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MICROFINANCE IN INDIA

Mission or Misery?

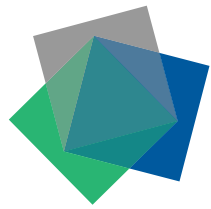
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EXECUTIVE SUMMARY

Decades before the Millennium Development Goals were dreamt of, poverty alleviation was a mainstay of election manifestos and government agendas across the developing world. India, with its large and rapidly growing population of landless and unskilled classes has consistently been a hub for experimenting with poverty-busting schemes. All have promised to drag the planet's poorest inhabitants into the middle classes.

Successive Indian governments have ridden to power on the back of now hollow sounding promises of wealth redistribution and the eradication of hunger. These promises reached fever pitch during Indira Gandhi's 'Garibi Hatao' (Eradicate Poverty) campaign in the 1970s that institutionalised the practice. Despite teams of government statisticians applying ingenious methodologies to definitions of poverty, several incumbent Indian governments have found themselves on the wrong side of history with respect to this key indicator of political success. While governments rehash short term, populist policies, the Reserve Bank of India (RBI) has tended to focus on longer term, less immediate policies of financial inclusion. The RBI initiatives have, over the years, been handicapped by bureaucracy and other barriers to success and have, at best, yielded mixed results.

The 21st century heralded a new dawn for poverty alleviation tools: the for-profit microfinance institution (MFI) became ubiquitous. Many MFIs were originally conceived as or had their origins in NGO-run or government supported not-for-profit models that took shape in the 1970s and 1980s. Some MFI innovators spoke so convincingly about their ability to deliver people from poverty, a 'punishment for a crime they did not commit', that one could have been forgiven for thinking they were a modern form of Gandhianism. In retrospect, the Mahatma may have been more impressed with tools that set out to improve the purchasing power and self-respect of the poor by subsidising salaried employment in well managed, sustainable companies and micro enterprises, rather than offering them the stress and suffering of self-employment funded by MFI loan juggling.

The ethical dilemma of the for-profit model and its impacts on poverty has heretofore been front and centre of the microfinance debate. Recent events in India, however, have pushed this debate still further and introduced a new, existential dimension to it. Jeffrey Sachs, the renowned economist, once claimed that "The key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development....They lack the minimum amount of capital necessary to get a foothold, and therefore need a boost up to the first rung." For successful long-term wealth redistribution, this 'boost' up to the first rung needs clarification. It

seems that earning a decent wage and training from a benevolent corporate affected by market forces may have significantly better real impacts than usurious handouts from under-regulated lenders.

MFIs in India are particularly susceptible to political interference. They compete with both politicians and government backed lending programmes for the same segment of the population. The ability of the Indian MFI industry to mitigate this risk depends on its ability to reduce the opportunities for politicians to be critical or indulge in overzealous legislation against them. With issues of excessive interest rate charges, over-lending to individuals and the adoption of coercive collection methods, however, the politicians are being provided with plenty of fodder to jeopardise the MFIs which seem to operate in a regulatory vacuum.

The southern Indian state of Andhra Pradesh had, until recently, been a poster child for MFI success, but is now the centre of the microfinance debacle. This crisis has been triggered by a combination of the highly successful listing of India's largest MFI, SKS Microfinance, which shone a spotlight on the scale of profits made by such businesses alongside several cases of suicides amongst MFI borrowers. While it has not been clearly established that indebtedness or coercive MFI tactics triggered the suicides, the political backlash was intense. In order to counterbalance the criticism brought by the opposition parties, the Andhra state government hastily pushed through legislation that effectively crippled the MFI industry in the state.

The knock-on effects of repayment defaults by MFI borrowers and concern from banks over the security of the loans they extended to the troubled MFIs have hurt the industry. It is remarkable that the Indian MFI market, that had shown so much promise, with an impressive track record of repayments on small sized loans and relatively low interest rates when compared with other parts of the developing world, suddenly slipped in to crisis.

The uncertainty surrounding their industry and its regulation forced other large MFIs that had planned Initial Public Offerings (IPOs) to put these plans on hold. The subsequent cash flow crunch brought down the biggest MFIs to their knees, with the second largest MFI in India admitting that if the situation did not improve in the next few months, it might be forced to terminate its operations.

On its part, the RBI established a committee, headed by Y H Malegam, to review the various issues and to recommend regulatory steps needed to prevent these incidents from recurring. It is likely that the Malegam Committee's recommendations will shape the future growth of the MFI industry and therefore impact related investment interest. Released in January 2011, we believe that

the recommendations, if implemented and enforced, will have wide ranging impacts on the industry, including some unintended ones.

Some of the key impacts include:

(a) the creation of entry and operational barriers through higher net worth, capital adequacy, loan portfolio allocation requirements and interest caps is likely to trigger consolidation within the industry, with a possibility of some banks absorbing some of the MFIs, if facilitated by the RBI;

(b) application of absolute and marginal interest rate caps and restrictions on other charges levied by MFIs will impact industry growth and profitability;

(c) application of interest rate caps, borrower household income caps and reduced loan limits will result in significant exclusion of households in remote areas and poor households whose incomes exceed the income caps but remain unbanked;

(d) development and implementation of industry specific corporate governance standards, greater oversight by the RBI, tailoring NPA definitions in accordance with industry peculiarities and vesting the RBI with discretionary powers over MFIs will improve corporate governance and transparency and;

(e) the establishment of a fully fledged credit bureau, limitations on the number of loans to each household, conditions on procedures for loan sanctioning and repayments will reduce the incidence of over-borrowing, multiple-lending and coercive recovery methods.

The industry's response has so far been mixed, with some of the larger operators backing the recommendations, relieved that while their profitability and growth might be impacted, their existence is no longer at stake. On the other hand, smaller and medium sized MFIs are wary that the regulatory restrictions placed would render their businesses unviable. The Malegam Committee's recommendations will undergo some changes before being put in to effect by the RBI. Yet, the recommendations provide a sense of the prevalent mood among the industry's policy makers and can be inferred as a clear signal on the general direction of policy. The speed of enforcement and the degree to which these recommendations are implemented will determine how much the industry will change and how likely it is to succeed.

In addition to the impending regulatory changes, it is important to also track developments related to the mobile banking and the Unique Identification Project - two enablers that may finally allow Indian banks to confidently meet the lending demand on which the MFI industry had thrived in.

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