The Economics Pioneers

Policy Brief: India’s Microfinance Industry

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Introduction

Microfinance is the provision of micro-credit or small loans to people from low-income communities that lack access to traditional banking services (Roodman 2011). Often hailed as the solution to poverty alleviation, microfinance started as an experiment performed by Bangladeshi economist Mohammed Yunus (Yale School of Management, 2011). He observed positive outcomes with micro-lending in Chittagong’s Jobra village and eventually established the Grameen Bank - the world’s first microfinance institution (MFI). The microfinance movement spread rapidly across developing countries in Asia and Africa throughout the 1990s, and eventually, MFIs became profitable and viable, increasing financial outreach to poorer population segments (Lieberman, et.al).

The microfinance boom also spread to India, with over a hundred registered micro-lending banks with an estimated gross loan portfolio of USD 2.85 trillion (Lele, 2022). However, the Indian microfinance industry is volatile and has been mired in controversy. In 2010, the industry was on the brink of collapse after farmer suicides due to indebtedness prompted high default rates (Biswas, 2010). This paper provides an overview of microfinance in India, investigates key issues and reviews new guidelines published by the Reserve Bank of India (RBI).

History of Microfinance in India

According to a survey conducted in Udaipur, only 6.4% of poor people had taken a loan from a formal institution, and the rest relied on family members and local moneylenders for credit (Banerjee & Duflo, 2012). In the 1950s, private moneylenders accounted for approximately 70% of rural credit in India (Sethi, 2015). Change arrived with the Indian government launching subsidised credit schemes as a development program. The first such scheme, offering subsidized loans to poor-self-employed people, launched in 1982. While other similar schemes were launched, the low-interest rate coupled with high default rates made these programs unsustainable. Moreover, the beneficiaries of these schemes were largely village elites and outreach to the impoverished was minimal (Banerjee & Duflo, 2012). The government issued loan waivers to defaulters, which further reinforced the view held by financial institutions that lending to the poor is costly (Sethi, 2015).

In the mid-1980s, self-help groups (SHGs) formed by local women started to emerge (Sethi 2015). With the help of other NGOs and the National Bank for Agriculture and Rural Development (NABARD) operational guidelines were formed for SHGs, and they gained financial assistance from regular banks. A high repayment rate solidified the viability of SHGs and led to the RBI categorising financing to SHGs by banks as a priority sector activity in 1996. Throughout the 1990s, several microfinance and development finance organisations were established, and SHGs became a crucial part of the Indian government’s poverty reduction plan.

The success of MFIs encouraged traditional banks to begin investing in MFIs (Sethi, 2015). Moreover, the ‘priority status’ of lending to MFIs provided commercial banks with strong incentives to finance MFIs through loans (Banerjee & Duflo, 2012). Thus began the commercialization of MFIs, and their focus began to slowly drift from social impact to profit-making. In 2010, the overindebtedness from MFIs led to several farmers in Andhra Pradesh committing suicide (Mader, 2013). As a form of protest, borrowers from several villages in the state defaulted on their loans, nearly pushing the Indian microfinance industry to failure. Recently, there have been growing accusations against MFIs related to coercive recovery practices like harassment, physical, verbal and sexual abuse.

What are the pre-existing issues in India's Microfinance Industry?

- Joint-Liability Groups (JLGs)

Similar to the idea of SHGs, MFIs started in India by offering credit to a small group of women called joint-liability groups (Banerjee & Duflo, 2015). The women in the group are responsible for ensuring everyone meets their payment obligations and are liable for the total debt issued to the group. While this offers flexibility to the women borrowing and allows MFIs to diversify unobservable risk, it also disadvantages those wanting to take a risk. Moreover, the structure can not only lead to welfare loss from moral hazard and free-riding but also create conflict and lead to peer pressure and constraints.

- Rigidity of Rules

Currently, the rules for repayment are also very strict for most MFIs (Banerjee & Duflo, 2015). Borrowers are often required to pay loan instalments every week. Consequently, borrowers may have to return the money when the business they withdrew the loan for has not even started producing returns. By contrast, local moneylenders often allow flexibility in terms of payment periods and delays. As a result, MFIs remain inaccessible.

- Overindebtedness & High-Interest Rates

MFIs in India used to charge a 24% interest rate on loans, but after the RBI removed this cap, interest rates might be as high as 100% (Economic Times 2011). The compounding power of this high-interest rate increases the cost of borrowing and increases the vulnerability of poorer populations to the impacts of adverse economic shocks (Puliyakot, 2021). High-interest rates combined with the extraction of multiple loans from different MFIs can quickly cause overindebtedness and push poorer populations into a debt trap.

- Language Barriers and Poor Financial Literacy

With less than a third of the Indian population being financially literate, overindebtedness becomes an even more menacing threat (Asian Development Bank, 2022). Financial illiteracy increases the risk of being exposed to predatory behaviours. To compound this effect, most MFIs in India require people to read and sign documentation in English, which presents a strong language barrier (Nina & Zafar, 2022). Consequently, people taking loans from MFIs are often unaware of the terms and conditions and are barred from making fully-informed decisions.

- Moral Drift Among MFIs

Since commercialisation, MFIs have had a capital structure heavily financed by debt (Pati, 2020). Consequently, a drive for profit-making among MFIs with high operating costs has caused them to drift from their objective of poverty alleviation. As a result, the incidences of multiple borrowing by clients, forceful loan collections, and even predatory or illusive behaviour are on the rise among Indian MFIs.

Policy Review & Recommendations

In 2021, the RBI increased the household loan limit to INR 300,000 for loans to qualify as microfinance and set the repayment limit to 50% of monthly household income. In harmony, both of these policies can bring positive change to the Indian microfinance industry. Many people often require higher loans than those that meet the requirements to qualify for micro-credit but are too poor to access traditional banking services. Therefore, an increase in the loan limit bridges this financial gap and allows the financing of MSMEs. Simultaneously, a progressive income-based household repayment limit helps to prevent over-indebtedness. However, given the profit-making desire of MFIs, there remains a risk that MFIs begin to finance mostly the households that can be charged higher within the loan limit. Consequently, this may exclude the poorest populations from accessing micro-credit and go against the very principle of microfinance.

The RBI also removed the price ceiling of 26%, which has already led to soaring interest rates and may worsen over-indebtedness leaving millions vulnerable to a debt trap. To manage risk and lower interest rates, microfinance funds can estimate the unobserved risk by interacting with the local community. For example, while in JLGs, the MFIs cannot observe individual risk, the other members in the JLG can (Ahlin, 2020). Therefore, MFIs should collect more information on the riskiness of an individual through relatively inexpensive measures. As a result, not only may interest rates lower due to less risk uncertainty, but it may also allow MFIs to forego JLGs and offer more flexible repayment rules. The role of the government might be to use its extensive network of rural development infrastructure to evaluate individual risk and conduct widespread financial literacy outreach programs.

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