

MicroSave India Focus Note 43

Commercialisation of Microfinance in India: Is it all Bad?

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A Historical Introduction

Microfinance in most of its forms, whether the original cooperatives, the self help group movement, or the more recently (in India at least) joint liability group-based “Grameen” model, has been a development activity. As such, it was focused on providing financial services to poor people with a view to allowing them to manage their meagre financial resources better. Across the globe, in the late 1980s and 1990s, there was a huge effort to formalise and professionalise microfinance. This was because in many cases, institutions’ community development roots also meant the absence of the rigorous systems and financial analysis necessary to build sustainable institutions. Thus, in significant part due to the efforts of CGAP, the techniques and language of banking and finance entered microfinance. Many remember the heated debates that resulted from the philosophical battles that raged as these changes occurred – and how much time was spent agonising as to whether microfinance was losing its soul. But few would argue that microfinance institutions (MFIs) are significantly stronger as a result of this change.

The Advent of Commercialisation

At some stage during this process, it also became clear that the involvement of the formal financial system was essential if financial services were to be provided to billions of poor people who did not have access to bank accounts or credit. Indeed, the rhetoric surrounding many of the pioneering microfinance institutions at their inception was around “demonstrating that the poor are bank-able” and that the formal financial system could (and should) serve them. Many NGO-MFIs built their donor-funded microfinance operations on the basis of this type of argument. It soon became apparent that professionally run MFIs could be profitable, and that it was possible to build sustainable institutions on the basis of microfinance. This led many NGOs to use microfinance as a way of creating longer-term self-financing programmes on the basis of lending to their poor members. This meant that organisations like Freedom From Hunger sought to deliver “Credit with Education” using the infrastructure and profits of microfinance to deliver additional services that they felt that the members should have. Few asked the members if they wanted these additional services, and over time as it became apparent that many did not, most MFIs phased these supplementary services out in order to

focus on the efficient delivery of financial services to clients.¹

Commercialisation is Essential

It is very clear that some form of commercialisation of microfinance is necessary for financial inclusion – both for credit and savings services. To provide credit on the scale that is necessary to deliver loans to all poor people that want them will require trillions of dollars. This scale of financing is beyond even the richest donors and most beneficent Governments, and is only available in the international capital markets. It is therefore essential to link MFIs to commercial providers of capital. Similarly, to provide safe and secure savings services, particularly under the current regulatory environment in India, commercial banks must necessarily be involved. And even in countries where the regulatory regime is more liberal, it is essential that financial institutions accepting deposits from the poor are professionally managed and profitable - and thus financial sound - so that those precious savings are protected and not lost.

In recognition of this, the 1990s and 2000s saw a growing emphasis on the “down-scaling” of commercial banks to serve the poor, and the “transformation” of NGO-MFIs into commercial banks. Transformation required equity investors, and these usually came in the form of patient “social investors” looking for a double bottom line of both social and (modest) financial returns. These investors allowed a growing number of successful microfinance banks with clear double bottom-line objectives. But change was in the air.

Commercialisation Comes in Different Forms

In India, only three years ago, soon after the financial successful IPO of Compartamos on the New York Stock Exchange, Sequoia made the first private equity (PE) investment in Indian microfinance, buying shares in SKS for an investment of \$11 million. This move fundamentally changed the nature of microfinance in India – or perhaps accelerated a trend that had already started.² Microfinance in India, as elsewhere in the world, was for commercial investors, a relatively new and unproven business serving a new market. Nascent businesses and markets necessarily attract high-risk, high-gain investors with a focus on quick profit. Investors in mainstream banks do not look for 30% per annum returns; but venture capital/PE investors do, since they perceive the risk of losing their investment as high. The sheer size of the Indian market, with (despite

¹ See *MicroSave India Focus Note 12* “Are There Lessons For India From Bangladesh?”

² See *MicroSave India Focus Note 42* “Microfinance In India: Built On Sales Targets or Loyal Clients?”

the repeated and best efforts of Government agencies) an estimated 90 million households still without access to formal sector credit, was seen as a tremendous opportunity by venture capital/PE investors. Within 3 years of the first Sequoia investment, nearly \$234 million of PE investor funds had been placed in a handful of Indian MFIs.

Commercialisation in India

India is a unique, diverse and immensely special country. It encompasses people following the ideals of Gandhi who offer themselves to serve the poor selflessly, as well as people with extraordinary commercial acumen who exploit the poor ruthlessly. Originally, all the original promoters of MFIs in India entered microfinance for its development potential. They believed in creating sustainable financial institutions providing credit to the poor, and were genuinely double bottom line organisations. In most, but not all cases, the entry of PE investor money changed that very quickly indeed ... realising 30% per annum returns cannot be done without a ruthless commitment to rapid expansion and profitability.³ The majority of the larger Indian MFIs with PE investors became single (financial) bottom line organisations, and their promoters, apparently dazzled by the colour of money, seemed to lose sight of the ideals on which they set-up their organisations.

With PE investments leveraging the banks' debt capital that was so freely available as a result of the priority sector lending requirements, the larger MFIs grew very rapidly indeed. This meant that the legal and governance structures of the MFIs struggled to keep up with the pace of change.⁴ The rules of the game were under-defined and almost made up as the market evolved. The transformation of NGO-MFIs into Non Bank Financial Corporations using the Mutual Benefit Trusts of members' shares became a common and often abused route to growth.⁵ And governance was, in most cases, not a priority. As a result governance did not evolve fast enough to match the complex and high finance involved in MFIs that were growing exponentially to serve millions of customers. Where the PE investors took Board seats they quickly crowded out any remaining social investors and, unsurprisingly given their exit strategies, drove growth to the exclusion of almost any other priority.

The Government of India

This has profound implications in India, where the Government sees reaching, serving and protecting the poor as its responsibility. India has witnessed a long history of Governments (including the British) battling

the moneylenders and trying to reduce the interest rates charged to the poor. Indeed many of the southern States have sought to invoke the anti-moneylender legislation against the MFIs and in the aftermath of the Krishna District crisis, the A.P. state government had specifically asked MFIs to reduce interest rates. Recently, the Reserve Bank of India (RBI) has also gone on record asking MFIs to moderate interest rates⁶ to the ultimate borrower – something that only a few, only recently, have managed to do.

In this context it is important to note that, while profitable, MFIs in India are probably the most efficient, and certainly offer some of the lowest interest rates, in the world.

Nonetheless, with the growing scale of the MFIs, the competition they provide for Government-sponsored SHG programmes and imminent IPOs from SKS, Share and Spandana, the Government and RBI, are showing growing signs of disquiet. The potential fallout from the SKS IPO is enormous. It is safe to assume that the growing stream of negative press will explode into a frenzy of accusations over foreign PE firms and unscrupulous Indian promoters profiteering on the back of the nation's poor. Government agencies are likely to look for legislative routes to reduce the scope for MFIs, and the RBI (which actually intervened to protect the MFIs in the Krishna crisis) will look for levers to curb the excess. The most potent of the levers available to the RBI is, of course, to exclude lending to MFIs as part of priority sector lending, which would significantly decrease the flow, and increase the cost, of bank lending to MFIs overnight.

But all is not lost. India could have a model of measured growth, with a double bottom line. Indeed some MFIs show signs of recognising that long term sustainability (and indeed profitability) will depend on loyal and satisfied clients. Perhaps this is a sign that the market is maturing, and that the exit of the PE investors will herald the arrival of less rapacious, longer-term investors with less ambitious expectations for returns on their investment. The commercialisation of Indian microfinance has allowed a massive increase in outreach and expansion of credit to the poor in India, at rates of interest that are (by world standards at least) relatively modest ... but there are many that wish that the path to growth had been more moderate, controlled, patient and focused on the double bottom-line.

³ See *MicroSave India Focus Note 42* "Microfinance In India: Built On Sales Targets or Loyal Clients?"

⁴ Sriram, M.S., "Commercialisation of Microfinance in India: A Discussion on the Emperor's Apparel", W.P. No. 2010-03-04, IIM Ahmedabad, March 2010

⁵ See *MicroSave India Focus Note 41* "Microfinance – Time To Get Back to Basics?"

⁶ Livemint.com-<http://www.livemint.com/2010/04/22231211/Group-says-high-rates-due-to-t.html>