The Indian Microfinance Predicament-Evidence in Literature and Practice

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Abstract
The downbeat development in Indian Microfinance has taken the world of microfinance by surprise. An industry that grew at 90% on an annual basis from 2002-03 to 2009-10 was reduced to just 7% growth in 2010-11 with its portfolio over the period October 2010 (when the crisis started) to the end of the year 2011 estimated by M-CRIL to fall by around 33%. As measured by CRILEX, M-CRIL’s growth index for microfinance, India’s microfinance industry is estimated to have reached 9,000 by 30 September 2010 but to have fallen back to just 6,000 a year later. How such a situation came to pass is the stuff of legend, repeated many times over in the history of industrial growth – a slow growth “tortoise” phase, an accelerating “nimble hare” phase, an uncontrolled growth “charging bull” phase and, now, a “bewildered deer” caught in the headlights of draconian regulation, uncertain which way to go.

The wave of transforming a public purpose, not for profit institution to a for-profit framework have shifted the strategic focus of Indian Microfinance from serving poor borrowers to earning profits for the promoters. The purpose of this study is twofold. Firstly, this paper discusses how the giant microfinance company (SKS) after taking a transformation root to commercialization (Commercial Transformation) has focused only on the promoters profit and not the investors. This slowly and steadily killed the tool of microfinance. Secondly, the paper focuses on understanding what caused microfinance in India to trip, and is also the first step in identifying the lessons the world can learn from the fall.

Key words: Microfinance, Microfinance Institutions, Commercial Microfinance, Commercial Transformation, Public Purpose Institution, Not -for-profit Institution.

1. Background and Introduction

The “great Indian microfinance crisis” is directly attributable to the success of SKS at raising funds from commercial sources over a number of years and more specifically to its IPO which followed from Compartamos’ successful first foray into the public capital market. While the success of SKS in raising substantial funds in the years that preceded the IPO may have seemed to be the industry’s salvation, in practice it has turned out to be its downfall. Microfinance in India, and much of the rest of the world, may never be the same again. (Sanjay Sinha,2011)

On October 15, the government of Andhra Pradesh, India’s fifth-most-populous state, issued an ordinance aimed at protecting women who “are being exploited by private microfinance institutions through usurious interest rates and coercive means resulting in their impoverishment and in some cases leading to suicides.” The ordinance seems designed to quash microcredit in the state, where it has grown explosively in the last five years through a process of commercialization that has brought ample capital and made millions for some investors and founders. (David Roodman, 2010)

Unfortunately, the ground truth remains murky for those removed from the situation. On the one hand, the harm of microcredit appear exaggerated in much of the current rhetoric: the inflammatory suicide charges may have been ginned up by the papers and political players with vested interests in other forms of microfinance. Still, there is good reason to worry that the fast expansion has gotten many poor people into debt trouble—into situations in which repayment is coerced, verbally or even physically, by peers and loan officers. What is beyond doubt is that the Indian microcredit industry, the largest in the world, is in serious peril; and that this crisis is sure to seed discussion worldwide about whether and how microfinance institutions (MFIs) can commercialize responsibly. (David Roodman 2010)

2. Literature Review

The growth of MFI’s have recorded about 8.5 million clients during the year 2008-09, a growth of 60% over the previous year. More than 50 percent of low income households are covered by some form of microfinance product. Nagesh Naarayana (2009)

There are different arguments concerning how to evaluate the performance of microfinance institutions. Meyer (2002), Citing from Zeller and Mayer (2002), indicated that there is what is called “Critical Microfinance Triangle” that we need to look at it to evaluate Micro-Finance institutions based on their objective. Here, the corners of the triangle represent outreach to the poor, financial sustainability and welfare impact. And “Performance criteria are required for each objective and all three must be measured thoroughly to evaluate micro-finance performance”, noted Meyer (2002). Navajas et al (2000), similarly indicated that there are six aspects of measuring outreach : depth, worth of users, breadth, length and scope. Where, depth of outreach refers to “the value the society attaches to the net gain from the use of the micro credit by a given borrower”, Navajas et al. (2000). The microfinance institutions participation in several developing economies is escalating from time to time.
Various studies on different countries on the performance of the MFI’s confirm this (Adongo and Stork 2005, Zeller and Meyer 2002, Meyer 2002)

3. Research Objective

The purpose of this study is twofold. Firstly, this paper discusses how the giant microfinance company (SKS) after taking a transformation root to commercialization has focused only on the promoters profit and not the investors. This slowly and steadily killed the tool of microfinance. Secondly, the paper focuses on understanding what caused it to trip is the first step in identifying the lessons the world can learn from the fall.

4. Methodology

To understand how the giant microfinance company (SKS) after taking a transformation root to commercialization has focused only on the promoters profit, has been researched by reviewing the literature done in past and also studying the working papers which are currently been researched. This connects with the theoretical background of the research. For the analysis of MFI, the study of M-Cril, NABARD and relevant publication on the development of related area in the country is been studied. Also, interviews with experts in the area of micro finance is conducted. These interviews are semi-structured. Semi-structured interviewing starts with more general questions and topics relevant to Micro finance especially related to the moral, ethical and governance implications of Commercial Microfinance in India. In some cases due to the sensitivity of the issue and special request of the interviewee the names of the interviewee are kept confidential.

4.1 Commercial Transformation

Following the pattern outlined in the pathway( Figure 1) SKS was established as an NGO (a registered Society) in 1997, and worked initially with donor funds and borrowings from development lenders like the Small Industries Development Bank of India (SIDBI). The process of transformation to a commercial entity started in 2003. A company titled, SKS Microfinance Limited was registered and to fulfill the requirements of the regulator, applied for registration to function as a finance company (known in India as a non-bank finance company, or NBFC). However, in order to qualify for registration as an NBFC, a company must have a minimum equity capital into the company which grew at fantastic 140% per annum.

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prices for their shares stood to earn lower but still very high multiples on their equity holdings at this time.

The total shareholding in SKS NBFC before the IPO consisted of 64.5 million shares valued at a total of $911 million. With a net worth of around Rs9 billion at the time, this represented a price to book value ratio of the order of 4.5 and a price to earnings ratio of around 16. In the event, with the share issue oversubscribed 13.7 times, the price settled at Rs954 ($21.20). Thus, SKS was valued at a total of $1.5 billion at a price to earnings ratio of around 25 with the price at around 7 times book value. The $368 million raised via the IPO was less than the $450 million proceeds of the Compartamos sale but it increased the SKS capital of around $200 million by over 80% (or $163 million) while the proceeds of the Compartamos sale went exclusively to the existing shareholders. Thus, SKS greatly enhanced its ability to leverage further growth. The subsequent rise in the value of the share on the stock market to a peak of Rs1,490 ($33), over 50% higher than the issue price, within two months of the IPO, shows how brightly investors viewed the future prospects of SKS until the Andhra Pradesh (state) government intervened in the practice of microfinance in the state, causing a major crisis in Indian microfinance. In a sense SKS had proved its ability to raise increasing sums of commercial capital from the capital markets in order to “eradicate poverty...by providing financial services to the poor...” (quote from SKS’s website).

If this experience could be repeated by other MFIs it would release substantial and growing sums of money for on-lending to low income families (if not necessarily the poor). While the development-oriented SKS was, thus, fully launched on its mission to “eradicate poverty” through fund raising via the “capitalist road”, it is interesting to examine the timing of its actions along the way. Figure 2 shows the pattern of growth of the leading Indian MFIs during the period 2006 to 2008.
past few years and particularly in the period since 2006 (Figure 5). This is contrary to expectation, with increasing competition in Indian microfinance there ought to have been a downward trend in yields but the reality points to oligopolistic behavior as each of the leading MFIs pursued the goal of maximizing profitability as well as growth.

4.3 Multiple lending

M-CRIL estimates that these practices resulted in around 40% overlap in those easy to reach clusters (nationwide) where microfinance operations became established. These overlaps reached the extent of 200% and more in some of the more microfinance oriented parts of states like Andhra Pradesh, Tamil Nadu and West Bengal. Thus, large numbers of the poorest families in India were (and continue to be) excluded even as others, better off due to their location advantage, were increasingly falling into a debt-trap due to the culture of easy money. Thus, yet another of the development objectives of microfinance, outreach to the poorest, was abandoned in the quest for low costs and high growth.

4.4 Increasing yields despite cost savings:

Increasing yields apparent from the figure, point to the fact that none of the apparent improvements in efficiency indicated by the declining operating expense ratio were passed on to clients. It is not surprising that the weighted average return on assets of the largest ten MFIs in India during the financial year 2009-10 was as high as 7.9% and 6.8% for the larger sample of 65 MFIs studied by M-CRIL, compared to 2.1% in 2005. And, a natural corollary of this was increasing commercialization of microfinance as more and more NGOs converted to commercial NBFCs. This was in the hope of obtaining large quantities of highly leveraged debt from commercial banks which would lead to high growth and, following the example of SKS and its peers (Share, Spandana and others), would lead to high profitability which attracts equity capital (from private investors) at high valuations enabling the original promoters to make dramatic fortunes in the space of a few short years. Figure 6 (following page) shows the progressive transformation of Indian microfinance from a predominantly NGO oriented sector to a substantially commercial one. By March 2010, over 80% of active borrower accounts serviced by Indian MFIs were with (commercial) NBFCs.

4.5 High Valuations:-

The advent, meanwhile, of high valuations in return for expected future profits – which sparked this rush to commercialization – began with the sale by SKS of its shares to Sequoia (a private equity firm) and continued with the sale of the equity of SHARE Microfin Ltd to Legatum followed by other similar deals. Each of these is reported to have fetched the promoters fantastic valuations in the range 5-11 times book value. In the Indian context, it is apparent that equity investors were swayed both by the ability to grow (and simultaneously generate profits) and by the tantalizing prospect of a huge and still apparently underserved market. The total apparent size of this market amounting to some 140 million financially excluded families was served only to the extent of around 20% (by MFIs) even if the figure of 27 million MFI borrower accounts at end-March 2010 is assumed to apply to unique borrowers (and multiple lending is ignored).

4.6 The industry’s Downfall:-

As indicated earlier, the process of capital raising by SKS was an absolute triumph for the growth strategy, PR skills and self confidence of its promoters, particularly Vikram Akula. It appeared, to many, that the industry’s future (not to mention the futures of dozens of other “me-too” promoters of commercial MFIs) was secure. In the event, it was precisely those qualities that were the downfall of microfinance.

Source: M-CRIL
Upon listing on 16 August 2010, the SKS share price jumped up 11% and climbed steadily thereafter until 28 September to a peak as high as Rs1,490 ($33), more than 50% higher than the final IPO price of Rs985, though the closing price on that day was Rs1,402 as shown in Figure 7. Thereafter, the price started to fall and, but for a few kinks, has been in steady decline since. The decline started with rumours about a dispute between the promoters of SKS and the CEO at the time of the IPO, Suresh Gurumani. This culminated in the sacking of the CEO on 5 October. Whatever the reasons for the sacking, it was too close to the IPO (just 10 weeks after) for the comfort of India’s securities regulator (SEBI) who asked the company for an explanation. There was also a challenge in the courts by investors aggrieved that they had not been informed about the promoters’ lack of confidence in their CEO at the time of the IPO; surely, the promoters could not have been happy with him in late July if they sacked him in early October. This shocking event also drew media attention back to SKS and to microfinance. Not only was there substantial speculation about the reasons for the sacking but it provoked renewed muck-raking by journalists who had earlier raised similar issues about the functioning of Indian microfinance when discussing the forthcoming IPO. Within days of the sacking, articles about the over-indebtedness of microfinance borrowers were back in the media and numerous recent instances of suicide by low income women in Andhra Pradesh were directly attributed to this situation.

On 14 October 2010, the Andhra Pradesh (AP state) government promulgated its now well known ordinance apparently aimed at protecting microfinance borrowers as consumers. The ordinance placed severe restrictions on the practice of microfinance in the state. It effectively made it impossible to continue the microfinance business in the state reducing MFI collections to 10-20% of expected levels and making disbursements virtually impossible in the near future. A few weeks later, the AP ordinance was converted into a regular law having been passed by the state legislative assembly. Spooked by this event, the commercial banks, hitherto providers of over 70% of the funds deployed in Indian microfinance, started to hold and delay their disbursements to MFIs all over India, not just to those operating in AP. While commercial bank lenders to microfinance continued to demand their repayments on time, they disbursed only small sums of money and, in sharp contrast to their earlier enthusiasm, with considerable reluctance. As a result, by end-March 2011 the portfolios of leading MFIs in India were reported to be down by between 20-30% from the levels six months earlier. In practice, what the world knows as the “AP microfinance crisis” has turned into the “great Indian microfinance crisis”. Let alone downfall, the industry has been in free fall over the past 12 months. M-CRIL estimates that by 30 September 2011, the size of the industry in the country as a whole had fallen by 33% from its end-September 2010 peak – from a CRILEX index of around 9,000 to just 6,000 (as shown in Figure 8).

5. Conclusion
Clearly, the revival of the Indian microfinance sector needs multiple actions at many levels: the central bank for regulation, the government for calibrated responses to the issue of client coercion and, above all, the MFIs to ensure more measured growth and better control systems. It also requires more informed investor behaviour to ensure that capital flows to socially responsible institutions in support of the long term economic benefits of financial inclusion rather than in pursuit of short term financial gains. A complete solution is yet to emerge but clearly a major churning in international microfinance – a rediscovery of development objectives and a better understanding of the needs of microfinance clients, both the poorest and the not-so-poor – is necessary.

6. Recommendation
A moderate rate of growth that both enables new staff to absorb the organization’s culture and undertake client acquisition in tune with its development mission and ensures that the system of control for rules governing aspects like client acquisition, loan refinancing and collection practices keeps pace with its expansion. M-CRIL’s experience suggests that growth rates of the order of 30%-50%, inversely proportional to the size of the MFI, are likely to be sustainable. A better understanding of the needs of low income clients for financial products so that the industry evolves from the simple regime of the “one size fits all” conventional Grameen loan to a set of (3-4) products specifically designed for the clients the MFI aims to serve. This would need to be regionally adjusted for loan size, loan term and repayment frequency depending on the economic activities of its clients.

A greater engagement with the political economy of the regions in which they operate so that bureaucracy, politicians and media are all kept aware and sympathetic to the MFIs’ operational practices and goals. A conscious effort to ensure that there is a diversity of sources of funds not just in terms of numbers of lenders/investors but also the type of such fund providers –
commercial banks, development banks, social equity investors, private equity investors and, equally, clients as depositors. Wherever the deposit option is available (as in Bangladesh) it provides an additional anchor of stability to the micro financial system.

7. Limitations
The whole research is conducted based on the views and reviews of the microfinance practitioners and microfinance researchers. Hence scope for further research is to understand the sentiments and preferences of clients of microfinance.

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