Don't Blame Microfinance

Guest Column

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Large low-income groups in India continue to remain excluded from basic opportunities and services provided by the financial sector. Opportunities for depositing small savings and access to loans during emergencies and micro-investments are the most urgent needs of many rural households. However, generally formal financial institutions are reluctant to serve the poor and micro-enterprises in the unorganised sector because of the perceived high risks, high costs involved in small transactions, low relative profitability, and the inability of the poor to meet the requirement physical collateral.

An alternative source of finance like microfinance has come as a breakthrough. MFIs have been successful in penetrating the previously unbanked section of society and have succeeded in providing them credit, making good the failure of formal finance.

However, the microfinance industry has recently come under severe attack on several grounds: interest rates are 'usurious', strong-arm tactics are employed, multiple loans are forced on hapless borrowers and the investors in such MFIs are making huge profits. Existing research on MFIs in India suffers from non-availability of data on the total cost of borrowing by source, multiple borrowings, interest rates and the impact of micro-credit on poor households. These questions were fairly addressed in an investigation conducted by the NCAER's Centre for Macro Consumer Research (NCAER-CMCR) in 2010 and the revelations are, in fact, interesting.

A major portion of MFI borrowers were females, mostly housewives. Corroborating the commonly held perception most borrowers belong to low-income households in both rural and urban areas. Over 50% of MFI borrowers are repeat borrowers. Most borrowers belonged to the 31-40 years group, in their productive years, who needed credit most in the absence of employment opportunities. A vast majority of borrowers were either illiterate or had studied only up to 'primary level'.

The survey also found that the most popular source of credit among the poor was informal (46%), while the least popular was formal (14%). It is interesting to note that MFIs constitute 18% of all loans, being the second most popular source of micro-credit.

The main charge is that MFIs charge usurious interest rates, give multiple-loans and employ strong-arm tactics to recover loans. Comparing average outstanding loan amounts we find them to be higher in the case of formal and informal loans.

Considering the loan size per unit household income as a measure of the household's indebtedness, it was found that the indebtedness coefficients were much lower for the MFIs, compared to the informal loans. Indebtedness is much more closely associated with informal loans than the MFI loans.

The survey found that only about 11% of the borrowers had multiple loans of which 21 % involved a loan from MFIs. Furthermore MFI loans are used mainly for asset creation with a major portion of them being used for business purposes (45%), with only a marginal portion being used to pay off existing debt. It is therefore difficult to accept the popular criticism that MFI loans are deployed in unproductive pursuits such as paying off existing debt or consumption.

MFIs are only one of the many sources of funds for small borrowers and are far from being the dominant one. Unless borrowers obtain multiple loans from MFIs, it is highly unlikely that indebtedness is an MFI related problem. An earlier survey carried out by IFMR: CMF had also found that MFI loans formed only a small share of total debt of marginal farmer households and higher categories.

The survey has also found that average MFI interest rates are much lower (25%) than those charged by informal sources (44%). The interest rates for commercial banks as reported by the respondents are much lower. However, there were typically high "unofficial" charges associated with these loans: wage losses, documentation charges, stamp duties, travel costs and bribes (these were the lowest in the informal sector). Additionally if one compares the gap between the loan amount applied for and the amount approved and that actually received, MFIs scored much better than their formal counterparts.

MFIs fill the gap left by the formal sector. The inability to the formal sector to serve the poor, due to a variety of reasons, is the primary reason that led not only to the MFIs' emergence but also their resounding success. Certain MFIs probably have charged exorbitant rates and have resorted to forcible loan recovery. But maligning the entire sector is uncalled for.

The sector does need regulation, but not a one-size-fits-all approach. MFIs attempt to alleviate the deplorable situation of the poor and require freedom to operate. Otherwise we will not only end up strangling them but will also have succeeded in cutting off an important source of credit available to the poor.

(The writer is Director, NCAER-CMCR)

- Empirical evidence from a survey does not support the common charges against MFIs
- Multifaceted failure of formal finance is what opens up a role for them
- Stringent MFI regulation would cut off a vital source of credit to the poor