak repayment abilities and their vulnerabilities. However, a lot is set to change at lenders' end. Two developments are noteworthy. One Scheduled Commercial Banks, particularly new private sector banks, starting lending unsecured loans to poor directly (and also indirectly through Business Correspondent route) and second, large NBFC-MFIs converting themselves into Small Finance Banks(SFBs). We will dwell upon these developments shortly.

At present three distinct institutional models of micro-lenders are in place: (a) state sponsored, either by central government (Bank-SHG Link program) or by state governments (MAVIM by Maharashtra and SERP by AP), (b) not for profit MFIs (trusts, NGOs, Section 8 companies) and (c) commercial micro lenders (Scheduled Commercial Banks, particularly in private sector, Small Finance Banks and NBFC-MFIs).

These three institutional models have their own strengths and weaknesses in terms of (a) raising adequate capital at reasonable costs, (b) financial self-sustainability, (c) providing credit plus services to the poor borrowers and (d) handling unavoidable delinquencies without invoking social political adverse reactions. These strengths and weaknesses are also getting reflected in their "financial" as well as "social" performance.

Out of these three, it appears that the first two models may face some problems in near future. For example BSL model is saddled with huge NPAs (7 % as per one report) and may lose momentum as the flow of funds may decline. BSL is also increasingly becoming savings mobilization platform than for credit dispensation. Impacts and outreach of the credit programs (e.g. MAVIM, SERP) sponsored by state governments needed to be analyzed further. Not-for-profit MFIs may not be able to expand their outreach and may have serious issues on their financial sustainability issues.

The third model, viz., commercial micro lenders, leveraging their strength of raising capital from domestic and international markets, are surging ahead. The share of three commercial micro lenders (SCBs, SFBs and NBFCs) together in the outstanding micro credit in the country is ever increasing and is likely to increase further in foreseeable future. There is another serious reason for discussing business model of commercial micro lenders in depth. Whenever media reported about the mass agitations against the micro lenders in the states like AP, Karnataka or Maharashtra in the past, invariably names of commercial micro-lenders appeared and not BSL program or not-for-profit MFIs.

Commercial Micro Lenders

We will discuss some of the issues associated with all the three commercial micro-lenders Small Finance Banks(SFBs), Scheduled Commercial Banks(SCBs) and NBFC-MFIs.

Small Finance Banks(SFBs) : Responding to RBI's decision to issue licenses for "new" type of bank, viz., SFB, number of large NBFC-MFIs applied and got the requisite license. Out of 10 SFB licensees, 8 are erstwhile NBFC-MFIs. In yet another development, Bandhan, another NBFC-MFI has become full-fledged bank. Converting a NBFC-MFI into a bank, full-fledged or small, is a significant development as there will be lesser ambiguity about to which "regulator" they are accountable to.

The period for which erstwhile NBFC-MFIs are in operation in their new incarnation(s) is too short to pass any worthwhile comments on their performance. It needs to be seen, whether changing tag from a "non-bank" to "bank" helps these micro lenders to eliminate all those reasons which prompts poor borrowers to agitate against them.

Scheduled Commercial Banks(SCBs) : SCBs, primarily large Private Sector Banks(PVBs), viz., AXIS, HDFC, ICICI, IDFC, DCB, Kotak Mahindra, RBI and YES are consciously building their own micro loan portfolio. In order to expedite this process few PVBs have acquired small and medium size MFIs in recent past. As per MFIN Report, in FY 2016-17 these PVBs together have disbursed Rs 51, 541 crores (70% direct and 30% through Business Correspondent partners) registering a growth of 28% over previous year. It is expected that PVBs will become largest micro loan lenders in next FY, with SFBs as runner up and NBFC-MFIs at third position.

Most of these PVBs are decades old and are known for better governance. They dealing with such a large number of poor borrowers directly is a new trend. Being listed, having acquired a "brand value", it is expected that they will be extra sensitive to any adverse publicity. The percentage of their micro credit portfolio in their overall loan portfolio will also be insignificant. This may make them more tolerant in case poor borrower(s) defaults. But again it is too early to pass any judgment on PVBs behavior while dealing with the poor borrowers.

Till such time, rich insights provided by experiences of NBFC-MFI model need to brought on discussion table. NBFC-MFI model is old enough to throw up empirical data for meaningful analysis. As may be seen from the following paragraphs, we tend to argue that there will always be social- political reactions whenever any micro-lender (be it PVB or SFB) is driven by the business logic and business practices being followed by NBFC-MFIs.

We have extensively used data provided in Bharat Micro Finance Report 2016 (Report) published by SADHAN, an association of MFIs for this purpose.

NBFC-MFIs: There are 4 different types of MFIs, viz., Cooperatives, Societies / Trusts, Section 8 Companies and NBFCs. In all there are about 170 MFIs operating in the country. However, among them NBFCs (50 out of total 170) are overshadowing every other form of MFIs in respect of all the performance parameters as shown in the table below (figures as on March 2016)

Parameter	All types of MFI taken together	Out of which: NBFC-MFIs	Percentage Share of NBFC-MFIs (%)
Clients	399 lakhs	320 lakhs	80
Branches	11,644	9775	84
Gross Loan Portfolio (Rs Cr)	63853	56,223	88
Managed Portfolio of Banks (Rs Cr)	16,914	11,243	66
Employees	103415	86385	84
Funds Raised in FY 2015-16 (Rs Cr)	39,331	38,372	98

In fact, within NBFCs it is a group of larger NBFCs (defined as those with gross loan portfolio greater than Rs 500 Cr) which dominate the show. There are 22 MFIs (out of 50) satisfying this criterion. .

Report also provides few other insights, useful for our discussions:

- Even though 97% of the clients served by MFIs are women, the women representation in the staff employed by MFIs is only 15%. This is noteworthy when there are allegations of highhandedness against MFIs while dealing with its clients.

- NBFC-MFIs witness high rate of attrition. During FY 2015-16, 23,098 employees opt out of service (as against 39,627 fresh recruited) of MFIs; significant number of them belonged to large size NBFC-MFIs. How one interprets this information? Due to high stress among the staff? or Easing out those who are not meeting stiff targets?

- Active Borrower per Credit Officer (ABCO) is another important performance parameter.

Gross loan portfolio	Less than 1 Cr	Between 1 Cr and 10 Cr	Between 10 Cr and 50 Cr	Between 50 Cr and 100 Cr	Between 100 Cr and 500 Cr	More than 500 Cr
ABCO	165	330	430	409	518	665

It may be seen that ABCO ratio increases with the size of the gross loan portfolio. Report also mentions "there are 14 large MFIs having ABCO above 1000 which indicates unrealistic targets being set for credit staff".

One explanation is larger MFIs, leveraging their financial strengths, invest in capital intensive technologies like handheld devices, computers and servers and hence their credit officers equipped to handle larger number of clients compared to smaller MFIs. Higher the clients handled by the credit officer, lower will be the operating costs of the MFIs and hence lower rate of interest offered to the poor borrower. But this interpretation also has other side.

Higher number of clients handled will reduce average time spent by the credit officer with each client and also dilution of quality of credit assessment. Credit products are not "consumer products" to be sold across the counter. It creates a longer term "relationship" between lender and borrower. This demands more "restful" engagement by the credit officer with the prospective borrower. More so when there are hardly any authentic papers to rely on as an input for this assessment process.

These insights throw up few "Unanswered Questions"

Unanswered Questions

Tensions in the lender-borrower relationship trigger when borrower defaults on its commitment to repay. Most of the defaulting poor borrowers are "genuine", i.e. they are not "cheats". Most of loan recovery officers are under age-old "carrot and stick" HR practice by their employers. If they could keep default to the minimum they will be rewarded; if failed consistently they may even lose the job. (Recall high attrition rate mentioned in the previous page). Not surprisingly, the recovery agents indulge in ruthless recovery methods, many are not even documented. Poor borrowers resist. When this happens to number of borrowers in the vicinity, individual discontent aggregates. The aggrieved borrowers seek leadership from local social, political activists, which they willingly provide. This leads to organized protests. The "default" no more remain a private "lender-borrower" affair but becomes a social-political issue.

Who is primarily responsible for such recurring situations? The related literature has enlisted many reasons viz., diluted assessment criteria, absence of centralized credit history database, borrowers' tendency to divert the loan purportedly taken for productive purposes towards consumption, force majeure conditions like floods, draughts and crop failures, or serious illness of the borrowers etc. All these reasons are not invalid, however, there is a need to go beyond them and seek answers to quite a few questions.

Income generation Vs Consumption: When poor borrowers use their loans for their emergency and consumption needs, it does not add anything to their existing income generating abilities. On the contrary, there is an incremental drag on their existing income sources in the form of fresh repayment obligations. Keeping this in view RBI in 2011 stipulated that a minimum of 70% of the MFI loans are to be deployed for income generating activities. This regulatory intervention has twin objectives: (a) improving income levels of the poor, however partially and (b) reducing the chances of default, as incremental repayment obligations will be supported by incremental income flows. Report (page 28) informs that the proportion of loan extended for income generating activities stood at 94% as against 70% minimum stipulated by RBI. This achievement is quite comforting. However few questions remain unanswered:

Unanswered questions:
If 94% of the loan availed by the poor is going for increasing their existing income levels, why there is a discontent, If any?
If the loans are purportedly diverted from "income generation" to "consumption", can micro-lenders absolve themselves from lapses in monitoring the "end-use" of the loans?
Is any poor borrower found diverting loan taken for "production" to "consumption" purpose been denied fresh loan, which is a standard practice in Banking?

Rate of Interests Vs Discontent: Malegaon Committee, set up aftermath of AP crisis conceded that one of the reasons behind MF Sector crisis in AP was usurious interest rates charged by MFIs. Accepting the Committee's related recommendation, RBI capped the rates of interest at 26%. Report (on page 1) claims that "MFIs started passing on the benefits of scale to their client borrowers. ..80% of sector's gross loan portfolio have extended loans at weighted average of 23.13%, far below the RBI cap of 26%".

Unanswered question:
If the nuisance of usurious interest rates, one of the root causes of the unrest among poor is being blunted, why the incidents of unrest recur?

Over-borrowing Vs Over-lending: Poor are routinely blamed for over-borrowings. Over-borrowing, defined as borrowing beyond one's repaying capacity is the genesis of many problems in the MF sector. Hence it is necessary to examine this statement of blaming the poor.

Keeping in view acutely uneven strengths of corporate micro lenders (or for that matter any lender, including private moneylenders) and vulnerable poor borrower, it is difficult to believe that poor borrower will be able to borrow unless the lender agrees to lend. The final "say" lies with the lender. Yes, occasionally, lenders do faults on judgements. But when large number of micro borrower struggle to repay, so much so that loan recovery officers have to resort to some force, this cannot be billed to judgmental error of lenders.

Unanswered questions:
Under "directed lending" policies implemented by the Central Government, Public Sector Banks are asked to chase certain targets in a given time frame. Who is compelling NBFC-MFIs to chase the targets, surpassing their past achievements every year?
Should not a lender lending an unsecured loan to an asset-less borrowers be over cautious?

Formal credit history Vs "Commonsense" of Lender: Loan officers of micro lenders blame "asymmetry of information" and "lack of centralized credit history" for over-lending. This is true, but partially. A trained and willing loan officer can circumvent such handicaps, it is not that difficult. He need not have to go far and beyond to collect information related to creditworthiness of his borrower client. Simply because almost all poor borrowers would have availed loans from the lenders in and around his village or basti. Poor borrowers themselves will not be able withstand more inquisitive and hard questions about details of their outstanding loans. Over the centuries, banking industry has honed such skills of gathering requisite information about the borrower. This is not to belittle importance of ongoing efforts to build credit history databases. They should be created as early as possible.

Unanswered question:
Is the problem of lack of organized credit history of an individual borrower is unsurmountable as it is being made out to be?
There are multiple MFIs operating in one town, or district; who has held back MFIs loan officers to exchange notes about each other's prospective borrowers?

"Crisis" in no one's interest

Eight years have lapsed since AP MF Sector crisis erupted. During pre-crisis days there was wide spread discontent among the poor borrowers against then active NBFC-MFIs. The concerned AP administrators and political leaders concluded that the lending and recovery practices of MFIs were hurting poor borrowers. They intervened heavily and imposed severe restrictions on MFIs. In response, it appears that MFIs systematically withdrew from AP. In pre-crisis years AP used to enjoy largest share of MFI's outstanding loan portfolio in the country; now it is insignificant. It is not loss of business opportunities alone; it took more than 5 years and substantial write offs for entire micro credit sector in general and NBFC-MFIs in particular to recover from jolts of AP crisis. This is not the end of the story. There are newspaper reports that, after withdrawal of MFIs private moneylenders in AP have become more active. From "pan" back to "fire" !

A major lesson from AP is: "C**risis in formal micro finance sector is neither in the interest of micro-lenders nor that of poor micro-borrowers.**

'Money Lending Prohibition Acts" enacted by almost every states are now decades old. Still, "private" lending is rampant everywhere, be it a village or an urban slum. There are reports that now-a-days, anyone with reasonable cash surpluses lends money to the poor people it their vicinity. They include teachers, government employees, community leaders etc. No one knows what is the volume, how much interest being charged in this informal credit sector. Being unregistered entities, it is extremely difficult first to identify and then to regulate these "new" (along-with the old) moneylenders. Sprouting of such moneylenders all over the places will prove to be disastrous for the financial wellbeing of the poor borrowers. It is beyond capacities of the local law enforcement agencies to eradicate them.

If the scourge of private, unregulated moneylending has to be controlled, if not abolished, there is an urgent need to stabilize alternate formal credit delivery institutions. The commercial micro lenders, amenable to the regulatory regime, have their strengths in terms of resourcefulness, scaling up the operations, adopting corporate banking practices and investing in capital intensive technology led solutions. However it is also observed that whenever commercial micro lenders get into overdrive, they end up in creating crisis like situation in MF sector. This cannot be attributed to oft repeated analysis of tighter regulation and better self-regulation.

The issues leading to recurring crisis in micro credit sector appear to be structural in nature.

Structural Issues

We have identified few "structural" issues prevalent in MF sector.

Excessive emphasis on "Credit Infusion": Most of the committees set up by GOI, RBI to examine issues in mainstreaming poor in formal financial sector have emphasized that the objectives of micro-finance shall be to "help the poor to lift themselves out of poverty". The associations of MFIs like SADHAN and MFIN proudly state that their "mission" is "to help poor in their quest for establishing sustainable livelihoods and improving their quality of life". Sadly, none of the agencies have bothered to translate these lofty objectives into monitor-able performance parameters of MF sector. It is premised that higher amounts of outstanding credit, at aggregate as well as at individual borrower level, is a proxy for welfare of the poor borrower families. There is a need to evolve different set of qualitative parameters while assessing "successes" of micro credit sector.

Fatal Combination: There is a mismatch between the business logic followed by the capital market driven MFIs and inability of the poor customer to fit in it. Many commercial micro lenders are increasingly raising resources from capital market, either through private equity route or IPOs. Many of them have already listed their shares on the stock markets; many others have plans to take the same route. The listed corporate "behaves" altogether differently compared to an unlisted entity in the identical business. The top management of the listed corporate is driven by the sole objective to "maximize the shareholders' value". This means to ensure that the price of the share being quoted on the stock market remains high and appreciates continuously. CEOs of listed companies are expected to provide "guidance" every quarter on how the company's growth will look like in subsequent quarter and over the year. They routinely announce their projected growth rates for outstanding loan portfolio and profit margins for the foreseeable financial years. The projected growth rates have to be necessarily positive all the time, otherwise the share price is likely to get hammered.

These growth targets at company's level then are broken down at individual loan officer level. In order to achieve these pre-determined growth rates of loan disbursements and profit margins, the loan officers dilute or paper out the formal assessment criteria and later resort to ruthless recovery methods respectively. Both are interconnected. Glossing over eligibility criteria leads to over-lending and increases the probability of defaults necessitating adoption of ruthless recovery methods.
On the other hand, many poor borrowers, prisoners of their own financial distress, behave irrationally while availing loans. They are indifferent to the rate of interest being charged. For them timely availability of cash is the sole consideration. This combination of "irrational" poor borrower and "target chasing" MFI is proving to be

fatal, eventually not only hurting the poor borrowers but discrediting the "responsible" corporate MFIs too.

Abandoning "Basics" of lending: "Credit Assessment" and "Credit Monitoring" are two time tested pillars on which lending activities shall rest; let the borrower be large corporate or a poor individual. Lenders do assesse creditworthiness of the prospective borrower. But creditworthiness is a function of amount of loan. A borrower may found to be creditworthy at "x" amount, but may disqualify for (say) "x+" amount. Overlooking credit absorption capacity and/or debt servicing capacity of the borrower is half invitation for default. Arriving at reasonable amount of loan to be lent needs to be followed up by "end use" monitoring to ensure that the loan is being used for the purpose for which it was given. Micro lenders in their compulsion to chase targets in a predetermined time frame and cut costs of delivery have almost abandoned this age old "wisdom". They have commodified micro loans, for which there are limits. If the business practices of the micro lenders are based on this premise of "commodification" of loan products it is bound to backfire.

"One Shirt Fits All" Approach: Poor engage in multitude of income generating activities. Each with different income profiles. The "profile" varies from location (rural, urban or hilly areas), extent of value addition (trading, petty businesses etc.), season (summer, monsoon, post-harvest) etc. The hallmark of poor people income profile is "unevenness". If the terms of repayment offered to borrowers factor in their "income profile", there will be less probability of default. This is possible without asking lenders to sacrifice their interest income(s), by basing the repaying schedule on "Discounted Cash Flow" principle.

But micro lenders by and large dish out standard credit products; whereas what is required in differentiated approach. There will always be a mismatch between "even" repayment schedules and "uneven" income streams of the borrowers; one of the root cause of defaults.

Concluding Observations:

There appears to be "correspondence" among the quite a few related variables: Constitution of MFIs → Company form → Regulated by Company's Act, RBI, SEBI → This being a legal form preferred by capital market investors, domestic as well as international → Substantial equity funds flows → Adequate equity and corporate structure provides comfort to the debt providers → Availability of funds facilitates expanding geographical footprint as also loan portfolio, investing in capital intensive technology platforms → Pressure on management to increase "shareholders' value" → Pressure on field staff to meet targets of "credit disbursements" as "recovery" → Field staff routinely resort to dilution of credit assessment and ruthless recovery methods, if required → Poor borrower reacts → Unrest aggregates → Burst into a social political issue.

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