THE DARKER SIDE OF MICRO FINANCE- A PERSPECTIVE

Parul Kochher*

ABSTRACT

Today we see microfinance institutions mushrooming in the country making big claims in improving the lives of the poorest of the poor. How justified are these? Is microfinance a panacea for all ills? This article focuses on the other side of the coin bringing into light some unspoken realities and challenges relating to the social and economic aspect of microfinance, giving some suggestions to make the microfinance model work in propelling India's future economic growth.

Keywords: Poor, MFI, Rural Banks, collateral, Recovery, Poverty, Employment

*Sr. Lecturer Economics-NIE, Noida

INTRODUCTION

Microfinance in the simplest terms means paying tiny sums to people with even tinier assets at reasonable rates[1] of interest. For rural households who do not own land or credit, micro finance could help establish a family enterprise, making a difference between grinding poverty and an economically secure life. Financial penetration becomes important in such cases. It has been seen that often-rural poor do not approach for loans thinking that the loan may never be granted and with no collateral in hand, they fear the worst. The regional rural banks, which were set up in the country as a direct result of the commercial banks to penetrate to the rural roots, failed miserably. The recovery rates were low, the non-performing assets were seen to increase and profitability levels markedly went down. Today these rural banks have turned profitable by giving cautious loans, stressing more on profitability rather than poverty levels. This combined with other stringent banking sector reforms marked the advent of microfinance. But to consider microfinance as a panacea for all ills would be a wrong statement to make for in that case, India would have been bereft of poverty by now. Microfinance has its own accomplishments, challenges and problems. There is a long road ahead. There is a usual tendency of showing only the successful borrower stories thereby creating hype. This paper focuses on the other side of the coin namely Microfinance and its failings. Micro finance models are the semi formal medium of giving financial. assistance to the poor that lies between the informal (money lenders) and the formal mode of lending (Regional rural banks). Micro finance as a mode of finance takes various forms. Let us evaluate some economic and social problems engulfing microfinance.

The Economic Issues-

1. Direct result of neoliberalism[2]- basic theme of microfinance is that the poor must pay for what is exclusively designed for them. (In the form of high interest rates). This is what neoliberalism is all about. We do not talk about subsidization of microfinance.

2. Subsistence farms difficulties-Agriculture in India is a multitude of subsistence farms. These are incapable of generating a sustainable income level for the farmers. Micro finance has

deeply penetrated into these farms make them fall into a vicious cycle of debt trap These farms when they get into taking microfinance are not able to repay back with the higher interest rates and thus fall again into the quagmire of poverty. Thus the basic microfinance model doesn't fit into the scheme of these subsistence farms. Indian specific farms have majority of landholders working on land which is less than 2 hectares in area. Hundreds of thousands of these farms have today fallen into the trap of abject debt and poverty.

3. Wide and bad extension of informality- As it has been recently seen in the mirth of SKS microfinance in India, microfinance could lead to crime and illegalities.

4. Management salaries and Bonuses- As was seen in the case of SKS the higher interest rates was attributed to high running costs which was in the form of huge salaries and bonuses given to the management. What is this if not neoliberalism?

5. High interest rates- We know that charging price high enough to cover costs in the short run is the sustainability fundamental for any business. In case of MFIs, it becomes different as they also have to make it affordable for their customers. Annually these micro finance interest rates compound to somewhere between 30-60 % which is argued as still being lower than what is charged by the money lenders. A logical reasoning then would be that if those who borrow are not able to generate sufficient funds from their investment then they are most likely to become poorer than what they were when the loan was borrowed in the first place. Also after paying such heavy rate of interest, there is little scope of the poor for savings as well as for investing in insurance. Thus the poor are seldom propelled out of poverty.

6. Justification for higher interest rates- If higher interest rates are paid then more of the poor people can be helped. This means the poor helping their counterparts, which doesn't seem to justify on any grounds. Commercialization of these institutes can also be seen from the fact of the lavish living of the executives working in these MFIs. There could be another side to this. If these interest rates are going to the borrowers in terms of share capital then charging higher interest rates would not be bad but this is not the case here.

7. Commercialization (SKS IPO) and greed seem to be the major goals of microfinance and not local development. Microfinance was originally started to help the poor come out of the poverty trap but the high interest rates led the bankers and investors saw in it an opportunity which could convert into a wealth creating formula for them. Microfinance off lately has become so commercialized that we come to the conclusion that the social on development considerations on which microfinance stood ground is nowhere in the picture and that there is a big difference in running as a business for profit motive and as an agent of social development. With interest rates as high as 24 % microfinance is indeed a great business to be in.

8. Worst cases- There are ample data to suggest that microfinance makes those at the bottom of pyramid worst. A conclusion by one of the studies[3] also suggested that microfinance is beneficial for those above the poverty line rather than those below it. Further studies have found out that taking MFI loan has better effects on the level of moderately poor rather than poor.

9. Lack of economies of scale- It is a well-established fact that those people who take loans from micro finance institutions can't ever compete with the economies of scale which could come to large borrowers who borrow from traditional sources. The chances of survival then become very difficult, an interesting case in sight was seen in Bosnia (people here were given microfinance loans to purchase cow in order to generate some additional income from sale of milk. The turn of events was such that this led to an oversupply of milk, pushing the other non borrowing "one cow farms tumble to poverty. This has another aspect as well; the profitability margins of large sized firms will also decline leading to lower investment in stock and capital. Thus, lower employment generation.

10. Not sustainable- Microfinance in the end may prove to be an institutional barrier impending the social and economic development of the nation. The inefficiencies in the working of the MFIs have been found to be technical in nature.[4]

11. Consumption smoothing[5] – This has become a major transformation from the income generating model as proposed by Yunus in his original Grameen bank model. People borrow loans to smooth their consumption in times of low incomes rather than for investing in income generating activities. Statistically it has been proved in India's case. Thus in actuality there is no addition to the net productivity level in the nation

12. Saturation of markets: The local economies of the developing and transition economies possess a limited market. The plethoras of micro enterprises which come up only add to the redistribution of the business rather than actually increasing the size of the market.

13. Fear of investment- It is a fact well known that poor borrowers by taking micro credit loans only protect their level of subsistence and there is a fear of taking risk of investing in new technology which could lead to higher profits.

14. Microfinance remains micro in nature- This is a major area of concern. You can't expect a poor person to rise with a loan of Rs 2000, quarterly repayments and activities of selling cow milk; the poor person can just maintain bare sustenance level. There is a need to connect the borrowers with the larger commercial chain and thus foray into the larger product and factor market.

15. Paradoxical in nature- Here it is pertinent to mention a very important paradox[6]- The poorest people can do very little with little amounts of credit, what they need is larger chunks of it.

16. Crowding out effect[7] of microfinance- Microfinance leads to crowding out effect specifically in developing economies where there is a need for technology driven and innovated sources of finance.

17. No importance to saving deposits- Micro finance gives too much of importance to credit side rather than savings. One of the major disadvantages of MFI-NGos is that they can't mobilize deposits from the general public.

18. The vicious circle- Loans are usually taken for present consumption and not for investing in profit generating activities. Interest rates are high, thus the poor just end up remaining poor which defies one of the main goals of microfinance.

19. Double debt spiral- This is an important phenomenon that has resulted out of microfinance. There are instances seen when not able to pay back to the MFI people are drawn to the local moneylender starting a double debt.

20. Funding Issues of MFIs- The reach ability and progress of MFIs is constrained due to the funding issues. Most MFIs tend to face a serious shortage of equity funds. Lack of equity capital creates a further constraint in banks funding to these MFIs. Whatever commercial lending by banks does exist is to the better off 10-15 MFIs. These MFIs raise funds at market rates which then becomes an expensive proposition.

The Social issues-

1. Empowerment of women- Empowerment is a wide term. Empowerment lies in the well being of a person, it is the freedom to lead different types of life as reflected in the person's capability. It is to make one's own choice, to increase autonomy and a small part is to control the economic resources. Microfinance loans have a tilt towards women as it is commonly seen that women spend a major chunk of their income on the welfare of their family. Once the loan is sanctioned they seem to be taking a backseat. The whole notion of empowerment of women seems to be a farce too as they may get the priority in getting the loan but once sanctioned they may not have control over the purpose on which it is used or no control on the money coming from their microfinance. They met get economic independence to a certain extent. Firstly women are seen to be going only for those activities which generate low income levels; they mostly always need their spouses'

endorsement. At the same time while setting up of enterprises they face the cost of heavier workloads and repayment pressure. It has also been found out that violence is enforced on the women borrower as she was legally liable for the transaction. Also important to note here is that the SHG system of empowering women does not challenge the social structure or the prevailing system. There is definitely a requirement of a change in social norms which the SHG's alone can't do.

2. Visionaries-Yunus (founder of grameen Bank) talks about people in developing countries should stop looking for jobs and start creating them. The most talked about successful cases and where hype is generated are the visionaries who went on to create flourishing microenterprises. The lesser known side of the story is that most of the borrowers work in subsistence activities, competing with each other in entry level jobs for very small earnings. Credit is only one part of the chain; they mostly do not have the vision to run a low class business. For them what is most important are livelihood opportunities.

3. Rapidly rising failures- the times have seen an increasing number of microfinance failures. This has repercussions of falling income, wealth and wages. People start selling their assets to pay the high interest loan alternatively they take a fresh loan to pay the previous one.

4. Lack of solidarity- As proclaimed by the Grameen bank model the social solidarity inbuilt in the microfinance model has given rise to intense social pressure leading to social violence and complete shamming of the legal process. Failure to repay loans brings stress in relationship. The stress is of two kinds. Stress amidst the borrower group and stress in the relationship between borrowers and staff.

5. Collapse of formal systems- By stressing so much on micro finance institutions are we not inviting the demise of informal system, which was a part of social security net, and cohesion, which existed earlier.

6. Self help groups[8] is only a number- The widespread growth of SHG's in India is only a statistical figure. Many a times the groups come together on an adhoc basis. Little can be

said about the actual poverty reducing impact of these SHGs. Moreover this group intermediation is not what the customer requires. They would if given a choice prefer individual services. Skilful leadership is a major issue here. Group formation leading to tremendous peer pressure creates a bad psychological pressure on the members of the SHGs In addition governance of SHG's also poses a major challenge. Membership and outreach of SHG-bank linkage remains limited and more confined to the southern states and groups are being formed in great numbers due to political issues of being easy vote banks etc.

7. Saturation in Microfinance: There is a lesson to be learnt from what was seen in the working of MFIs in the kaveri district of Andhra Pradesh. Many MFIs were asked to be closed as the poor showed an inability to absorb any more credit. There were other multifarious issues that stemmed up , notable ones being, an urgency to grow at all costs, no consumer protection, deceptive interest rates, over lending to name a few. The raids in Krishna district of Andhra Pradesh went on to show that MFI's were charging 35 % rate of interest whereas on paper it was showing only 15 %. Some glaring media insights went on to show that physical coercion was used in cases where borrowers were not able to pay back. Are these microfinance institutions any better than the so called stereotypical moneylender.

8. Subsidized credit- The high rate of interest makes the credit unaffordable for poor. To reach the actual poor the credit has to be subsidized. But there is a question mark here. How far it should be subsidized. Usually the interest which is charged is done on the following equation. Interest paid+ administrative cost+ profit spread. The problem with microfinance loans is that they are small and far too many such that the administrative cost becomes prohibitive in relation to loan size.

9. Importance to social performance- If the MFI is solely focussed on financial performance then it would be very little interested to know the social impact of the loan on the client. Say, if the client is unable to pay back the MFI see only a drop out. In case the period of the

loan is extended and hardship faced by the client is understood there would be a second chance (loan repayment probability) for the MFI.

10. Sustainability of MFI – This is a big question today. With no collaterals, and giving of loans in good faith could work only unto a certain limit. We cannot forget the high administrative costs here

11. Non hiring of women by the Grameen Bank and MFIs- Why banks and other MFI's have such low employability levels of women? These institutions talk about advancement and social empowerment of women. But they do not want to employ them as their staff members. Thus there is a major contradiction here and one of the major criticisms of microfinance in the current times.

Solutions-

1. Creation of jobs- It is worth remembering that microfinance doesn't add to poverty but stable jobs do.
2. Promotion of large enterprises- A direct result of the first is the government participation in country like ours for direct promotion and establishment of large enterprises
3. Reasonable wages not interest- What is needed as of now is that the poor get steady jobs for a living which they can sustain.
4. Increased productivity- Creation of jobs is not enough. Only increased productivity thorough use of latest technology and capital can lead to better wages to get the poor out of the quagmire of poverty.
5. Move towards livelihood finance- This means providing all sorts of financial services (short term, long term, insurance, infrastructural and human capital development), this will help eradicate poverty from the roots rather than superfluously as in the case of micro finance.
6. Sustainable growth rates- These can be achieved by the MFIs if they maintain efficiency and tap the capital markets at an opportune time.

7. Creation of a multiplier effect- This effect can be created by putting money through micro loans to the small and medium enterprises. This will lead to income generation by creating sustainable employment.
8. Selection and motivation of entrepreneurs who would be given microfinance loans is also very important. Education also plays a very crucial role here. In here the methodology of mentoring should be promoted which means an intense personalised input by a senior guide to foster the personal and professional growth of Microfinance Entrepreneurship.
9. Market linkages for inputs and outputs are also very important. This further calls for development of trade and industry policy framework.
10. Demand side- till date all studies on microfinance only focus on the supply side. Very few[9] show that demand side is also important. In other words, we need a healthy vibrant domestic market of demand for these micro enterprises. There has to be a market with enough number of people with adequate money to buy what these micro enterprises are actually selling.
11. More Innovations are needed in the area of microfinance. These could be lending in kind, Leasing finance etc. government should recognize these innovations from time to time.
12. Importance of savings- Today there is an unfulfilled demand market for savings and deposits. Without this integral part microfinance remains just another micro credit story. It is a major misconception to think that the poorest of the poor cannot save. Also the successful MFIs have been those which have incorporated the provision of deposit service.
13. Improving the working- Need to make the understanding of financial services for the poor better and also emphasize on the saving side of credit rather than lending. The bigger MFIs can serve those who need capital for the working of small and medium enterprises. For the poorer the informal institutions can handle it better. Thus MFIs need further enhancement to make their impact deeper and better. There is a need for the MFIs to recognize heterogeneity in the demand for financial services. As staff in these MFIs is evolved from NGOs, they possess limited skills in finance, management, MIS, accounting etc. MFIs should focus on attraction, rention and deployment of good staff at all levels.

13 Complete Understanding- the MFIs need refinement in their methods to understand the financial status of borrowers and viability of projects they will undertake.

14 Commercial Bank- Microfinance Mix- This is the need of the hour. The MFIs are still in nascent stage. The banks can cross subsidize their micro credit and charge interest rates below cost. The banks may in general lack the staff skills and knowledge of non profit Organizations but they offer much greater transparency and much lesser risk which are two very important factors which we need to consider. These large scale banks have vast networking of branches, high scale of operations and also have the ability to provide low cost funds which MFIs can't.

15 Social performance assessment- This should be done by MFIs to measure their progress. This could be done on following parameters.

1) What percentage of borrowers start saving after the loan is repaid?[10]
2) The depth of loan coverage(This would women borrowers, loan size, number of borrowers who live in rural areas)
3) Amount of financial services offered in addition to loan
4) Cost of operations
5) Percentage of repaid loans.

In addition to this the performance of the MFI should be evaluated on two basic grounds one is the client service relationship and the other the financial performance of the MFI.

17. Women empowerment- This will not come from only taking a microfinance loan. Empowerment is complete when women are able to control and manage their loans rather than acting as mediators along with proper training, education, knowledge, awareness and development of skill set.

18. Lowering of interest rates- If lowering of interest rates is done through a reduction in transaction and administration costs rather than government imposed measures then it could propel a good future for the MFIs. How public policy can help?

1) Interest rates can be lowered by making the MFIs more competitive in nature.

2) Public policy on simple improvements such as investment in road links, bridges, and reliable supply of electricity could help the industry.

3) Improving of management skills by special training programmes.

4) Interest rates could also be brought down by bringing the operation costs down by usage of developments in the fields of IT.

5)Operating costs leading to a fall in interest rates could also be brought down by deploying part of staff operations by agents who are paid commission based on amount of savings mobilised, loans disbursed and repayments made.

6) Reducing costs of bad debt- This could be done by screening candidates before making the first loan decision, checking borrower's history etc.

19. Poverty reduction impact of MFIs- This impact is measured by a ranking known as the indexed based ranking. This reflects multi dimensional aspects such as basic needs, wealth, and type of housing, sanitation and food security.

20. Transformation of NGO's into NBFC's- This has to be carefully studied as this is a delicate issue. Although this may lead to an increase in profitability through diverse sources of funding including equity, debt and greater outreach. But at the same time if profitability comes through targeting better off borrowers, offering fewer products. Also to be taken into account is the fact that NGOs have more flexibility to operate, test products. An NBFC needs a heavy amount of equity to start up as this is the only way how an MFI can raise funds from the market. There is a proposal for making an NBFC company which could start on a lesser capital requirement.

21. Regulation and governance of MFIs - A need for regulation of MFI's is also felt. But these regulations should not be restrictive or inflexible in nature. Existing regulations in India are designed with commercial banking in mind. What is required is a dedicated regulator and a relevant set of rules. They should be minimum in nature; this in turn creates a sense of accountability in the working of MFIs. Governance issues could be resolved by making the depositors and borrowers also shareholders. Also as the MFIs grow larger governance should vest with the professionals.

22. Flexibility in Microfinance loans- Though operational headaches may arise (It is easier to train staff to collect payments on a regular basis. Let us here look at another side we know that the clients have a tough time paying in that period it would be better to make payments less and infrequent. This saves loan officer time. This can be done by specifying a number of low periods but not their timing.

CONCLUSION

There are some gross anomalies seen in the basic microfinance model. Successful economic development has always called for the poor to work on wages rather than self employment. Also higher incomes always handle debt better. Let us not romanticize the idea of poor as entrepreneurs. They would be willingly ready to take up a job if given. It would be in the interest of the nation if energies are channelised away from the hoopla of microfinance into something more constructive like the state and businesses setting up of labour intensive industries. There is little statistical evidence to show that microfinance has produced poverty alleviation benefits. This has further conclusive evidence in the village of Bangladesh where Yunus started his Grameen bank model; thousands are still trapped in abject poverty. The domestic savings instead of being diverted to microfinance will be much more productive if it is put to technology driven, growth oriented enterprises. This wave of microfinance and the coming up of plethora of microfinance institutions is the direct result of the era of neoliberalism which stresses the importance of the private sector in contrast to state efforts. It won't be a truism to say that Microfinance can't be a panacea to all ills. The hype and expectations surrounding it are definitely inflated. As we have discussed in the given article the widespread growth of SHGs is only a number. Their actual poverty outreach is questionable. Had microfinance been that magic drug there would not be stories about the high rate of farmer suicides in India. Moreover, is it actually reaching the poor? There have been many studies to suggest that very slow progress is being made by the MFIs to reach the actually poor. We need to pay special attention to the depth of outreach. Also to be understood is that Microfinance industry can't grow alone, it needs complementary efforts from the government in education of human resources(better educated clients reduce costs to the MFIs), Use of new communication , information technology could be few examples.

It is pertinent to understand here that there will always remain a conflict between the commercial aspect and the development aspect of microfinance.

It is left to the MFIs to decide where they want to focus upon. A balance needs to be struck here. The state role becomes important in the sense that decent wage paying jobs in local economies will generate a sufficient market for these micro enterprises. There is no single solution for poverty. It is a dynamics of interplay of several factors where conjoint results have to be evaluated. Micro finance is only one such factor. But since it is one of the factors it does give the poor some hope and self esteem. Also micro finance institutions could bring real social progress if their policies are carefully designed and implemented. The government has till now turned a blind eye to the modus operandi of these MFI. There is a growing need for the emergence of an ideal MFI. This will be an institution which can serve its members as a non profit organization but at the same time has investment capabilities of a common bank. An institution which is genuinely concerned with the economic, social and personal and skill set development of its members. The concluding lines are that there are essentially dual goals for any MFI, social impact and financial stability along with the working philosophy the less you have, the more you get. The dual pursuit of social ends and financial profits continues to be an ongoing tension in microfinance.

Tables and figure

Table 1- Microfinance Statistics in India

MFI Loans	4.4 billion
Active Borrowers	26.1 million
Deposits	204.9 million
Depositors	2 million

Source: Market Mix, 2009 data

Table 2- Legal Forms of MFIs in India

Type of MFIs	Estimated number
1. Not for profit MFIs a.) NGO – MFIs b) Non profit companies 2. Mutual benefit MFIs	400 to 500 10
2. Mutually aided cooperative societies and institutions	200-250
3.For profit MFIs a) NBFC	6
Total	700-800

Source: NABARD website

Table 3- Banks Contribution to MFIs as on 31 March, 2010.

Name of the Agency	No. Of SHGs	Saving Amount	Exclusive women SHGS	Amount
Commercial Banks	4052915	367389.24	3350054	290057.64
Regional Rural Bank	1820870	129937.49	1240342	99686.25
Cooperative Bank	1079465	122544.16	720040	60121.86
Total	**6953250**	**619870.89**	**5310436**	**449865.75**

Source: NABARD 2009-2010 report on Microfinance

Table 4 -Physical Statistics of SHG Bank numbers

(In lakhs)

Total number of SHGs savings linked with banks	69.53 lakh
exclusive Women SHGs	53.10 lakh
Total number of SHGs having loans outstanding as on	48.51 lakh

31 March 2010	
Of which exclusive women SHGs	38.98 lakh
Estimated number of of families covered up to 3	97 million

Source: NABARD 2009-2010 report on Microfinance

Table 5-Financial statistics for SHG- Bank linkage

Total savings amount of SHGs with banks as on 31 March 2010	` 6198.71 crore
Out of total savings of exclusive women SH	` 4498.66 crore
Total amount of loans disbursed to SHGs du	` 14453.30 crore
Out of total loans disbursed to women SHGs	` 12429.37 crore
Total amount of loans outstanding against SHGs as on 31 March 2010	` 28038.28 crore
Out of total loans o/s against women SHGs	` 23030.36 crore
Average loan amount outstanding per SHG as on March 2010	` 57795
Average loan amount outstanding per member as on 31 March 2010	` 4128

Source: NABARD 2009-2010 report on Microfinance

Table 6-Interest rate schedule for MFI

Item of cost	Basis of cost	Interest Rate
Cost of funds	RBI Prime Lending Rate	9%
Cost of delivery of funds	Money order charges by general post office	5%
Cost of provision of bad debt	As per RBI norms	1-3%
Profit margin	Minimum required to maintain capital	1-2%

	adequacy	
Total		21-24%

Source: Planning Commission.nic.in

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[1] See table MFI interest schedule, generally ranging between 20-24 % annually
[2] Focussing on neoclassical , an economic theory which is based more on efficiency of market forces rather than government intervention
3 for details refer Jonathan Murdoch, Analysis of effects of microfinance on poverty reduction

[4] For details refer to Quayyam Abdul and Ahmad munir; " Efficiency and sustainability of Microfinance in South Asia"
[5] When the current income is not able to meet the current consumption.
[6] Dichhter's Microcredit paradox
[7] Blocking investment through higher rate of interest
[8] MFI's in India follow this form wherein a group of individuals starts lending to one another and the bank enters later on.
[9] For details see Pollin, Microfinance False hopes and real possibilities
[10] Loan repayment only shows that the borrower made enough money to cover cost of loan and interest.