Evaluation of Microfinance Institutions in Varanasi with Special Reference to Client Education

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By

Vinita Kalra and H. P. Mathur

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Dedicated to our parents

Ms. Haribhajan Kaur and Mr. Nirmal Singh
Ms. Shanti Devi Mathur and Mr. Om Prakash Mathur

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Vinita Kalra
H. P. Mathur

EXECUTIVE SUMMARY

The last two decades have witnessed a powerful opening up of the world of microfinance. Beginning in the early 1990s, the development community came to realize that microcredit providers could recover loans provided to poor and low-income people and cover their costs, and thus reach large numbers of people. At that time, donors and microfinance providers alike focused primarily on a single product (credit) for a particular client group (micro-entrepreneurs). Microcredit was delivered mainly by specialized microfinance institutions (MFIs), most of which were non-governmental organizations.

Over time, the notion of microcredit broadened from microcredit to microfinance, and then into the concept of building entire financial systems that serve poor and low-income populations — financial systems that are "inclusive." This new, more ambitious and complex vision has captured the attention of governments, international financial institutions, philanthropists, social investors and mainstream bankers.

For a long time it seemed that microfinance could accomplish social and financial goals simultaneously and without friction. The number of people gaining access to financial services climbed steadily, while microfinance became increasingly commercialized and transformed into a more financially efficient industry. Sustainability of market growth was rarely questioned during that time.

As a consequence of the international financial crisis and global recession, microfinance experienced its first serious setback in 2008, followed by problems in many countries, including India in the past couple of years. The southern state of Andhra Pradesh, the biggest market for the country's microfinance institutions, was at the centre of the storm, and populist moves by politicians led to mass default on loans of more than US$ 1.5 billion.

An examination of the complaints against microfinance industry practices identified three problems: a) mis-selling of micro-credit products, b) usurious interest rates, and c) coercive debt collection practices. From the perspective of financial regulation, these issues pertain to the distribution of credit services by the MFI to the borrower.

Against this backdrop, a shift in the industry is taking place, drawing our attention away from the financial institution and back to the client. Indicators of a renewed concern for clients include the issues of fair and transparent pricing, sensitivity to over-indebted clients and the ethical behaviour of staff. While client protection is necessary to ensure that clients have the information they need to make an informed decision, financial education gives them the competence to evaluate that information. Financial education can reduce the risk of lending, provide a valued service, and support a client-centred approach. Better informed customers will demand more from financial service providers and put pressure on MFIs to improve the effectiveness and efficiency of their operations. This calls for perspicacious evaluation of policies formulated by MFIs regarding client education in terms of its utility for clients, and close examination of the practices of MFIs in order to assess levels of policy compliance. While evaluating, the present work focuses on the efficacy of financial education as a tool to improve client protection, and develops the Microfinance Client Awareness Index to evaluate the factors that impact levels of financial awareness in microfinance clients.

FOREWORD

As competition grows within the microfinance industry, consumer protection has emerged as a critical focus area and there have been concerns related to over-indebtedness, improper debt collection practices and high interest rates. The high visibility and recognition of microfinance ever since the Nobel prize award to Mohammed Yunus in 2006, pioneering the Microfinance Model now to set up of MUDRA, as a development and refinance agency for MFIs and 8 out of 10 SFB licences to MFIs has raised public scrutiny and, hence, the stakes for industry leaders. In today's climate of global economic crisis, timely concerns about predatory lending and profiting from the poor bring attention to the need to endorse and embrace ethical behaviour, particularly among those pursuing a double bottom line.

Although the principles of consumer protection are intended to benefit financial service providers and their clients, the asymmetries between what microfinance institutions (MFIs) endorse and what clients understand have the potential to undermine those efforts. Understanding both perspectives helps identify the potential pitfalls of charging ahead with campaigns to disseminate and operationalize the principles without engaging the consumer. This book highlights the priorities of both consumers and financial institutions and identifies the potential barriers to the effective practice of consumer protection principles.

Consumer protection calls for client education that will enable clients to develop relationships with financial service providers on the basis of knowledge and choice, as opposed to hesitations and prejudices. Consumers need to know their rights in order to exercise them. These rights include the right to understand product choices and choose the one that is best for them. Can MFIs and other financial institutions be expected to look beyond their own financial interests to empower clients to make informed decisions? Financial service providers clearly have a role to play in advancing consumer protection, but the knowledge or the requisite awareness clients need to protect themselves may not always be appropriate for these institutions to provide. Client knowledge is fundamental to effective consumer protection, but the extent to which client education can be the voluntary responsibility of financial institutions remains an area to be explored.

In this book, the author has proposed the Microfinance Client Awareness Index (MCAI) – a measure that is used to determine levels of financial awareness in microfinance clients. This comprehensive index is first of its own kind that not only allows comparisons between different MFIs on the basis of their clients' awareness scores but also indicates which particular areas of knowledge and skill they should pay attention to in their future training programs, to protect their clients from being over-indebted. This can lessen the threat of mass default as reported in certain regions of the country.

Such an index, in my view, can be used to monitor the progress of policy initiatives for the financial awareness of microfinance clients in a country over a period of time, and will be most useful for policy-makers and academic researchers.

I am confident that this book will contribute significantly to the improvement of policies and practices in the microfinance field.

Mr. Govind Singh
MD & CEO, Utkarsh Small Finance Bank Ltd.
18th May 2018

Preface

The last two decades have witnessed a powerful opening up of the world of microfinance. Beginning in the early 1990s, the development community came to realize that microcredit providers could recover loans provided to poor and low-income people and cover their costs, and thus reach large numbers of people. At that time, donors and microfinance providers alike focused primarily on a single product (credit) for a particular client group (micro-entrepreneurs). Microcredit was delivered mainly by specialized microfinance institutions (MFIs), most of which were non-governmental organizations.

Over time, the notion of microcredit broadened from microcredit to microfinance, and then into the concept of building entire financial systems that serve their poor and low-income populations — financial systems that are “inclusive.” This new, more ambitious and complex vision has captured the attention of governments, international financial institutions, philanthropists, social investors, mainstream bankers, and even some royalty and celebrities.

For a long time it seemed that microfinance could accomplish social and financial goals simultaneously and without friction. The number of people gaining access to financial services climbed steadily, while microfinance became increasingly commercialized and transformed into a more financially efficient industry. Sustainability of market growth was rarely questioned during that time.

As a consequence of the international financial crisis and global recession, microfinance experienced its first serious setback in 2008, followed by problems in many countries, including India in the past couple of years. The southern state of Andhra Pradesh, the biggest market for the country’s microfinance institutions, was at the centre of the storm, and populist moves by politicians led to mass default on loans of more than US$ 1.5 billion.

An examination of the complaints against microfinance industry practices identified three problems: a) mis-selling of micro-credit products, b) usurious interest rates, and c) coercive debt collection practices. From the perspective of financial regulation, these issues pertain to the distribution of credit services by the MFI to the borrower.

Against this backdrop, a shift in the industry is taking place, drawing our attention away from the financial institution and back to the client. Indicators of a renewed concern for clients include the issues of fair and transparent pricing, sensitivity to over-indebted clients and the ethical behaviour of staff. While client protection is necessary to ensure that clients have the information they need to make an informed decision, financial education gives them the competence to evaluate that information. Financial education can reduce the risk of lending, provide a valued service, and support a client-centred approach. Better informed customers will demand more from financial service providers and put pressure on MFIs to improve the effectiveness and efficiency of their operations. This calls for perspicacious evaluation of policies formulated by MFIs regarding client education in terms of its utility for its clients, and close examination of the practices of MFIs in order to assess levels of policy compliance. While evaluating, the present doctoral work focuses on the efficacy of financial education as a tool to improve client protection, and develops an indicator to evaluate the outcomes and impact of financial education in relation to broader development goals.

The study is divided into nine chapters. The *Introduction* presents an overview of the global growth of the microfinance industry. The Indian scene and its origins come next in line. The chapter also takes up a discussion on the microfinance models practiced in India, the legal structure of MFIs, and changes in the regulatory framework emerging from the Andhra Pradesh crisis.

The second chapter (the literature review) discusses the related studies to date, on the relevance of transparency and client education in the microfinance industry, and provides the rationale for the present study. It further identifies the gaps in the literature and sets the groundwork for the study.

The third chapter, on research methodology, spells out the purpose, significance and methodology of the study. It refers to the exploratory research design that is put to use and specifies the scope, period and population of the study. The relevant tools and techniques used to analyse data, including the steps followed in constructing the composite indicator, are explained. The background information showing the profile of MFIs and their clients has also been included in this chapter.

The fourth chapter deals with policies and practices of MFIs regarding loan-price terms and transparency. This chapter delineates, at length, the status of transparency amongst MFIs in conveying their loan-price terms to clients, and the extent to which microfinance clients understand their loan contracts. Further, it explores which aspects of their loan terms are important to MFI clients and what the implications are for regulation.

In the fifth chapter, the indicator named the Microfinance Client Awareness Index is developed to determine levels of financial awareness in microfinance clients. This index is a comprehensive measure that incorporates information on several aspects of financial awareness in one single number lying between 1 and 2, where 1 denotes complete ignorance and 2 indicates complete financial awareness of the microfinance product. This chapter describes the steps followed in the construction of the Index, particularly the definition of the theoretical framework, the quantification of categorical survey questions, the univariate and multivariate analyses of the dataset, and the set of weights used for calculating the scores and ranks of the Index. This chapter also discusses the robustness of the results.

The sixth chapter, *Determinants of Microfinance Client Awareness*, discusses the relationship between the Index and the socio-economic characteristics of the respondents and microfinance-related variables, to identify the factors that are significantly associated with financial awareness.

The policies and practices of MFIs regarding staff behaviour and the collection of dues are discussed in the seventh chapter, to assess the gap between policies and the practices of MFIs and to check if clients are facing problems related to these issues. Further, it analyses the recognition of financial rights by poor borrowers regarding staff behaviour and collection practices adopted by MFIs.

In the eighth chapter, the policies and practices regarding grievance redressal systems implemented by MFIs are dealt with, to identify if the formal grievance redressal systems are in place and if the difficulties faced by microfinance clients are resolved in a timely manner.

The last chapter, on conclusions and suggestions, discusses the outcome of the entire exercise by throwing light on the present circumstances of the Indian microfinance industry. The chapter proposes recommendations aimed at policy-makers, MFIs, donors, and the research community. The chapter concludes by elaborating on calls for work on various fronts.

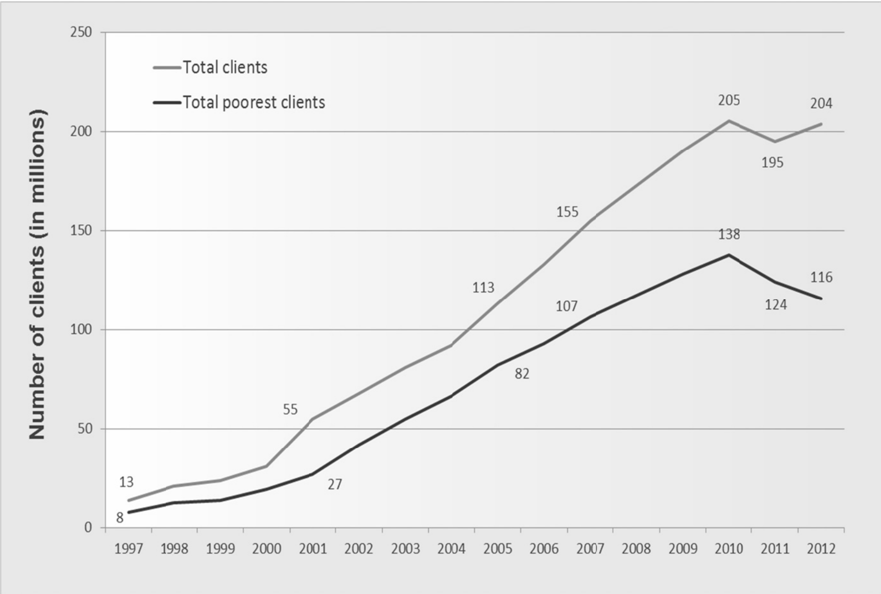
CHAPTER I

INTRODUCTION

Microfinance is one of the concepts in finance that has continued to excel over the last two decades, and to which numerous groups and institutions attribute their financial success in various development projects. Though not so active, microfinance has been prevalent for centuries among savings and credit groups and numerous savings clubs all over the world, offering financial services to poor populations often neglected by commercial banks. The origins of global microfinance institutions (MFIs) can be traced back to the mid-1970s in Latin America and South Asia, when various credit and savings groups merged to form more stable microfinance institutions. This paved the way for the international microfinance industry which now meets the numerous financial requirements of individuals. Over the last two decades, the global microfinance industry has experienced an increased rate of growth and has taken the international financial markets by storm. Statistics indicate that the industry has expanded its limits and currently can serve up to 200 million clients across the world's geographical regions (Figure 1.1).

Moreover, the microfinance institutions help to accelerate economic development in developing countries by offering a viable source of finance to large numbers of people who wish to invest in and build financial foundations. Microfinance institutions have also played a significant role in ensuring that their members are protected against financial shock, ensuring that children remain in school despite challenging financial times such as fluctuating inflation. Two major factors are implicated in microfinance comparing favourably to other financial institutions and interventions: cost-effectiveness and the prospects for sustainability (Morduch et al., 2002).

In addition, the development of international microfinance has led to the creation of favourable economic environments in the various regions which have adopted microcredit programs. These programs have been significant not only in terms of helping those who face financial problems but also by impacting on possible economic crises, political instability, and the occurrence of natural disasters. The savings invested in these institutions are normally returned to members in the form of credit loans which are then used to recover and correct affected projects, as well as support their daily needs.

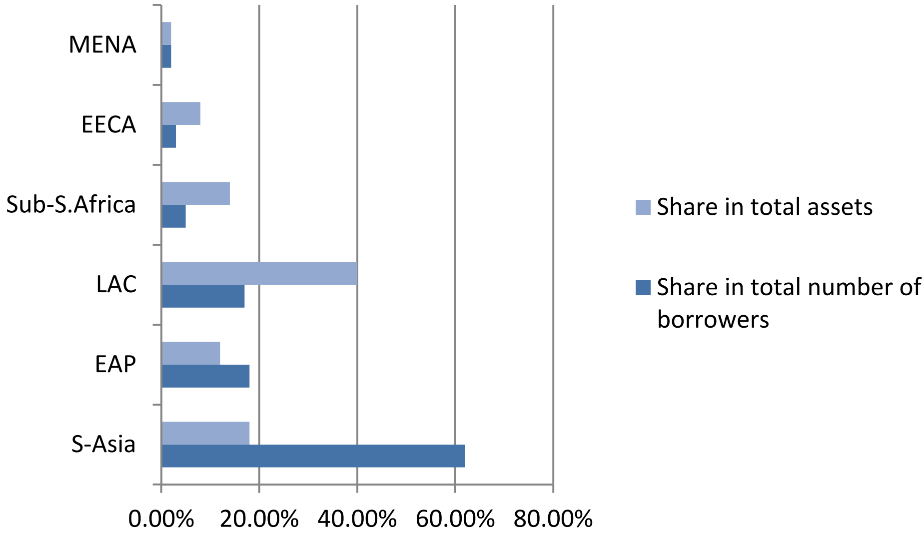


Source: Micro Credit Summit Campaign Report 2014 (Massie, 2014).

Figure 1.1: Expanding client base.

The rapid development of international microfinance programs, especially in developing economies, has resulted in more even patterns of consumption and facilitated a reduction in the seasonality of labour supply. This is because of the numerous employment opportunities that have been created by microfinance institutions across the globe; members have substantial amounts of capital to invest and can create self-employment through business ventures (Andrew, 2006). In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, developing self-confidence, and financial literacy and management training. Microfinance is not simply banking; it is a development tool (Ledgerwood, 1999).

The popularity of microfinance reached a peak in 2005 when the UN created the "International Year of Microcredit". A year later, the "father" of "banking for the poor", Bangladeshi Muhammad Yunus, was awarded the Nobel Peace Prize. He experimented with microloans for the rural poor during the 1970s. From there, the concept spread rapidly across the globe. Most borrowers still live in rural South Asia and the East Asia and Pacific (EAP) region (see Figure 1.2). Over time, microfinance has also expanded into Latin America and the Caribbean (LAC), Eastern Europe and Central Asia (EECA), and Sub-Saharan Africa (Sub-S. Africa).



Source: MIX Market, DB Research (2012).

Figure 1.2 Market Share of Microfinance by Region (2010).

1.1 Microfinance Defined

One of the first definitions of microfinance in India was the "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards". This definition was proposed by the Task Force on Supportive Policy and Regulatory Framework for Micro Finance, set up in 1999 by the National Bank for Agriculture and Rural Development (NABARD).

Further, The Micro Finance Institutions (Development and Regulation) Bill, 2012 (Ministry of Finance, 2012), introduced some changes to the definition of "microfinance services," explained as any one or more of the following financial services provided by any microfinance institution:

(A) "micro credit facilities involving such amount, not exceeding in aggregate five lakh rupees for each individual and for such special purposes, as may be specified by the Reserve Bank from time to time, such higher amount, not exceeding ten lakh rupees, as may be prescribed;
(B) a collection of thrift;
(C) pension or insurance services;
(D) remittance of funds to individuals within India subject to prior approval of the Reserve Bank and such other terms and conditions, as may be specified by regulations;
(E) any other such services, as may be specified, in such manner."

At the core of microfinance is the provision of loans through a group-based methodology. In India, two principal concepts can be distinguished.

1.1.1 Self-Help Group Bank Linkage Model

The self-help group has between 10 and 20 members who pool savings and lend among themselves. It was first conceived by non-government organizations (NGOs) like MYRADA[1] and PRADAN[2] during the 1980s. Since 1996, NABARD has mainstreamed a nationwide bank linkage program that offers additional, beyond their own savings-credit, to SHGs.

1.1.2 Grameen Group/MFI Model

The Grameen group comprises five members who guarantee each other loans which are provided by microfinance institutions. The Grameen methodology originated in Bangladesh, where it was configured into a highly standardized loan product that provided poor people with small, cost efficient loans. The Grameen approach targets the entrepreneurial poor who invest ever-growing loans into their small-scale businesses such as petty trade, poultry, and milking cows, etc.

1.2 Growth of Microfinance in India

Over the past 20 years, the Indian financial system has made significant progress in terms of resource mobilization, geographical and functional reach and financial viability. Table 1.1 provides a summary presentation of the financial system in India (with particular reference to microfinance).

Table 1.1: The Indian Financial System

Type of Financial Institution	Institutional Ownership	Regulated by	Number of Institutions
Commercial Bank	Government Private – Indian Foreign	RBI	26 20 40
Regional Rural Bank Local Area Bank	Government Private-Indian	RBI/NABARD RBI	82 4
State Cooperative Bank District Cooperative Bank Primary Agricultural Cooperative Societies	DCCBs/State Government PACS/ Individuals Individuals	State Government NABARD State Government	31 371 ~93,400
Non-Bank Finance Company	Private- Indian	RBI	12,375
Business correspondents of banks	Mainly private individuals or business establishments	RBI via the banks	95,767
Microfinance Institutions as…			Estimated numbers
NBFCs Section 25 companies Cooperatives, MACS Societies/trusts	-as above- Private – Indian Individuals No ownership structure	RBI State Government Central/State government	~50 5 100 500
Self-Help Groups	Unregistered – member equity	Self, some Supported /guided by NGOs	With outstanding bank loan- 4.35 mn With bank savings- 7.96 mn

Source: M-CRIL Review-2012

At the end of March 2012, the banking sector was comprised of 86 scheduled commercial banks with a consolidated asset base of Rs73 lakh crore (US$1.43 trillion). In addition, there were 82 regional rural banks (RRBs) consolidated from the 196 that originally existed before the amalgamation process started in 2006. In 1996, the RBI mandated the establishment of local area banks – essentially RRBs under private ownership – but only six were ever licensed and just four are functioning today. In addition, there were 12,375 non-bank finance companies in India in May 2012, out of which just 271 were permitted to accept/hold public deposits.

There is also a network of cooperative banks, with 31 state cooperative banks (SCBs) and 371 district central cooperative banks (DCCBs). The main aim of the rural cooperative banks is to provide crop and other working capital loans, primarily for short-term purposes, to farmers and rural artisans. The cooperative banks do this either directly or by financing the 93,400 primary agricultural cooperatives functioning within their operational areas. In urban areas, the financial services of the banks and NBFCs are supplemented by the operations of over 1,645 urban cooperative banks (M-CRIL, 2012).

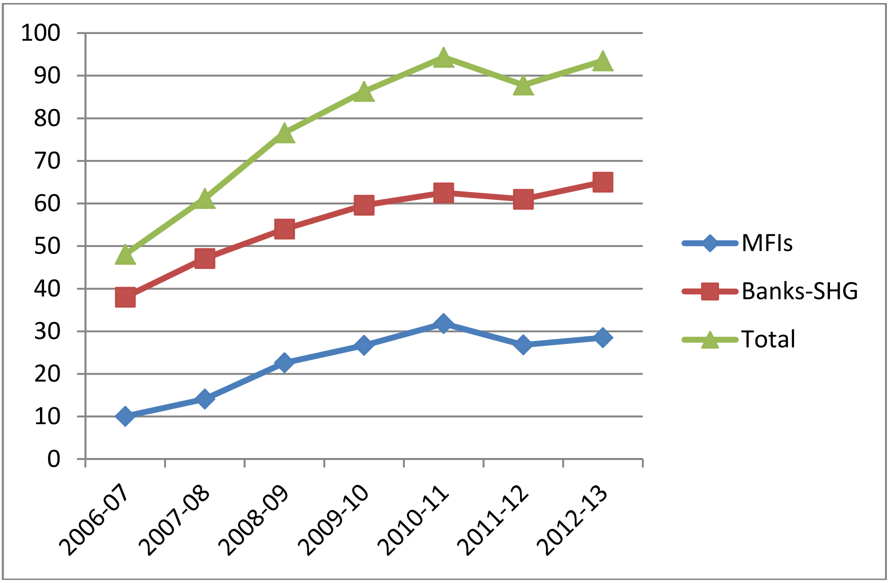
In recent years, the Reserve Bank of India has attempted to promote financial inclusion by introducing the device of business correspondents — individuals or business outlets in diverse locations, providing basic banking services to small-account holders. By the end of March 2012, the number of business correspondents in India grew to nearly 96,000. This was in addition to 83,000 branches of scheduled commercial banks, over 14,000 branches of RRBs, 93,000 rural primary agricultural cooperatives (PACs) and around 2,000 branches of urban cooperative banks (UCBs) (M-CRIL, 2012).

The government of India recently announced "*Pradhan Mantri Jan Dhan Yojna*," a national financial inclusion mission which aims to provide bank accounts to at least 75 million people by 26 January, 2015. To achieve this milestone, it's important for both service providers and policymakers to have readily available information that outlines the gaps in access, as well as interactive tools to help better understand the context at the district level. The RBI's release of draft guidelines for small finance banks and payment banks as part of the introduction of differentiated banking in the country is a welcome step. While small finance banks will help in credit outreach, payment banks will help fill gaps in access to formal payments and remittances systems. It is also the case that the experience and outreach of SHGs and MFIs needs to be integrated into the scheme of things.

According to the Human Development Report, 2011, of the UNDP, 41.6% of India's population (or around 500 million people) live on less than the poverty benchmark of $1.25 a day (at PPP). The proportion of the population below the $2 a day benchmark is 75.6% (or nearly 900 million people). In this context, while the importance of financial inclusion for facilitating people's lives is apparent, the level of inclusion achieved is not great. While accurate information on financial inclusion is not available, at least 65% of the adult population is said to be unbanked (lacking an account with a formal financial institution) (Kunt et al., 2012).

The average number of accounts held per adult in the developed world is 3.2. India is well behind this figure: deposit accounts at commercial banks stand at 747 per 1,000 of the population, and another 69 with cooperatives, amounting to little more than 1.5 accounts per adult (a large proportion of which are in multiple holdings). It is not surprising, therefore, that over the past few years, the Indian microfinance industry — both the bank-financed self-help group programs and the microfinance sector served by NBFCs and NGO MFIs — engaged in providing microcredit services and grew very substantially with a peak of some 94 million credit accounts by March 2011. As a result, India was said to be the world's largest microfinance market, having surpassed Bangladesh's total of around 30 million accounts in 2006 (M-CRIL, 2011).

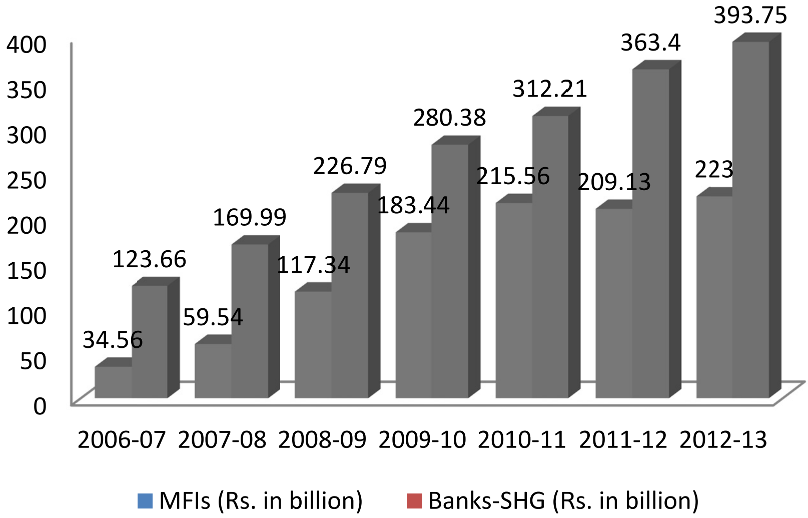
The SHG bank linkage program (SBLP) and the microfinance institutions (MFIs) achieved a combined growth in their customer base of about 8.8% in the year 2010-11, compared to 2009-10. The combined borrowing customer base increased to 93.9 million in 2010-11; it was 86.3 million in the previous year. However, two decades after it was launched as a way of linking the poor with financial services, the sector was confronted with its biggest crisis yet, in October 2010. A series of events over the previous four years, since the Krishna crisis, eventually culminated in the Andhra Pradesh government bringing in a tough ordinance which effectively darted the aggressive plans of MFIs, hitting the capital markets after the success of the initial public offer of SKS Microfinance Ltd. The Andhra Pradesh government imposed a ban on MFI operations in the state, which led to funds for microfinance drying up all over the country, as commercial banks responded to the political risk by stopping the flow of wholesale loans to MFIs. This adversely affected the MFI industry and the number of active borrowers fell by 7% in the 2011-12, compared to a growth rate of 9.3% in the previous year (Puhazhendhi, 2012). Sa-Dhan data indicates a revival of dynamism in the microfinance sector since 2011–12. The combined portfolio (SBLP and MFI models) increased by about 442 million between March 2012 and June 2013, or by 7.7%. The number of active borrowers also rose by 6.5% (Nair et al., 2013).



(Customers in millions)
Source: Microfinance India: State of the Sector Report 2013, Sage Publications

Figure 1.3: Comparison of SHG and MFI client outreach

Outstanding SHG loans from banks showed an increase of about 11.3%; the MFIs showed an increase of 17.5% in their loans in 2011. Overall, the loans outstanding in the microfinance sector increased by about 13.8% in 2011 (Srinivasan, 2011). However, the AP ordinance not only adversely affected the MFIs' growth but also the SBLP program. The number of active borrowers under the SBLP program, with loans outstanding against them, declined by 2.4% in 2011-12, compared to 62.5 million in the previous year. However, the amount of loans outstanding increased to Rs.393.75 billion (an 8.4% increase over the previous year).



Source: State of the Sector report 2013, Sage Publication

Figure 1.4: Comparison of Loan Portfolio of SHGs and MFIs

The end-March 2014 portfolio of the MFIs accounts for just 0.40% of the total credit outstanding from the banking system, but it has grown from just 0.29% and now accounts for over 27% of the microcredit portfolio of the banking system (41% in 2010), which amounts to around 16% and 13% of the total credit outstanding from the RRBs and cooperative banking system, respectively (MCRIL-2014).

1.3 Regulatory Framework in the Microfinance Industry

While microfinance is now established as a significant component of the country's financial system, and its contribution to financial inclusion continues to rival, if not exceed, that of the rural banking system, the efficacy of that contribution is now under threat. Emerging from the crisis, the Government of India has proposed bringing in the Microfinance Act. This would mean that the sector would be under the watch of the central bank. Under this system, MFIs would be able to offer limited deposit services to low-income families (recognizing their need for savings facilities) and would be protected from the whims of local government because the industry would be governed by national laws.

In this regard, the voluntary code of conduct developed by Sa-Dhan and MFIN recommends that MFIs be fully transparent in the communication of loan details, interest rates, and the calculation thereof, and lays special emphasis on client protection and good governance. It states:

- "Mandatory training on Code of Conduct for MFI staff and awareness building for clients
- Integrity and Ethical Behaviour
- Transparency
- Appropriate interaction and collection practices
- Privacy of confidential client information
- Mandatory client data sharing with Credit Bureau
- Good governance structure for Member MFIs
- Grievance Redressal Mechanism
- Client Education"

Further, regarding the financial education of clients, the code of conduct specifies that:

1. "MFIs must have a dedicated process to raise clients' awareness of the options, choices, and responsibilities vis-à-vis financial products and services available.
2. New clients must be informed about the organization's policies and procedures to help them understand their rights as borrowers.
3. MFIs must ensure regular checks on client awareness and understanding of the key terms and conditions of the products/ services offered/availed. (As part of internal audit systems or through some other regular monitoring)"

This calls for the perspicacious evaluation of policies formulated by MFIs regarding client education, with respect to its utility for its clients. Close examination of the practices of MFIs is also required, in order to assess levels of policy compliance.

1.4 Review of Literature

There has been a great deal of research on the issue of financial education, from both a policy perspective (Bayer, Bernheim & Scholz, 1996; Bernheim, 1998; Braunstein & Welch, 2002; Caskey, 2001; Fox, Bartholomae & Lee, 2005) and a pragmatic perspective (Bowen, 1996; Garman, 1998; Hogarth & Swanson, 1993; Montalto, 2000; Perry & Ards, 2001; Rand, 2004; Toussaint-Comeau & Rhine, 2000). For our purposes,