A Face-off with micro finance – world over

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GLOBAL PERSPECTIVE

The world's seven richest men could wipe out global poverty and their combined wealth would be enough to take care of the basic needs of the poor across the globe. Interestingly this would be the fastest and the easiest way to tackle the global concern!

To deal with the challenge of eradicating poverty we have found solution in a revolutionary concept called Micro-financing. Micro-finance emerges from the local cultures and mentalities and it bridges the gap or atleast helps traverse the path from modest dwellings to achieving better standards of living. Today, there are 13 million micro credit borrowers worldwide, with a US$ 7 billion in outstanding loans with repayments as high as 97% and annual growth rate being 30%. The figures tell a story themselves about the promising future this concept holds for all developing countries.

How did the revolution begin?

It started as what I would call the ***'US$ 27 revolution'*** and it was Prof. Yunnus who gave the world **the microfinance revolution – *'Grameen Bank'***, where by lending mere US$ 27 to 42 people he changed their life and the rest is history. The micro-credit began works on a joint liability model used by most MFIs

Ffinancial institutions, donors and private equity are the source of funds which is pooled in by the MFIs and then disbursed to several self-help groups (SHGs) across villages. From these SHGs it goes to the several households in need for capital for various purposes.

Commonly, an MFI does a comprehensive survey of the villages and then based on certain parameters chooses a village and offer their mission, methodology and the services to the villagers. Thereafter villagers are asked to gather in a group of five to serve as guarantors for each other enforcing them to be loyal to each other. This is done so that in case a group member is not able to repay the loan, the others can help him/ her in making payments. In case if any member defaults in the loan the group is penalized and sometimes is also barred from taking a further loan. On the other hand making timely payments also attract incentives. This peer pressure always brings out the diligence in paying the loan and acts as collateral for the MFI.

After this set up the group training begins. From understanding of the business skills, helping identify the business generation activity to calculation of interest, credit discipline, signing of names and so on; the members of the group are trained thoroughly for five days. Thereafter a village centre is created of all these groups which ensure that all the groups duly meet their responsibility of paying loans. This creates a dual liability system and finally the finances start flowing in. The loan repayment is in weekly installments. The group needs to put some amount of their income in a separate account as savings and there is another account maintained separately for fines. First one or two members of the group are given loans where if for the next six weeks there is no default then the other members of the group are given loan. Surprisingly women are better in repaying their loans than men.

Another way of expanding operations is by linking the MFIs to the formal sector lenders aligning the strengths of the two. By entering into a joint venture with the commercial financial institutions the MFIs can access the broader base of resources while retaining its accessibility to the poor. This would mean that the financial institutions would provide huge funds and the MFIs will act as conduit in determining how the loans can be packeted in smaller proportions to be of use to low income households.

The three eminent models of micro-financing that have laid their success stories before the world and several other countries are following their footsteps are the Grameen Bank model of Bangladesh, Banco Campartamos Model of Mexico and the BancaSol Model of Bolivia.

MODELS OF MICRO FINANCING

Grameen Bank Model: The first of all the models that emerged Grameen Bank established the fact that lending the poor is not just beneficial socially but brings economic upliftment as well. As on February 2009 Grameen Bank served more than 7.7 million poor Bangladeshi families. In 2007 they paid a dividend of 20% to the borrowers who are also the owners of the bank. Grameen Bank today has 4 million borrowers of which 96% are women. Another amazing fact that emerged was that repayment rate was as high as 96%-98%. In Bangladesh alone every year poverty levels come down by 2%. The strongest point of this model is that it believes that the income generated by the poor should go back to the poor to bring about sustenance and also helps them to grow even more.

Comparatmos Bank Model**:** Though involved in a lot of controversy on its ideology the profits made by the bank is distributed among the investors serving as bait for attracting more investments and establishing that investing for the poor can also be attractive. This bank has been quite successful in its proposition as it raised $400 million through an IPO in 2008 – the first Latin American micro-finance institution to raise capital through public offer, but is charging as high as 100% interest rates to the poor. The contention is that the model is far away from the concept of philanthropy on which concept of micro-finance was established and is shifting the money from the poor to the rich which is morally unjustified. In spite of the humungous debate the number of borrowers has risen from 60,000 to 900,000 in last eight years and the repayment rate is as high as 99% says much about the success of this model as well.

***BancoSol Model*:** This is somewhere in between the first two extremist, where the banks retain minimum profits for themselves. BancoSol of Bolivia was an NGO (PRODEM) that converted itself into licensed commercial bank. As an NGO, in 1992 it had a loan portfolio of $4 million serving 14,300 clients within four years after its transformation its loan portfolio had grown to $43.1 million with 69,900 loans outstanding and 50,000 savings deposit account.

The bank is not dependent anymore on the donors' funds and there is access to commercial funds and private sources of funds, but this surely came at a higher cost. Also as a bank the regulatory capital requirements reduced the assets availability. Their growth was not a product of higher interest rates charged, but they increased the size of the loans and the tenure of maturity as well. There has been no mission drift and it like a portfolio of funds created and where small size loans are given to the poor and larger loans are given to repeat clients. The bank has survived the operational and financial challenges posed before it without creating a bigger hole in the pockets of the poor and deserves the accolades.

Self Employed Women's Association (SEWA) is a bank in the West Indian state of Gujarat was founded in 1974 and is on the lines of Grameen Bank. Whereas Kenya's Rural Enterprise Planning Commission (K-Rep), Accion Comunitaria del Peru and Genesis in Guatemala are all following the lead of BancoSol.

In understanding of these models there was a mooted question posed was on the high interest rate charged by the MFIs or banks providing micro loans. Whether commercialization of the microfinance and the high interest rates charged to the poor **Is as risky a proposition as it is assumed to be?**

There is lot that has been spoken about microfinance contributing in a big way for the upliftment of the poor. A driver of economic growth – Micro finance is helping people break away from the shackles of poverty and fueling the spirit of entrepreneurship. What comes as the natural process of growth and improvisation of the mirco lending concept there have several arguing that the commercialization of the concept has bereaved it of its very essence.

There is a serious trade off between reviving the conditions of the poverty stricken people from their very own funds and seeking help from outside investors like the foreign institutions to seek profits out of investments in micro loans.

The poor would always be poor and the rich would always be rich and the categorical difference exists because of 'money.' Before the concept of microfinance emerged the poor did not have the means to get access to the finances that would revive their conditions and break the shackles of the categorical difference. The fact that they were poor kept the commercial banks away from them as it was risky for the banks to lend without any collateral, guarantee, source of recurring income to support the repayment and so on.

With evolution of micro loans, the poor got access to funds and were able to attain financial stability. With petty loan they churned much bigger loans and moved away from abject misery. The concept like wildfire spread across the globe. The Grameen Bank model worked where the people from the village ran the bank set their rules and helped each other to be self-sufficient. The concept amazed all as what emerged was – lending women was more meaningful that lending to men. As Prof. Yunnus rightly put it that ***if you give money to a man he would buy a fish and eat it but if you give money to a woman she would use it well to buy fish for the whole family.*** There were very few reported defaults whereas on the other hand commercial lending institutions were writing of several billions in defaults against lending to the non-poor.

To keep in pace with the demand and supply of loans it was essential that the non-profit seeking institutions became profit seeking institutions and reached out to the capital markets to bring in more and more of funds. In 2004, international capital markets woke upto the attractiveness of investing in micrfinance.

There have been several who contest that accessibility is what matters whereas others contest that it is coming out from the clutches of indigenous moneylenders and falling into the hands of organized institutions that practice usury themselves. As per the analysis of 28 studies on informal moneylending rates in various countries across Asia, Latin America and Africa, 76% of the moneylending rates exceed 10% which includes a whooping 22% that exceeds 100% per month.

The nominal interest charged by most MFIs in the Asia Pacific region ranges from 30% to 70% (on reducing balance method) plus the commission and the fees charged separately. To add to the misery of the poor there is a compulsory deposit requirement; high frequency of repayments keeps the borrowers on their toes all the time. There have been several governments contesting that there should be ceiling rate applicable to the interest rates charged by MFIs.

Even though these MFIs get loans at a discounted rate – there lending rates do not come down. For instance in India ICICI bank lends these MFIs at a 9.5%-11% range whereas the lending rate for these MFIs has remained hovering as high as 16%-30%. Servicing of smaller loans and maintaining records for such small term granular loans is costlier than the larger loans provided by commercial banks. So, high interest rates seem to be a quick justification for the same. Even though the interest rates seem to be high these are still acceptable to the borrowers for various reasons, a) there is availability of loan and b) the interest rate charged by MFIs and banks are less than what a moneylender would charge, that would be as high as 50% of interest per day or keeping a family member as collateral as bonded labor. In Philippines there is a concept of ‘five and six,’ where you borrow 500 pesos in the morning and return 600 pesos by the end of the day. Also where a commercial bank would charge a 13% rate of interest rate p.a for say $1 million, if the MFIs were to charge a similar rate on $100 loan such lending institutes would not sustain in the long run. It is like a labor intensive unit trying to cope up with capital/ machine intensive unit. So in order to break-even they need to charge a higher rate of interest

On the pre-text above there are several questions posed –

Whether competition from large commercial houses will be able to bring the interest rates down and with the extra edge they gain over the other MFIs - on their scale of operation?

As long as there is more of demand more these loans than there is supply there is enough room for competition to fit in. Currently micro loans have been accessible to 30 million households whereas people living below the poverty line are as high as 500 million households.

Will putting a ceiling on the interest rates be helpful, to deal with this problem?

The answer is a clear cut no, lower interest rates would mean recurring losses which will not only dissuade the present institutions in business but new entrants would also shy away. Writing off the losses with the govt availed subsidy is not the solution either as this sort of an arrangement may not sustain in the long run. This would also mean that the MFIs would cherry pick borrowers to fit the bill and completely defeat the purpose of having MFIs.

In countries like Nepal and Papua New Guinea where the infrastructure is poor and personnel/ operating costs are high. Such an arrangement would certainly not work out.

What is a possible solution to high interest rates posed?

Several MFIs in several countries have been expanding their scope of operation with the high interest rates. This means that inspite of the prevailing rates being high, poor are willing to pay much of the interest for a sheer reason that the need for finances is higher than the pinch in the pocket it makes for them. ACLEDA bank in Cambodia, Rakyat, Indonesia, Xaan and Xac Banks, Mangolia, Compartamos Bank in Mexico are some of the appropriate examples in this regard. As per one of the CGAP reports the average income of the borrowers from the Bank of Rakyat has increased by 112%. So, one may not see this as a problem at all in the first place.

Countries where ceiling rate is applicable are Vietnam and People' Republic of China and the growth rates have been reported stunted.

The only way interest rates can be brought down are by reducing the costs incurred on carrying out MFIs activities and policy makers have a role to play. Indirect help extended by the policy makers can be in the form of improving the physical, financial and human resources and infrastructure facilities. Direct benefits can be relaxing the regulatory capital requirements, liberalizing and promoting international and local participation in the equity of such institutions and reducing the dependence on donors.

Imposed lower interest rates is not recommendable for any country however a gradual downturn in the interest rates is eyed as witnessed in countries like Cambodia and Mangolia.

THE INDIAN PERSPECTIVE

The legal framework for establishing a co-operative movement came about in 1904; Reserve Bank of India established an Agricultural Credit Department in 1934 and then came the Regional Rural Banks in 1975, the Integrated Rural Development Program (IRDP) in 1978 and the premier agency for rural credit NABARD was established in 1982. The history of micro credit/ micro financing goes way back in India.

The Anand Milk Union (more popularly known as Amul) was one such dairy co-operative movement in India that was revolutionary and changed the face of rural India making many women in villages self-sufficient and independent.

To cater to the needs of the poor and the impoverished and to provide a helping hand in alleviating their economic condition microfinance movement in India began. Microfinance is defined as rendering of financial services in the form of credit, savings, deposits and insurance to low income group people and to individuals who fall below the poverty line for creating social value. The rural money lenders or the mahajans extracting exorbitant amounts for the loans extended to the poor and the needy had been prevalent in all parts of the country. Sometimes the interest rates are as high as 36% to 60% as these moneylenders enjoy the monopoly. To provide relief from the exploitation of such money lenders and to also provide finance to those who did not have access to these money lenders concept of microfinance came into being.

The low income population, specially the rural population does not have the access to the regular commercial banking channels. Absence of formal employment and inability to provide any collateral against the loans makes them 'non-bankable.' Typically these individuals do not have any collateral to offer against the loan demands. So, microfinance institutions have a role to play to bridge the gap between the financial institutions and the poor.

Micro finance institutions thereby are very pivotal in developing countries to help economically marginalized population to access capital to be micro entrepreneurs and become operationally self-sufficient in all respects. Today NABARD, SIDBI, HDFC, RRBs and many co-operatives are engaged in extending micro finance to the poor. NABARD started the self-help group (SGHs) and bank linkage program as a pilot project in 1992 which went to become the most popular model of micro financing. Today there are millions of families today are benefiting from this movement and the movement is fueling in them the spirit of entrepreneurship.

In 1991 – 1992 NABARD started the project of linking the SHGs with the Banks with a view to providing meaningful banking facilities to the poor. RBI added to the initiative by advising the banks to actively take part in the project. In 2000 the Govt. of India vide their notification dated August 29, 2000 has included ‘Micro Credit/Rural Credit’ in the list of permitted non-banking financial company (NBFC) activities for being considered for Foreign Direct Investment (FDI)/Overseas Corporate Bodies (OCB)/Non-Resident Indians (NRI) investment to encourage foreign participation in micro credit projects. This covers credit facility at micro level for providing finance to small producers and small micro enterprises in rural and urban areas.

In India, both institutional and non-institutional channels of supply of credit exist. While the share of informal loans in rural credit has gone down from a 91% in 1951 to 45% in 1991, there are still around 80% of marginal/ landless farmers who do not have access to credit.

According to the Ford Foundation report, the financial cost ratio (cost of funds as a ratio of portfolio outstanding) is amongst the highest in the world at 8.5%, whereas in neighbouring Bangladesh it is 3.4% and in Sri Lanka it is 4.3%, because (as mentioned above) the MFIs do not benefit from the cost of funds collected as savings. In spite of this, the rate of interest in India is one of the lowest in the world, because of high repayment rates and high productivity of field staff. The borrowers per staff member in India are the highest at 439, whereas it is 131 in Bangladesh and 175 in Sri Lanka. Similarly, the cost per borrower in India is also one of the lowest at USD14, next to Bangladesh at USD10. The operating expense ratio of 12.3% is higher in India when compared to Bangladesh (11.9%) and Sri Lanka (10.4%).

According to a Saadhana (2007) report there are 1400 MFIs in the country and 260 million people below the poverty line MFIs in India are quite progressive but there is much more ground to cover as yet.