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Whose Risk is it anyway?

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Microfinance Focus , December 13, 2010: The focus of concern during the recent past has been on the risk to MFI-NBFCs. Several articles have appeared on the need for MFIs to give priority to risk assessment and management, to insurance, to provide for political risk and to securitize their portfolios, but very little has appeared on the risk borne by the clients - until the reported suicides brought their risk squarely into the political domain. This note focuses on the risk borne by clients.

But first I would like to make my position clear and distinguish between two groups: The first group consists of the poor who need credit plus other opportunities for livelihood activities to survive. These activities largely include a mix of dryland agriculture, farm and plantation labour, small trading, animal husbandry, cottage industries and collection of forest produce. My position is that the poor need some extra investment in order to go beyond survival and enter into the growth trajectory. These opportunities are provided by all round growth in the area due to investment by private or public sector and by NGOs to reduce risk and increase productivity in agriculture related livelihoods, to provide health, education, infrastructure and industry etc. This extra investment also has to take the shape of institutional support- like the SHGs at the base - which provides the poor with the space to set their agenda to support their livelihood strategy which comprises several activities, as well as with the skills, confidence and linkages to use the opportunities provide by all round growth and to neutralize oppressive power relations arising from local power structures and gender. This extra support cannot be given as a short term credit at commercial rates where repayments are fixed by outsiders. It requires a degree of subsidy –not of the assets but of the services required to support the livelihood strategies of the poor and for institutional capacity building (ICB) so that the SHGs function as genuine participative and membership institutions. This requires a long term perspective.

I do not think the business model of the MFI NBFCs which is driven by venture/private capital, quick disbursements, weekly repayments, high profits and remunerations for senior staff, a focus on valuations and IPOs and a quick exit is appropriate for this group. It increases their risk, often beyond a level that they cannot bear. The SHGs and the SHG-Bank Linkage Model (as it was originally conceived) is to me the appropriate strategy for this group. The affinity among

the members provides the pressure for recovery and their savings provides the space to adjust repayments when a member has a genuine problem with cash flow. In Myrada's experience, interest rates from groups to members also fall from 20-24% to stabilize between 12 % to 14%.

The second group is not poor; their livelihood strategy largely includes non farm activities; but they cannot grow to meet their aspirations without access to credit even at market rates. They cannot get this credit from banks because they do not have land records or fixed assets like houses to provide security and no credit history. They do not have the confidence and skills required to negotiate with banks if they need credit for activities in the non-farm sector and do not have access to working capital from official financial institutions. Unlike in the agricultural sector, there are a few Government sponsored schemes which are really working that support this group. They rely on private credit from relatives, friends and finally moneylenders –all at differing interest rates. Of course borrowing from relatives involves an obligation to lend them when their need arises. The business model of MFIs can meet the needs of this group provided profit is not maximized at which level there is little difference between them and the moneylenders. In maintaining a balance, good governance of the MFI can play a greater role than regulation; but evidence indicates that good governance is in short supply. The major problem is that MFIs will need security to back their loans to this group. The MFIs and the borrowers do not have the time or resources to invest in forming SHGs where internal pressures to manage and repay loans operate. The JLGs will not function for long if one member fails to repay. The security will have to take the shape of assets. Most of the families in this group have some gold which they pledge against loans. This is why those Financial Institutions dealing in gold loans are growing so fast.

The words “marginalized” and “excluded” in this paper include both groups –the poor and the not poor who have no access to credit from the official system. Of course there is a group that does not fall clearly into either of these categories but in a way has features of both. We will leave this group out for the moment.

This distinction between the two groups is relevant to the current debate due to the following: Over the past few years the MFI NBFC model was held up as the most effective in promoting rapid financial inclusion of the marginalized. Both groups mentioned above were included in this term. The current crisis shifted the focus to the SHG approach and the SHG-Bank Program. Some say that this is the only approach. To me it is the appropriate strategy to address the hurdles that are in the way of the poor to be fully included into growth (not just into the financial system). The SHG model has features which do not make it an effective model for fast disbursement of credit. It is not appropriate for this second group which needs credit. The hurdles in the way of the second group do not arise from lack of confidence of skills or linkages; they arise from lack of infrastructure water roads and power, from a corrupt government service delivery system and from lack of working capital. The MFI loans to this group are used both for investing in

income generating activities as well as to purchase consumer items including gold. The temptation to borrow in excess of their capacity to repay is strong, especially when there is sales pressure from several MFIs who come to their doorstep.

Others say that both models (MFIs and SHGs) as well as the third - the moneylender - are appropriate without making this distinction between the groups. This is a "chairman's approach". They are appropriate but to respective groups.

Let us now revert to the risk for borrowers - primarily borrowers in the first group of the poor but also in the second group where the borrowers have succumbed to the temptation to borrow from several MFIs - multiple borrowings. They are locked into a cycle of regular repayment. Together this excess borrowing and cycle of repayment also increases their risk considerably especially when their cash flow is interrupted.

Risk and the official policy promoting inclusion: Inclusion of the poor (the first group) into the formal financial system of the country involves considerable risks and costs on their part. The SHG model was an attempt to lower this risk and costs for the poor by providing an intermediary institution which the poor managed. Profits to the Banks were low; they were satisfied since the program was categorised under the priority sector and repayments far exceeded those under previous programs like IRDP. But the MFI/NBFCs have not included the marginalized into the country's financial system as they claim. They have in fact included them directly into the international financial system which is not only inappropriate as a first step but raises the level of risk that clients have to bear. The international financial system is driven by venture and private capital whose DNA is characterized by high profits, high cost (interest, salaries and commissions), IPOs, quick exits and frequent and regular repayments on the part of the borrower. These are the features of the MFI/NBFC business model. This raises the level of risk to both categories of clients considerably.

Between 2003-2008 integration of the country's trade and financial sectors with the world economy grew steeply and quickly. The main concern of the RBI during this period was to manage this integration. The RBI cautioned that it should go slow; words like "calibration", "a road map", "step by step" were used. Alongside, initiatives were taken to strengthen the country's institutions before this integration was speeded up in order that they could cope. The RRBs were consolidated, efforts to revive the Cooperatives - rural and urban - were taken, a Working Group was set up and a plan drawn up for restructuring long term lending institutions for agriculture. The pressure from other Government sources in the country however was to move faster with this integration on the belief (mistaken, I think) that the impressive growth rates achieved were almost exclusively due to opening up of the trade and financial sectors to the world

economy. The RBI's step by step approach gave time for the country's financial and trade institutions to cope with the pressures of integration.

Unfortunately the RBI did not take the same approach with regard to the MFI-NBFC's in their rapid growth on the grounds that it was urgent to integrate the poor into the international financial sector. The RBI took actions - but they related to plans for extending financial services into the interior (Business Correspondents and Facilitators and use of technology), removal of caps on interest rates (Banks could charge commercially viable rates for priority sector loans below Rs. 2 lac) etc. The RBI's focus was on pushing the official financial system further into the interior on one hand and, on the other, a "hands off" approach as far as the MFI-NBFCs were concerned, encouraging them at most to "self regulate"! "Soft regulation" of MFIs was the policy that gained ground, because it was assumed the MFIs are local, community based organizations which they are not. This lack of regulation/direction increased the risk of the marginalized who were "included" by the MFIs.

The induction of venture and private capital into the MFIs in a major way during the past three years is primarily responsible for raising the level of risk to clients. Venture/private capital seeks to maximize profit and to do it quickly. Their mission is to take high risks and they expect to be rewarded with high and quick profits. The investors argue that since they do not use debt, they should not be regulated. None of them in the US has asked to be bailed out. This makes good sense. But by including the marginalized into this sector the pressures created by these features (high risk /high reward) are passed on to the clients which raises the level of their risk. Multiple borrowing is resorted to as a first step out of this situation but this cannot last and there comes a stage when the client can no longer bear it. The SHG Bank Linkage program was brought under the priority sector to encourage the banks to promote the flow of credit to the poor, but the SHGs provided a safety net. Once Banks lent directly to MFIs they ended up pushing money and going along uncritically with the culture and practice of the MFIs which used Bank's finance to include the clients more deeply into their neo liberal model. The Banks were only concerned with the level of repayment which was good and which gave them the leverage that their performance in the priority sector provided. As long as the repayments were good, the MFIs were encouraged without any attempt at regulation.

Risk and the focus on Speed to include by disbursing credit (and by implication to include). Speed to disburse is the dominant feature both of the neo liberal model of the MFIs and also of the SHG model after it was adopted by the Government as part of its official strategy to mitigate poverty – fortunately high profits and remunerations were not part of the Government's strategy. The SHG Bank Linkage Model grew slowly till 2000 and with adequate investment in building the institutional capacity of the SHGs before Bank loans were extended. When it became part of Govt. policy in 2000, pressure was exerted by dedicated Government officers at the District to grow fast and achieve targets. As a result,

the quality of SHGs declined and so did their performance in mobilizing savings, in deciding on loans (equal distribution became common), managing repayments (NPAs increased) and in building a supporting environment for a livelihood strategy. SHGs were formed to achieve targets, with the wives of the Panchayat president and secretary dominating proceedings; they borrowed from Banks and lent outside at higher rates ;other members did not benefit while repayments to banks was good. Official reports focused only on disbursements; corrective measures were taken to balance the spread in areas where growth was slow but no investment was made to add value or to support increases in productivity and diversification. No priority was given to form SHGs on the basis of affinity where the poor members were identified in public and then had the freedom to form SHG by self selecting their members. Very few SHGs were provided with institutional capacity building so that all members participated in decision making. All this took time; the Government was in a hurry to disburse and include.

The SHG is not a good model for speedy disbursement of credit; but it is a good model for lowering the risks of the borrowers as well as the lenders. The SHGs have savings which they use to cushion irregular cash flows; they are able to adjust to urgent and unexpected situations, yet Myrada's analysis of its SHGs shows that their common fund increases year on year. The MFIs do not work with SHGs as forming and nurturing them takes at least 3-6 months before loans can be extended. This is too slow. They claim that they work with Joint Liability Groups. If the members are jointly liable, why does the staff of the MFI have to exert pressure on clients for repayments? One MFI when asked which groups it was working with, came up with a new one "SHG-JLG"; it had promoted 20,000 in one year! Speed is the order of the day and the message from the Govt. supports a faster level of integration in both systems – national and international.

The impact of the focus on speed on the MFIs operations is logical. The velocity of money plays a major role in generating profits. So they insist on weekly repayments. This increases the borrowers risk and vulnerability to local power groups. Incomes from agriculture are lumpy not weekly; incomes from animal husbandry are usually monthly. Clients are forced into activities earning daily like labour or shops or into a pattern of multiple borrowing –where they have space to borrow from one and repay to another. In fact my experience is that both multiple borrowers and MFIs who are lending to the same individual are happy to continue. The former use multiple borrowing as a safety net and the latter finds that it keeps the velocity of disbursements and repayment high. One practice that contributes to this is that borrowers hardly ever repay the entire loan before their loans are topped up. However if their source of income collapses, if their borrowings are largely used for consumption (as is the case with MFI loans since the clients cannot find investment opportunities to absorb the credit flow) and if the pressure to maintain the schedules of repayment continue as before, the pressure can become unbearable.

Risk and Interest rates: High interest rates are justified, the MFIs argue, because the risk of lending to small borrowers is high, the cost of delivery at the doorstep is high and finally the rates are far less than those of the private moneylenders. But high interest rates to the poor in the first group increases their risk. More significantly, the claim that there is high risk involved does not seem to fit the over-all picture which shows high profitability. The State of the Sector report 2010 (N. Srinivasan) indicates that out of 60 MFIs which reported on profitability, six had ROAs over 7%; thirty five had ROAs over 2%. In contrast the public sector banks in 2009 had average ROAs of 0.6% with the best being 1.6%, while the best private bank had ROAs of 2%. The yield on portfolio confirms this picture; in the case of 23 MFIs it was above 30%(the highest being 41.29%). Further the report says that the assumption that economies of scale will result in drop of interest rates resulting in lower yields was not confirmed. Obviously the DNA drove the MFI to maximise profits and competition did not decrease rates as it was expected to.

The poor are boxed in a high interest rate regime. Yet the MFIs did not agree to reduce their interest rates even when it was clear that the risks had become unbearable, On the contrary their spokesperson said:” The basic fact is that providing credit is expensive, difficult and risky. If MFIs have to be sustainable, society will have to get accustomed to the interest rate”. (The Week Nov 14,2010 pg 24)

As a result the largest MFI recorded a 116% jump in net profit at Rs. 81 crore in the second quarter ending Sept 2010 as against the corresponding period last year. No one questions that profits should be made, but the level of profit required to meet all costs, cover risks and expand operations is different from the level of profit required to meet all these costs plus attract venture and private capital, pay salaries and commissions higher than the remunerations of the CEO/MDs of the largest private banks. Valuations not values seem to drive the sector. While this again can be justified, it does not seem to be an appropriate business model for the poor where values are required to guide the governance of these institutions. The MFIs can provide credit to the non-poor but regulation by the RBI is required; self-regulation was tried in 2005 but no one bothered to comply.

And the major question - What should be the interest rate?. The figure of 24% is floating around in official circles. The problem is that the effective interest rates of MFIs is far from clear. There appears to be a difference of 5% to 10% between the rates as provided by the MFI and the rates that emerge from an analysis of the books of the clients. Professionals in this field say that the MFIs do not know how to calculate effective interest rates. No wonder one representative remarked that the MFI made profits by accident. The management of add-ons like insurance also add to the credibility deficit. MFIs argue that the cost of credit form banks is high and that they should be allowed to mobilise public deposits if interest rates are capped. Interviews with clients show clearly that they do not

have an idea of what they actually pay over and above the capital. They are satisfied if credit keeps coming preferably through the practice of “topping up”. In fact interviews with those clients who had succumbed to the temptation of multiple borrowings showed clearly that they wanted to borrow from several MFIs to maintain a cash flow which coped with repayments as well as their expenditure. Multiple borrowings and topping up serve the same purpose as far as they are concerned. In turn this increases their risk substantially.

To get some guidance about interest rates let us go to the SHGs. We find that interest rates of SHGs in Myrada stabilise after two years or so between 12% and 14%, which is about 3% to 4% above cost of credit from Banks. Not for profit MFIs which do not pay high salaries but adequate to attract experience and capital from Banks manage to make a surplus at interest rates between 17% to 19% where the average cost of credit is around 9% -10% and annual growth rates are 40% to 50%. For Profit MFIs should be able to manage their affairs and attract capital (not venture capital and high valuations) by charging effective rates ranging from 15% to 17% above the average cost of credit. This would put interest rates for the For Profit MFIs in the range of 24% to 29%. At present they are charging about 20% to 30% above the average cost of credit. Commissions on add ons like insurance need to be biased in favor of the client and not to maximize profit of the MFIs.

To conclude: The poor in the SHGs manage with interest rates of 12% -14% and they have managed with interest rates higher than these in the initial period till they built up their groups common fund. They can therefore cope with interest rates of around 17% which Not For Profit MFIs are levying. The risk involved is manageable; the cushion provided by the SHG will help them to tide over urgent needs. The not poor in the second group can cope with higher interest rates levied by For Profit MFIs but the rates should not exceed 30%.

Competition among MFIs has not had an effect on reducing rates, neither has self regulation. The bottom line is that interest rates, commissions, salaries, profits have to be regulated by the Board. It has to come from good and value based governance which seems to be in short supply. The decision by the Board to go in for an IPO will surely force management to focus on the coming quarterly figures as the logic of the financial markets dictates it should. This will further integrate (include) the marginalised into the free market system of which the share market is perhaps the best expression of high risk and profits. This will in turn increase the risks of the clients who are particularly vulnerable.

The exorbitant hike in airline fares attracted quick reaction from government- first to reduce the fares and later to ensure that they are transparent. This case is so similar to the one related to interest rates because the reasons put forward by both parties are similar. The result in the case of the airline fares is that fares have been reduced. But airlines tried their best to avoid transparency in exhibiting the real fares. In fact the first attempt was so confusing that one had to

be in the travel industry to unravel them. Ditto for interest rates. Why is the Government hesitating to regulate interest rates? Years ago I was asked by senior official whether the liberalisation policy would affect the poor. My answer was that the poor have survived in a liberal economy – their wages rise and fall on demand and supply, they pay above market interest rates; they are not subsidized. Those around the table may have difficulty in adjusting. If Govt. can move so swiftly in the case of airline fares, why the delay in the case of interest rates – both to set a ceiling as well as to ensure transparency?.

Are MFIs really better than moneylenders? To begin with in neither of these groups is the effective interest rate transparent. The objective of moneylenders is to ensure repayment of interest not of the capital and they are flexible as regards the amount of repayment. But they can adopt this approach since they have long term relationships with the client and no software to conform to which requires standardisation in repayments.

In the late 80s I asked a group of village people in Bidadi to select symbols to describe their sources of credit. First they pointed out to a large boulder –“that” they said, “is the bank; we cannot move it”. Next they placed a small boulder in the middle with some pieces of newspaper beneath. “This” they said is the Cooperative; the paper is the money we have to pay for a loan”. Third they placed a twig of parthenium (popularly called congress grass), to symbolize the moneylender; “once this comes in the field we cannot remove it”. Then I asked “In which do you have the greatest trust”. Without hesitation they pointed to the twig of parthenium. (A Year later they add a flower to symbolise their SHG). The moneylender lives among them or close by and is involved in several other activities in the life of the village. In the MFI the speed involved in dealing with borrowers fails to build sufficient trust and understanding between the two – this is where the moneylender scores over the MFI. One MFI staff has to cover several borrowers who are usually asked to come to one place at a fixed time. The time for the next group to meet is fixed. It is very much like a private bus which has to stop at fixed times and for as short as possible over the route. If the staff delay, another MFI will reach the group and secure their dues just as the private buses have to rush in order to keep ahead of the competition. If the borrowers are late they are fined in many cases; trust is not built in this business model.

Once again our experience with SHGs as well as with MFIs indicates that the interest rates operating in SHG model is the most appropriate for the poor, while the interest rates operating in the For Profit MFIs is appropriate for the not poor but who are in need of credit. In keeping interest rates within limits, the governance of MFIs has a greater role to play than any regulation since it involves other costs related to salaries, commissions as well as over all institutional values.