**Microfinance recovers from Andhra nightmare**

*The future holds out both threat and opportunity. New banking licences which are going to be issued can help microfinance institutions to pursue sustainable growth. But chit funds and ponzi schemes need to be reined in*

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Business Standard, 14 July 2013

New Delhi: Now that the Andhra Pradesh crisis is behind it, the Indian microfinance industry is well poised to move forward with enormous benefit from hindsight. In this, it will be helped by a vastly improved regulatory regime that has come into place in response to the crisis. Plus, what is most exciting is that the future holds both a threat and an opportunity. The threat is in the shape of chit funds and ponzi schemes, highlighted by the collapse of the Saradha Group in West Bengal. Chit funds eat into the vitals of the economy at the grassroots level where microfinance institutions (MFI) work. On the other hand, if a robust microfinance network is in place, the need for poor people to turn to these scourges will go down sharply.

And the opportunity that will allow MFIs to pursue sustainable growth lies in the new banking licences that are going to be issued. **Two MFIs, Janalakshmi and Bandhan,** have applied for banking licences which were promised in the first place by the then union finance minister in his budget speech to take forward financial inclusion. (MICROMETER)

First, a look at how things are right now. The Andhra crisis has brought about a clear distinction between Andhra- and non-Andhra-based MFIs. The men, so to speak, have been separated from the boys. MFIs with extensive operations outside Andhra have got over the setback that the industry overall suffered and, compared to the previous year (2011-12), in 2012-13, achieved a growth in gross loan portfolio (GLP) of 39 per cent, compared to 7 per cent for Andhra MFIs. The industry as a whole achieved a "major recovery", says **Chandra Shekhar Ghosh, chairman and managing director of Bandhan,** by returning to growth with a rise in GLP of 23 per cent, compared to a fall of 14 per cent in the previous year (2011-12).

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But the crisis is still hurting. Writing off bad loans has caused the overall equity of the industry to fall for the second year in 2012-13 by 41 per cent, after doing so by 25 per cent in 2011-12. The Andhra MFIs' equity has been reduced to negative. So, after two years of bloodletting, the industry's equity is down to 44 per cent of what it was in end-2010-11. The quality of the loan portfolio (measured as portfolio at risk) of non-Andhra MFIs remains sound at under 1 per cent. As for the Andhra MFIs, they had secured a moratorium on debt servicing obligations under corporate debt restructuring till June this year. As they may not get another moratorium, the prospects for those unable to bring in substantial amounts of fresh equity are quite bleak. Says Samit Ghosh, managing director of Ujjivan, "The disconcerting news is that studies indicate that in Andhra customers have no choice but to return to moneylenders due to government legislation that virtually bans MFIs from operating there."

The industry overall is today more disciplined and on a sounder footing as the Reserve Bank of India (RBI) has stepped in with elaborate regulation. To tackle the fundamental problem of multiple lending several MFIs lending to the same borrower in competition with each other, so as to fulfil their own targets RBI has put a ceiling of two loans per customer. No MFI can now offer a third loan to a customer who already has two. Plus, no customer can have overall borrowings of over Rs 50,000. MFIs also have to work under two key constraints. They cannot earn an overall margin of more than 12 per cent (the part of their interest income they get to keep for themselves after paying the banks from whom they borrow) and borrowers cannot be charged more than 26 per cent within a 4 per cent maximum-minimum range. This has put pressure on margins and forced MFIs to use technology to manage costs and spread them over larger numbers of borrows. Gross loan portfolio and number of clients per loan officer have gone up across the board. That is, an individual loan officer is processing more lending and attending to more customers, thus raising his productivity and cutting costs. The average loan outstanding per client has also gone up.

Thus there is a premium on size. The future of smaller MFIs is not bright as their costs per borrower or loan are higher. This consolidation is inevitable in any maturing industry but it creates a barrier to entry which is unhealthy in an industry that is still young and has tremendous need to innovate. It is usually startups who take a lead in innovation.

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What of the future? Industry leaders flag three issues. One is they need more products. The industry still offers virtually one product - group guaranteed instalment loans - for varied purposes, of course. On one hand, they need to give different kinds of loans, as banks do, like loans for micro-enterprises, housing, education and healthcare. They also need to offer different savings and investment products to customers in areas like pension and insurance. Above all, they need to offer customers a reliable, easy and cheap remittance facility. MFIs are seeking to diversify under the regulatory ceiling of 15 per cent for non-MFI businesses and also seeking to earn fee based income, says Chandra Shekhar Ghosh.

Some of the diversification can be done through business correspondents who act as a link between banks and MFIs. They can bring most banking services to the doorstep of the customer who has little time to travel to a bank. But more products and wider reach are best facilitated by becoming more resource rich through greater size.

This is where the banking licence comes in. Life will change for a microfinance institution it can accept deposits as Grameen Bank of Bangladesh does. A bank pays savings account customers 4 per cent interest, whereas an MFI has to borrow from a bank, in order to lend, at over 10 per cent. So an MFI-turned bank can both pay more for accessing deposits and charge less for loans. Chandra Shekhar Ghosh says, "If we are able to attract low cost deposits as a bank, then we can cut 10 percentage points from our current lending rate of 22.9 per cent."

To be a bank you have to satisfy the regulator that you are financially strong, have robust systems and are derisked in your business. In India, if a bank fails, the government has to pick up the tab for the small depositors. Industry sources say that RBI should think a little out of the box when it comes to giving banking licences to MFIs. There can be a narrow banking licence which lets an organisation accept deposits, give small loans to poor people and keep a significant chunk in government securities. This way such organisations don't have to lend to corporations and go in for periodic corporate debt restructuring, which is currently the bane of India's public sector banks. The point is microfinance is a sound business proposition as a poor person who borrows at even 25 per cent is far better off because she would otherwise have to pay a moneylender much more. The risk, as happened in Andhra, is an MFI getting greedy, chasing targets created in business plans given to private equity financiers, and commission-earning sales agents shoving loans down the throats of villagers. Then musclemen are brought in when recovery starts slipping and you get suicides.

Today there are two risks facing microfinance, both political - but one above board and the other not so. The under-the-radar political risk for MFIs is chit funds and ponzi schemes. They run away with the meagre savings of poor people, returning them to destitution and preventing them from investing what might be called retained earnings in income generating ventures undertaken with micro credit. Microfinance borrowers losing their savings to ponzi schemes are also liable to default on their microfinance loan repayments. As ponzi schemes usually enjoy political support, as has been revealed in the case of the Saradha Group, they pose a political risk for microfinance. Legitimate deposit taking MFIs can offer the poor much higher rate of returns than banks give right now, thus weaning them away from the promise of high returns that ponzi schemes hold out.

The other political risk is overt. **Samit Ghosh** points out that the government is planning "a ten-state rollout of the **National Rural Livelihood Scheme** (highly subsidised self help group loans funded by the World Bank) which is likely to adversely impact the sector. Such initiatives are populist palliatives which are politically motivated. Over the last 60 years they have had very limited impact on poverty alleviation. They are unfortunately likely to create tension between the state-run programmes and the microfinance industry."

While the industry has travelled a long way by securing recognition from the RBI as non-banking finance company MFIs (NBFC-MFI), the big future need is to ensure that the MFI legislation, currently stalled, is passed by Parliament. Once that happens, MFIs can look forward to securing a more permanent place in the sun.

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