THE ECONOMIC TIMES
Thu, Oct 14, 2010 | Updated 04.41AM IST

12 OCT, 2010, 04.34AM IST, M S SRIRAM,

Are MFIs showing shylockian streak?

When microfinance started in the country, it was about getting the banks to finance microcredit , and attracting investments. Nobody discussed interest rates.

We thought that this debate was settled. Interest rates are a function of cost of funds, the risk perception on the underlying activity and the customer, and cost of operations. Of course, every lender would maximise the return on investment to the extent the market would allow.

Therefore, to argue about interest rates without a context and call it usurious is inappropriate. It could be termed usurious when the returns look super-normal.

But now, with controversies from the world of microfinance making headlines, the first punching bag for naysayers would be to term MFIs as usurious. A benevolent argument is that with volumes, technology and competition, rates would fall and settle to level providing a reasonable return.

There are two valid reasons why the interest occupies the frontline argument against MFI:

l The rates are set after considering factors including delinquency. If we believe the recovery figures — upwards of 99% — of MFIs, then the delinquency would be minimal and would have driven the rates down to the extent that the loans are considered fairly secure — with a social collateral. The group formation and intensive follow-up costs that add to the overheads should be partly offset by lower delinquency.

l Competition has not reduced rates. People are talking about multiple lending, leading to the creation of a bubble. The argument that with scale, competition and efficiency, the rates would fall has not been held out.

Two instances that provide material to the interest rate critics are:

l When the Andhra Pradesh government cracked down on MFIs a few years ago, the MFIs and their association could have taken a principled stand that the rates being charged were appropriate as per their cost structure. Instead, the largest MFIs responded by lowering the rate. The association responded by a code of conduct.

l When RBI recently sought inputs on whether microfinance lending should continue to enjoy priority sector status, two large MFIs responded by slashing their rates immediately and substantially.

We argue that there is logic in setting rates. Competition should ideally bring down rates as the market matures. However, this is not happening. The rates at the client level are relatively inelastic. The rate movement over the last decade of microfinance shows that the cost of funds — through increased rates — has offset the operational efficiency gains made by MFIs. A worry MFIs might have: if the rates are reduced, they are locked at that maxima and MFIs have to be sure that it is indeed sustainable. Raising rates is extremely difficult.

MFIs are competing for the same client, and the client is borrowing indiscriminately and not choosing, thus transmitting the competitive pressure to the MFIs. The MFIs have an anxiety to grow — a result of commercialisation — and are cutting corners in their appraisals. Thus, future risk costs looming large.
What should the government do? The choice is simple:

l Let it be. The bubble will burst and institutions will collapse. The lenders, banks, that have exposure to MFIs will lose money. This does pose a systemic risk.

l Investigate the implication of multiple lending; examine what it would do to the families of the poor and whether it would pauperise them. Take action to moderate the lending based on findings.

l Signal MFIs to be cautious in their growth and indicate that they are being . The government has taken the third path, the MFIs are not picking up the signals and are responding by forming more associations and credit bureaus instead of an internal clean-up. Since these institutions are not keen on an internal clean-up, the state has to step in. The best option for the state would be to inspect a few large MFIs and check if the systems and processes are fine, due diligence is done on the client, identity and purpose of the loan is established, the underlying purpose is recorded, and the loan is not irresponsibly dumped on the client.

This would yield horror stories for the state/RBI to act. This is superior to a policy change of reintroducing interest rate caps and knocking MFIs from the priority list. Before knocking them off the list, find out whether there is reason for such action. The state can do this, if it cares. But it is easier to issue a statement saying that we advise the banks to ensure that they impose an interest rate cap. The state has taken an easy way out but not the most appropriate way.

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