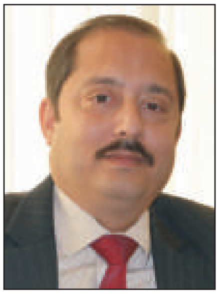

The Crisis and beyond : journey of MFIs in India

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The advent of microfinance

In most developing countries, directed and subsidised rural credit programmes initiated in 1950s started to exhibit by 1990s similar institutional weakness, cornering of subsidies by the better off and the exclusion of the needy from the reach of financial services. As a response to these shortcomings of the formal sector, internationally in somewhat disparate settings of Bangladesh, Bolivia and Indonesia, microfinance experiments took root. In the late 70s, pioneering work by Professor Muhammad Yunus in Bangladesh was followed in the 1980s by PRODEM[1] in Bolivia and Bank Rakyat Indonesia (BRI) to provide financial services to poor people ignored by banks, primarily on account of their meagre requirements and lack of collateral in both the scope of their outreach and ability to recover costs, these interventions demonstrated techniques for lending to the poor that were more effective than previous approaches. While all this laid the foundation for the evolution of the concept 'Microfinance' in the late 1980s / early 1990s, during the early period of experimentation and pilots, it was termed primarily as 'Microcredit', but also as rural finance, agricultural credit, nonfarm credit and microenterprise finance. The term 'Microfinance' gradually replaced 'Microcredit' to acknowledge the integration of other services such as savings with credit.

The impetus for the kick-start of microfinance intervention in India in the early 1990s can be attributed to multiple factors : the realisation of the inability of the formal banking system to reach the poor sustainably, beginning of financial sector reforms in the early 1990s and successful microfinance interventions across the world especially in Asia and in India by NGOs. In this backdrop, many donor funded NGOs started group based savings and credit activities. As the microfinance work was taken up by the existing NGOs working in a range of developmental areas, the microfinance component was an add-on to the existing work. The next phase under this approach had two features namely separation of microfinance as a separate vertical and reducing dependence on donor funds.

As financial intermediation required a different set of competencies, systems and attitudes, most NGOs found it difficult to cope with the additional requirement, which resulted in separating microfinance activities. The limited nature of donor funds and the desirability of moving the sector towards sustainable operations was realised early. Just as NABARD had taken the leadership role for the SHG programme, SIDBI took a similar role for the MFI model which relied on making funds available to MFIs for on lending to clients. Enabling funds flow to the MFIs also entailed more transparent financial operations, which expedited the process of separating microfinance operations with separate financial statements. In order to accelerate the process of financial inclusion through the MFI model, SIDBI launched the Micro Credit Scheme in 1994 for extending financial support to the disadvantaged sections of the society through well managed Non-Government Organisations (NGOs). The NGOs were encouraged to on-lend to disadvantaged sections of society with emphasis on women for setting up the micro enterprises. It was followed by setting up of a dedicated department in 1999 called “SIDBI Foundation for Microcredit”.

Initially, SIDBI relied on lending directly as well as institutional strengthening through training and

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1. Promotion and Development of Microenterprises (PRODEM) was created in 1986 in Bolivia as a non-profit financial institution.

capacity development. In order to ensure linkage with the banking system for flow of debt funds, SIDBI supported M-CRIL[2] in developing a rating tool for MFIs. The development of a rating tool by M-CRIL ushered in a new phase by providing a credible third party assessment of performance and gaining the confidence of bankers. Though reliable figures for bank lending to MFIs till 2005 are not available, SIDBI's cumulative lending to the sector reached ₹137 crore by 2005.

Though by 2005, the MFI model had undergone transformation with emergence of "microfinance only" organisations as against earlier clubbing of microcredit with other development activities, moved to a system of external ratings for performance assessment, established linkages with the banking sector and received the support of apex institution in the form of SIDBI, it retained its ideology of client focus and had a modest outreach of 1.76 million (M-CRIL 2009). The sector was dominated by MFIs organised as societies and trusts and employed a variety of models (Grameen, Individual and SHG) in delivering credit services.

It can be said that by 2005, microfinance had well and truly arrived as the new mantra in tackling the vexed issue of providing financial services to the poor in a win-win paradigm.

The chase for numbers and valuation followed by the hard landing – What went wrong?

The pangs experienced as part of the bank led inclusion efforts till 1991 had demonstrated clearly that for deeper levels of inclusion, a target driven approach and a set model of products and services would not work. The microfinance initiatives started with this vital learning and initially the focus was on building social capital with the underlying belief that would be an intensive activity, both in terms of human resource and time. The MFIs (from their initial phase to mainstreaming phase) remained true to these fundamentals. Things changed post-2005.

The MFI model started with NGOs broadening their service delivery and later establishing separate microfinance focussed subsidiaries. Development was a key concern and growth was moderate. The total outreach of the model in 2002 was a mere 1.76 million in 2004 (M-CRIL 2009). The linkage of MFIs with banks based on independent ratings pioneered by M-CRIL in 2000 led to infusion of substantial sums of money into the system. In order to ensure financial discipline, banks relied on prudential norms like debt to equity ratio to have reasonable levels of leverage. MFIs registered as societies and trusts found it difficult to raise capital from external sources due to their legal form and retained earnings from operations were not enough to mobilise sufficient debt for scale up. This triggered the transformation phase with MFIs scrambling to transform into Non Banking Finance Companies (NBFCs), the only legal route permissible and acceptable to equity investors. Banks also found NBFCs as the preferred form as these are regulated by the Reserve Bank of India (RBI).

At this stage, it is necessary to document the regulatory stance of the Reserve Bank of India (RBI), which closed the other vital option for funding i.e. deposits. Call it conservatism or prudence, the policy stance of RBI has always been that deposit mobilisation is the sole ambit of banks and it is too risky to allow MFIs to collect deposits from low income families. Thus while in India, deposit taking by MFIs (even those registered as NBFCs) is not allowed at all, in other countries (Pakistan, Nepal, Cambodia) relatively few institutions are licensed for deposit taking. This leaves the possibility of generating loans and equity funds from commercial markets as the only serious, medium term option for financing the credit needs of low income families. This one legged paradigm of microfinance faced by MFIs in India left them with no choice but to transform to NBFCs.

The transformation phase starting around 2004 had been so comprehensive that it changed the entire landscape. By 2008, all major MFIs had transformed into NBFCs and dominated the sector accounting for 90% of market share by 2010. Issues involved with the transformation process in the form of Mutual Benefit Trusts by some of the leading MFIs were the earliest pointers of the sector drifting from client focus and has been well captured in the paper by Prof Sriram (Sriram 2010). Of the MFIs continuing as Societies or Trusts, only for a few, it was a matter of conscious strategy while for majority the capital

2. Micro-Credit Ratings International Ltd. (M-CRIL) is a microfinance rating agency working globally with focus on Asia. www.m-cril.com.

requirement for becoming an NBFC (minimum capital requirement of ₹2 crore) proved too steep.

Having the appropriate legal form under its belt, MFIs were set to attract private capital for equity and leverage that for accessing bank loans. Success factors of the model were paraded in the form of high recovery rates and massive jump in outreach, peppered with an occasional anecdotal story of smiling clients and the demand for ever higher funds was predicated on the huge exclusion gaps to be filled in India. In short, the MFIs promised year on year phenomenal growth with their clearly demonstrated, replicable and low cost model. Equity investors were mesmerised by this promise – the prospect of attractive returns with negligible risk and started chasing MFIs for equity investments. The equity investors came in all sizes and shapes ranging from multilaterals like IFC to venture capital funds like Sequoia capital to private equity. MFIs in order to continue to be attractive to investors went single-mindedly after growth. The equity deals reached a peak in 2009-2010 with equity valuation touching a high Price / Book Value of 7 to 10 (CGAP 2010a). With equity in place, bank funding to MFIs also touched a high of ₹17,000 crore by March 2010 excluding portfolio sales and securitisations.

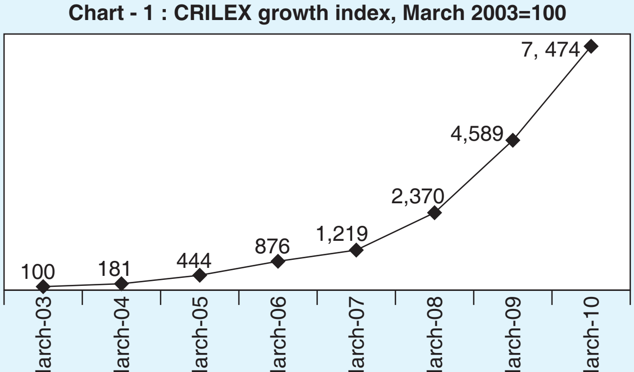
Table-1 : Year wise equity deals in India

Financial year	Amount (US$ Mn.)	No. of Deals
2007-08	52	3
2008-09	178	11
2009-10	209	29

Source : Srinivasan 2010 : 53

The growth spurt was obvious with MFI outreach touching 26.7 million clients by March 2010. M-CRIL developed CRILEX for March 2010 went up to 7,474 (CRILEX is a composite index of the growth of MFIs in India and uses information on the number of borrowers as well as size of loan portfolio) (Chart-1). By 2009, 9 Indian MFIs figured in the top 20 list of MIX Market.

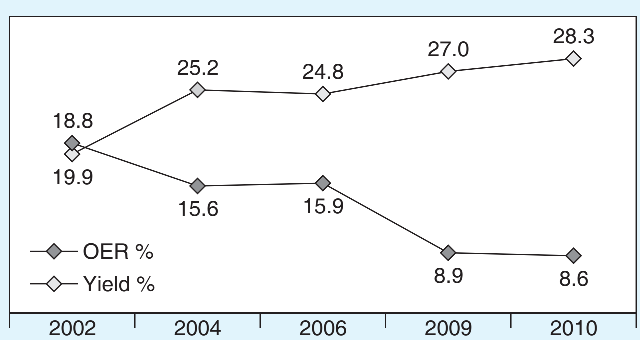
Chart - 1 : CRILEX growth index, March 2003=100



While the marriage of equity investors with MFIs was being consummated, clients fell by the wayside. Srinivasan (2009, 128) succinctly captures this drift "Many MFIs started financing the poor but somewhere they lost the customer focus and along with that mission too…. It is no more about improving income generation in the hands of the customers. Book value multiples, price to earning ratios and enterprise valuations dominate the discussion." Growth was achieved by cutting corners on client acquisition process, improving efficiency and thereby profitability, rolling out a plain vanilla product (50 / 52 week loan) which obviated the necessity of investing in staff training and changes in operational systems, ignoring investments in control systems and MIS and competing in similar areas.

Lower levels of client relationship building efforts coupled with gains in productivity (measured by clients per field staff) led to impressive gains in efficiency (Chart-2). With yield on portfolio remaining constant and not falling in tandem with efficiency gains, profitability went up making MFIs the darling of investors. Return on Assets (RoA) for top 10 Indian MFIs in 2009-10 were 6.5% as against global average of 1.5% (M-CRIL 2010). To the credit of the Indian MFIs, this resulted in Indian MFIs being the most efficient globally with global average for Operating Expense Ratio (OER) as per MIX being 20% in 2010.

Chart-2 : Trend in portfolio Yield and OER



Source - M-CRIL 2010

The growth engine was however not sufficiently matched by investments in human resources and control mechanisms. Massive recruitment at lower levels led to a situation, wherein trainee staff were heading the branches. Pressure to achieve higher productivity led field staff to look to centre leaders and agents to bring in clients in a shorter period, thereby further eroding the link between borrowers and loan officers (Srinivasan 2010).

By end 2010, almost every state was witnessing high competition, credit saturation, multiple borrowings and rising default rates. It was evident that something was going to break and while institutions with deep understanding of the sector had predicted the rupture a good one year in advance, others were still gung-ho with success of the SKS IPO. M-CRIL in its 2009 annual review of microfinance observed ominously, "The concern is that some of this high growth may have been stimulated by the advent of investment in Indian microfinance by private equity groups keen to maximize numbers under any conditions in order to boost firm size and improve share valuations. This stimulus is apparently leading to the cutting off corners in matters of consumer protection - multiple lending, over-indebtedness and consequently coercive collection practices - that are likely to trigger interference by political, religious or other community groups in the practice of microfinance (and may already have done so). Such practices result partly from the geographical concentration and rapid consumer enrolment that has occurred due to high growth" (M-CRIL 2009 : 1).

As voices of sanity and caution were ignored and these happenings were rationalised as one off incidents in pursuit of massive inclusion required in India, it was clear that a bigger crisis was round the corner. Unfortunately, the heavy handed ordinance of Andhra Pradesh government in October 2010 proved to be the straw that broke the back of microfinance. Linking it to the issue of SKS IPO or government's genuine concern for microfinance borrowers is not fair as there were a host of factors leading to the government ordinance. Industry observers and borrowers have pointed to variety of reasons like overlap with SHG programme, multiple borrowings, rising default rate under SHG programme as also intense media scrutiny of SKS IPO and possible envy / concern with profitability of MFIs (WMGF 2011, Srinivasan 2011), of which not all could be attributed to MFIs. However, the reasons offered by the Andhra Pradesh government focussed on coercive recovery practices, indiscriminate lending and usurious interest rate have not cut much ice with industry observers (Legatum 2012).

Within a span of months of the ordinance which resulted in massive defaults in Andhra Pradesh, the darling of investors and bankers became a pariah. The implications have been so huge that the sector has shrunk by 60% with the outreach dipping by nearly 10 million clients by March 2012.

Rebuilding phase : Post 2010

The crisis brought home the point that microfinance will have a sustainable future only if it a) brings back the focus on clients through reaffirming its social agenda b) redefines operational metrics balancing both sides – institution and clients and c) remains dynamic to client needs by going beyond the single product basket. If it sticks to these cardinal principles, it will by default avoid issues like multiple lending and public policy censure.

However, in midst of growing criticism, it has to be remembered that MFIs have played a vital role in inclusion in India. In 2010, MFIs accounted for nearly 40% of credit accounts for small borrowers with an outreach of 26 million customers, rest being accounted by small borrower accounts of RRBs and Commercial banks. The point is MFIs need to bring back the focus on clients and that is what they have done post 2010 through the following inititaives.

Initiatives to bring back customer focus

The initiatives can be broadly grouped as industry initiatives and government regulation.

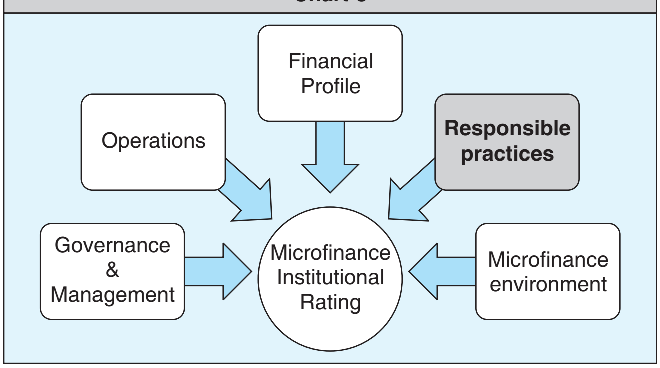
Industry initiatives

a) Social rating & Microfinance Institutional rating

Social rating was developed by specialised microfinance rating agencies such as M-CRIL. While social rating remains as an in depth tool for assessment of social performance, the recent events have clearly shown that certain aspects of social performance such as client protection also have a bearing on institutional and financial sustainability. Realising this microfinance rating agencies such as M-CRIL worked on a global initiative during 2011 supported by the Ford Foundation and Rating Initiative based in Luxembourg to refine the existing financial / credit rating product by integrating key areas of social performance. Initially termed as "Responsible finance rating" during the pilot phase, based on industry feedback and experience gained during the pilot, it was decided to term it as "Microfinance Institutional Rating (MIR)".

MIR expands the holistic assessment framework used by specialised rating agencies as opposed to pure financial evaluations used by mainstream rating agencies. Client protection principles, responsible profits and alignment of mission with governance and organisational practices have been integrated into the rating framework of MIR. The MIR framework is shown in Chart-3 below.

Chart-3



b) Social Performance Task Force

Social Performance Task Force (SPTF) an international initiative through its painstaking work over the years involving practitioners, funders, networks, technical service providers, microfinance rating agencies and researchers has recently in June 2012 been able to develop and adopt universal standards in social performance for MFIs that establish clear guidelines on social performance management and reporting. The process involved pro-actively pursuing feedback and suggestions for revisions from more than 1,300 members of the Task Force, as well as experts outside of the Task Force.

Meeting the standards signifies that an institution has "strong" Social Performance Management (SPM) practices. The standards are based on the following metrics[3]:

- Define and Monitor Social Goals;
- Ensure Board, Management, and Employee Commitment to Social Performance;
- Treat Clients Responsibly;
- Design Products, Services, Delivery Models and Channels That Meet Clients' Needs and Preferences;
- Treat Employees Responsibly; and
- Balance Financial and Social Performance.

The SPTF standards have been incorporated by microfinance rating agencies such as M-CRIL in their rating framework and the MIX market reporting template for MFIs on social performance.

c) SMART Campaign and Client Protection Principles

The Smart Campaign is a global effort housed at Accion International's Centre for Financial Inclusion aiming to unite microfinance leaders around a common goal : to keep clients as the driving force of the industry. To help the microfinance industry achieve this goal and its double bottom line objective, it is working with microfinance leaders from around the world to provide microfinance institutions with the tools and resources they need to deliver transparent, respectful, and prudent financial services to all clients.

Table-2 : Principles of Client Protection
• Appropriate product design and delivery
• Prevention of over-indebtedness
• Transparency
• Responsible pricing
• Fair and respectful treatment of clients
• Privacy of client data
• Mechanisms for complaint resolution

The campaign has worked on developing the seven principles of Client Protection (Table-2) with the help of industry experts. Microfinance rating agencies have played a key role as part of the technical committee in evolving 'adequate' as well as 'high' standards associated with each of the seven principles. While the adequate standards ensure that institutions do

3. http://sptf.info/sp-standards accessed on 1st July 2012

not cause harm to clients, high standards entail doing good to the clients.

SMART campaign has rolled out CPP certifications, wherein M-CRIL is the certifier for India. 4 MFIs in India have been CPP certified till date demonstrating their adherence to Client Protection Principles.

d) Code of Conduct

Before the crisis, the Indian MFI industry had a code of conduct developed by Sa-Dhan[4]. However, the Code was voluntary and there was no mechanism of checking compliance and taking corrective actions. MFIN[5] formed in 2009 also had its own voluntary Code of Conduct. The two codes were more or less focused on similar issues like transparency, governance and client protection, but there was no formal mechanism to check actual practice and take corrective action.

While these two associations represent two different streams of the MFI model, smaller community based MFIs organized as Societies and Trusts being represented by Sa-Dhan and bigger NBFC-MFIs being represented by MFIN with some overlap, before the crisis, there was hardly any common strategy and action. The 2010 Andhra Pradesh events changed the scenario, with IFC and Dell Foundation taking the initiative in harmonizing the two codes of conduct into the Unified Code of Conduct[6] which was adopted in December 2011. The Unified Code of Conduct (Table-3) goes beyond the fair practices code for NBFCs stipulated by RBI and prescribes standards for governance, integrity, transparency and client protection. In the changed scenario, both associations have indicated that member's adherence to the unified code of conduct will be checked as adoption of the code is mandatory. The ability of associations to perform actual checks on compliance remains to be seen, but SIDBI and banks have started asking for CoC adherence assessments by external agencies like M-CRIL for accessing bank funding.

Table-3 : Code of Conduct - Aspects covered
● Defines core values of microfinance
● Norms for
- Integrity
- Transparency
- Client protection
- Governance
- Recruitment
- Client education
- Data sharing-credit bureau
- Grievance redressal

Regulation & Responsible Microfinance

After AP crisis, RBI set up a Committee of the board under the Chairmanship of Mr. Y. H. Malegam, which gave its report in January 2011 and justified the existence of MFIs as well as their coverage under priority sector definition. However, the committee also followed the report with various recommendations on interest rate, income ceiling for microfinance borrowers, loan ceiling and norms for consumer protection significantly. The recommendations were considered by RBI and followed by issuing of guidelines in May 2011 and December 2011. While the major recommendations of the Malegam committee were accepted in spirit, RBI made critical relaxations in interest rate cap, loan ceiling and income level of borrowers.

Two aspects of the framework put in place by RBI are significant. First, it has accepted the creation of a separate category of NBFCs called NBFC-MFI conditional on meeting asset class norms and secondly, these regulations only cover NBFC-MFIs leaving out MFIs operating as Societies or Trusts. This gap is sought to be plugged through the Micro Finance Institutions (Development and Regulation) Bill, 2012, introduced in the Parliament in May 2012 as it is omnibus in its coverage. However, as the basic framework put in place by RBI for NBFCs will apply to other institutions also, that is what will influence responsible finance by MFIs.

Summing up

Inclusive finance or Microfinance is built on the premise that a strong motivation for a positive social change can be put at the heart of financial institutions which otherwise operate mostly according to mainstream best

4. Sa-Dhan was formed in 1999 as association of community organisations and currently has a membership base of 251.
5. MFIN was formed in 2009 as representative organization of NBFC-MFIs and has a membership base of 46 leading MFIs.
6. http://sa-dhan.net/Resources/Code%20of%20Conduct%20for%20MFIs%20in%20India.pdf

practices defined for enterprises that aim at creating value for their shareholders. This can only be ensured if institutions focus on maintaining the fine balance between institutional sustainability and needs of clients. Jolted by the AP crisis and realizing its mission drift during the phase leading to the crisis, the sector through various initiatives - internal as well as external- has bounced back by correcting its course demonstrating its resilience. It is estimated that the client outreach has reached 26.5 million by 30th September, 2013 and funding both equity and debt has started flowing back to the sector. It is hoped that passing of the regulatory bill pending before the Parliament will provide greater stability to the sector.

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Guidelines on Basic Savings Bank Deposit Accounts for Financial Inclusion

Banks have been advised to offer a Basic Savings Bank Deposit Account (BSBDA) that will offer the following minimum common facilities to all their customers:

i) The account should be considered a normal banking service available to all.

ii) This account shall not require any minimum balance.

iii) The account will provide an ATM card or ATM-cum-debit card.

iv) Services will include deposit and withdrawal of cash at bank branches as well as ATMs; receipt / credit of money through electronic payment channels or by means of deposit / collection of cheques drawn by central / state government agencies and departments; and

v) While there will be no limit on the number of deposits that can be made in a month, account holders will be allowed a maximum of four withdrawals in a month, including ATM withdrawals.

These facilities will be provided without any charges. Also, no charge will be levied for non-operation / activation of an inoperative BSBDA.

Banks would be free to evolve other requirements, including the pricing structure for additional value-added services beyond the stipulated basic minimum services on a reasonable and transparent basis that is applied in a non-discriminatory manner.

The BSBDA would be subject to Reserve Bank instructions on Know Your Customer (KYC) / Anti-Money Laundering (AML) for opening bank accounts, issued from time to time. If the account is opened on the basis of simplified KYC norms, it would be treated as a 'Small Account' and would be subject to the conditions for such accounts.

If a customer has other savings bank deposit accounts in the bank, he / she will be required to close it within 30 days of opening a BSBDA.

Existing 'no-frills' accounts should be converted to BSBDA.

Source : Reserve Bank of India (RBI), Annual Report, 2012-13.