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Policy Brief # 10

Access to Credit Post Microfinance Crisis

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The microfinance crisis that began in 2010 with the enactment of "The Andhra Pradesh Microfinance Institutions (Regulation of Money lending) Act, 2010" by Andhra Pradesh (AP) Government has had a great impact on the Indian microfinance sector. Even after almost three years, the sector is still trying to recover to the pre-crisis growth rates. SKS Microfinance Ltd., the sole listed microfinance institution lost almost 90% of its share value from its all-time high of Rs.1,490.70 in September 2010. It has lost its position as the biggest MFI in India owing to its non-performing AP portfolio and reduced lending in rest of the country during the crisis. However, it has been able to sustain the crisis and has achieved three consecutive quarters of profit by the first quarter of financial year 2013-2014.

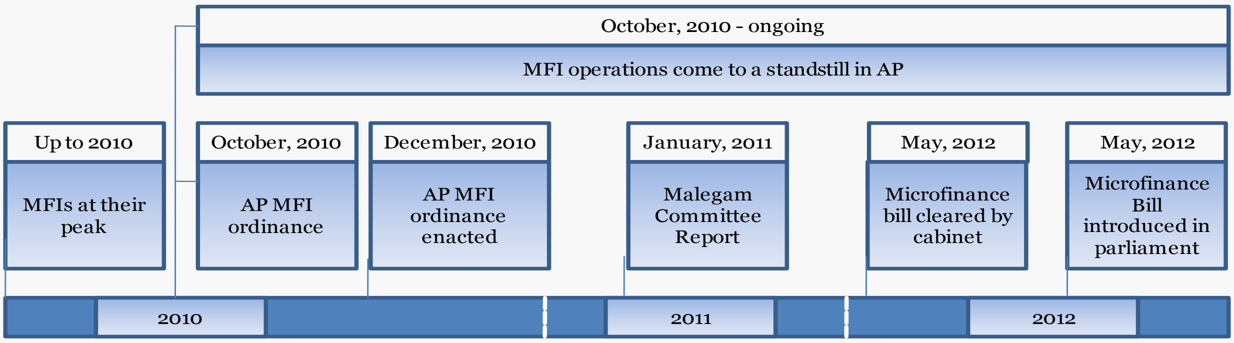
The recent return of investor confidence in the Indian microfinance sector is perceived positively by all. A number of MFIs have been able to secure funding through securitisation deals (worth Rs.683 crore ($110 million) by Bandhan, SKS, ESAF[1]) and bank loans ($11 million to Equitas and Satin Credit Care by Standard Chartered Bank[2]) in the first quarter of financial year 2013-2014. Unlike SKS, other AP based MFIs have not been able to turnaround. In September 2013, four AP based MFIs SHARE Microfin, Asmitha Microfin, Spandana Sphoorty Financial, and Trident Microfin requested Reserve Bank of India (RBI) to allow banks to offer them fresh loans.[3] These MFIs have been registering negative net worth owing to poor recovery rates, which is expected to deteriorate further unless ground level operations resume.

The crisis has resulted in a credit gap in these markets, especially in AP and also in other states, owing to drying up of MFI funds and cautious lending by banks. A study of the impact of the microfinance ban in AP by the Indira Gandhi Institute of Development Research published in July 2013 provides quantitative evidence of the negative impact on clients.[4] The study shows that consumption in AP dropped by 19.5% in the first four quarter after December 2010. The impact of the sudden loss of credit access is seen across all income classes.

MicroSave conducted a study in August 2011 to collate clients' experiences, opinions and needs, to inform policy makers and perhaps help devise solutions most suited to the requirements of the poor.[5] To further enhance understanding of the effect of the microfinance crisis on poor clients two years after it started, *MicroSave* conducted another study in July 2012 in two states - Andhra Pradesh and West Bengal. These states have been home to some of the largest MFIs in India including SKS and Bandhan, and remain crucial epicentres of microfinance activity in India.[6] While the MFIs in AP have struggled to make a turn around, MFIs in West Bengal, such as Bandhan, still grew during this period – albeit at a reduced rate. This Policy Brief draws a comparison between how access to credit for the MFI clients changed in these two states post AP crisis, and its impact on the MFI clients.

[1] Refer to news digest on India Microfinance
[2] Refer to brief on MicroCapital
[3] Refer to article "Allow banks to offer us fresh loans: MFIs to RBI"
[4] Sane, Renuka and Thomas, Susan, "The Real Cost of Credit Constraints: Evidence from Micro-Finance" July 2013
[5] Refer to *MicroSave* research study on "What are Clients doing Post the Andhra Pradesh MFI Crisis?"
[6] Refer to *MicroSave* research study – Access to Credit in Andhra Pradesh and West Bengal Post Microfinance Crisis

Snapshot of the MFI Crisis



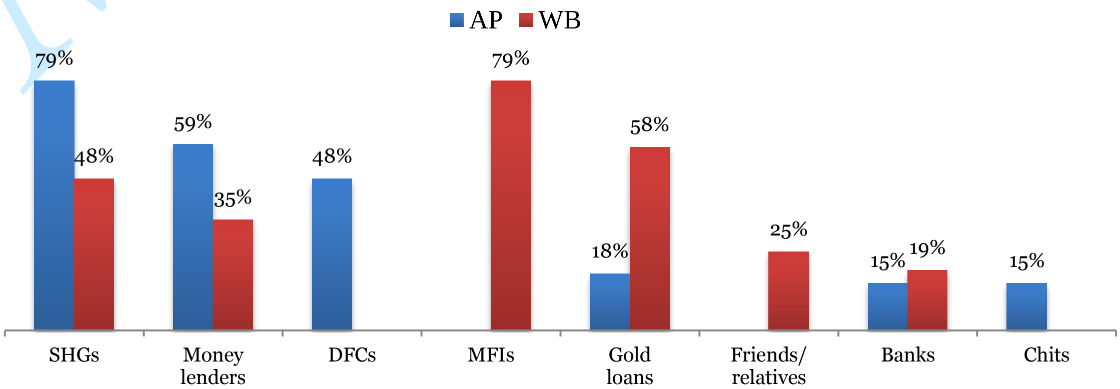
In October 2010, the State Government of Andhra Pradesh issued an [Ordinance] to regulate the MFIs operating in the state, alleging exploitation of poor and ignorant borrowers. The Ordinance, "The Andhra Pradesh Microfinance Institutions (Regulation of Money lending) Act, 2010" enacted in December 2010, contained stringent provisions which immediately resulted in near-total suspension of MFI operations in the state. The Act mandates that all loan repayments must be made monthly at the *Gram Panchayat* offices. This effectively negated the two significant advantages the MFIs had: repayments in smaller amounts and doorstep service delivery. The Act also requires MFIs to obtain prior approval from the District Rural Development Agency (DRDA)[7] before giving loan to any SHG member, effectively strangling new disbursements.

Almost three years after the enactment of the Ordinance, MFI operations have almost come to a standstill in AP. MFIs, which had boasted more than 95 % recovery rates, found themselves staring at repayment rates of 10%-15% during 2011, and this further fell to below 1%[8] in 2012. In the first half of FY 2010 -11, MFIs had disbursed Rs.5,000 crore ($800 million at today's exchange rate – nearly 50% more at the pre 2010 exchange rates) to borrowers in Andhra Pradesh. This sharply reduced to a mere Rs.8.5 crore (less than $2 million) by the second half of FY 2010-11.[9] In early December 2010, MFIN, the network of NBFC-MFIs reported that MFIs were unable to collect Rs.7,200 crore ($11.6 billion) outstanding loans in Andhra Pradesh.

Current Sources of Credit

Microfinance operations have come to a complete stand still in Andhra Pradesh. However in West Bengal, MFIs are still running and growing effectively albeit in a subdued manner. The graph below indicates clients' current sources of credit.

Figure 1: Sources of Credit (Percentage of Sessions)



[7] District Rural Development Agency (DRDA) is responsible for SHG movement at the district level and is implementing agency of SERP at district level.
[8] Based on discussions with staff and management team of MFIs during July 2012 research
[9] See [Microfinance in India: A crisis at the bottom of the pyramid, How the Government of Andhra Pradesh has severely damaged private sector microfinance and put 450 million of India's rural poor at risk, Legatum Ventures]

In AP, most of the clients are borrowing from SHGs promoted by SERP, which was set up by the government of AP.[10] After MFIs stopped their operations, the AP government initiated a major push to increase bank linkage credit to SHGs. However, the increase in credit from banks has not been sufficient to meet the credit gap created by the absence of MFIs. Apart from the traditional moneylenders, many other informal credit providers have sprung up in the absence of MFIs. Moneylenders, daily finance corporations (DFCs), pawn brokers etc. are having a field day by exploiting the poor clients.

In West Bengal, most clients still borrow from MFIs. However, the amount of credit is often insufficient and, as a result, clients borrow from other sources – most commonly SHGs under the SGSY scheme.[11] However, the use of SHGs still remains low because of the insufficient loan amounts offered, uneven distribution of SHGs, and the restriction of membership to SHGs under SGSY (which is only for BPL families). Loans from formal sources are often inadequate and for a fixed term, as a result of which clients resort to informal sources to meet credit requirements in the intervening period. The most common informal sources are moneylenders, gold loans from jewellers or pawn brokers, and friends and relatives.

Trend analysis of various credit sources demonstrates this. In AP, as MFI lending stopped, credit from other sources surged. Figure 2 shows sharp decline in usage of MFIs and sharp rise in money lenders and DFCs over the last 2 years. SHGs and banks have steadily increased over past 5 years. However, the increase is not sufficient to fill the gap created by MFIs, resulting in the flourishing of informal sources.

Figure 2: Trends in Usage of Credit Sources in AP

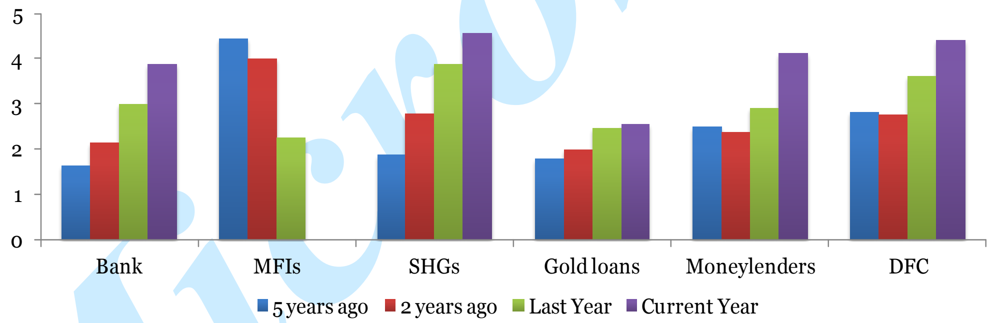


Figure 3: SHG Bank Linkage in AP

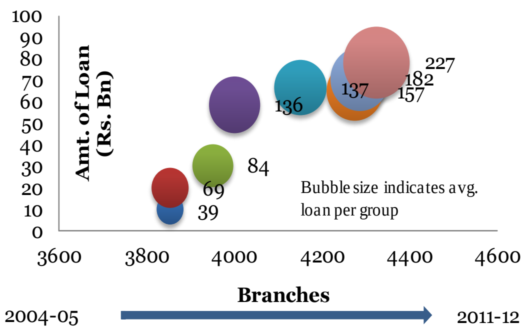


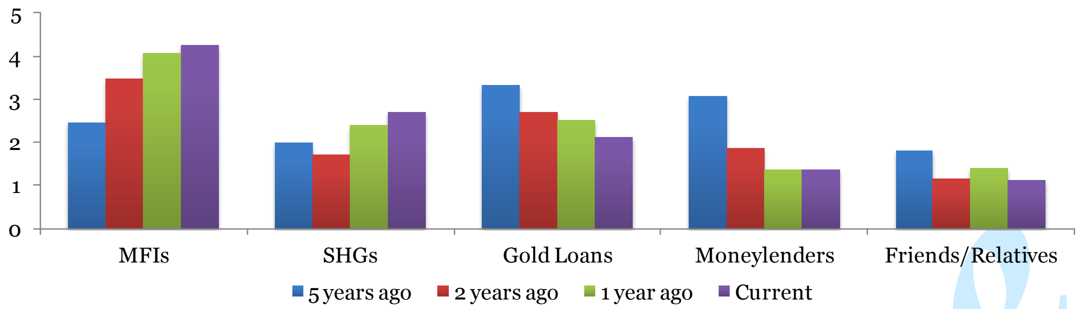
Figure 3 shows the change in SHG bank linkage in AP from 2004-05 to June, 2012.[12] The X-axis indicates the number of bank branches disbursing loans to SHGs, the Y-axis indicates the amount of loans disbursed and the size of the bubble indicates average loan size per group.

The amount of loan disbursed has increased from Rs.65 billion ($1.05 billion) in 2009-10 to Rs.78.66 billion ($1.27 billion) in June 2012, an increase of 21%. Much of this was driven the 44% increase in size of loan per group, from Rs.157,000 ($2,532) in 2009-10 to Rs.227,000 ($3,661) in June, 2012.[13]

In contrast to this, in WB the usage of informal sources has gradually reduced over the years with expansion of MFIs. However, MFIs' growth has been slower over the last 2-3 years due to the sharp reduction in bank lending to MFIs after the AP crisis.

[10] Refer to the website http://www.serp.ap.gov.in/SHG/index.jsp
[11] Refer to "Master Circular on Priority Sector Lending- Special Programmes - Swarnajayanti Gram SwarozgarYojana (SGSY)" dated 1st July 2010 for more details
[12] SERP - Progress Report, June 2012
[13] SERP - Progress Report, June 2012

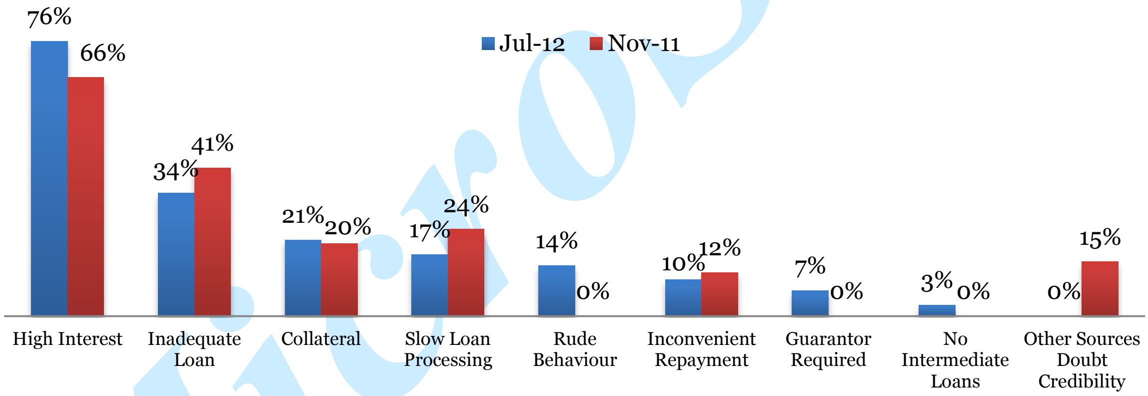
Figure 4: Trends in Usage of Credit Sources in WB



Pain Points of Accessing Alternate Sources

In AP, members of the community have taken credit from a variety of sources to fill the credit gap left by the shut down of the MFIs. Figure 5 below highlights the pain points in accessing credit from other sources in the absence of MFIs. In 76% of the sessions, respondents said that they had to pay higher interest rates and accept insufficient loan amounts (34% of the sessions). In 21% of the sessions, respondents mentioned that they faced issues with pledging collateral especially for gold loans and bank loans. Apart from that respondents had to bear with the rude behaviour (14%) of the service providers and slow processing time (17%).

Figure 5: Pain Points in Accessing Credit from Other Sources



Girigiri loans

Daily finance is called *Girigiri Vaddi* in local parlance. Respondents said that many people have started daily finance companies in the last two years. Daily finance has become very attractive business, and people who have even a lakh rupee started lending and are running successfully as there is a huge demand for credit.

"We have taken have taken loans from daily finance companies due to lack of any alternative source. They charge upfront interest of Rs.1,500 for Rs.10,000 and we have to pay Rs.100 per day for100 days"- Rani, Manchiryal

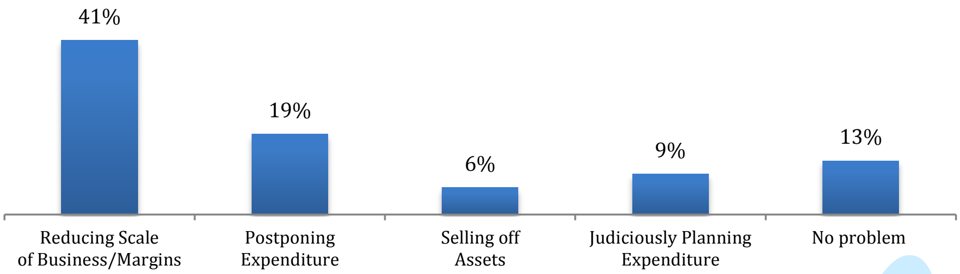
"Memu ilane undalani anukunte maku appulu avasaram ledu kani memu unnavallam kavalante maku pettubadi kosam appulu kavali".

(If we want to live like this (in poverty) we do not require loans, but if we want to come out of poverty and become rich we need loans to invest in our business").

Impact and Coping Strategies in Absence of MFI Credit

Difficulty in availing credit from alternate sources has impacted the economic activity of low income households in AP. During the research in AP, respondents mentioned that they postponed their expenditure (in 19% of the sessions) due to lack of sufficient credit from alternate sources. They also postponed expenditure because of unfavorable terms of available credit. In 41% of the sessions, respondents affirmed that they reduced the scale of their business or completely shut it down for want of credit. Due to the high rates of interest, interest cost is now a major component of expenditure, eating into profit margins of the borrowers. In some sessions, respondents spoke of having sold off their assets such as house, cattle, gold etc. to meet their productive, as well as nonproductive, expenditure.

Figure 6: Coping Mechanisms Adopted

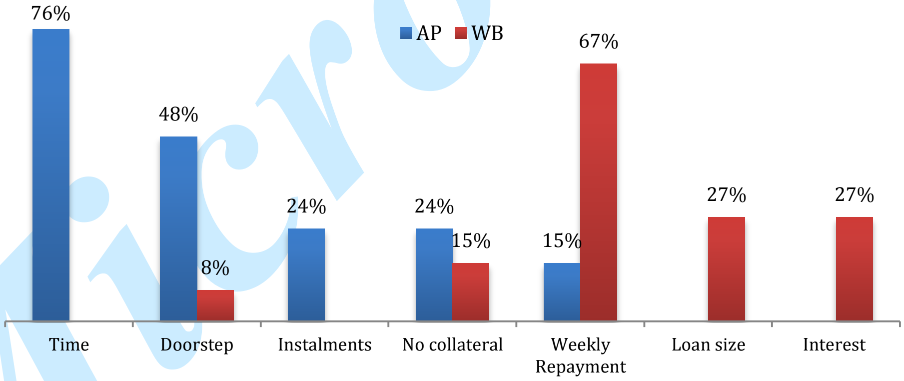


It is interesting to note that 13% of the respondents mentioned that they do not face any problem in the absence of MFIs. Respondents realise that it is already two years since the MFIs closed. They think that the prospect of MFIs returning is bleak as the government is not favorable to MFIs – and so have made alternative arrangements.

What did Clients Like About the MFIs?

MFIs provided clients with an efficient credit channel and had created a "connect" with the clients. The research shows that clients do find clear value in the services offered by microfinance institutions. In AP, clients appreciate MFIs' fast loan processing time. They could plan their expenditure as they were certain that they would receive the loan within a specified time. Clients found the doorstep delivery model of the MFIs very convenient as they could repay the loans at centre meetings without the need to go to the branch office. Many clients preferred MFIs as they offer loans without collateral and the repayments can be made in small weekly instalments.

Figure 7: What Clients Like About MFIs?



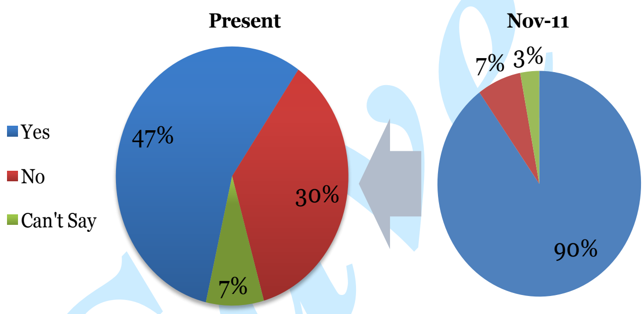
In West Bengal, clients preferred the weekly instalments of MFIs as it helps them pay small amounts and reduce the debt burden progressively. MFIs instilled a sense of credit discipline among the borrowers. Clients favoured MFIs because of lower interest rates (between 22% and 27%) as compared to other informal sources (between 60% and 120%). MFIs offer relatively larger amount of loans ranging from Rs.5,000 to Rs.50,000 depending on the loan cycle. It is interesting to note that respondents in WB did not talk about the timely disbursement of loans. This may be because of delays in the sanctioning of loans by MFIs struggling to meet their clients' demand with limited credit lines from banks after the AP crisis.

Conclusion and Recommendations

The Andhra Pradesh MFI crisis has shaken up the sector. While MFI operations in AP have come to a standstill, MFIs in other states like West Bengal are managing the new regulatory environment. The introduction of "The Micro Finance Institutions (Development and Regulation) Bill" by the central government has brought much needed clarity and stability to the sector. However, MFIs with exposure to AP still have a cause of concern because of the state government's reluctance to relinquish its control over MFIs through the separate state regulation.

MicroSave's research findings from the AP and WB study highlights the importance of microfinance institutions as an effective channel to reach out to the poor and marginalised sections of the society. Other studies also show that the ban on MFIs has a negative impact on MFIs borrowers.[14] In the context of the global debate on the negative effect of for-profit microfinance for the low income illiterate/semi-literate segments, it is clear that such abrupt policy restrictions can have negative effect on welfare. In absence of MFI loans, the resultant credit gap is being filled by informal sources at higher interest rates.

Figure 8: Willingness to Repay in AP



The current crisis has done irreparable damage to the credit discipline nurtured by MFIs over the last 7-8 years. The willingness of the delinquent clients to repay MFI loans is also alarmingly low in AP (only in 47% sessions respondents were willing to repay MFI loans). Every stakeholder (i.e. MFIs, government, regulator, media and even clients themselves) has played a role in the destruction of credit discipline. It will now require collective efforts from all these actors to revive the much-needed discipline that is core to the success of financial services industry. While MFIs need to become more transparent and client friendly, regulators will have to come out with robust regulations, government will have to support MFIs to build a positive image, media will have to be more responsible and supportive, and most importantly clients will have to impose self-discipline for their own good.

The last section of the policy brief presents key recommendations for MFIs, regulators, and MFI funders/lenders in order to nurture a strong and client-focussed microfinance industry.

Recommendations for MFIs

Over the last decade MFIs have grown manifold, and in doing so, many have also lost contact with its clients. During the research, it was clear that MFIs had been insensitive to the needs of the clients—offering only credit products, and target driven lending resulting in instances of multiple borrowing. To regain its image of being an approach with double bottom line (social and financial), and bring the clients to the fore and to the core, MFIs need to do the following:

1. Work closely with the government, NGOs, aid agencies, and other financial institutions to achieve social as well as financial inclusion objectives. MFIs can collaborate with or assist the government and aid agencies in initiatives such as:
   - Financial education campaigns,
   - Impact assessment studies,
   - Awareness campaigns on health related issues such as maternal health and child care etc.
2. Proactively involve, and be part of, industry level discussions on issues concerning the sector and more importantly, the clients. In WB, the MFIs were able to contain the impact of the crisis by initiating prompt and open dialogue among all major stakeholders and ensuring clear communication to the clients about the situation.
3. Adopt industry best practises to retain credibility and provide better services. Some examples are:
   - "Pricing Transparency" by Transparency International,
   - Social ratings, and
   - Corporate governance rating.
4. Diversify the asset portfolio and develop products that meet financial needs of specific customers and customer segments. These could be:
   - Agri-value chain financing,
   - Farm/dairy loans,
   - Livelihood development activities through individual and business loans for MSMEs,
   - Micro-housing loans, and solar loans etc.

[14] Sane, Renuka and Thomas, Susan, "The Real Cost of Credit Constraints: Evidence from Micro-Finance" July 2013

5. Diversify the product portfolio to offer new products and services such as micro pensions. Several banks as well as the Government are now using the Self-Help Group (SHG)/MFI distribution channel to deliver voluntary pension products for bottom-of-the-pyramid customers.[15] ESAF, KGFS, and Arohan are some of the MFIs that are currently offering micro-pension products.
6. Overhaul operations and delivery mechanisms to ensure high levels of client satisfaction. MFIs can explore opportunity to become BCs of banks so that they can use their existing resources (staff and knowledge) to provide a broader range of financial services to their clients.[16] Some of the MFIs that have experimented with alternate delivery channels are SKDRDP, Grameen Financial Services, and Cashpor.[17]

Recommendations for Regulators

The reactive policy decisions and restrictive regulations have not only interfered with the growth of the microfinance sector, but have also resulted in negative impact on their poor clients. Regulators need to avoid such reactive regulations and create more enabling environment for the industry to grow. Also, to avoid another MFI crisis across the country, the regulator should closely monitor the lending and recovery practices of the MFIs. Actions also need to be taken to avoid over indebtedness among the borrowers. On its part, the regulator needs to do the following:

1. Maintain an open dialogue with different stakeholders in the industry through regular interactions to understand the needs of the industry.
2. Include client protection measures as part of the monitoring and control measures—covering customer satisfaction, grievance handling mechanisms, training and awareness initiatives, and loan utilisation checks. Field visits and interaction with the clients could be considered as part of the monitoring and control measures.

Recommendations for Investors and Funders

The investors and funders need to continuously monitor and ensure that these MFIs are lending responsibly and meet the norms of client protection. Investors/funders need to do the following:

1. Conduct regular due diligence and loan portfolio audits to ensure that the MFIs adhere to best practices and policies and conform to socially responsible lending practices.
2. Provide need based capacity building to MFIs on various aspects such as client protection, corporate governance, and transparency and include these in the criteria while making investment decisions.
3. For banks, create a single window clearance for SHG-Bank linkage loans (for self help promoting institutions such as SERP). This is to avoid the delays in disbursement of SHG loans so that clients do not have to resort to informal sources at higher interest rates.

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[15] Government of India's New Pension Scheme (NPS), with a provision of periodical withdrawals, combines the attributes of a voluntary savings product into a pension product

[16] See *MicroSave* research paper "Are Banks and Microfinance Institutions Natural Partners in Financial Inclusion?"

[17] See MicroSave research paper "Making the Business Correspondent BC Model Work for Self-Help Groups"