

# Reimagining microfinance

The current model works, but at a modest growth rate

ILLUSTRATION: AJAYA KUMAR MOHANTY



The commercial model of microfinance in India is inspired by Grameen Bank of Bangladesh, and known as the “joint liability group” model. This model is focused on women organised in groups to provide unsecured loans and transact business in a weekly or a monthly meeting. While there are changes in the operating details, three elements — regularity in transactions, focus on women, and unsecured loans — have remained intact.

This model was successful and scaled up rapidly. It was supply-driven; group meetings aggregated transactions and provided a mutual guarantee — a kind of social collateral — for unsecured loans; the loan amounts and the repayment instalments were standardised across borrowers, offered on a “take it or leave it” basis. Transactions with 30-40 women could be done in a window of 30 minutes in a group meeting. The interest rates were more than 24 per cent per annum, operating costs were in control, and growth came from discovering new families in new geographies.

The microfinance model, with high interest rates, was never a model for poverty eradication. These interest rates work well for working capital or businesses that need modest investment with regular cash inflows. The moment a business needs significant investment capital with a longer payback period, the compounding effect makes the interest rates stressful. For instance, it works well to buy a milch animal but would not work for setting up a small dairy farm with investment in land, cowsheds and additional labour.

Microfinance unlocked the slack in poor households, particularly the spare capacity of space and labour. In the past three decades, it has served this unlocking well. The landscape has changed and this model is no longer working for aggressive growth.

It is important to note that all crises in microfinance have been geographical: Whenever a region was saturated, a crisis followed. Each crisis came with three familiar allegations: Usurious interest rates, coercive recovery, and multiple lending. When multiple lenders chase clients without being competitive on terms, it becomes a stress on the demand side.

In the past years, demonetisation and the pandemic broke the basic operating rules of the model. Demonetisation broke the belief in group liability as some households in the business of essential services recovered faster (milk supply and eateries) than others (beauty parlours). Microfinance institutions (MFIs) recovered whatever was available without insisting on group guarantee, and this broke the sanctity of group guarantee and zero tolerance for default. The pandemic broke the sanctity of group meetings.

MFIs have tinkered with their offers, giving up on group guarantee and introducing graduation loans, and gone digital in collection. All these were done without fundamentally reimagining the model beyond women and group meetings.

In every crisis, they look to the regulator and the self-regulatory organisation for guardrails and better data from credit bureaus. On the other hand, clients have been creative, playing one MFI against the other; ringleaders control village operations; and take to creating multiple identities to get more loans. Initially, MFIs were ahead of clients, but now the clients have turned the creativity table against MFIs.

The policy response has been a victim of group-think. These stakeholder consultations reinforce the extant model. The Reserve Bank of India’s (RBI’s) use of household income for defining microfinance and fixing a repayment level is prob-

lematic because of the following reasons: (a) It is impossible to determine household income when it is from informal sources and volatile; and (b) fixing the outer limit of the repayment obligation at 50 per cent is too liberal. Imagine paying 50 per cent of your income for loan repayment, especially for the poor, where we expect the survival expenses to be a significant proportion of the income. This limit is an invitation for household financial stress.

In a welcome move, the RBI changed the definition of an MFI to have only 60 per cent of the loans under the above definition. The other 40 per cent could be diversified. This is an acknowledgement that there is limited growth in microfinance loans without further inducing stress. The definition helps in diversifying the MFI balance sheet. However, as the operating model of MFIs remains unchanged, they end up deploying the residual 40 per cent of the loans to the same category of borrowers and in the same geographies, where borrowers fail the income test.

The recent announcement of the revised credit-guarantee scheme by the Union government solves an imaginary problem. For a sector with a three-decade track record and with publicly listed companies operating, getting finance to lend should not be a problem. If it is, then it is an indication that the demand system is broken. The credit guarantee imagines that the demand system is not discovered, which is fallacious.

The diversification of the MFI balance sheet should address the segment above microfinance and below micro, small and medium enterprises. This segment is financially literate, somewhat included, but is unable to get meaningful finance. These are a smaller subset of graduating microfinance borrowers looking at a larger enterprise that needs capital investment, assessment of cash flows and longer tenors. These will need finance at lower interest rates, without the borrower having to attend group meetings. This is meso-finance and the policy, as well as the business architecture, needs to reimagine this segment rather than flog the extant microfinance model.

As for the microfinance business, the writing on the wall is clear. This model works, but at a modest growth rate. With the current inflation rate and an economic crisis looming, similar issues will crop up again. Our experience shows that the poor and the vulnerable, and the informal sector get hit first and because of the nature of informality, they do not get counted. Their recovery is bound to be slower.

The next innovation has to be on reimagining savings to create internal household buffers than external props. This is also a warning for data-based, supply-driven lending models. Watch out for the next crisis in fintechs, which are also supply-side players lending on the basis of data without a client interface.

The author is professor, Centre for Public Policy, Indian Institute of Management Bangalore



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M S SRIRAM