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Summary of Proceedings Conference on Microfinance

Jointly organized by the CAB and CMF at CAB, Pune on
January 18, 2008

As the microfinance innovation spreads across the country several challenges arise. In areas where microfinance has existed for a few years and has expanded, issues relate to expanding the outreach to include the poorest, managing competition and determining the product portfolio, among others. In areas untouched or underserved by microfinance, one of the challenges, for instance, is to design the programmes and delivery mechanisms best suited to the needs of the clients either through introducing flexibility in existing products or designing new products. Over the past few years, there has been an increasing amount of research and innovation in the practice of microfinance to document and address some of these issues.

It is in this context that the Centre for Micro Finance (CMF) in partnership with the College of Agricultural Banking, Reserve Bank of India (RBI) organized a Conference on Microfinance. The objective of the conference was to bring together researchers, practitioners, bankers and policy makers to discuss and share results from various experiments they have conducted in research and practice that have led or could lead to improvements in microfinance programmes or policies. The conference also provided a platform for those involved in the sector to learn from field experiments, discuss policy implications and develop a policy framework. It also helped to identify areas for further research and experimentation of relevance to both practitioners and policy makers.

Over three sessions, original research findings were presented on 1) issues of product design, 2) challenges in offering innovative financial and non-financial services with micro-credit, and 3) emerging issues in the microfinance sector. Following is a summary of the major issues/recommendations that emerged from the discussions and presentations :

Inaugural Session

<i>Welcome Address</i>	Shri Sandip Ghose , Principal, College of Agricultural Banking, Reserve Bank of India, Pune
<i>Special Address</i>	Dr Nachiket Mor , President, ICICI Foundation for Inclusive Growth
<i>Special Address</i>	Shri C S Murthy , CGM-in-Charge, Rural Planning and Credit Department, Reserve Bank of India
<i>Special Address</i>	Shri T Y Prabhu , Executive Director, Union Bank of India
<i>Special Address</i>	Ms. Annie Duflo , Executive Director, Centre for Micro Finance

In his welcome address, Shri Ghose expressed his delight in the CAB-CMF collaboration and hoped that the conference would succeed in encouraging more interaction between academicians, microfinance practitioners, bankers and policy makers. Shri Prabhu, in his special address, spoke about the efforts made by the Union Bank of India towards promoting financial inclusion particularly its pygmy deposit schemes and the provision of biometric cards to hawkers.

In his special address, Dr. Mor spoke about the importance of high-quality research for designing microfinance products and policies and the sectoral attempts to achieve inclusive growth. He welcomed the CAB-CMF initiative in bringing together the world-class researchers and high-level practitioners and policy makers. The two key challenges the sector is facing today, Dr. Mor argued, are that of value addition and operations. While the positive effect the presence of a bank branch has on rural poverty in a given area had been established by Pande and Burgess, an important question that remains to be addressed is whether consumption smoothing leads to value creation considering that a large percentage of credit is utilized for consumption purposes. While speaking about operational challenges in the sector, he highlighted the debate centered around the SHG-bank linkage model vis-à-vis the Grameen and the Joint Liability model, in terms of sustainability and social value addition. In particular, a recent RBI report finds that the cost of funds to a bank for SHG lending is around 12-14% raising a question whether the current interest rates charged are cost effective in the long run. On the other hand, the SHG-bank linkage model is considered superior because RBI considers credit linkage after just 6-7 days inappropriate. Apart from the issues related to operations and delivery mechanism, Dr. Mor expressed his concerns about the collection practices of microfinance institutions (MFIs) and banks.

Shri Murthy, in his special address, raised concerns about the skewed growth of the sector towards the southern states. He observed that in some states MFIs overlap with the banking infrastructure and emphasized the need for the sector to focus on expanding access and outreach in 13 states that National Bank for Agriculture and Rural Development (NABARD) had identified as under-served. He also expressed concern about the continued focus on credit and urged practitioners and policy makers to take note of the constricted growth of savings and mechanisms to satisfy individual credit needs within the framework of group lending. He opined that there is an urgent need for the sector to evaluate the recovery practices employed by the MFIs and develop technology based solutions that would allow the MFIs to track their activities and also create an enabling environment for the functioning of credit bureaus.

In her special address, Ms. Duflo spoke about the Centre's objective to identify and bridge knowledge gaps in the practice of microfinance by facilitating interactions between researchers, practitioners and policy makers, and the dissemination of research findings to promote evidence-based programme and policy design. She expressed her delight in the CAB-CMF initiative and highlighted its potential to achieve these very objectives.

Technical Session I

Theme : Improving Businesses – Product Design and Additional Services

Chairman: Dr Nachiket Mor, President, ICICI Foundation for Inclusive Growth

Paper I: A Snapshot of Small Businesses in Hyderabad: Results from a Large-Scale Survey

Presenter: Professor Abhijit Banerjee, MIT

Paper II: Experiment on Repayment Schedules and Business Training for Micro-entrepreneurs

Presenter: Professor Rohini Pande, Harvard University

Paper III: Tailoring Products to Clients' Needs

Presenter: Ms Jayashree Vyas, SEWA Bank

Professor Banerjee drew upon preliminary results from a CMF research project in Hyderabad slums that is focused on evaluating the impact of micro-credit on households. The dataset of 2400 households reveal that most businesses are labour intensive (not requiring any specialized skills) at sub-optimal scale suggesting constrained access to risk capital or imperfect risk sharing mechanisms. Also, there was a lack of innovation and diversification of activities with many individuals involved in similar type of businesses and narrow profitability margins. The lack of diversification could be due to a lack of awareness about alternative businesses or the lack of incentives to innovate because it is easier for neighbours to adopt the innovation and drive profits down. Also, 69 per cent of the households have at least one outstanding loan and 46 per cent of the households have more than one outstanding loan. However, only 8 per cent of those who had loans had taken it for business purposes. This leads to a question as to why households were not attempting to double their capital and grow their business. Perhaps, such an influx of capital would not be sufficiently transformative implying that the Spandana loan may not be large enough or people may simply find it difficult to save.

Speaking about the possible role of government and that of subsidies, Professor Banerjee pointed out that subsidies could function as a credit multiplier cutting the cost of credit, increasing the ability to repay and take larger loans, and, reduce transaction costs. Also, if there is a concern that people are not aware of the cost of their loans and that they may not be willing or able to pay for financial literacy, the government could intervene to promote financial literacy.

Professor Pande presented results from a research project that tested the impact of flexible repayment schedules with an MFI, Village Welfare Society (VWS), in Kolkatta. From the experiment, it was obvious that monthly repayment schedules had no discernible effects on client default or delinquency. The study compared repayment behaviour and other indicators among three groups of clients randomly assigned to a) weekly meetings and weekly repayments; or b) weekly meetings and monthly repayments; or c) monthly meetings and monthly repayments. The rate of default in all three groups was virtually identical. However, early repayment indicative of fiscal discipline was higher for weekly repayment clients, and monthly repayment clients worked more on the day before the repayment was due and borrowed more from husbands to repay loans. It was also observed that although clients that met more regularly had greater familiarity with fellow group members, this familiarity did not translate into greater financial reliance and these clients relied on traditional networks for making payments such as family and friends. These results are discussed in greater depth in Field and Pande (2007).

The most important implication of the results from this study is that the MFIs can potentially reduce their transaction costs through less frequent repayment schedules without significantly increasing their rates of default. While this study was conducted with first time borrowers who consequently had smaller loans in an area where competition was absent, further experiments with the same set of clients in their subsequent loan cycles are on-going and would allow the researchers to test the effects of larger loans and also, potentially, the effects of increased competition on default rates with the entry of other MFIs into the area.

Professor Pande also presented findings from a study in collaboration with SEWA Bank to examine the impact of business training on financial and business behaviour of its members. Preliminary results from this study indicate that the business training increased borrowing in general and training with a friend (peer) had significant effect on clients' savings. In addition, the uptake of the training differed between the treatment groups. The attendance rate among peer-trained clients was 69 per cent and 63 per cent among individually-trained clients. While the results are indicative of the positive effects of business training, further experiments are necessary to determine the effect of follow-up sessions on long-term retention rates, and to disentangle the reasons why training with a peer influences the savings and borrowing behaviour of clients. This would help design appropriate programmes that would be likely to positively impact financial status of clients in the longer-term.

Describing the efforts of SEWA Bank to tailor products to the needs of their clients, Ms. Vyas traced the history of product development at the Bank from their first basic savings and credit products to financial literacy training

today. She emphasized that SEWA Bank's product development strategy has been driven by rigorous research and a system of continuous feedback from field staff and clients. In the late 1980s, for example, the results from a Harvard study indicated that women were confused about personal and business needs, and consequently, taking impulsive financial decisions and were not using the 20 different products offered by the Bank effectively. This led to the development and offering of a financial literacy curriculum that emphasized the management of cash and the power of compounding. Most recently, when they deputed village leaders on a commission basis to start daily collections for savings and loans, SEWA Bank realized that their staff incentives were oriented towards collecting loans (2.5 per cent commission with an average collection of Rs 500 a day in comparison to 2 per cent commission on an average collection of Rs 100 a day).

Technical Session II

Theme : Addressing Vulnerability Through Microfinance

Chairman: Dr Ajit Ranade, Chief Economist, Aditya Birla Group

Paper I: Health Insurance: Opportunities and Challenges

Presenter: Professor Esther Duflo, MIT

Paper II: Targeting the Hard-core Poor in West Bengal

Presenter: Professor Raghav Chattopadhyay, IIM Calcutta

Paper III: Addressing the needs of Migrant Workers: Remittances

Presenter: Shri. Md N Amin, Adhikar

Professor Duflo presented the preliminary findings from a randomized experiment with SKS Microfinance to evaluate the impact of offering catastrophic health insurance to micro-lending clients. Households experience frequent and costly health shocks which often result in financial jeopardy. While MFIs have the potential to lower transaction costs through their established delivery channel and large client base, and address adverse selection issues by combining the delivery of health insurance with credit, they face threats such as selective drop-outs and under-utilization of the insurance policy, and of course, the question of whether it ultimately benefits the client remains.

Speaking about the preliminary findings from the baseline and take-up data, she said that it revealed a considerable unmet demand for insurance. Households face frequent 'health shocks' with 93 per cent of the households experiencing a serious health event resulting in an expense of at least Rs 300 or more than 7 days of work loss; and 6 per cent of households had at least one member hospitalized in a given year. Hence, there is potential for a health insurance product to reduce the financial risks households face. The insurance policy administered by Lombard covers catastrophic illnesses that include delivery, hospitalization and accidents. SKS made this policy mandatory to its clients along with renewal of loans to minimize adverse selection. The take-up data revealed that there was no significant difference in the rate of loan renewal or the composition of the clients who renewed their loan when the product was made mandatory. These results suggest that this mandatory policy did not affect SKS financially and the high rates of renewal would help them cover operational costs. Coupling insurance with other much needed products that the poor lack access to may be a promising mechanism for reducing adverse selection and ensuring the sustainability of insurance schemes.

Microfinance faces persistent criticism about the discrepancy between who it claims to target and its actual outreach. There is a growing consensus, even among practitioners, that microfinance does not reach the poorest of the poor. MFIs may neglect ultra poor households because of their high vulnerability to shocks, making it less likely that they would invest the loan in productive activities and spend it on consumption items. Bandhan, a Kolkata-based MFI, started the "Chartering into Un-ventured Frontiers Targeting the Hard Core Poor" (CUF-THP)

programme in 2006. This grant-based programme for the ultra poor households draws inspiration and technical support from a similar programme run in Bangladesh by the Bangladesh Rural Advancement Committee (BRAC).

Professor Chattopadhyay presented findings from a study that assessed the effectiveness of Bandhan's identification strategy for the ultra poor. This is a part of a longer-term study that evaluates the impact of Bandhan's grant programme for the ultra poor. The strategy adopted by Bandhan consists of a series of discussions and interviews at the village and household level, starting with a Participatory Rural Appraisal (PRA) to identify ultra poor households in each hamlet using wealth rankings, followed by detailed household survey and a personal visit by the THP coordinator to verify the results of the PRA and identify the beneficiary. By comparing households that were identified as ultra poor by Bandhan and households that appeared poor according to an economic census but were not identified as ultra poor, the researchers were able to evaluate the accuracy of the identification strategy. The results indicated that Bandhan's procedure is able to identify a sub-population which is notably poorer in certain respects, particularly readily observable attributes (land, assets and access to formal financial services). The study confirmed that the peer wealth rankings established by PRAs generate a reliable assessment of relative poverty households ranked as poorest by their neighbours also appear less advantaged. However, economic census alone, as is done for many government assistance programmes, is not sufficient to identify a poorer sub-population recipients were not found to be noticeably more disadvantaged than non-recipients. These results have broader implications for the efficiency and effectiveness of the programmes that target certain sub-populations, particularly the poorest of the poor.

Shri Amin of Adhikaar spoke about his organisation's remittance product for migrant workers from Orissa. He stressed the difficulties migrants face in accessing formal financial service providers for remittances a combination of rigid Know Your Customer (KYC) norms, absence of network at the destination, and opportunity costs they face (loss of a day's wages). Apart from the difficulties in access to remittance products, migrants encounter a lot of health and occupational hazards compounded by lack of civic amenities and poor living standards. While there is an estimated Rs 2000 crore worth of inward remittances from just the State of Gujarat to Orissa, there is an absence of regulation concerning remittances and there is an urgent need for it.

Technical Session III

Theme : Emerging Issues in Microfinance

Chairman: Shri C S Murthy, CGM-in-Charge, Rural Planning and Credit Department, Reserve Bank of India

Paper I: What is an Informed Consumer? The Psychology of Debt

Presenter: Professor Sendhil Mullainathan, Harvard

Paper II: Competition in Microfinance

Presenter: Shri Doug Johnson, CMF

Paper III: Microfinance and the Market

Presenter: Professor Jonathan Morduch, NYU

Professor Mullainathan presented findings from a CMF Loan Contract Information Study that was aimed at understanding whether and how MFI clients comprehend their loan contracts. The study identified which aspects of loan contracts are important to clients and the implications thereof for regulation. The findings revealed that clients think about their loans in terms of how much they owe on a weekly basis and not in terms of interest rates and interest expenses. This raises a question of whether it is reasonable or realistic to expect small borrowers to have a deeper understanding of their loans, whether this understanding is necessary at all and the relevance of financial literacy training. Hence, a top-down regulation that works on this assumption borrowers should be able

to calculate and understand their interest rates may stifle access to financial services rather than protect small borrowers.

Professor Mullainathan also spoke about findings from a study that surveyed 1000 micro-entrepreneurs (vendors in Chennai) who had taken and continue to take a high-interest debt for financing their working capital. There are two ways in which these individuals finance their businesses. The first is the meter loan/daily loans which are characterized by their high interest rates (averaging 5 per cent per day). The second source of financing is buying goods on credit, where a vendor incurs an interest rate that averages 17 per cent for the sample. Interestingly, over a long period of time, the interest payments alone constitute nearly half their income while the size of their business remained the same. It is striking that if these individuals had attempted to save small amounts of money (assuming they have access to a suitable savings mechanism), for e.g. drink one less cup of tea a day, in 30 days, given the power of compounding, they would have doubled their income. Faced with persistent borrowers - the average number of years these women have been using costly debt is 13 years - it is pertinent to wonder whether they are confused i.e. they do not understand the costs (interest rates) or tempted i.e. they just happen to make bad choices while taking loans they do not actually need.

Shri Johnson presented results from one of CMF's studies on competition in the microfinance sector. Through the use of a dataset on MFI clients in a highly competitive region, interviews with managers of MFIs, and interviews with clients who had borrowed from more than one MFI, CMF sought to quantify the extent of multiple borrowing and to determine how multiple borrowers differ from those who borrow from only one source. The key finding of this study was that there is no negative relationship between multiple borrowing and repayment performance. In fact, over a 3 year time frame of loan disbursement records, multiple borrowers had a lower or equal arrears rate than their single borrowing counterparts in the same villages or colonies, which in turn was lower than the overall arrears rate of all clients in the sample. The study also found that all the MFIs (for which data was available, except one operating in urban locations only) had equal or better repayment rates in more competitive branch locations (defined as villages with at least 3 MFIs with multiple borrowers) than in less competitive ones.

Professor Morduch spoke about the pressing trade-offs in the microfinance sector illustrating that, often, the best choices are not obvious. One such trade-off concerns interest rate policy and debate on the need for interest rate caps. It has been theorized, and established to a certain extent, that when institutions are pushed to decrease their interest rates, they will look towards increasing their loan sizes, consequently, shifting away from the poorer clients. In India, compared to the global scenario, average costs are relatively high and the interest rates are relatively low (given these costs). This raises important questions of whether (a) an increase in interest rates would lead to an exclusion of certain populations and (b) technology and competition will impact costs as MFIs expand outreach and scale-up. The other trade-off, he described, was regarding loan usage. Money being fungible, even 'production loans' will be used for consumption, and the MFIs face a trade-off between possible financial implications of such behaviour (non-productive loans leading to lower repayments) and the institutional urge to help households smooth their consumption cycle and address emergencies. Speaking about the third trade-off that of profitability/commercialization and social value addition/mission drift Professor Morduch opined that while the sufficiency and ability of 'profitability' as an indicator to attract investments into the sector is not well-established, ensuring that the MFIs think about sustainable growth could only benefit the poor. That is, even if it leads to weaker targeting, it could help achieve larger absolute coverage.

Valedictory Session

Learning from the Conference and Future Research Needed

Shri Michael Walton, Policy Advisor, IFMR

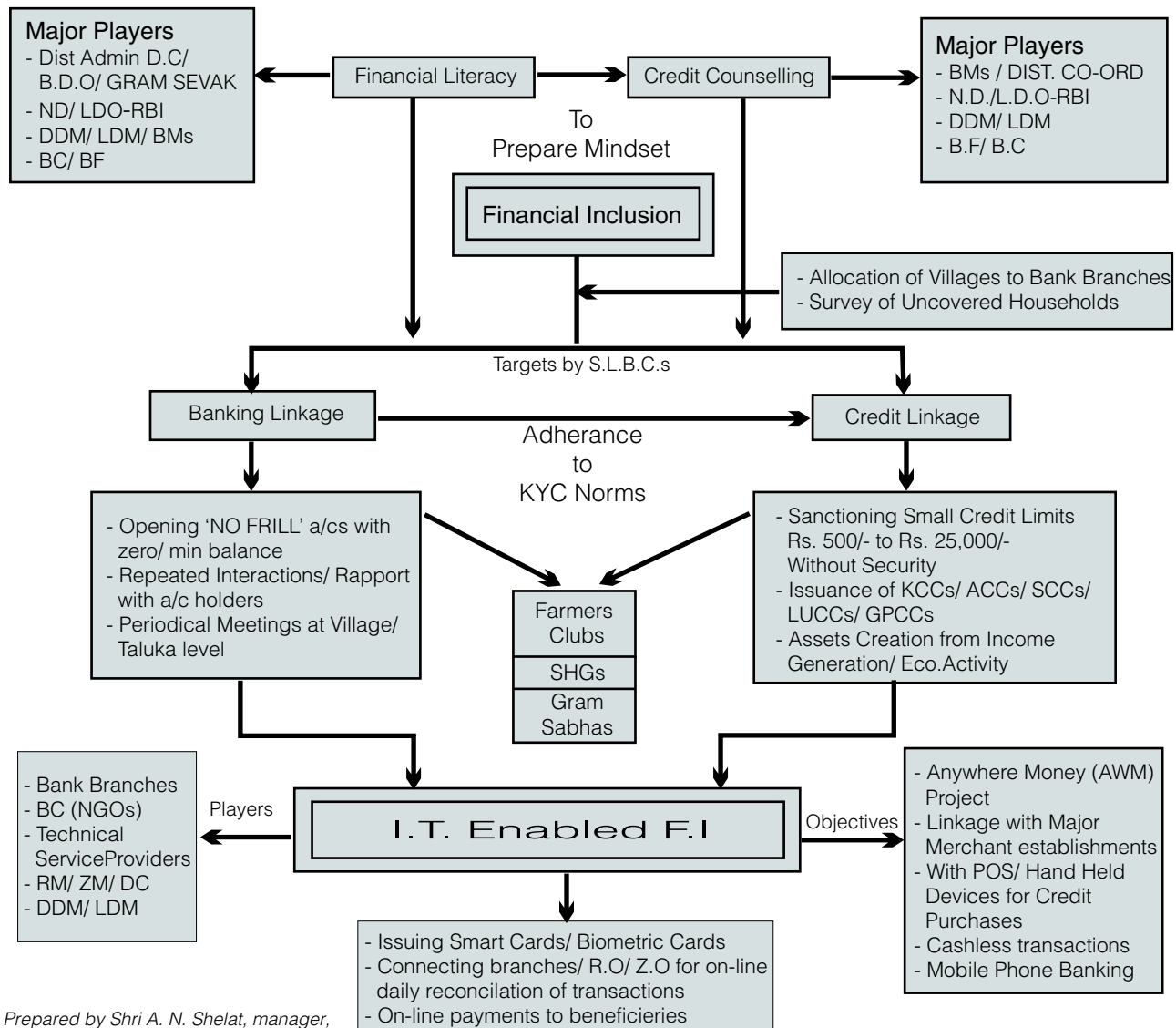
Vote of thanks

Shri Sandip Ghose, CGM & Principal, CAB

Shri Walton, in summarizing the discussions, spoke about the need for greater interaction between research, policy and practice. He underlined the importance of evidence-based research in helping distinguish highly effective programmes from those that are irrelevant and contribute to increasing levels of poverty. A perfect harmony of interests is difficult to achieve among researchers, practitioners and policy-makers given the differences in requirements and constraints arising from the environments they operate in. However, by better dissemination of the relevance of research to policy and product design, and designing better organisational structures that seek evidence-based results, congruence can be achieved.

In his closing remarks, Shri Ghose said that the conference had generated many ideas for further research and collaboration between researchers, practitioners and policy makers. He expressed hope that the interactions would continue outside of the forum, and stated that the Centre for Micro Finance and Collge of Agricultural Banking would approach policy makers and present the results and recommendations from the discussions.

What & How of Financial Inclusion



Prepared by Shri A. N. Shelat, manager, RBI, RPCD, MRO, Mumbai