Commercialisation of Microfinance

M S Sriram

Microfinance has attracted the attention of several private equity players and more and more funds are being pumped into the sector

WHILE ACTIVITIES that could be termed as "microfinance" have been carried out in the country for a long time, this term seems to have caught the fancy of several players in the last few years and has been getting media space and space in the minds of the policy makers. If we take the definition of microfinance to be "provision of financial services to people who otherwise did not have access to formal institutions due to small transaction size", we would then realize that several attempts both by the state as well as the voluntary sector have been made in bringing these services to the poor and the disadvantaged with varying degrees of success.

There have been several attempts made by the state for having inclusive financial services. However most of these initiatives have been at creating structures that should foster inclusive financial services - some of which were to have state partnered co-operative movement, promotion of regional rural banks and also offering several schemes from the supply side to meet the overall objectives. The schemes offered by the state have in the past not only covered loans [with and without subsidies], savings but have also extended the facility of insurance to the disadvantaged sections of the society at reasonable costs. However there are questions as to how well these schemes have actually touched the people who were expected to be benefited from the schemes.

In the past three decades we see that a low key revolution has been happening in this space and it is suddenly gaining momentum in the last four or five years. The revolution is about getting the poor and disadvantaged, particularly the women organized into groups in

The author is Professor at IIM, Ahmedabad.

order to address their own issues pertaining to financial services.

While our own home-grown experiment of forming self-help groups has had varying degrees of success across the country, we have also seen a model inspired by the Grameen Bank of Bangladesh taking roots in the country. Unlike the self-help group model, the Grameen model is simple, easy to replicate and easy to scale. Therefore it is natural that it has attracted the attention of several players as it could reach the services to a larger number of people very quickly. Before getting into the issues pertaining to these models, I will highlight the significant differences in these models.

Self help groups are more flexible than Grameen type groups - having a membership of 10 to 20 women, they are almost independent business entities and they need not be embedded in a federation or linked to a bank. They are more in the nature of mutuals or micro-cooperatives operating as stand alone units with a choice of association. Usually self-help groups start with savings as a pivot and do lending of the saved resources in a manner similar to that of bishis. Only when they reach a certain scale do they get linked to an external agency such as a bank for leveraging greater credit. Even when the groups associate themselves with the bank, it is the group that is the entity in the books of the bank and not the individual members. Having taken a bulk loan from the bank the members decide from amongst themselves as to who should get a loan, on what terms and tenor. Thus these groups are largely democratically governed, self managed and locally run. These groups might seek the help of a local NGO or resource persons to help them to deal with the technicalities of the operations. It is very evident from the above description that these groups are empowering because they leave the fate and management of the group to the members themselves. Therefore it is to be assumed that such methodology has a very slow process of growth and the failure rates could be much higher than the alternate methodology. While the figures of formation of self help groups and their linkage to the banks over the last three decades appear to be impressive there have been valid questions raised about the quality of the groups that appear in the national statistics.

On the other hand, Grameen type groups are promoted by agencies that follow the Grameen methodology. The usual practice is to do a wealth ranking to identify the poorest of the population, organize the women of such households into groups of five and consolidate them with eight groups in a centre. Once such groups are formed and they pass the group test (which checks out the women's knowledge on the operating philosophy of the organisation, the terms of the loan as well as some social parameters) the microfinance institution that operates on the Grameen methodology starts giving loans.

Savings in such groups is secondary, partly due to regulatory considerations and partly because the organizations are basically credit-oriented. Apart from attending the meetings and reciting the rules of the organisation and transacting credit and repayment the women in such groups are hardly in any decision-making/account-keeping role. The methodology is fairly standardized with loan sizes pre-specified, interest charged on a flat basis, installments being equal and the loan repayment term also being fixed with a weekly interval for transactions. Thus this standardization helps the organizations running the Grameen type of programme to quickly replicate and rapidly open offices and form groups. The focus is more on whether the women are ready to transact rather than on whether they are ready to take charge of the management of their groups. The management of the groups is done externally. Thus it is possible that such groups grow very rapidly and keep going as long as the organisation is able to offer credit and the customers are in a position to absorb credit. Unlike the replicators the original Grameen model in Bangladesh provided the borrowers with an ownership right in the organisation by offering and making each borrower a shareholder. The

Indian replicators have adapted all but the ownership principle in their roll out.

The Grameen type of microfinance activities have constantly justified the high interest rates that they charge. They argue that formation of groups and taking credit to the doorstep of the borrower involves fair amount of financial resources and unless there is some other source of income to subsidise the costs, they have to be ported on to the borrowers. In any case most of these institutions stop accepting grants once they achieve a certain scale, and of late the commercial players who are entering this large market are coming in with a sustainability requirement from day one, without any subsidy. The argument of the Grameen type of microfinance institutions is that the subsidies on group formation of the self-help groups are hidden because they are usually absorbed by the institution that promotes these groups and these institutions could be grant funded. Therefore the high interest rates [in some cases reaching near about 36-38% effective interest rates] have been justified.

While the self-help group also charges high interest rates when compared to their borrowing and transaction costs, this has largely been justified with the fact that the surpluses actually remain within the group and could be potentially distributed back to the women at any point in time. Infact several groups do distribute a good dividend periodically or pay back their members in kind. However when the Grameen type of microfinance institutions make profits, these profits go back to the investors - like in any privately owned firm. Thus these microfinance institutions are therefore similar to any commercial finance company operating in a niche market where there are arbitrage opportunities for a formal sector financial institution to come in.

As the methodology of replication of Grameen type operations has now been fairly standardized and these operators enter areas where some preparatory work on microfinance has already been done, the developmental costs are no longer as high as they used to be. The second thing that we need to remember is that when many of these organizations started work their own borrowing costs were high because of the high interest rate regime. Now the interest rates have also come down to moderate levels. Thus it is evident that the Grameen type of organizations involved in commercial microfinance seem to be making good profits. So much so, microfinance has attracted the attention of several private equity players and more and more funds are being pumped into the sector.

While the investments to the microfiance sector is most welcome, we should pause to see why all the investments are coming in only to companies that are following a single methodology of microfinance delivery. Is there something about the profitability of the model that is attracting the private investments. Given that the focus of microfinance has shifted from players who were basically from the developmental field to players from the private sector, would there be greater pressures on continuing the delivery of greater profits? If so, are we moving towards some microfinance institutions in some areas chasing the same set of clients with an oversupply of credit? If this is happening it is a cause for worry.

A couple of years ago this issue was raised in Andhra Pradesh and the microfinance institutions made it out to be a fight between the government promoted self-help group movement and the privately owned MFIs. However, the issue cannot be brushed aside as just an ideological issue and has to be addressed keeping in mind the cost of delivery and a justifiable return on investments. That interest rates charged in Latin America and Sub-Saharan Africa are much higher or that the money lenders are charging high rates of interest are actually no justification to have interest rates that produce super-normal profits that could beat the banking sector returns. The organizations involving themselves in purveying credit to the poor possibly should consider the set of borrowers as long term customers that lay golden eggs and not try to look at very short term gains. In this regard the scramble for investment in microfinance institutions, particularly from the private equity space is to be seen with caution. ❑

(Email: mssriram@iimahd.ernet.in)