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Quest for fast growth lands India's microfinance institutions in soup

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Vijay Mahajan has seen it all. The IIT-IIM alumnus founded Basix, one of India's first efforts at social entrepreneurship, in 1996 and has since
been a keen observer of the progress of India's microfinance (MFI) sector.

Immortalised in public consciousness by the famed Grameen Bank in Bangladesh, the fledgling MFI sector in India is in a spot. It's battling labour trouble, discontent in some places and its practices have caught the attention of regulators. At the crossroads, a mis-step or a wrong turn could cause serious damage.

Fifty five-year-old Mahajan doesn't flinch when he says that MFIs will find the solutions to their current problems. They need only look back at their origins, he says over coffee at a popular teenage hangout in Hyderabad, a setting not exactly conducive to a trip down memory lane as youngsters lie sprawled across mattresses smoking hookahs, swinging their heads to some heavy metal fare.

What Mahajan wants to emphasise is on the origins of MFIs as an act of social philanthropy, and how a set of aggressive players who moved in later have rewritten the rules for everyone.

In the process, the industry is seeing some worrying developments. While repayment rates continue to be almost perfect, multiple borrowings are rising alarmingly, triggering concerns that some of these borrowers might be falling into a debt spiral as they borrow from one MFI to repay another.

In the last year alone, there have been concerted actions by communities in Karnataka, Uttar Pradesh, Orissa and elsewhere to block repayments. There has been labour trouble in Nagpur, Warangal and Karimnagar and matters have reached a point where a handful of banks, notably ABN Amro, increasingly unsure about the quality of the loans, have capped their exposure to MFIs.

In the industry, opinion is divided on how serious these issues are. Are these unconnected, isolated instances? Or is a deeper crisis taking root that could drag the whole cause of financial inclusion. Take Kolar N Srinivasan, former chief general manager, National Bank of Agriculture & Rural Development (Nabard), and author of the latest sector report on microfinance, cites studies as saying that 25% of borrowers in Kolar had more than five loans, while three loans was the average for all borrowers. Take Karnataka, and the penetration of microfinance loans among poor households stands at 263%. In Andhra, the number is a staggering 823%.

What explains this trend of multiple lending? A former employee of Spandana, a prominent MFIs with operations predominantly in Andhra, says rural women are borrowing more because more money is available.

The argument has some merit. Over the last 10 years, Andhra has seen an explosion in rural credit. Earlier, says K Raja Reddy, who handles research at APMAS (Andhra Pradesh Mahila Abhivruddhi Society), there were three sources of rural credit — banks, family and moneylenders. That has changed now.

Today, thanks to AP's Pavala Vaddi (Telugu for 1/4th interest) scheme, banks offer loans to self-help groups (SHG) at 3% and lend directly at 8-9%. Village organisations give bridge loans of Rs 10,000 under another state SHG programme called Velugu to members at 12%, while traditional sources lend at about 24% and MFIs lend at 29% or so.

However, while banks do offer cheaper credit, they don't fully meet households' needs partly because they are reluctant lenders. And while an SHG is eligible for a loan after the first six months, there are instances where groups have waited as long as five years.

The upshot? Most of them approach banks to get all the cheap credit they can, and then turn to MFIs for the rest of their needs.

The village threshold

To be fair, MFIs didn’t invent the credit needs of Indian households. Money enters the village economy only after the harvest, and the rural population has always borrowed to meet expenditure requirements. But what is new is the MFIs’ insistence on weekly repayments. It is not easy to sustain weekly repayments in agricultural areas where money supply itself rises and falls with the agricultural cycle.

This problem could have been fixed by connecting women to larger markets. Moumita Sen Sharma, VP and head (microfinance and sustainable development) at ABN AMRO, says she spotted the risk of multiple lending in 2008. And when the quantum of money flowing into villages is higher than the village economy’s absorption capacity — and also given the insistence on weekly repayments — women will start borrowing more to service old debts.

But not all agree with this hypothesis. YV Shiv Narain, vice-president (finance), Spandana, says MFIs are not injecting more money than what villages can absorb. He cites the Raghuram Rajan Committee report that estimated the credit absorption capacity of an Indian rural household at Rs 50,000. "That was in 2006-07. Today, inflation adjusted, that could be as high as Rs 80,000. And even if you put together all the amounts one can borrow from multiple MFIs, you will still not add up to that number," says Mr Narain.

But it sounds blithe to extend one number across all villages and income strata without factoring in any variation. While traveling, ET saw that women in smaller villages, particularly, were struggling to repay.

Lending on a high pitch

The multiple avenues of credit that have opened up in Andhra and Karnataka villages also mirror the change in the nature of funding for Indian MFIs over years. Ten years ago, the microfinance industry comprised philanthropy-based models built around long-term soft loans.

Around 2001, the industry began attracting funds from development financial institutions (DFIs) like SIDBI and IFC. In the mid-2000s, came the private equity firms and Microfinance Investment Vehicles (MIVs). The next evolution will be an IPO, partly because some of the investors want to cash out.

The second reason for an imminent IPO wave is the aspect of scale. Basix’s Mr Mahajan says that the pace at which the larger MFIs are growing, they have reached a size where private equity cannot provide enough capital to fulfill the RBI’s capital adequacy ratio norms.

Padmaja Reddy, the founder MD of Spandana Sphoorty Financial (Spandana), drives home the point Mr Mahajan makes. Singapore-based private equity fund Temasek is picking up a 10% stake in her company for Rs 200 crore. The deal, says Narain, will take care of growth for the next 1.5 to 2 years. But Ms Reddy is even more aggressive. She says the Rs 200 crore will suffice for just a year’s needs.

During this period, the capital knocking at the MFI doors too changed its colours. While the trusts charged 1% interest for 10-12 years, the DFIs picked up equity but could waive dividends for some years. The MIVs and the PEs, however, want to exit sooner and expect better returns. In the process, MFIs with PE investors now have to keep their (and also the promoters’) demand for higher profitability and faster growth rates.

MFIs have met these expectations mainly by adding new customers and increasing loan sizes.

Spandana’s outstanding loans stood at Rs 400 crore in 2007, but by this January, that had risen to Rs 3,150 crore. The company plans to grow at 100% over the next year, and expects half of that growth to come from existing customers.

Larger rival SKS is no different. Between March 2008 and March 2009, SKS’ client base almost doubled from 1.87 million to 3.95 million. During this period, amounts disbursed almost trebled from Rs 1,678 crore to Rs 4,398.83 crore, and outstanding loans rose from Rs 1,050 crore to Rs 2456.53 crore. The company, which declined to be interviewed for the ET article, is reportedly preparing for an IPO.

Meanwhile, investors have been quick to reward growth. In 2007, Spandana was valued at Rs 125 crore. Today, as the Temasek deal shows, it is valued at Rs 2,000 crore. When it tried to raise funds, Mr Narain says, the company received as many as 17 letters of interest from the likes of Warburg Pincus, Citibank and Bain Capital.

On the ground, however, the MFIs' growth is creating an unnerving situation. Even among those in the industry, there are fears of a mass-delinquency. In fact, Andhra is the most penetrated market in the world, on par with Bangladesh, says Daniel Rozas, a contributor at industry blog Microfinacefocus.com. "The state was already at 6% overcapacity a year ago. Explaining these numbers without allowing for extensive multiple borrowing is indeed a challenge," he says.

Lending continues to rise in these saturated regions. Loan sizes have gone up, and now, apart from offering fresh loans to retire existing ones, MFIs are now introducing concurrent loans (emergency loans, marriage loans, education loans) to existing customers.

The irony is that the explosion in credit supply, far from turning away fresh suppliers, is attracting more. MFIs continue to expand into areas where other MFIs are already present. "If another MFI is already active in the village, lesser time is needed to train people about the Grameen model," reasons a former MFI staffer.

Besides, the industry doesn't know what proportion of loans are being used for productive purposes, for consumption, or for debt refinancing! Ask why, and it blames the borrowers, who cite one income generating activity or another while borrowing – a response to the MFIs wanting to lend only for productive uses.

So, what gives?

A Nabard senior manager points to the irony of it all. "This was supposed to be about empowering women. But today those women work as labour to repay their loans. How can anyone pay a 30% interest in these areas and still be left with anything at all?" he asks.

The looming dark clouds have forced Sa-Dhan, the industry association, to come up with a stronger code of conduct. However, the idea itself seems still-born. For one, voluntary codes rarely work. And then there is the small issue of the industry being vertically split between NBFC MFIs and the MF NGOs. Sa-Dhan is struggling to retain both within its fold. For that reason, it is unlikely to read the riot act to anyone.

No code will be effective unless the MFIs take a relook at the way they assess the performance of its field staffers. They are currently monitored on two parameters: how much they are able to lend, and how much they are able to recoup.

Those like Mahajan feel that in order to obtain a better sense of the bubble-vulnerability of the Indian microfinance sector, an analysis of members' loan exposure levels against their repayment capability needs to be conducted.

Accordingly, this year, around 30 leading NBFC-MFIs, collectively accounting for around 85% of the Indian market, are creating a common database of borrowers which will help the industry get a full idea of clients' total indebtedness and credit worthiness before disbursing loans. This will work if all MFIs sign up.

It should also be remembered the industry's environment is pushing it towards faster growth. Investors, we know, are looking for high returns. More recently, drawn by the higher repayment rates, public sector banks have begun preferring larger MFIs.

R Premchand, whose NGO used to supply microcredit around Karimnagar, rues that bankers' policies have changed. "Till two years ago, they encouraged people like us. Now, they are encouraging NBFCs," he says.

On the whole, MFIs trying to avoid the high returns game are struggling to find investors and loans. Take Basix. Mahajan had been looking for investors at the same time as SKS. The latter raised $76 million.

Basix, after trying for two years, managed \$10 million, and half of that from SIDBI.

The company has had to increase its growth rate. Smaller MFI-NGOs are facing these pressures as well. A minor stampede is underway, even by industry stalwarts, to register themselves as NBFCs. Others, like Premchand, have decided to exit the business.

Taking a leaf out of basic business management, if nothing else, Indian MFIs can start looking at aligning their short-term and long-term interests.

If they stick to short-term goals, at some point, someone else — politicians, borrowers the RBI, the courts, Centre or state governments — will step in and take charge of the industry's destiny.