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Vijay Mahajan: Rebuilding a Stronger Microfinance Sector in India

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The microfinance sector in India has gone through turbulent times in the past couple of years. The southern state of Andhra Pradesh, the biggest market for the country's microfinance institutions, was at the center of the storm, and populist moves by politicians led to mass default of loans of more than US$ 1.5 billion. Operations are almost at a halt there.

The central government has now stepped in. The Microfinance Institutions (Development and Regulation) Bill, 2012 puts the Reserve Bank of India firmly in control of the sector. Vijay Mahajan, the president of the Microfinance Institutions Network of India and also the founder and chairman of the Basix social enterprise group talked to India Knowledge@Wharton about the implications of the new bill and the way ahead for the sector.

An edited version of the transcript appears below.

India Knowledge@Wharton: The government has introduced The Microfinance Institutions (Development and Regulation) Bill, 2012. It allows the Reserve Bank of India (RBI) to fix the maximum interest rates microfinance institutions (MFIs) can charge. Given the cost structure for an MFI, what would you say is a break-even interest rate?

Vijay Mahajan: [The break-even interest rate] is a function of scale. It is a pretty steep downward sloping curve. Assuming the borrowing rates are at around 13% to 14%, if you have a million customers, you could break even at 24%. If you have a half-million customers, you could probably break even at 26%. Anything less [than a half-million customers], you will not really break even at 26%. Earlier, the practice was that MFIs used to charge high interest rates in the initial years, build volumes, and then keep cutting the interest rates and eventually reach equilibrium. Now, like any other financial institution whether an insurance company or a bank, an MFI is also expected to finance its losses until break even through its equity.

India Knowledge@Wharton: So what will happen if the RBI fixes a rate of, say, 16% or 18%?

Mahajan: In theory, the RBI can do that, but as we have seen, the RBI has been very sensible. They have gone on a data-based decision. The Malegam Committee has recommended 24% and in a December 2011 circular, the RBI has mentioned a cap of 26%. This is a huge landmark [in the history of India's microfinance sector] because this is the first time that the regulator has accepted that small loans can cost as much as 26%. This is a huge acceptance of the reality. And in all these eight months that the circular has been there in the public domain, there has not been a single criticism of it in the Parliament. While there have been many questions in the Parliament about the microfinance sector, there has not been a single question about interest rates.

India Knowledge@Wharton: But is it ethical to charge the poor much higher rates than you would charge the rich?

Mahajan: The question is -- it is realistic to charge anything less than cost? Ethics comes later. To me, one fundamental law of economics is that no economic activity can continue in perpetuity unless it covers its costs at efficiency levels…. If we have to really compare, what we should compare is the total cost or what is called the all-in-cost of borrowing a loan of comparable size from a bank versus borrowing from an MFI. There are numerous studies that show that adjusted for the all-in-cost, all small loans cost in the range of 22% to 30%. Under no circumstances will it

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be economically possible to give a micro loan at a price lower than a larger loan … If we were charging the poor a*margin* higher than to the rich, then *that* would be an ethical issue.

India Knowledge@Wharton: The bill is also bringing in restrictions on coercive collection. What impact will this have on MFIs in India? Some people believe that this could be the end of the road for MFIs in India.

Mahajan: Not at all. This coercion issue has been highly exaggerated. In fact, what I have seen over so many years is that any coercion that happens is not from the MFI side, but from within the group [that takes the loan] itself. In a women's self-help group, the friction is almost always between the leader and the women who default because the default gives a bad name to the entire group.

India Knowledge@Wharton: So now what is the road ahead for the microfinance sector in India?

Mahajan: We have had a very nasty shock in the last year and a half. Some specific MFIs, including Basix, have suffered severely and may or may not recover fully. But the sector as a whole is on its road to recovery and will limp back to normal. It will take some time though. It was a nearly US$6 billion sector in the middle of 2010 and today it's less than US$4 billion. I am talking of amount outstanding, the loans. So even if grows by 25% to 30% a year, just to get back to the size of 2010-2011 will take two more years.

India Knowledge@Wharton: When you look at the past two years, what are some of the lessons learned from the crisis that the sector went through?

Mahajan: It depends on how you define the sector. If you take all stakeholders, including the government, then I think the one actor that has not learned any lessons from this crisis is the Andhra Pradesh government. They were already lending at an unrealistic rate of 3% per annum – or rather, they were basically subsidizing bank lending to self-help groups. Now they are increasing the subsidy to 0%. They have also not accepted that [the setback to this sector] has caused a lot of damage to people in that they have lost access [to microfinance] and have had to go back to moneylenders at high rates.

Other than the Andhra government, I think almost everyone else has learned positive lessons. The Central Government, for example, has this whole new draft of the Microfinance Bill. The 2007 draft never got enacted because that Parliament got dissolved in 2009. The new draft is completely different. First, it defines microfinance much more widely than micro-credit; it includes savings, insurance and money transfers. Secondly, it firmly places RBI as the regulator. Thirdly, it has taken into account the concerns about consumer grievances and consumer protection issues…. It is a good balance between ensuring the sustainability of the providers and protecting the consumers.

India Knowledge@Wharton: What are the top concerns of the microfinance sector in India today?

Mahajan: Right now, the top concern is that despite the fact that the central government has introduced the bill and the RBI has come up with the new regulatory framework, banks have not started lending. There is still a huge liquidity crunch. So step one is that banks need to start lending again to MFIs. Step two is for equity to come back. Or maybe equity needs to come back for banks to start lending. And step three is to restore normalcy in Andhra Pradesh, which requires a huge political will.

The unconstitutionality of the action of the Andhra government is something that has not been talked of adequately. In a nation that wants FDI investments and wants to upgrade its economic laws, for the whole financial system to just stand by and allow this kind of vandalism -- US$ 1.5 billion of loans, which were performing for 15 years, were allowed to be converted into an unofficial waver -- is simply unacceptable. The government put nine million of its own citizens into a state of default. Today, no one is standing up from the financial sector to say this is wrong. Tomorrow, the politicians could do the same thing to larger financial institutions.

There is another area that needs focus. Because of RBI's conservatism, it does not permit anybody except banks to accept savings deposits. This is a good thing because it ensures that people's deposits are safe

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and in well-regulated institutions. But the problem is that access to these institutions is limited. Even today, the majority of the population does not have access to bank accounts. These people are condemned to unregulated saving schemes and scams…. So we need the RBI to ease up on the concept of microfinance banks or small finance banks and ensure that the deposit is guaranteed through insurance so that the depositors' money is safe.

India Knowledge@Wharton: Are we likely to see this happening any time soon?

Mahajan: Interestingly, in the Microfinance Bill one of the services is called "thrift" -- they are still hesitant to use the term "savings" -- which permits small savings, subject of course to RBI approval. But RBI is still not in favor of this.

India Knowledge@Wharton: Going back to your point about equity, should Indian MFIs look for funding from foreign investors at all? Muhammad Yunus (founder of Grameen Bank, Bangladesh's famed MFI) for instance, believes that an MFI should be funded domestically rather than from for-profit or even not-for-profit foreigners.

Mahajan: Bangladesh has had an extremely special situation where the Grameen Bank, under the ordinance of the government, could take deposits right from 1979. This is not possible for MFIs in India even today. More importantly, Grameen Bank has been raising bonds in the Bangladesh bond market. Also, the other MFIs in Bangladesh -- which are not banks like Grameen -- have all been taking deposits. It's kind of "permitted": The central bank does not stop them from doing it because it has been done historically. So for Professor Yunus to say that we must rely on domestic resources doesn't give the complete picture of the favorable framework in Bangladesh.

Now let's look at India. We have a capital adequacy requirement of 15%. This means that for every Rs. 1000 crore (US$180 million at an exchange rate of Rs. 55 to a dollar) that you lend to the poor, you need Rs. 150 crore (US$27 million) of equity. Estimated demand is about Rs. one lakh crore (US$18 billion). So you need almost Rs. 15,000 crore (US$2.7 billion) of equity. To put this into perspective, the total private equity that has come into the entire microfinance sector across the globe up to now is US$1.1 billion. So one can't simultaneously ask for capital adequacy and also say it should come only from Indian sources.

India Knowledge@Wharton: Globally, what are the top concerns in this sector?

Mahajan: The biggest issue globally is that microfinance is still not seen as way beyond micro-credit. Our view is that poor people, like anyone else, need a whole range of financial services like credit, savings, insurance, money transfers and even pensions. They need access to affordable financial services, which will keep their money secure. Therefore we need inclusive financial systems and not just some throw-away products like weekly micro-credit loans. But what has happened is that the Grameen Bank credit model, probably due to its success, has impinged into the consciousness of most of the political leaders to the extent that they think of microfinance as only micro-credit loans. The real challenge is to make them realize that the entire financial system needs to be opened up and be more friendly and more affordable to the majority of the population. The other issue is that supply trails demand significantly in almost every category and there is need to build institutional capacities.

India Knowledge@Wharton: One last question. According to recent media reports, the performing loan book of your organization, Basix, is now around Rs.124 crore (US$22 million), compared with Rs.1,808 crore (US$327 million) in September 2010. The number of Basix borrowers has also fallen to around 200,000 from 1.74 million. Are these figures correct? What measures are you looking at to revive the organization?

Mahajan: Basix is an accidental victim of the Andhra Pradesh crisis. It has suffered very badly and still has bad debts of over Rs. 500 crore (US$90 million) in Andhra alone, which is more than double the net worth of the company. So the damage is virtually irreparable now. We have gone for a corporate debt restructuring where banks have converted their loans to us into equity. The company is effectively now 90% owned by banks.

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