Small is beautiful and efficient

The Financial Express, 18-Nov-2008

Microfinance has remained largely decoupled from the global financial crisis

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While the global economic crisis has made the notion of decoupling seem absurd, there is one sector that is largely decoupled—namely, microfinance and the rural poor clients it serves. Those of us in the microfinance sector have known this all along, but hopefully the global economic crisis will make the mainstream financial world see this as well.

At first glance, the idea that microfinance is decoupled from the financial crisis may seem rather strange. But if you think about it, microfinance clients are less integrated into the formal economy. They don't use or depend on imports; they rely instead on domestic goods and services. And even there, consumer spending is a low percentage of their overall expenditure. They are also not affected by currency fluctuations. On the other hand, the clients of conventional retail banks are exactly the opposite—thoroughly integrated into the global economy.

The other reason microfinance is decoupled is because micro-loans are primarily for income-generating activities. Loans also usually have a shorter maturity and the staff have much closer ties to borrowers, often meeting with them weekly. This enables practitioners to reduce borrower-specific risk as they can carefully monitor the repayment of micro-loans and adjust lending practices if necessary.

In addition, poor clients have tremendous resilience. Over the years, they have proven that they have the capacity to adapt to shifting economic currents; this is part of the survival skills that have enabled them to cope with drought, crop failure, other calamities and the general seasonal swings in their annual income over the years. The clients of mainstream banks have little ability to adapt in the manner in which poor clients have been able to do so.

Progress of the microfinance programme

As on March 31, 2007 (Amount in Rs crore)

Particulars	Self-help groups* 2006-07 No.	Self-help groups* 2006-07 Amount	Microfinance institutions# No.	Microfinance institutions# Amount
Loans disbursed	11,05,749 (1,88,962)	6,570.39 (1,411.02)	334	1,151.56
Loans outstanding	28,94,505 (6,87,212)	12,366.49 (3,273.03)	550	1,584.48
Savings accounts with banks	41,60,584 (9,56,317)	3,512.71 (757.50)		

* Figures in parentheses indicate the share of SHGs covered under SGSY
#Actual number of MFIs provided with bank loans would be lower as several MFIs have availed loans from more than one bank

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Moreover, studies have shown that the return on enterprises for microfinance clients are very high, averaging around 50% even after the cost of capital. Thus, even if there is some negative impact from the financial crisis, the poor have high enough margins to weather this. The reason that returns to the enterprises of the poor are so high is that rural markets are incredibly inefficient, so micro-enterprises can add significant value with little effort. In addition, most micro-enterprises are driven by family labour, which is typically more productive than external labour. Combine this with minimal capital expenditures—a village kirana store for example is a home front store—and no taxes or legal costs because of being in the informal sector and you get very high margins for micro-enterprises. The result is that, despite the collapse of the mainstream financial world, microfinance continues to thrive.

At SKS, for example, in the month of October, we disbursed Rs 512 crore in loans to our existing 30 lakh clients and added 4 lakh new clients—that's close to 10 clients a minute! And we continue to see huge demand across the country. Meanwhile, our repayment rates remain 99%. We see this vibrancy in microfinance not only in India today, but also saw this during the recession of the late 1990s that hit Southeast Asia and Latin America. Despite the turmoil, MFIs held a steady loan portfolio and some even increased their profits.

Finally, microfinance companies are typically privately-held companies that usually have long-term owners that are less driven by market forces. Also, priority sector policies ensure that, despite credit tightening, the government has a strategic interest in ensuring that the rural poor get funding. In addition, average debt-to-equity ratios in microfinance are in the 3-6 range as opposed to much higher leverage ratios in commercial banks. This makes the microfinance sector much stronger than the mainstream commercial financial services world.

What is most significant is that investors are starting to realise that even in these tough times, microfinance is a quality investment. Consider the statement of the chief investment officer of TIAA-CREF, one of the largest pension funds in the world. In making a $43 million investment in the MFI, ProCredit in 2006, he said, "this investment in ProCredit, gives us an opportunity to seek competitive returns through socially responsible investments that we believe have a low correlation to traditional equity and fixed income markets."

The idea that microfinance is negatively correlated or decoupled from the financial world is also taking hold in India. This month, SKS received $75 million of private equity, the largest equity investment in microfinance in the world. And this closed just a few weeks after Lehman Brothers collapsed. Even Bill Clinton commented on the phenomenon, saying investors should "consider the poor of developing nations as viable investment alternatives to today's turbulent markets." If investors heed these words, the flow of capital to microfinance and the poor that benefit from it would truly be the silver lining of the economic crisis.

The author is founder & CEO of SKS Microfinance