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Crisis in Indian microfinance and a way forward: Governance reforms and the Tamil Nadu model

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In recent months, microfinance practitioners worldwide have been holding their breath over events unfolding in India. Beginning in summer 2010 with controversies surrounding the IPO of SKS, a large microfinance institution (MFI) and a major player in the market, the crisis subsequently exacerbated in the state of Andhra Pradesh, with borrowers defaulting on payments and taking their lives. Echoed by the media, hostility to microfinance rose to unprecedented levels and some politicians even encouraged borrowers not to pay back their micro-loans. In fear of deterioration of MFIs' financial solidity, numerous banks suspended flows of funds to them, leaving them severely cash-strapped.

Yet until recently, Indian MFIs were widely praised for their contribution to the fight against poverty. By providing financial services to low-income clients, particularly women who would otherwise have limited or no access to them, microfinance has enabled them to develop small businesses and to reduce the volatility of their incomes. Even tiny loans have often been sufficient to empower the Indian poor. How, then, can the current turbulence be explained?

Our study of microfinance in India, now at the end of its second year, addresses these concerns in a twofold way. First, it has extended from the study of a single, focal partner institution to a more global picture of the whole set of inter-organisational partnerships that relate MFIs to relevant stakeholders and regulators; as such, it is best positioned to bring to light systemic issues and to identify suitable policy responses. Second, our analysis focuses on the state of Tamil Nadu, geographically close to Andhra Pradesh and similar to it in terms of size and maturity of the microfinance market, but where the crisis has not spread. It thus enables to identify differences in the operations of MFIs in the two states which, despite a common landscape, may explain their differential capacity to achieve financial and social performance. On this basis, our analysis aims to contribute to the definition of a more sustainable model of microfinance, possibly to be extended to other parts of India.

Systemic bottlenecks in Indian microfinance: a need for enhanced governance

To understand the nature and propagation of the Andhra crisis, it must be acknowledged that microfinance is a network of partnerships and relationships: between poor clients and the microfinance institutions (MFIs) that provide financial services to them; between MFIs and their funders, be they multilateral institutions, donor governments, non-governmental

organisations (NGOs), for-profit companies, banks or cooperatives; between MFIs and regulators. The intrinsic complexity of the system, consisting of many layers and involving multiple actors, results in a great deal of uncertainty on where risk is and how it spreads. It also makes more difficult to track the chain of direct and indirect effects of regulatory measures, and to assess their global impact.

To shed light on the intricacies of the system, at least in part, we have mapped the complete network of “wholesale” relationships through which MFIs based in Tamil Nadu obtain credit from various institutions and organisations in order to support their activities. We have built an original database of lending relationships for 2006-2009, including all MFIs that are either headquartered in Tamil Nadu, or have operations there (36 organisations) and their wholesale lenders (89 organisations). The database has been built from multiple sources, primarily audited financial statements and rating reports of MFIs, which are verified by accredited third parties and are therefore highly reliable. Complementary information has been obtained from the 2009 Microfinance Report of Sa-Dhan, a network of microfinance actors in India; MixMarket, a specialised web-based data service; annual reports and web sites of MFIs. Finally, qualitative insight has been obtained through fieldwork, with a series of interviews performed by the authors with relevant MFIs and other stakeholders in 2009, 2010 and 2011.

The figure below represents the wholesale lending network of Tamil Nadu for the financial year 2008-9. MFIs are represented as grey circles and lenders as black or white squares; a tie between a square and a circle corresponds to a lending relationship. Black nodes are banks and white nodes are other types of lenders (NGOs, government agencies, multi-lateral institutions, and specialised microfinance funders). The size of round nodes (MFIs) is proportional to their number of lenders and, conversely, the size of square nodes (wholesale lenders) is proportional to the number of their MFI borrowers in the state.

The cohesiveness of this network reveals similarities across MFIs in terms of their providers of wholesale loans. 2006 and 2007 data, not visualised here, display a similar pattern. MFIs in Tamil Nadu share a tendency to borrow from a large number of domestic banks (70% of all lenders in 2008). They diversify their sources of funding by increasing the number of banks from which they borrow but they hardly seek diversity in terms of *type* of lenders; indeed the presence of governmental and intergovernmental agencies, voluntary organisations, and specialised investors is limited compared to other countries. Among the largest lenders are HDFC bank, ICICI bank, and Axis bank. Very few non-banking lenders occupy central positions, namely Small Industries Development Bank of India (SIDBI), a governmental agency; Friends of Women’s World Banking (FWWB), a non-profit organisation; and the specialised microfinance investor Oikocredit, through its local subsidiary Maanaveeya Holdings. Only 20% of all lenders are international (Citibank, BNP Paribas) and operate through their Indian offices or subsidiaries.

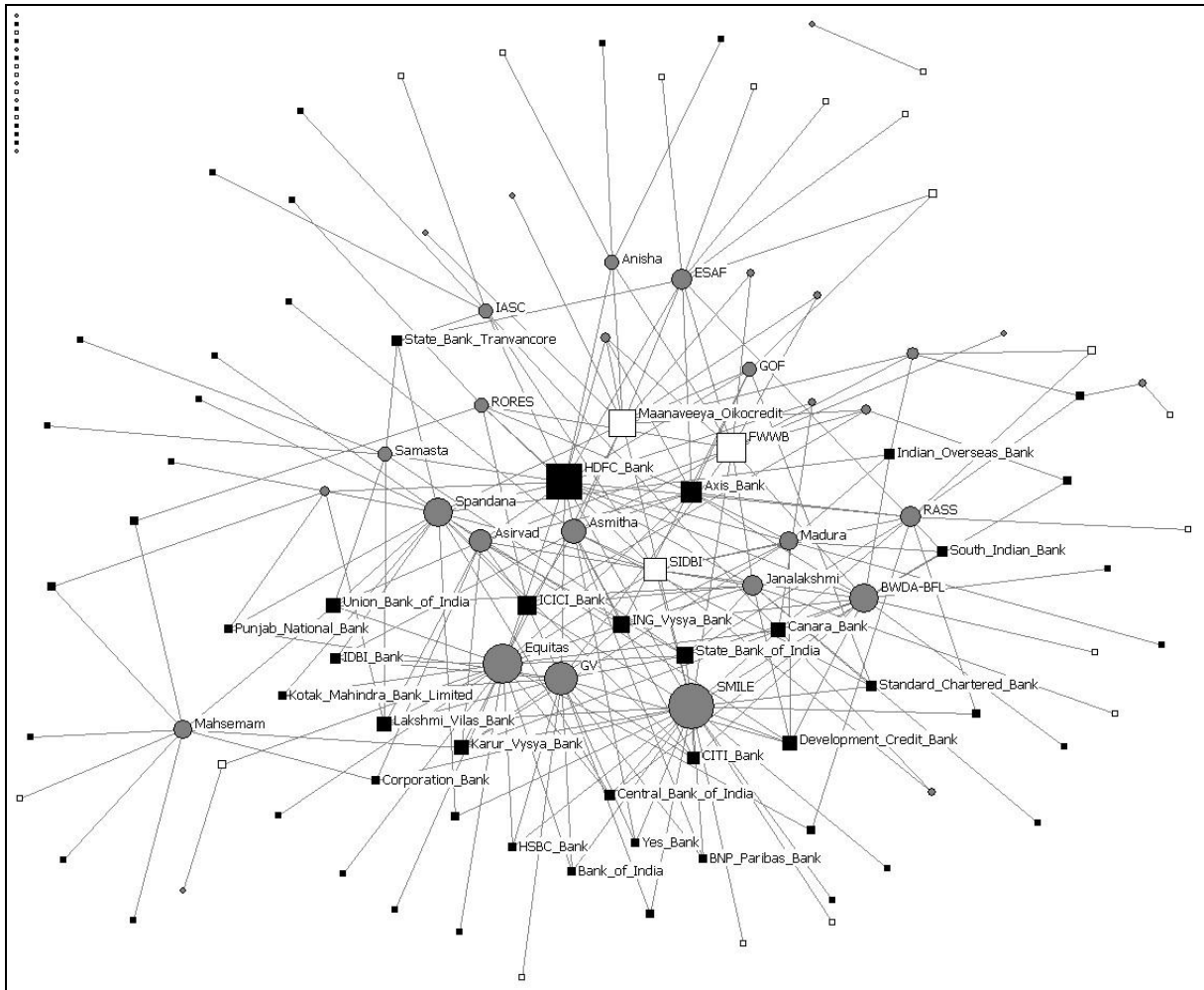


Figure 1: The network of wholesale lending relationships for microfinance in Tamil Nadu.

By and large, this configuration is shaped by requirements imposed by the law as well as the national regulator, the Reserve Bank of India (RBI). In particular, the so-called “Priority Sectors Lending” (PSL) rules oblige banks, both public and private, to direct 40% of their net credit (32% in the case of foreign banks) to agriculture and weaker sectors, including small businesses and deprived segments of society. Many banks find it cheaper and easier to meet these requirements indirectly, through loans to MFIs, and leave to them the task of “covering the last mile” to reach out rural or poorer communities. Hence a large, and growing, amount of wholesale loans has flown from banks to MFIs, with an increase of about 200% over the years considered in our study (Lok Capital 2010). The global financial crisis has not weakened this trend as the presence of public-sector banks remained momentous even when some foreign and private banks slightly reduced their exposure in 2008; when conditions eased at the beginning of 2009, large domestic banks such as HDFC and ICICI increased their exposure, while new ones entered the market (Srinivasan 2009).

Though well-intentioned, this measure has backfired, producing an excess of easy credit from banks to MFIs that yielded unwanted consequences. MFIs have felt under pressure to use these massive amounts of money quickly, but with little control on quality and integrity of their services; and incentives for them to seek funding from other bodies have weakened, with a form of “crowding out” favouring domestic banks over more socially-oriented investors. As a result, microcredit has swollen but has not been accompanied by comparable progress in the

provision of financial literacy training programmes, preparation, follow-up and support services; their governance has not improved either as most banks usually limit their monitoring activities to checking the capacity of a sample of clients to repay, but do not have the resources and competencies to assess their overall socio-economic situation. Finally, many MFIs complain that although banks' loans are of relatively easy access, interest rates are higher than those charged by governmental agencies, charities, or other socially-oriented investors, and therefore induce them to raise the interest rates that they themselves charge to final clients. Ironically, as a result, the riskiness and fragility of poorer clients has increased instead of diminishing.

This effect, which is present nation-wide, has certainly contributed to fuelling the crisis in Andhra Pradesh and may still fragilize MFIs in other parts of the country. Excessively rapid growth of the sector, lack of sufficient monitoring of clients, and exorbitant interest rates have often been blamed for triggering clients' over-indebtedness, inability to repay and suicide.

The crisis-induced hesitation of banks to provide new loans has been a widespread concern for MFIs throughout India as few alternative sources of funding seemed accessible. Indeed by law, foreign ownership of Indian non-banking financial companies (NBFC, a category that encompasses most MFIs) cannot exceed 50%, a measure which discourages international equity contributions and increases appetite for debt. Access to the latter, in turn, is largely limited to the domestic wholesale market, because it is not allowed to borrow from foreign companies unless they are listed in a stock exchange. Finally, relatively high minimum capital threshold and capital adequacy ratios are necessary for MFIs to be authorised to take deposits and savings; as a matter of fact, only 8% of those in our sample are in a position to offer such services. Such restrictions obviously reinforce the dependence of MFIs on PSL rules for banks, and their vulnerability in case of a change in the law (not expected at the moment).

Other systemic issues, noticed by many commentators of the recent crisis, are the absence of a national ID system and of credit bureaus, which make it difficult for MFIs to properly assess clients' over-indebtedness and overall risk.

These considerations point to the need of devising a more sustainable regulatory framework for Indian microfinance, opening the way to a wider choice of funding sources for MFIs to sustain their operations. It would not be advisable to remove PSL requirements (at least not in the short run), but new measures should be introduced to facilitate access to alternative providers of loans. Diversification and a higher degree of competition in the market would lower the cost of wholesale debt –and could eventually be passed on to final clients in the form of lower interest rates. Higher involvement of wholesale lenders that are social investors, public-sector bodies, development agencies and charities rather than banks, may also improve MFIs' corporate governance, especially disclosure of financial, operational and other information as well as monitoring practices and customer services. This will, of course, require some necessary –and perhaps painful – adjustment in the short run, but will certainly benefit the sector in the long run. The RBI is now working at new rules that may possibly include some of these provisions, but whose features will only be known later in the year.

The Tamil Nadu model: consortia of for-profit and non-profit organisations

The above issues relate to national regulation and therefore, one may ask why they have differentially affected the two neighbouring – and otherwise similar – microfinance markets of Andhra Pradesh and Tamil Nadu. To answer this question, it must first be reminded that according to many commentators, the for-profit orientation of MFIs in Andhra, epitomised by SKS's IPO earlier in 2010, was excessive and played a significant role in triggering the crisis. Greed, it is often claimed, prompted many MFIs to aggressively expand their client base without much consideration for the fragility of the poor communities they targeted. In fact, these accusations renew a debate that has been recurrent in the microfinance literature since the 1990s, namely the potential trade-off between financial and social goals. While today's consensus is that microfinance should strive to achieve both goals, some doubt that this is doable. In India, SKS's move was criticised by many as opposed to the interests of the poor.

However, MFIs in Tamil Nadu offer interesting examples of how the dual goals of microfinance can be reconciled. A number of interviews conducted in January 2011 with leading practitioners in Chennai, Villupuram and Pondicherry, convinced us of how genuinely keen they are about their social mission. They have in fact devised a variety of solutions to combine the provision of financial services to the poor with social initiatives. A common model involves the creation of a consortium of specialised organisations, typically a non-banking financial company (NBFC) in charge of microfinance, formally for-profit; and a non-profit body (usually under the legal status of NGO or Trust) to provide social services. For example our focal institution, BWDA, is a NGO which runs, among other things, a college of arts and sciences; its commercial arm BWDA-BFL provides financial services. The children of BWDA-BFL's clients are the primary target for the educational services of BWDA's college. Similarly, Sarvodaya Nano Finance Ltd consists of a network of non-profit primary schools which parallel its microfinance provision services, organised in a separate NBFC. Hand-in-Hand is a Public Charitable Trust that runs several social programmes and has expanded from its original Tamil Nadu location to other developing countries including Brazil, Afghanistan, and South Africa; its microfinance arm is Belstar, again a NBFC. Another prominent example is Equitas, which also includes a NBFC in charge of microfinance provision and a non-profit Trust that operates a number of social programmes for microfinance clients, including a healthcare service, primary schools, after-school tuition for children, and a subsidised grocery store. The NBFC is committed to contribute 5% of its annual profits to this Trust.

This model is worth further exploration and may set the example for renewal of microfinance activities in India as a whole. When financial service provision is closely tied to social services, and sometimes funds them at least partly, mission drift is less likely, and the growth of micro-credit can be expected to accompany growth in the provision of supporting services. To some extent, this solution may address one of the causes of the recent crisis in Andhra Pradesh, by ensuring a more comprehensive approach to development, empowering clients in a broader sense, and ultimately increasing their capacity to repay their debts.

The legal separation of the two bodies, one for profit and the other non-profit, also has the advantage of ensuring greater transparency and better governance, as well as some protection for the social entity in case the commercial one experiences financial difficulties.

Further studies are also needed on how to measure the impact of microfinance when it is accompanied by a whole set of social services. A broad, long-term set of criteria to measure impact will be needed in order for this model to expand beyond Tamil Nadu.

Conclusions and recommendations

To conclude, our study points to the need of two types of measures:

- 1) Necessary improvements in regulation at system level, in order to enable MFIs to access a wider and more diverse range of funders, to lower the cost of funding that they face, and to improve internal governance and management practices.
- 2) Further research on the Tamil Nadu model of a consortium of a for-profit NBFC in charge of microfinance and a non-profit body providing social services, with focus on its potential to improve the capacity of MFIs to strive towards financial sustainability without losing sight of their social mission.