After the MFI Crisis: Assessing the role of government-led microcredit alternatives

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April 1, 2011

The microfinance revolution that started 30 years ago has resulted, as of last count in more than 3,500 microfinance institutions (MFIs) that collectively serve almost 150 million clients worldwide (Daley-Harris, 2009). Proponents of microfinance claim that by using innovative contract features, such as joint liability, frequent repayments and escalating loan sizes, MFIs have managed to achieve high repayment rates while serving a fraction of the world’s poor. Without proper access to financial services, the poor have to rely on their own scarce resources and uncertain incomes to invest in education, start new businesses or enhance the productivity of the land they cultivate. Underinvestment in these crucial assets tends to keep their overall productivity low, making it very hard for them to escape the vicious cycle of poverty.

The recent crisis in AP, however, has called into question the role that MFIs play in providing access to financial services to the poor. The crisis was triggered by an ordinance promulgated by the government of Andhra Pradesh1 in response to allegations of over-indebtedness of clients due to careless lending practices and rumors of debt-related suicides among MFI borrowers.

While there may be some truth to these allegations, partly a result of the rapid growth that MFIs have experienced in recent years, especially in AP, MFIs do serve an important segment of society, particularly those individuals without assets that can be used as collateral. Repayment rates remain low today and if the recommendations of the Malegam Committee are not

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1 The ordinance required that repayment collections occur at panchayat offices, waived retroactively loans if twice the principal had already been repaid, and required registration of MFIs with district authorities who could, at any time, cancel it.
implemented successfully, the microfinance sector may wither or disappear altogether. If this were to happen, what then are the feasible credit alternatives? And will they contribute to the efficiency of the credit markets for the poor?

Perhaps one consequence of the diminished role of MFIs as credit providers for the poor may be an enhanced role for the government. In order to assess whether this would be desirable, and given its relevance, a closer look at the current evidence regarding the effectiveness of government-run institutions in providing access to credit for the poor is clearly warranted.

In this article we report findings from a survey conducted in three districts in AP in 2007 designed to assess the performance of rural credit cooperatives and in particular Primary Agricultural Credit Cooperatives (PACS). The experience of PACS may prove useful to shed light into the debate about the role of government intervention in access to credit for the poor.

Another government initiative that is often seen as a viable alternative to microfinance, especially in AP, is the SHG model based on teaching community members how to provide and manage financial services among themselves. Poor women come together in a group that meets periodically, each contributes savings to a group account that is then on lent to members. SHG are an example of a “promoter” approach to use the term coined by Stuart Rutherford in his 2000 book *The Poor and Their Money*. Rutherford claims that most poor people prefer to have financial institutions that are professionally managed because of the gains from specialization. The organizational effort required on the part of customers is much greater in community-based schemes. Beyond a certain level of sophistication, specialization becomes a requisite for further development. In his review of the schemes, he finds that loan funds administered by community members without specialized, professional skills tend to have less organized recordkeeping, poorer follow up on loan collection and less robust financial management.

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2 The Malegam committee was set up in October 2010, following the ordinance promulgated by the government of AP. The Committee was tasked with proposing regulations for the microfinance sector to curb issues related to over-borrowing, multiple-lending and forceful recovery methods. The proposals include, among others, the creation of a credit information bureau, the adoption of a customer protection code and perhaps more controversial, a cap on lending rates.

3 Primary Agricultural Cooperative Societies (PACS) are the lowest tier of the rural cooperative banking system. They focus primarily on providing short term (seasonal) credit for agricultural purposes and are regulated by NABARD. According to the Reserve Bank of India, there were 94,942 PACS in 2008, each one serving 7 villages on average, and a total membership of 131 million individuals, 79 million of which borrowers (Johnson and Meka 2010).
Many of the SHGs in AP receive external funding from commercial banks. Repayment of these wholesale loans from banks has been high, although there are some signs of rising default. The consensus among practitioners is that the track record of externally funded groups is quite weak, especially if external funds are associated with donors and the government, considered soft on collection.4

Consistent with this argument, we find evidence that PACS are used as political instruments and that borrowers respond by prioritizing all debt obligations (MFIs, informal lenders, etc) before repayment of PACS loans. This indicates that the culture of repaying government owned institutions may be low and that a private sector solution that is shielded from the government’s interference may be desirable.

The article proceeds as follows. We first describe the data and the sources of credit used by the sample of households interviewed, we then discuss the PACS management practices and the impact of politics in the culture of repayment. Section 4 concludes.

1. Data and Sources of Credit

Our data includes 72 PACS from the districts of Anantapur, Mahabubnagar and Vizianagaram with audited recovery rates as of June 2004 between 25 and 75 percent. We interviewed 1,060 farmers from 106 different villages, of which 847 were PACS members and 213 were non members. The population in these villages is mostly engaged in agriculture (82.6 percent) and only about half of household heads are literate.5 Half of the sample own less than 5.5 acres of land. 6.3 percent of our farmers are marginal farmers (owning less than 1 acre), 40.2 percent are small farmers and the remaining 54.3 percent own more than 5 acres of land. Among PACS borrowers, 8.1 percent are marginal farmers and almost 42 percent are large farmers. Thus, we find little evidence that PACS prioritize marginal and small farmers. This lack of targeting is consistent with cross-country evidence by Beck, Demirguc-Kunt and Martinez-Peria (2008) which find no significant association between greater government ownership of banks and financial access across countries.

4 Murray and Rosenberg (2006) argue that borrowers’ perceptions about the origin of the funds for their loans greatly influence their willingness to repay.
5 We use stratification weights to report population averages.
Table 1 reports the preferred source of credit and actual use by source. One striking finding is the relatively limited role of self-help groups (SHGs) both as the preferred as well as actual choice. The data show that only 6 percent of households have a loan with a SHG and they are almost never the preferred source for credit (less than 2 percent of households rank SHGs above other sources). Marginal farmers exhibit a slightly higher preference for SHG loans than small and large farmers but they end up borrowing the least from this source (less than 10 percent of households). Informal loans, quite surprisingly, are the preferred and used source by a large margin among all groups of farmers. This is probably due to the higher flexibility they offer. Loans from PACS are the preferred source for marginal farmers, and indeed it is the dominant source of credit for marginal and the second source for small farmers, below informal credit. In sum, the larger penchant of marginal farmers for SHGs does not translate into greater access relative to small and large farmers who also borrow more heavily from formal and informal sources.

These differences in lending methodology are echoed in Table 2 which reports the characteristics of loans in the sample by credit source. The main differences in the characteristics lie in collateral requirements, interest rate, maturity and average loan size. Both PACS and formal sources of credit require collateral. In terms of changes in the interest rate, informal loans charge nearly twice as much as loans from PACS and they also have a shorter maturity. The problem with PACS, however, is that the average loan size is smaller (a median of 10,000 versus the 20,000 of informal sources) and their collateral requirement. Indeed, half of the PACS borrowers say they cannot cover expenses in agricultural inputs with a PACS loan plus cash at home. Three in four say they would like to borrow more and most of them also borrow from other sources besides PACS, mainly from informal sources. This is especially true for larger farmers.

2. PACS Management

We have also inquired into the management practices of PACS and the evidence points to a lack of the proper incentives to improve repayment. Secretaries of PACs, for instance, are remunerated by and large using a fixed compensation, unrelated to repayment or other performance measures. Secretaries have on average only 1.5 years of formal education. They
have been trained in accounting for less than two months and they only have an average of three years of experience as accountants. Presidents, on the other hand, have higher qualifications, but secretaries play a more important role in the day to day operations. Perhaps not surprisingly, the quality of record keeping for more than 50 percent of PACS is poor, and only 5 percent of PACS provision loan losses.

Questions in the survey about governance present clear evidence of misalignment between the perceptions of members compared to those of PACS committee members and presidents. The perception of the outside influence is a telling example: between 20 and 30 percent of members consider that admission and termination of members and credit decisions are influenced by outsiders. In contrast, no president or committee member thinks so. In addition, nearly 40 percent of members think that loan decisions of a PACS tend to favor certain members, while less than ten percent of presidents and committee members think so. Respondents are usually skeptical of the motives of PACS management. They believe, with a probability of close to 50 percent, that PACS’s presidents do not look after members’ interests, and they assign a probability of 40 percent to the proposition that the president will abuse his power on his own interest.

3. The role of Politics

A first hint of the potential role of politics comes from looking at the political connections that PACS members and management have relative to non members. The data show that close to 60 percent of PACS members have the same political affiliations as the head of ward member of Panchayat. In the case of presidents or community members, this figure climbs to nearly 75 percent and most committee members have the same political affiliation as the president.

Consistent with this finding, there is evidence that links the behavior of government-run credit providers to the electoral cycle. Cole (2009) for example finds that agricultural credit increases by 5–10 percentage points in an election year, particularly in districts with high level of electoral contestation. This pattern is not found in nonelection years or in lending by private banks. Cole (2009) also shows that this capture is costly as elections affect negatively loan repayment, and election-year credit booms do not increase agricultural output either. An explanation for why government-run lending institutions in India are more generous during elections come from Cole, Healy and Werker (2009) who using rainfall, public relief, and election data examine the
reaction of voters to the response of governments to adverse shocks. They find that voters only
respond to the government relief efforts during the year immediately preceding an election.6

Unfortunately, this culture of subsidies and frequent government reliefs undermines the culture
of repayment as borrowers take advantage of the lax enforcement of credit contracts. The data
clearly show that farmers anticipate that with probability close to 50 percent, a relief package
that benefits PACS (but not MFI or informal lenders) will be announced in case of a drought.
Since farmers do not benefit from a relief package if they repay the loan before the
announcement is made, all farmers have an incentive to wait (even after the loan due date) until
the announcement (if any) is made.

We also asked farmers about their perceived probability of different events related to loan
repayment, and their answers show similar patterns. For example, farmers perceive that their
loan with a PACS will be rescheduled in the event of a drought with a 70 percent chance, while
this probability drops to 55 percent for Commercial Banks and only 25 percent for MFI. The
same pattern occurs with the perceived probability of loan forgiveness. Besides, PACS appear
more likely to issue loans in amounts lower than requested (the difference between PACS and
MFI exceeds 30 percentage points) and less likely to issue new loans even if the previous ones
were fully repaid. PACS are less trustworthy of savings and more likely to have a share of the
loan deducted as a bribe. Not surprisingly, the loans most likely to suffer from this problem are
those issued by PACS. MFI loans, on the contrary, are the ones perceived as less likely to do so.
There is a nearly 20 percentage point gap between the two loan sources. Besides, loans from
PACS are perceived as less likely to be repaid even if a good harvest follows a drought than are
either loans from commercials banks or MFI.

Finally, respondents answered a hypothetical question that asked to provide a ranking of lenders
they would pay first if they had an outstanding loan from different lenders but did not have
enough money to meet all repayment obligations. As it turns out, PACS loans always appear last

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6 The international evidence show the same patterns. Dinç (2005), for example, shows that increased lending by
government-owned banks right before elections is not specific to India but can be observed in data from 22
developing countries. Khwaja and Mian (2005) also find that in Pakistan, politically connected firms are able to
secure larger and cheaper loans from state-owned banks and default on these loans much more than other non-
connected firms.
in the repayment priority list, behind all other loan types. The first in the list is always a loan from an MFI. The recent crisis in AP reminds us that the high repayment achieved by MFIs through allegedly coercive techniques is very unpopular and counterproductive, but at the other extreme, the frequent announcement of relief measures for political gain is also harmful.

4. Conclusion

If an expanded role for government has to be the solution, we need to be careful in ensuring the effects of government interventions have the intended consequences. It is also important to be realistic in our expectations regarding the role a government can play in broadening financial access for the poor. There is strong evidence pointing to the crucial importance of government institutions regarding the functioning of the financial sector in general and access to credit in particular. However, instead of replacing private agents in the market, governments can make a more valuable contribution in securing an adequate environment for private credit institutions to flourish and to improve institutional mechanisms in ways that further the availability of credit to poor individuals. The range of policies that would contribute to this goal goes beyond the extent of this article: building these institutions involves decision-making with long time-horizons, and the guidance provided by existing research is only partial and incomplete. We have, however, some good indications on where the right path might lie. Providing good institutions, such as efficient, speedy and fair courts is an area where only the government can play an active role. Also, governments can provide much needed registries of credit information, liens and property ownership. Reliable legislation that defines the rights and responsibilities of companies and financial institutions and, in general, reducing contractual uncertainty and ambiguity are all crucial parts of the financial infrastructure most conducive to broadening access to credit.

Reforms in these areas may be difficult to accomplish in the short term, but there are many other dimensions where progress comes at lower costs: Djankov, McLiesh and Shleifer (2007) use a panel of aggregate data for 129 countries over 25 years to confirm that creditor rights and the existence of credit registries (public or private) exhibit a strong correlation with higher ratios of private credit to GDP. Interestingly, the information infrastructure (for instance, credit registries) matter relatively more (compared to creditor rights) in poorer countries than in rich countries.
The experience of India in the 1990 also gives insights into ways the government can work to ensure access to credit is available to those who need it the most: Visaria (2006) shows that the new expedited mechanism introduced there for loan contract enforcement resulted in a sizeable increase in loan recoveries, as market participants were able to bypass the inefficient court procedures then in place.

Also, consistent with the evidence we presented in this paper, Caprio and Honohan (2004) argue about the importance of ensuring the independence of bank supervisors from the political sphere, and of the supervised entities themselves, in order for banks to promote social welfare and not their own or that of the officials.

In sum, in this paper we have provided some evidence showing that government controlled PACS (and SHGs) suffer from weak governance and poor management and will continue to be captured by politicians. This evidence is consistent with cross-country evidence that emphasizes governance and institutional issues as critical in explaining differences in the performance of public sector interventions.

Some of the recommendations of the Malegam Committee are a step in the right direction to restore confidence in the microfinance sector but it is critical that the details are worked out and they are properly implemented. If not, we risk that the ordinance promulgated in AP will inflict lasting damage to the repayment prospects of all loans, worsening the credit prospects for everyone, especially the most vulnerable.

References


Loan Characteristics

<table>
<thead>
<tr>
<th></th>
<th>PACS</th>
<th>SHG</th>
<th>Formal Sources</th>
<th>Informal Sources</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of Loans since April 06</td>
<td>861</td>
<td>175</td>
<td>454</td>
<td>1,051</td>
</tr>
<tr>
<td>Median Borrowed Amount</td>
<td>10,000.00</td>
<td>7,000.00</td>
<td>20,000.00</td>
<td>20,000.00</td>
</tr>
<tr>
<td>Mean Borrowed Amount</td>
<td>15,734.30</td>
<td>8,725.14</td>
<td>44,564.98</td>
<td>26,522.36</td>
</tr>
<tr>
<td>Std Borrowed Amount</td>
<td>29,993.24</td>
<td>6,871.54</td>
<td>141,475.30</td>
<td>40,678.09</td>
</tr>
<tr>
<td>Maturity (Months)</td>
<td>24.32</td>
<td>14.80</td>
<td>15.55</td>
<td>17.11</td>
</tr>
<tr>
<td>Annual Interest Rate (%)</td>
<td>16.85</td>
<td>19.07</td>
<td>20.10</td>
<td>31.71</td>
</tr>
<tr>
<td>Pct. of loans that require Physical Collateral (%)</td>
<td>98.14</td>
<td>4.00</td>
<td>91.41</td>
<td>8.09</td>
</tr>
</tbody>
</table>

Formal Sources includes Basix / Bartiya Samruddi / KBS Bank or NGO, commercial banks, rural bank and government bank. Informal Sources refers to friend/relative, local money lender, landlord/employer, local grocery store, pawn broker and others. Physical Collateral includes land, house, gold, crops or livestock (the rest of loans required guarantor, fund-savings or other collaterals).

Table 3

Perceptions on credit and repayment

<table>
<thead>
<tr>
<th>Perceived probability of ... (1 to 10)</th>
<th>PACS</th>
<th>Comm. Bank</th>
<th>MFI</th>
<th>PACS - Comm. Bank</th>
<th>MFI</th>
<th>PACS - MFI</th>
<th>Comm. Bank - MFI</th>
</tr>
</thead>
<tbody>
<tr>
<td>Repayment rescheduled if drought</td>
<td>6.986</td>
<td>5.552</td>
<td>2.425</td>
<td>1.434***</td>
<td></td>
<td>4.561***</td>
<td>3.127***</td>
</tr>
<tr>
<td>Repayment forgiven if drought</td>
<td>6.532</td>
<td>4.696</td>
<td>2.079</td>
<td>1.836***</td>
<td></td>
<td>4.453***</td>
<td>2.617***</td>
</tr>
<tr>
<td>Loan amount lower than requested</td>
<td>6.388</td>
<td>4.996</td>
<td>3.446</td>
<td>1.362***</td>
<td></td>
<td>2.912***</td>
<td>1.550***</td>
</tr>
<tr>
<td>New loan after full repayment</td>
<td>4.756</td>
<td>6.263</td>
<td>6.777</td>
<td>-1.506***</td>
<td></td>
<td>-2.615***</td>
<td>-0.509**</td>
</tr>
<tr>
<td>Share deducted from loan as bribe</td>
<td>4.722</td>
<td>2.889</td>
<td>2.862</td>
<td>1.833***</td>
<td></td>
<td>1.860***</td>
<td>0.027</td>
</tr>
<tr>
<td>Share capital / savings misused and lost</td>
<td>4.677</td>
<td>2.423</td>
<td>3.339</td>
<td>2.255***</td>
<td></td>
<td>1.139***</td>
<td>-1.116***</td>
</tr>
<tr>
<td>Repayment of loan in case of droughts but good harvest</td>
<td>4.656</td>
<td>6.095</td>
<td>6.502</td>
<td>-1.399***</td>
<td></td>
<td>-1.806***</td>
<td>-0.407*</td>
</tr>
<tr>
<td>Rank of repayment of loan if not enough funds to repay all (1 to 3)</td>
<td>2.514</td>
<td>1.876</td>
<td>1.610</td>
<td>0.638***</td>
<td></td>
<td>0.904***</td>
<td>0.266***</td>
</tr>
</tbody>
</table>

* Conditional to have more than one source of credit.