Crossfire: 'The recent microfinance crisis in Andhra Pradesh in India, where the local government effectively put a stop to the operations of all the MFIs, resulted from the lack of restraint by banks and investors; the industry "had it coming"'

TOM SANDERSON and SHUBHANKAR SENGUPTA

In our regular debate between experts, Crossfire invites Tom Sanderson and Shubhankar Senguptato to debate the following: 'The recent microfinance crisis in Andhra Pradesh in India, where the local government effectively put a stop to the operations of all the MFIs, resulted from the lack of restraint by banks and investors; the industry "had it coming"'.

Dear Shubhankar,

Let me start by saying this topic is a huge and lively debate, with complex factors at play. I do not claim to be an expert on the situation in Andhra Pradesh (AP). In fact my experience is in Africa, particularly Uganda, and I have always believed microfinance to be a pro-poor development intervention.

The incentive structure for commercial MFIs point strongly in favour of investors

Commercial MFIs have been able to scale-up their services to many millions of customers

As I see it, the crisis in AP has been stimulated by the unchecked drive for profits. The incentive structure for commercial MFIs (microfinance institutions) points strongly in one direction: in favour of investors. The pressure to service debt and equity investments in MFIs trickles all the way down to the loan officers on the ground and directly influences their behaviour. Loan officers and their managers actively seek new clients, prefer frequent repayment schedules (e.g. weekly repayments rather than monthly, in order to maximize the circulation of money), high repayment rates, larger loan sizes and fast repeat loans. Together with high interest rates and charges for associated ledger and membership fees, the commercial model can and does generate high returns. In a world of prevailing low interest rates and relatively low returns on investment, commercial microfinance investments – sometimes spread across a number of MFIs – do look very attractive to investors.

Unsurprisingly, this model has attracted large capital inflows and enabled many commercial MFIs to scale-up and extend their services – mainly microcredit – to many millions of customers. This is mostly good and

Tom Sanderson is the UK Director of Five Talents, an International NGO that supports MFIs linked with the worldwide Anglican Church. Shubhankar Sengupta is the promoter and Managing Director of Arohan Financial Services Pvt. Ltd, a 5-year old MFI with a 250,000 customer base which operates in the eastern states of Assam, Bihar and West Bengal.

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it is exciting to see the market operating so effectively.

However, this market-based growth of MFIs, if left unchecked, leaves open the risk that clients will be poorly served and institutions become vulnerable to massive default. I think this is what has and is happening in AP. Clients are being encouraged into debt, sometimes taking multiple loans to pay off prior loans, not always understanding the repayment schedules and risks, the fees and penalties, and not given supportive training or mentoring.

On the other hand, the socially motivated microfinance sector (usually not-for-profit) places a much higher priority on improving the livelihood of the client (not the investor). This translates at the loan officer level into more training – pre-loan training and ongoing mentoring – as well as products to encourage savings, a culture of client protection, pricing transparency and the avoidance of over-indebtedness. Socially motivated microfinance recognises the complex nature of family livelihoods, for example the competing demands of business investment versus health shocks, educational needs and so on. The long-term aim is to build a robust and self-sustaining household, which has productive capacity, has access to credit but is not addicted to debt, and has emergency and routine savings to smooth shocks and make investments.

The two models are not mutually exclusive, but I believe it does require committed leadership and appropriate governance to hold in balance these two strong incentives: the pro-poor and the pro-profit incentive. Indeed, even in the not-for-profit model I am very aware of the desire for growth in numbers of clients and the pressure to increase the operational and financial self-sustainability of the MFI. These things can easily lead to mission-drift towards a focus on bigger numbers and better performance and a consequent dilution of emphasis on positive livelihood impacts and outcomes.

I know the AP crisis has distinctive issues regarding self-help groups, political and media involvement which I have not addressed here. I look forward to hearing your reflections.

Yours,
Tom

Dear Tom,
Thanks for sharing your thoughts.

Most of us in the development sector who went into microfinance a decade or so ago, are instinctively uncomfortable with the idea of commercial equity investors in a space which we see as ours. This stance is more often than not based on some facts, some fear and some ignorance.

Greed is not the prerogative of the investor community; it can afflict MFI promoters, NGO

There has been a regulatory vacuum where there are no laws and rules specific to microfinance practice

Overwhelmingly it is the for-profit MFI which charges lower interest, has better governance and is subject to far more scrutiny by stakeholders

founders and aid workers too. A reading of *Despite Good Intentions* by Thomas Dichter (2003) is illustrative. A sensible investor or banker or entrepreneur will take a long-term view of their business model for sustained profitability, focus on meeting a wider range of client needs and not obsess about maximising short-term gains. Any good company does this.

The entry of commercial investors into microfinance is to be welcomed. It is their presence which has enabled MFIs in India to scale dramatically in the last 5 years and reach out to 25 million households. Surely this is pro-poor and to be celebrated.

I admit that the explosive growth of the MF industry in India has brought with it certain problems, chiefly over-financing to clients leading to stress at the household level. But this has to be seen in perspective. The 'over-concentration' of MFI activities is only in a few patches in India, namely large parts of Andhra Pradesh, some parts of urban Karnataka and urban West Bengal.

When we compare for-profit and not-for-profit MFIs in India, overwhelmingly it is the for-profit MFI which charges lower interest, has better governance and is subject to far more scrutiny by stakeholders. My point is that legal form is not the key issue here, it is management intent. Most of the for-profit MFIs today were non-profits once. Because they were better managed institutions they found it possible to attract investors and grow by converting into finance companies.

So what caused the AP crisis? To me there are two principal reasons:

1. An envious state bureaucracy that could not digest the fact that its own mammoth microfinance programme was faltering in spite of subsidies and state support.
2. A regulatory vacuum where there are no laws and rules specific to microfinance practice.

The Microfinance Act by the AP State Government has been challenged in court on the grounds of being unconstitutional and violative of fundamental rights of the citizen. One is hopeful that the Act will be over-turned by the judiciary.

The industry has been making representations to the Reserve Bank of India (the Central Bank) for 10 years for microfinance-specific regulations, but this demand was ignored, citing the small size of the industry. The problems we see today are a result of a lack of regulation. If we had rules related to multiple-lending, transparency and operational practices even three years ago, this current crisis could have been averted. Regulation would have also brought in protection from arbitrary action by political and administrative forces.

There are some MFIs who have allowed ambition and avarice to take over their good sense

The drive of board members and CEOs to some extent reflects the pressure from their investors

So are all MFIs innocent lily-white do-gooders, cruelly and grievously wounded by a bullying state government? Unfortunately, not quite so! There are some who have allowed ambition and avarice to take over their good sense. The whole industry is suffering from their 'galloping pride'.

Tom, if you are seeking villains of the story from within, it is not bankers and investors, it is the promoter. All MFIs are run by very strong promoters. The fact is that nobody can make these people do anything they do not want to do. Blaming financial institutions is the easy way out, and saves us from naming names!

Best regards,
Shubhankar

Dear Shubhankar,
Thank you for your letter.

You raise a number of points which I shall address in turn:

1. You refer to 'MFI promoters' and suggest that they exert the strongest influence on the growth and direction of their MFIs, with some exhibiting greed and self-interest.

I assume by 'promoters' you mean specifically the boards, CEOs and management of MFIs, as distinct from their investors and bankers. I take your point on this since ultimately the 'promoters' are responsible and accountable for their actions and the actions of their institutions. However I do think there is a relationship here, where the drive and ambition of board members and CEOs to some extent reflects the pressure from their investors, bankers and indeed their competitors too. Perhaps some of those who first entered the industry as not-for-profit participants and who established the first MFIs have been replaced over time by new board members and CEOs who have more commercial ambitions?

2. You welcome the entry of commercial investors in MFIs and attribute upscaling to the resources that they have brought to the industry. I think we are largely agreed on that one.
3. You note the 'over-concentration' of MFIs in some areas of India.

To me, this would tend to mean that prices would be competed down, economies of scale maximized, ruthless marketing to stay ahead of the competition, and differentiation on product and market segments – with, one would expect, the inevitable collapse of one or two providers. Perhaps, on one level, this market mechanism is exactly what we are seeing in AP?

4. You refer to 'an envious state bureaucracy' and a 'regulatory vacuum' as key reasons for the current crisis.

You are much better acquainted than I am with the specifics, but it occurs to me that what began as state promotion of self-help groups and official support for their saving and lending programmes has been threatened by the fairly rapid emergence of the commercially driven and commercially resourced private sector providers. The architecture of the state SHG (self-help group) sector seems to me to have been fairly successful in extending financial services to millions of formerly excluded people. NGOs (like Five Talents) have cooperated with SHGs to extend and reinforce services with good impact. However, as I understand it, the private (for-profit) MFI sector has increasingly captured some of the 'state' market, has extended access further and provided more choice and more sophisticated products.

The state SHG sector seems to me to have been fairly successful in extending financial services to millions of formerly excluded people

To me this makes the India case unusual and complex, with microfinance provided by three rather than the usual two actors: NGO and commercial providers – the usual ones – but also in this case the state (or para-state). In my experience, which is mostly in Uganda, the state is the regulator and not a direct actor in the MFI space. This raises the issue of the appropriate role of state versus private provision in the MFI sector in India. It would be easy and tempting for the Indian regulators to respond with regulations which favour the state sector and protect the original model – perhaps the recent State Ordinance in AP is seen in this way.

In Uganda, the state is the regulator and not a direct actor in the MFI space

I am not particularly looking for your 'villains' or 'lily-white do-gooders'! But I would like a happy ending to the story in India, where all MFI actors (be they two or three main types) can each effectively provide clients with much-needed financial services accompanied by appropriate regulation that protects consumers and ensures a sustainable industry.

Best wishes,
Tom

Dear Tom,
I note happily that we are not in real disagreement on most things! There is only one point where I would like to give a different view.

You mention that over-concentration should lead to differentiation, price wars and even death of the inefficient players.

Ideally this should happen. Unfortunately, this is not the situation on the ground. In brief:

1. MFIs are still in a seller's market, even in the so-called 'over-heated' markets and have set ways of doing things.
2. MFIs are not coming up with variety in their product offerings.
3. Within a wide price (interest) range, clients are indifferent. The problem is compounded by the fact that many MFIs are less than transparent about their effective interest rates. So the client often

MFIs are less than transparent about their effective interest rates makes a sub-optimal choice when deciding whom to borrow from.

In this imperfect market, nobody dies. Of course, one could argue that with further growth and competition a shaking out will happen. I would have been comfortable with this if we had been just another business – selling soaps, cell phones or T-shirts. But we are in a social business where the well-being of the client should come first. The present imperfections in the market are leading to clients making choices out of ignorance, over-indebtedness in poor households and insufficient incentive to innovate for the MFI.

MFIs should be allowed to mobilize savings from their customers

These shortfalls call for regulation. Regulation is not just policing but also about market and institutional development. I would like to see microfinance retain its characteristic of a social enterprise. This need not be inconsistent with the demands of private equity capital. Private capital is vital if all the millions of poor Indians have to be reached by microfinance.

The characteristics of social enterprise need not be inconsistent with the demands of private equity capital

I would also like to clarify that when I mentioned the promoter, I meant only the 'big chief'. MFIs in India are neither that old nor evolved to have stepped out of the shadows of the person who started the entity. What big chief wants, big chief gets. Nothing wrong here I feel. It's part of the evolutionary tale of an industry. Some of our big chiefs may have gone a bit wayward, dazzled by acclaim (especially international), money and fame. Hopefully, this is temporary. I know most of them personally and can vouch that they mean well.

Beyond this exchange of who and what caused this present crisis in microfinance in India, I would like to make some forward-looking suggestions for the powers that be to consider:

1. Recognise MFIs as a distinct class of financial institutions.
2. Allow MFIs to mobilize savings from their customers. The poor need savings more than credit and who is better placed than MFIs to provide this service? It would also bring down the cost of funds for MFIs which will translate into lower lending rates.
3. Set standards for disclosure of information to clients on effective cost of loans.
4. Help MFIs avail themselves of the services of credit bureaus.
5. Provide tax breaks to MFIs given that they serve the national goal of financial inclusion.

Yours,
Shubhankar

Reference

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