Microfinance Institutions and Priority Sector Credit: Strange Mix up

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While the banks in India have been lending to the priority sectors since the late sixties, as directed by the regulator of the banking sector, the Reserve Bank of India, Microfinance Institutions (mFIs) are the new entrants. Entering into the banking sector during the liberalised era of Financial Sector Reforms, they have a free play, remaining beyond the realm of the regulator.They came, they saw the fortune below the pyramid of poverty and they conquered the gullible poor. The speed with which some of them have made inroads into the credit-starved segments, have inevitably met with fatal accidents. When the Government of Andhra Pradesh sought to regulate them, the facade was dismantled and the real picture emerged.

It appears that the obsession to attain the targets prescribed for credit to the priority sectors has thrown into winds the basic tenet of priority sector lending to the poor ***at reasonable rates of interest.*** In the initial stages of introducing directed credit, the lower interest prescription for these loans was followed religiously. The planners and the regulators were consciously adopting the low interest rate pattern for the borrowers under the priority sectors until the entry of mFIs into the rural credit scene. Monetary pundits, who were decrying the exorbitant interest rates charged by moneylenders, now quote market theology to justify the high rate of interest charged by mFIs.

The Report of the Committee to Re-examine the Existing Classification and Suggest Revised Guidelines with Regard to Priority Sector Lending Classification and Related Issues (chairman: Sri. M V Nair) has tried to justify the practice of classifying the advances made by banks to mFIs for on lending as priority sector advances. Falling in line with the current situation, the Committee has stated its stand as follows: "Bank credit to Micro Finance Institutions extended for on-lending to individuals and to members of SHG,s /JLGs are eligible for categorization as priority sector advance under respective categories, *viz* agriculture, micro and small enterprise, and micro credit (for other purposes) provided not less than 85 percent of the total assets of mFIs are in the nature of 'qualifying assets'. Further, at least 75 percent of the total loans given by mFIs should be extended for income generating activity". The pricing guidelines prescribed for mFIs include the following: Margin cap at 12 percent, processing fee up to one percent of total loan, interest charge capped at 26 percent to be calculated on a reducing balance basis and insurance premium as per IRDA guidelines.

The mFIs are obtaining loans from banks at 10 to 12 percent and are duly permitted to

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charge 36 to 46 percent to the ultimate borrowers according to the above prescription. And the lending banks merrily classify such advances as priority sector advances. This has the tacit approval of the regulator as there is no legal framework to regulate the working of mFIs. The procrastination on the part of the Government of India in passing an appropriate act adds to the misery of the poor borrowers. Besides the banks, there are 'angel investors' who have vested interest in perpetuating the high interest regime of mFIs. Exploitation of the fortune below the pyramid goes on unabated. Prof. Prahlad's dictum is twisted to as- "eradicating the poor through profit". Instead of lending to the poor through the sophisticated mFIs, it would be better to lend through the gramin banks, which have already established strong rural credit delivery base. It would be cost-effective, scalable and sustainable.

Micro Credit: Painkiller? Not Permanent Cure?

It is necessary to examine as to whether micro credit could be a permanent cure for eliminating the sufferings of the poor. MFIs tend to propagate a view that they are eradicating poverty through the micro credit that they lend. The success story of Grameen Bank of Bangladesh is often quoted to justify this stand.

In an interesting article *Grameen and Microcredit: A Tale of Corporate Success,* Anu Muhammad (2009) has presented the other side of the story relating to the much-talked about Grameen experiment and the proliferation of micro credit institutions in Bangladesh. Duly recognising the pioneering role played by the Grameen Bank, it is argued that "The model created a good opportunity for expanding the market for finance capital, thereby ensuring GB's spectacular success. However, it failed as a tool for poverty alleviation and empowerment of women". The pathological symptoms of poverty are too deep-rooted to be cured by small doses of credit. Micro credit may provide temporary relief like the painkillers but may not give permanent relief from the pains of chill penury. The high cost of the capsule adds to the patient's misery, though the vendors refuse to accept the empirical results. This in brief is the line of argument, which is very cogently presented. The article breathes fresh air into an arena, where the rules of the game are decided by the stronger players, ostentatiously for the benefit the poor. It is better to concede the ineffectiveness of micro credit ***alone*** in eradicating poverty. The proponents of some of the financially successful micro credit institutions in India, who boast of raising poor women above the poverty-line, should take note of this revelation.

Grameen Bank in Bangladesh has become a financially viable model, not necessarily because of its social objectives. One among the many such objectives is promoting credit as a human right. A laudable objective it is, no doubt. Corporatisation of grameen bank projects was the major factor, which has contributed to the profitability of Grameen Bank. As many as 21 independent companies were promoted by it. The most profitable among them is Grameen Phone, which has

grown as the largest mobile company in Bangladesh. Over 3.49 lakh borrowers of Grameen Bank were given loans for purchasing GP mobiles, with Nokia being the sole beneficiary. Prof. Muhammad Yunus is quoted to have declared that, "according to Grameen Bank's own internal survey, 56% of its borrower families have crossed the poverty line by 2005". In the real economic situation, for thousands of poor families, crossing the ubiquitous poverty line at one point of time does not mean a permanent elevation to the ***not poor*** category. Drifting below the poverty line is a common feature for thousands of poor families subsisting at the margin. How many out of the 56 percent of families rising above the poverty line are able to remain permanently there is a million dollar question. The author reports that only 2.26 % of the branches of Grameen Bank have reported that all their borrowers have gone above the poverty line. Quoting another study of 1997, it is observed that less than 5% borrowers could lift themselves out of the poverty line. Sustainable development in the income generating activities is very difficult to achieve in a short span of time. And certainly credit alone is not the engine to facilitate this process.

Myths built around mFIs

The mFIs have successfully built many myths around their propensity to help the poor to prosper as indicated by the very high repayment culture. The higher recovery performance is not because of the improvement in their income. The former chairman of one of the public sector banks, Sambamurthy (2011) explodes many such myths. He strongly argues, "Higher repayments hide more than they reveal. There is no measurable connection between success of micro enterprise and high repayment. This is more due to the devious contractual structure, namely, group collateral and multiple borrowings. More often than not the poor take fresh loans to repay earlier loans and are awash in debt. There is a huge disconnect between repayment and development as the poor have fall-back strategies to repay micro loans and also the ingenious social collateral designed by the mFI to take care of likely failure of micro enterprise."

Distortions of the interest rate structure in India arising as a result of deregulation, in practice turned out to be biased against the small borrowers compared to the big borrowers. Micro-finance institutions were permitted to operate without any restriction on the interest rates charged by them. Exploitation of the poor borrowers started taking place, when the regulator became totally indifferent. When the banks were directed to lend at rates in the range of 10 to 12 percent, mFIs were charging 36 to 40 percent. Very conveniently it was argued that this rate of interest was still cheaper than that charged by the moneylender. Replacing the traditional moneylenders, the mFIs started operating like very sophisticated players but exploited the poor borrowers unquestioned.

An economy like ours, no doubt, needs multiple credit agencies to operate in the rural sector. But they cannot be allowed to exploit the poor. ***If they cannot afford to be cost-effective credit agencies, they have no right***

to operate in rural areas. A five star hotel cannot serve a cup of tea at a price lower than Rs.25 or more. It need not go to rural area to serve. What is needed in the rural area is a clean dhaba selling tea at Rs.2. Does not one of the giant Indian MNCs operating in the FMCG segment, sell small crisp biscuit packets at Rs.2 in the rural market? A popular hotel in Bangalore promoting a ready- made food unit has started selling pickles in small sachets for one rupee, fulfilling the felt need of the labour class very satisfactorily. Little sachet of pickles adds spice to the dry roti the hungry labourer eats for his lunch. It is a win-win situation.

Mega Bucks in mFIs:

The process of globalisation and commercialization of micro credit has become a universal phenomenon. Mega bucks from the global financial markets are flowing into the poorer countries, where the demand for micro credit remains insatiable. Fortune-hunters are digging under the pyramid, replacing the rapacious village money-lenders. There are angel investors too willing to lend huge amounts to mFIs in India also. They naturally expect high returns on their investments.

There are many religious institutions having huge surplus of money accumulating because of the offerings made by devotees. If a part of such funds are kept as deposit with gramin banks, they could serve a large number of credit-starved poor customers. Take the case of a gramin bank in Chittoor district in Andhra Pradesh.Religious munificence has elevated Tirupati, one of the most popular pilgrim centres in Andhra Pradesh into a major deposit centre. The offerings made by innumerable devotees thronging to the abode of Lord Venkateshwara, from all over the country, have made it the richest temple in India. Tirumala Tirupati Devastanam Board is the major depositor in this temple town. There are 72 branches of almost all banks in the town, having deposits of Rs.6,554 crore as on September 2011. The annual growth rate of deposits is as high as 30.8 percent. The growth in deposits has enabled Tirupati town to improve its rank to 68th among the top 100 banking centres in India.

Chittoor district, in which Tirupati is located, is an agriculturally prosperous district, where 340 branches of different banks are functioning, including 91 branches of Saptagiri Grameena Bank. The total deposits mobilised by all these branches are Rs.14,184 crore, over 45 percent of which are originating from Tirupati town alone. Incidentally, Saptagiri Grameena Bank is operating with a credit-deposit ratio of 119 percent, unlike the other commercial banks. Its total deposits are Rs.1852 crore and advances are Rs.2213 crore. Lending at interest rates prescribed by the Reserve Bank of India, it could earn a net profit of Rs.56.84 crore during FY2012. ***With a little more benevolence of Lord Venkateshwara – like placing more deposits with this Bank - the grameena bank would be able to reach out to more small borrowers in its area of operation in Andhra Pradesh***. And this task it can easily accomplish, compared to microfinance institutions, which are struggling to survive in the state. Grameena banks are

the best suited rural credit agencies in the Indian context. (Thingalaya, 2007).

Regulating mFIs:

There have been deliberations about the need for regulating the activities of mFIs since long. Recently Microfinance Institutions (Development & Regulation) Bill was reported to have been cleared by the Union cabinet. "The Bill provides for regulation of MFIs' services, such as micro-credit facilities, thrift, pension or insurance services and remittance of funds, and prohibit MFIs from carrying on activities without registration with RBI," The Bill is yet to be passed.

Till recently, the banking sector in India was operating under the highly regulated interest rate structure prescribed by the Reserve Bank of India. As far as the interest rates charged by mFIs, the regulator does not appear to be interested in regulating them. The angel investors' lobby perhaps has something to do with this dis-interest. The regulator may be conveniently adhering to the market theology. Nobody ever cares to talk about affordability of the borrowers.

If the banks continue to extend credit to the mFIs, there is nothing wrong in it as a business proposition. But to classify such advances under priority sector would be sacrilegious. Charging very high rates of interest to the small borrowers militates against the very conceptual frame of priority sector credit. Originally, a few sectors of the economy were accorded priority status, based on their strategic importance (like agricultural sector or small scale industries) or for welfare considerations (small borrowers, landless labourers self employed persons). Secondly, banks were directed to lend a stipulated percentage of their advances to these sectors. Thirdly, it was stipulated that these segments should be given loans at affordable interest rates, which were prescribed by the Reserve Bank of India. Over the years, the coverage of the sectors under the priority category was increased, the lending targets were gradually revised upwards but the differential rates remained with some modifications, even when the total interest rate deregulation took place. To be qualified for the priority credit label, the credit extended to the small borrowers should carry reasonable rates of interest.

Tail piece

Recently while in the Nilgiri district in Tamil Nadu on a lecture programme on Financial Inclusion, I came across a very interesting saying on rural indebtedness, popular among the Badagas. It says: the burden of debt is head load while the interest burden is cart load.

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