

The Need for Individual Lending in Mature MFIs

The intended outcome of any microfinance program is the improvement in the economic status of its clients. Impact studies have provided mixed results about the actual outcome; however, that at least a considerable section of the clients have graduated from smaller loans to larger loans is unquestionable. This leads one to the stark differences in the loan demand between clients in a single joint liability group. The risk associated in standing guarantee to a loan of Rs. 25,000 is far more than that associated with a loan of Rs. 5,000. So, group guarantee actually builds up a natural threshold on the loan amount within a group. This forces those clients with larger demand to either look for additional sources for credit—which unfortunately still happen to be the money-lenders whom microfinance programs intend to replace—or settle for a status quo in their livelihood status. As such clients are never a majority, even microfinance institutions (MFIs) also find it difficult to cater to the entire loan requirements of these “big-ticket” clients and are forced to put a formal or informal cap on the loan amount that can be disbursed per client.

However, as microfinance is entering the mainstream financial services market, product diversification has provided answers to this situation. Mature clients with spotless credit history and with demonstrated business aptitude can now benefit from a new methodology: individual lending. Individual lending is “the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment” (Ledgerwood, 1999, p.83). This model provides credit access to individual borrowers who are selected on an individual, discretionary basis and often have at least some small form of fixed assets or income. The Bank Rayat in Indonesia and ADEMI in the Dominican Republic (an ACCION affiliate) are institutions that have adopted this approach successfully. Each loan is specifically tailored to the individual and business involved. This approach tends to work

best when used with larger urban businesses or small rural farmers, since collateral is generally required. Also, the personal nature of the relationship between the bank and the borrower often results in repeated transactions over a long period of time. However, the problem of lack of asset collateral still remains unresolved in the case of this product. A novel approach combining the credit history of the client (which includes the experience of the field staff with the clients) and a thorough cash flow analysis of the intended income-generating activity has been adopted to replace the asset collateral. As MFIs are becoming older, there has been an increased need for designing such products for their mature clients. The MFI performs a thorough analysis of every potentially funded business venture. Borrowers receive loans based on past performance, credit histories, viability of business propositions, and references. To encourage repayment, borrowers provide collateral and/or co-signers. Credit officers have close long-term relationships with clients. The individual approach is most commonly associated with commercial banks. Successful individual micro-lending programs are usually highly modified variants of systems employed by commercial banks. Individual lending has been applied most successfully to urban clientele.

Group lending models have found considerable success in serving clients that are just starting very small businesses (typically with no employees but themselves). But the programs tend to impose limits on wealthier borrowers. As a result, both BancoSol and the Grameen Bank have abandoned group lending for their wealthier and most-established borrowers, and this turn toward individual (lender-borrower) contracts represents the leading edge of a growing split within the microfinance movement.¹ The trend is also very clear in Eastern Europe and Russia. For example, Opportunity International’s “Trust

¹ Churchill (1999) describes early experiences with individual lending in the microfinance context. It is especially notable that members of the ACCION International network, among the earliest practitioners of group lending in Latin America, are now turning steadily toward individual lending.

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Microcredit Product: An Action Research on Fixed vs. Flexible Repayment Schedules

Are MFIs too rigid with repayment schedules on loans? Loan-defaults have been noticed time and again in borrowers engaged in seasonal enterprises. Many do not deliberately renege on payments; they are unable to pay back during the lean period, and often dip into their savings and consumption expenditure. Some even find themselves resorting to informal creditors. Can MFIs then allow more flexibility?

KAS, an MFI that operates in the states of Orissa and Chattishgarh, faced problems of repayment from its clients engaged in dairy-related enterprises, especially in Orissa, where dairy is a primary livelihood option second only to agriculture. Cattle do not yield milk when they are calving, so how do clients pay back in the lean period without dipping into their savings?

KAS Foundation's clients also have a range of livelihood options comprising of usual activities of agriculture, dairy, micro-enterprise, and short-term business which allow them to exploit time utility (purchasing at lower prices and selling at higher prices later), form utility (engaging in peeling or other forms of non-timber forest products), and place utility (purchasing at one place with surplus and selling at places with scarcity at higher prices).

The capital required for these short-term activities is very low (from \$ 4–\$40) and the return can be as high as 100% within a three-month time-frame. Therefore, it is possible that if KAS exempts clients from monthly repayment obligation during that time, clients might be able to undertake some of these income generating activities; KAS Foundation's recovery performance will not be impaired.

Bearing in mind the lean season challenge and the income generating opportunity, KAS Foundation, in collaboration with Prof. Sendhil Mulainathan (Harvard University) and Centre for Micro Finance, Chennai, has started a two-year action research project to study the impact of specially designed repayment schedules for dairy clients organized in self-help groups (SHGs). Because of the varied socio-economic conditions of clients even at the group level, it makes more sense to tailor repayment schedules to individuals rather than groups. How then could group solidarity be preserved? The challenge lay in allowing individual flexibility yet maintaining common features and rules for everyone in the group.

Banks" for poorer households in Macedonia, Bulgaria, Croatia, Romania, Poland, and Russia remain committed to group lending practices, with clients in this niche typically starting with loans well under \$1,000. Opportunity International's programs for the less poor, however (as well as programs supported by the European Bank for Reconstruction and Development (EBRD) in Russia, Kazakhstan, and Bosnia), have embraced individual-lending as a core component of micro-lending.² Uncollateralized loans in this niche begin at about \$2,000 and average around \$5,000. The experiences suggest that in areas that are already relatively industrialized, the group lending model may be a poor fit for potential clients. At the same time, the experiences with group lending offer important lessons for the design of individual-based credit contracts even for wealthier clients in transition economies (Morduch & Aghion, 2000).

Effective individual lending models across the world have the following characteristics: guarantees of loans by a co-signer or through collateral, screening of borrowers by credit check/character reference, fitting loan size to business needs, increasing loan size over time, average loan amount larger than group loans, close personal relationship with individual clients, frequent, close contact with individual clients, long period of time spent with individual clients, loans largely for production.

The ability to secure collateral helps the individual-based programs, and the success of microfinance programs in general (individual programs in particular), is also linked to particular methods of gathering information, monitoring loans, and enforcing contracts (Morduch & Aghion, 2000). With regard to information gathering, the Russian micro-lending program relies heavily on staff visits to applicants' businesses and homes, rather than just relying on business documents (Zeitinger, 1996). In rural Albania, applicants must often obtain a loan guarantee and character reference from a member of the local "village credit committee." Thus, even where group lending is not used, novel mechanisms are in place to generate information. Documentary evidence tends to be deemphasized relative to standard banking practices and local character assessments gain prominence.³ Still, while good information gathering is a necessary condition for the success of microfinance programs, it is

not sufficient to ensure contract enforcement and prevent strategic default. Even if loan officers do a good job of eliciting information at the screening stage (before the loan is given) and at the monitoring stage (after the loan is made), loan officers still face the problem of enforcing debt repayments once the returns on borrowers' investments have been realized. To get around the problem of enforcement, nearly all microfinance institutions rely as well on dynamic incentives (Morduch & Aghion, 2000). These mechanisms complement the use of social sanctions in China and of collateral requirements in Russia and Albania. Dynamic incentives boil down to the threat not to refinance a borrower who defaults on her debt obligations. The threat is enhanced by promising to extend steadily larger loans over time to good customers. Because borrowers typically desire larger and larger loans, the promised increases enhance the borrowers' loss from being cut off. However, when there are multiple lenders in the same geography, this practice of dynamic incentives may not have its intended outcome.

In India, the preferred form of micro-finance loan is group lending. According to a study by Sa-dhan (Industry Association of Community Development Finance Institutions in India), only 7 per cent of micro-finance loans in India is to individuals. Many of the large micro-finance institutions provide individual loans to clients who have a track record and have improved their economic status; the provision of individual loans to first-time borrowers is not common.

How can lenders give collateral-free loans in the absence of group lending? One approach is to take non-traditional collateral. For example, the lender may accept the borrower's degree certificate, driver's license, marriage certificate and such other documents as collateral. The logic here is that what matters most is the value the borrower attaches to losing the item than what the lender expects to recover from selling them. Bank Rakyat Indonesia, a leading name in micro-finance, uses this technique effectively. Another way of reducing credit risk in the absence of collateral is to insist that borrowers demonstrate habitual savings for a certain period before a loan is sanctioned. The SHG-Bank Linkage model, India's homegrown micro-finance model, uses this technique in conjunction with group lending. In the case of MFIs using the JLG or Grameen model, legal structures (eg: NBFCs) enforce a ban on collecting savings. However, innovations like the Banking Correspondent model provide options for MFIs to collect savings under the principal-agent model with MFIs collecting fees for delivering the services of savings. The financial and legal implications of

2 Opportunity International has been a leading microfinance provider in Eastern Europe, serving just under 90,000 clients in 1998

3 Churchill (1999) describes similar monitoring and information-collection mechanisms in individual lending programs run by the Alexandria Businessman's Association in Egypt, ADEMI in the Dominican Republic, the Cajas Municipales of Peru, Financiera Calpiá of El Salvador, and the Bank Rakyat Indonesia.



becoming a Banking Correspondent need to be fully understood from certain organizations that have taken up this agency role before making it a widely acceptable model.

Individual and group methodologies require different operational and financial structures. The choice of structure is based on organizational goals, profitability objectives, and risk tolerance. Individual lending and group lending have different cost structures. For instance, because of the increase in loan amount per client, some of the administrative costs on a per client basis would be lower; however, due to increase in the due diligence and monitoring costs which get translated into decreased case load per loan officer, costs on personnel might increase. Individual lending requires careful analysis on behalf of the lending institution prior to fund disbursement. Evaluating the loan proposal and defining the terms for each particular client, which may take considerable amount of time, is costly to the MFI. Add to this the increase in risk for the MFI, there would be an increase in the Loan Loss Provisioning resulting in reduced profitability. Even from the strength of the social capital perspective, empirical results (Paal & Wiseman, 2006) have shown that lenders can earn higher profits by offering joint liability contracts as compared to individual liability contracts.

The main challenges in the Indian context for individual lending happen to be introducing non-traditional collateral mechanisms, training the field officers in the skills required for a cash-flow-based business appraisal and designing appropriate cost structures to make such new products into sustainable revenue models. Even operational models would be very different for different contexts. For instance, an MFI operating in a relatively poorer and entirely rural geography might not have the numbers to operate separate branches for group loans and for individual loans whereas, an MFI operating in a semi-urban or a densely populated area can

have separate branches for group loans and individual loans. Despite the challenges for individual loans in the Indian context, the need for such a product seems to be higher amongst the mature clients. The entire mature clientele may not require individual loans, but even if only a quarter of such mature clients graduate to individual loans, which normally are

double in amounts to group loans, it would be a good business proposition for the MFI. If the objective of microfinance is to provide financial services to those not within the reach of the mainstream financial system, then individual lending might become important for MFIs as even these relatively bigger ticket loans cannot be provided by the mainstream institutions because of their lack of reach to the individual client level.

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the rain fails, the households suffer: not only do their own lands yield less, but they may have difficulty finding work near their village, since other farms are also suffering. Traditional methods of coping with risk, such as borrowing from nearby friends or relatives, may be less helpful when everyone is in the same predicament.

In cooperation with ICICI/Lombard, the Self-Employed Women's Association (SEWA), in Gujarat, has begun to help farmers by offering them insurance against poor monsoons. We are currently in the middle of a study involving 100 villages to assess the potential benefits of rainfall insurance.

Without insurance, a failed monsoon may force a household to sell productive assets, forgo medical care, or reduce food consumption. Moreover, anticipating this vulnerability, households may shy away from planting high-yield crops which produce more but are more vulnerable to rain shortfalls.

For decades the government has attempted to protect farmers against weather risk by offering crop insurance. Indeed, many government banks require the purchase of crop insurance as a condition of providing an agricultural loan. Yet, few are eligible to purchase the insurance, and those who do, often receive payments only years after their loss.

Private insurers have been reluctant to insure individual farmers' crops. It is very expensive to pay someone to measure the extent of crop loss of an individual who has planted only an acre of land. Insuring private crop loss is difficult: companies attract households with the lowest land quality, and the fact that the crop itself is insured may reduce farmers' willingness to spend money or resources to ensure the highest possible yield.

Recent innovations in the insurance sector have led to the development of rainfall insurance which may dramatically improve the livelihoods of rural poor (both farmers and landless laborers) by substantially reducing their vulnerability to adverse weather conditions. For several years, BASIX, a microfinance institution based in Hyderabad, has offered weather insurance to its clients, and these policies currently reach thousands of households.

Rainfall insurance policies, including those offered through SEWA, are based on measurements from an official rainfall station located close to a farmer's land. The insurance policy pays the farmer a specified amount of money if there is a rain shortfall, and the payment increases with the severity of the shortfall. This

Rainfall Insurance

Over 500 million people in India rely on agriculture as a main source of income. While some have access to irrigation, the quality of the monsoon is still tremendously important. When

To help design the dairy loan products, CMF conducted one month of focus-group discussion market research among KAS Foundation's dairy clients. Based on the findings, two products were recommended. Both products are INR 6,000 (\$133) loans of 24 months loan tenure at 10.75% annual flat interest rate.

The first product, Dairy Research Advance Payment (DRAP), is implemented among 50 groups. Clients need to repay two principal installment and one interest installment in the first six months. After six months, as clients have already prepaid six additional principal installments, they have the opportunity to skip any six principal installments in the remaining loan tenure. While designing this product, there is no attempt to link loan use with repayment liability. Assumptions are that (i) repayment will come from "household income" not from "asset purchased with loan" alone and (ii) clients should have enough disposable income in the first six months; since the lactation period for most cattle lasts for six to nine months after purchase, clients will surely have enough disposable income from dairy and other household income.

The second product, Dairy Research Coupon Based (DRCB), is also implemented among 50 groups. At the time of disbursement, clients are provided with a booklet containing 24 monthly principal installment coupons and 24 monthly interest installment coupons. In first three months, clients need to make mandatory monthly principal and interest payments. After this, clients make mandatory monthly interest payments, but the client can lag behind two principal installment obligations. This lagging behind can take following forms:

- » Two consecutively skipped principal installments
- » Two consecutively skipped principal installments, then in the subsequent third month, repayment of one additional principal installment along with the obligatory principal installment for that month. The client will lag behind by only one principal installment while maintaining regular payments for the coming month. In this case, the client again can skip one more installment in following months. The client will then be lagging behind by two principal installments.
- » One skipped principal installment in any month, followed by regular repayment; clients still need to compensate for this missed installment. Even with one skipped principal installment, the client can skip one more installment as long as they do

solves the problems of high transaction costs—the insurance policy pays if the official weather station reports insufficient rain—and also eliminates adverse selection and moral hazard.

Yet merely offering a product to farmers and agricultural laborers does not guarantee that they will take it. Financial contracts are complicated, and it can be difficult for a farmer to understand why she should spend money now to get an uncertain payout in the future.

Indeed, our survey in three districts of Gujarat found that SEWA members had very low levels of financial literacy: when given a short test that included questions about risk, inflation, and interest rates, members scored on average no higher than the would have simply by guessing. This was despite relatively high math skills—respondents answered, on average, two thirds of the math questions correctly.

Our ongoing study began with a baseline survey of 1,500 households in 100 villages. SEWA offered rainfall insurance to individuals in 33 randomly selected villages, with 64 serving as a comparison group. Insurance will be phased into these villages at a later date. Of the 500 individuals surveyed in the villages where insurance was offered, approximately one-third purchased insurance.

Preliminary results indicate that rich households and households in which the head of household was literate or educated were much more likely to purchase insurance. Members' attitudes towards risk also mattered. In the baseline survey, respondents played a simple game, which let them choose between "safe" option (Rs. 50 for sure), and increasingly risky options that offered a higher return. Two months after the survey, households who had picked safer choices were much more likely to purchase insurance than those who had selected riskier option.

To improve our understanding of how households think about risk, SEWA targeted different households with specific marketing messages. These messages were randomly assigned. Households that received a flyer emphasizing the benefits of rainfall insurance ("protection against drought") were more likely

to purchase insurance than those receiving flyers emphasizing the potential negative impact of not purchasing insurance ("without insurance, you may be vulnerable to a drought").

The most important question remains unanswered: does rainfall insurance improve the welfare of the households that buy it? In the coming years, SEWA will expand its marketing efforts, target a greater share of the eligible population, and introduce insurance in 33 of the 67 remaining study villages. By carefully tracking households in these 100 villages, we hope to gain a clear understanding of the benefits, and limitations of rainfall insurance.

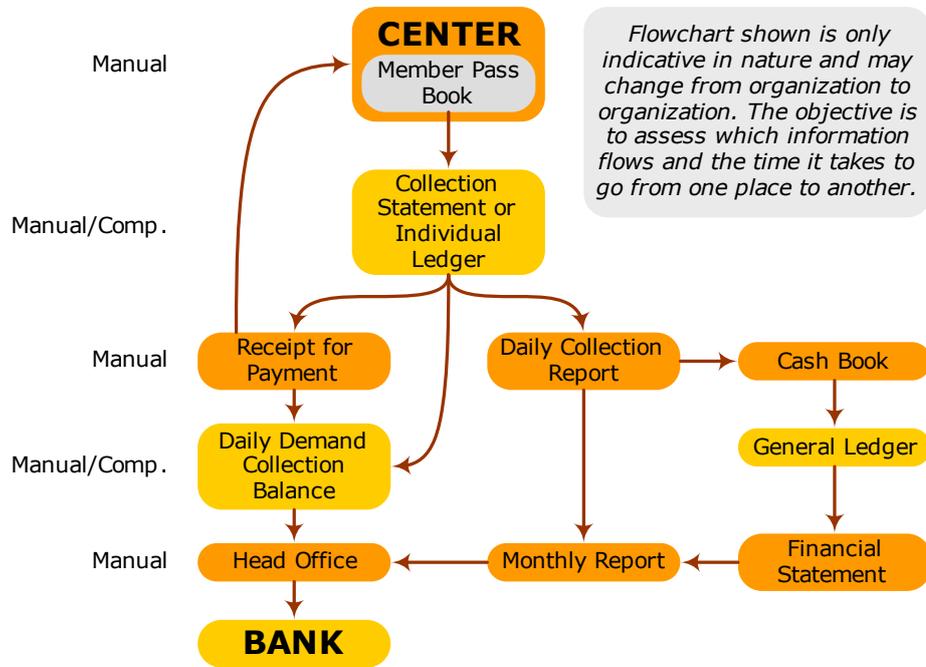
Management Information Systems for Micro Finance Institutions

Microfinance, as its name suggests, is delivery of small packets of financial products translated into large volumes of daily transactions. However, such large number of transactions leads to excess of information flow. Because customer-interface and knowledge are of paramount importance to the sector, efficient handling of this information becomes all the more important to MFIs.

Keeping in view how critical it is to have real-time, accurate, and complete information, Management information systems (MIS) has attracted attention of most MFIs. An MIS is any system that processes raw data into meaningful information which management can use for decision making. MFIs today are bending backwards to redefine their processes, refine their communication, and integrate them with latest technologies. Often MFIs consider MIS synonymous to computers and software. However, in reality computers and software may serve only as a single component in the system. Any soft-



Flowchart : Information Flow in an MFI Branch



ware derives its blueprint from live systems and processes that are being practiced on-ground, thus, unless an MFI, on the ground, has an accurate and timely information flow with inbuilt checks and verification processes, it should not begin to think of computerization. MFIs undertaking computerisation before assessing and rectifying their processes suffer a twin loss in terms of money due to faulty software development or implementation and because of aberrated reporting.

An MFI with “perfect” systems on the ground should always aim for customised software solutions. Computerisation not only eliminates human errors but is also capable of better analytical results. Computerisation also reduces paper work, reduces operational costs, and increases efficiency. However, any technology adoption brings with it a new set of problems. Most MFIs with computerized systems end up creating a separate department to handle hardware or software related problems. Furthermore, effective training is necessary, especially with regards to entering sensitive data.

Depending on the availability of resources—particularly labour and funds—and long term planning, an MFI may need to decide whether it wants to adopt a computerized solution or a manual solution for record-keeping. Most of the MFIs currently maintain parallel systems of information to reduce their dependency on software generated reports. Besides increasing cost, this raises questions about the credibility or reliability of their software choices.

With increasing stress on sustainability, MFIs are now becoming more concerned about their profitability. Profitability, being a function of portfolio quality, dictates various operational

and administrative decisions taken by any MFI. For example, many MFIs incentivise credit officer’s performance as per the size and quality of portfolio handled. In that case, the MFI’s MIS needs to be able to reliably store data reflecting the true status of the portfolio.

While there may be different approaches for MFIs to judge their MIS, the most effective would be to map pictorially the entire information flow from clients to MFI branches and from MFI branches to their head office, assess the reliability and timelines of data reported, and verify the consistency of data at different levels of consolidation. A typical flowchart is illustrated in the diagram “Information flow in an MFI Branch” on this page.

To briefly summarize MFI operations, all weekly transactions taking place in the center⁴ (portfolio related information) are recorded on the collection statements (also called Individual Ledgers). The data from collection statements flows to General Ledgers on the same day and these General Ledgers form the basis of financial statements and weekly or monthly reports. There are often various levels of monitoring and verification checks—for example, by middle management such as the area manager or divisional manager, by internal audit, or by the head office—to avoid any fraud, mal-data entry, and data mismatch. While these statements are generalized, different MFIs will have different systems for information collection, verification, and reporting depending on the credit delivery methodology, legal status, organisational set-

4 A “Center” is a mutually agreed place where groups (generally consisting of five women each) and an MFI credit officer meet weekly for undertaking various financial transactions like repayments and loan disbursements.

up, and funding requirements. The basic reporting for any MFI revolves around staff reports (attendance sheet, performance report, and work plan), portfolio quality reports, fund requirement report and financial statements.

This structured pictorial representation of MIS would help the MFI to assess:

1. informational gaps in the flow;
2. the rate at which it is able to report data at a required frequency;
3. the exhaustivity and reliability of the data reported;
4. the relevance of data for its reporting requirements (for funders and management).

As already mentioned, apart from the internal relevance of MIS to MFIs, funders, in the broader sense, (equity investors, lenders, donors) are also becoming stringent on detailed reporting. For example, one of the popular modes of lending to MFIs is via the partnership model where the MFI acts only as an agent to the partner bank. Since the portfolio generated under the partnership model is on the bank’s balance sheet, the bank is under obligation to comply with the series of norms prescribed by the regulators.

Some MFIs find it difficult and costly to timely fulfill reporting demands of lenders or investors. CMF is working in close collaboration with MFIs to identify informational gaps in MIS through development of information flow maps. Such a study will help banks better understand the methodologies followed by different MFIs, enabling banks to help MFIs with a series of alternative options for streamlining their operations. Besides providing reassurance to the partner-Bank, it will also serve as a guiding exercise to the MFI for its MIS improvement.

The State of the Sector: A Discussion with Prabhu Ghate



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not lag behind by more than two principal installments.

If clients make up their skipped principal installments, they can again avail the option of skipping principal installments as mentioned above. The client cannot prepay more than two principal installments. This product allows for flexibility at the individual level while remaining easy to administer; in this method of skipping or prepaying principal installments, the client and the loan officer need to only be observant that (1) one compulsory interested payment is made every month; interest cannot be prepaid or skipped, and (2) at any point after the third month, the difference between the number of months remaining in the loan tenure entry in the principal coupon book and the interest coupon book should not be more than +/- 2 months.

DRAP works like a debit card—the flexibility option depends on the performance of the clients in the previous six months. DRCB, on the other hand, works like a credit card—the flexibility option can be availed first, and then the skipped principal installments can be made up. The performance of these two products will be analyzed against the KAS routine product (Rs. 4,000 (\$ 67), 24 months loan tenure @ 10.75% flat per annum interest rate with fixed repayment schedule of principal plus interest per month) and the same KAS routine product but with higher a principal amount of Rs. 6,000 to isolate the effect of the higher principal.

Selection of both the control and treatment groups will be randomized. A baseline household survey will be done to measure the existing conditions, followed by short quarterly surveys designed to track income flows and identify any patterns or logic in skipped principal payments. Larger surveys will be conducted after one year and at the end of the loan tenure.

It can be assumed that products in sync with the client's economic profile will increase product uptake, promote better utilization of the loan, and presumably reduce willful default due to better investment planning by clients. However, movement towards a more flexible schedule could strain the organizational capabilities of the MFI and might lead to increased transactions cost or higher levels of operational risk. CMF will analyze the impact of the two proposed loan products based on KAS Foundation's recovery performance to see the impact of this change in repayment schedule from operational, financial and risk perspective. Findings of this research project will be available by the end of 2008.

Q: You have worked on the issue of informal finance for many years with the ADB. Many people think "MFI" is just a fancy name for a moneylender. What is your view regarding the relative positioning of the MFI and the moneylender?

A: *It is very unfair to regard MFIs as moneylenders for two main reasons. For one thing, they offer credit at much better terms. Secondly, there are very good reasons why many MFIs pick a credit minimalist approach. Doing finance is a full time complicated job and there is a lot to be said about just doing that well and letting others do other stuff (and in no way am I implying that finance is the only thing needed).*

Q: Do you think that MFIs should become a permanent part of our landscape or should we really be concentrating on strengthening our existing formal financial channels—regional rural banks (RRB), cooperatives, public sector banks? What changes would be required in formal channels to make them cater to the poor?

A: *MFIs are to be seen as the last mile—the connecting link to the rest of the financial sector. They've developed technology that banks do not have. If banks get into the business of organising groups and all, they won't be able to do it effectively. The private banks are not doing direct microfinance. Banks are doing bulk financing of MFIs and doing the Partnership Model but no bank is doing direct retail finance. They are not retailing microfinance because of the Prime Lending Rate restrictions (on small loans less than Rs.2 lakh in value). The way they get around it in the ICICI Partnership model is that the interest rates on the lending contracts which is in fact below the PLR is not the final interest rate charged to the borrower. The MFI keeps the difference to cover its own costs. If the PLR restriction were removed and if public opinion could counterbalance the banks charging cost recovery rates, then they could easily make 20% rate loans and pay service fees to the MFI out of that. Until then I see NBFC and NGO-MFI always being around.*

Q: You spent seven months last year working on the state of the sector report for CARE INDIA for which you traveled around the country taking a pulse of the people and work on the ground. What was your take home from that whole process?

A: *It was a tremendously satisfying experience*

and a continuous learning process for me. I was very inspired by action on the ground. Despite all the problems and shortcomings, here was something very very good happening because of civil society. Microfinance is a civil society movement, and a development movement, and a financial movement in that order.

...microfinance is a "co-production" between NGOs, bankers, venture capitalists, trainers, accountants etc...

It was very encouraging to see so many people coming together from all different backgrounds. In a broader sense—and to borrow a term from Ajay Nair's paper on the SHG-Bank linkage movement—microfinance is a "co-production" between NGOs, bankers, venture capitalists, trainers, accountants etc.

Q: You have agreed to write the report again. What is your take on the theme this year and why?

A: *Well, this year we are going to try to build up a basic team of people to do the report every year. One person can't keep doing it every year and it certainly shouldn't be a monograph. It needs to be much broader based so we are trying to rope in more people. We are also trying to cover topics that got left out last year such as impact assessments, urban microfinance, and community based microfinance such as co-operatives and SHG federations. The three core chapters will be the first three chapters—an overview and two chapters to bring people up to date on the SHG and MFI channels. We have not picked any single theme this year. Instead the idea is to complement the first report so that between the first two years, we would have covered most of the important aspects of the sector. We will cover emerging topics like remittances and insurance every two to three years. We also hope to provide up to date statistical information on the sector in every report.*

Q: Looking back, what do you think have been the consequences of the March 2006 skirmish

I think the AP crisis has led to many more positive outcomes than any negative impact it might have been at the time.

between MFIs and state government in Andhra Pradesh over interest rates and unethical practices, and what will be the consequences longer term? Is the crisis over or not? Is such a crisis likely to happen in other states to the same extent?

A: *I think the AP crisis has led to many more positive outcomes than any negative impact it might have been at the time. For example, it expedited the microfinance bill. It also led to first the interim and now final code of conduct*

drawn up by Sa-Dhan. More generally, it lead to much greater awareness and appreciation of the need for the quality of lending administration in terms of transparency in dealing with borrowers, borrower satisfaction and greater borrower understanding of lender practices. I think people are now more aware of the need to try to achieve these things. I do think the crisis is over in the sense that there was no contagion effect beyond Krishna district. Although there is a mixed picture on the extent to which recoveries have improved in Krishna district. Another positive outcome is that all four big Andhra MFIs are accelerating their expansion outside Andhra to underserved areas.

Q: Large corporations such as Reliance and Bharti are looking at microfinance—existing MFIs or setting up new ones—as an avenue to penetrate the rural market both to seek suppliers and customers for their products. In development jargon we would call this the perfect combination of bottom of the pyramid and livelihood promotion approach. How do you react to this news?

A: I think this is an excellent idea. I presume the model they have at the back of their minds is the Grameen one. Perhaps they are planning to assist MFIs to finance larger loans that may be required. I'd like to see more details.

Q: The Ministry of Finance promises to table the NABARD Amendment Act in order to create a single microfinance regulator in this Parliament session. Meanwhile, the Rangarajan Committee on Financial Inclusion is likely to recommend the creation of a new category of NBFCs called MF-NBFC defined as companies providing thrift, credit, insurance, remittances, and other financial services up to a specified amount to the rural and urban poor. They propose such companies should be exempt from state moneylender acts and should be able to receive foreign debt and equity investment from venture capital and mutual funds. Do you think both these proposals adequately fill the present regulatory vacuum? What else do you think should be included in a regulatory framework for mf?

A: I'm very glad to hear the Committee is thinking of recommending creation of MF-NBFCs because the microfinance bill excludes NBFCs. It is very important to allow NBFCs to mobilise thrift. Regulations are far too stringent to allow that because these are regulations are common to all NBFCs and not just microfinance NBFCs. For various reasons, savings are extremely important to MFIs and borrowers. I do hope that

one of these things happens—either the bill is amended to include NBFCs or the RBI should create a new category. NBFCs can already receive foreign debt and equity investments and are already exempt from state moneylender acts. Remittances are missing from the bill but other financial services could be included later. I think the microfinance bill is a great step forward in proposing to allow thrift. The microfinance bills talks about not allowing demand deposits. They seem to imply there is a prudential risk because there could be a run which could create cash management problems for the MFI. But people need to be aware that for the poor especially, the liquidity of savings is very important and the one of the purposes of savings is to have cash available for emergencies. One unfortunate aspect of the

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bill is that it brings cooperatives into its fold and it is unfortunate because it will now require cooperatives to apply for a certificate of registration to take thrift whereas they already do this under existing regulation. This is a step backward for cooperatives. You can argue that NABARD is more likely to regulate them than the existing set up of Registrars but it is going to be a huge task. There are several thousand cooperatives and for NABARD to have to grant certificates of registration to all of them and to monitor all of them is unfair. Some cooperatives are functioning very well. It would be a pity for them to be hamstrung now by having to seek approval. After all cooperatives are mutual institutions which is the justification for allowing them to mobilise thrift from their members unlike societies and trusts. But if the bill were to delete cooperatives then they would miss out on the benefits of effective regulation. Some of the positive aspects of the bill is that it is going to provide for much better reporting, lay down auditing requirements, performance benchmarks and gather data. So all those things are very useful for the sector as a whole and I would like to see everything included whether it is being done by cooperatives or trusts or whoever. The bill should be careful not to affect existing saving activities of cooperatives.

Q: What do you see as the most important challenges the industry will have to face in the next few years? What should MFIs, policy makers and sector-wide players focus on in your view.

A: In the CARE report I highlighted what I think is the most important challenge in the sector. We must create greater awareness of the importance of allowing MFIs to charge cost recov-

In the long run, microfinance as we know it should put itself out of business. That is how you would define success.

ering interest rates. Soon after the report was released, the Finance Minister was quoted in the Hyderabad edition of the Times of India acknowledging this point explicitly talking about MFIs being allowed to do so in other countries. We need that view to filter down to the state level and to the public generally. To that extent, that is still a challenge. But I would now put the main challenge to be capacity building. The need to enhance capacity is a huge complicated task that has to be done by a whole different set of actors. That is the main task for the sector. The sector needs to induct a huge number of professionals at a senior and management level to handle work like MIS, accounts, financial analysis etc. Field level staff can be trained in-house. MicroSave has stepped into capacity building but we need more.

Q: What do you feel are the most important questions that still have not been answered by researchers working on microfinance in India or elsewhere in the world?

A: I think the biggest need is for researchers who are willing to spend a long time in villages and do the kind of detailed work that economic anthropologists do. We need to study the integrated economic system of the household—consumption, production, cash flows. Most of the questions of interest to the sector now can only be answered by careful in-depth field studies. We want to look at questions of equity or loan distribution within SHGs, how do they handle loan disbursement and collection, what is the loan usage, questions of accountability and repayment rates within SHGs. All this can only be answered by people who adopt the methods of economic anthropologists using participant observation and immersion in the field over periods of time. Only this kind of research is going to enable us to understand the economics of the household. How profitable are microfinance clients? How do they manage to sustain the high interest rates we charge them? Would they be able to survive when wage employment becomes more widely available? Are they engaged in so-called inferior activities because the opportunity costs of their labour are virtually nil? We need to understand the behavioural aspects and dynamic workings of joint liability groups and self help groups. In the long run, microfinance as we know it should put itself out of business. That is how you would define success.



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