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As Microfinance Grows in India, So Do Its Rivals

Small Credit Lines Were Supposed to Trim the Practice of High-Interest Loans in Rural Areas, but Moneylenders Flourish

By KETAKI GOKHALE

Mahabubnagar, India

The practice of making tiny loans to poor people, or microfinance, was supposed to help drive traditional village moneylenders from rural India.

Instead, traditional moneylenders, who typically charge high interest rates, are thriving, even in areas most heavily targeted by microfinance, which was begun as a way to help combat poverty by granting the poor access to capital to start businesses. Muhammad Yunus, the Bangladeshi founder of microfinance, won a Nobel Peace Prize.

Even as the government and nonprofit organizations came together to create the Indian microfinance market in the 1990s, traditional moneylenders' share of total rural Indian household debt grew to 29.6% from 17.5%, according to a government survey. Another recent survey by the Reserve Bank of India found that between 1995 and 2006, the number of registered traditional moneylenders increased 56% to 19,627 from 12,601. Though much harder to quantify, unlicensed lenders are believed to have made similar gains, the survey says.

Borrowing Money in Rural India

One potential reason for their growth: Some microfinance borrowers say they need village moneylenders to help them pay their debts on time. Some academic researchers believe the moneylenders are keeping afloat many microfinance groups.

Peer pressure to pay back microfinance loans is intense, because microlenders almost always require borrowers to join small, tightknit groups. If one member defaults, none can get another loan. Microloans have a stellar repayment rate -- close to 100% -- and some analysts believe a hidden reason is the stopgap provided by moneylenders.

Sanjit Das for The Wall Street Journal

Women gathered at a microfinance group meeting in Mahabubnagar in Andhra Pradesh, India.

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Microfinancing has boomed in recent years. Though founded as nonprofits, the Indian microfinance industry has been turbocharged by private-equity firms, nearly doubling in the year ended March 31, delivering $2.5 billion in loans. Many microfinance lenders have recently registered as for-profit finance firms with the Reserve Bank of India, the Indian central bank, giving them wider access to funds but limiting them to "reasonable" interest rates. Those rates are still high -- between 20% and 40% annually, according to the Consultative Group to Assist the Poor, or CGAP, hosted at the World Bank.

But the rates are still lower than those offered by the traditional Indian moneylending industry, a chaotic jumble of pawn brokers, gold merchants and other private moneylenders -- some licensed, most not. For centuries they have monopolized rural Indian credit markets but have been accused of fleecing people who don't have access to formal banking by charging exorbitant rates and seizing all their belongings as collateral. They typically charge between 24% and 120% annually, according to CGAP.

Proponents of microfinance say people deeply in debt to moneylenders can now refinance their loans with a lower interest rate offered by microlenders. They also say it has boosted health and education levels among the world's poorest and has empowered women.

A new study from the Abdul Latif Jameel Poverty Action Lab at the Massachusetts Institute of Technology shows that households with existing small businesses or a high propensity to start one benefit from microfinance -- they use the loans as investments. The study also found that these households cut back on "frivolous consumption," such as alcohol and tobacco, in order to divert more funds for investment purposes.

Here in Mahabubnagar, a city of migrant workers that has one of the highest concentrations of microfinance in Andhra Pradesh -- and one of the highest concentrations of moneylenders -- M. Murlidhar owns a traditional moneylending business. He says people are "repaying their loans faster," and that the "overall rotation of money in society has been increased" by the advent of microfinance and government lending programs.

The city has 50 registered moneylenders, and an unknown number of unregistered lenders. On the town's main drag stand prominent offices for virtually every kind of lender from moneylenders and microfinance companies to chit funds, a sort of savings club that auctions its funds to the highest bidder. Locals say lending is so frothy that it is possible to get day loans in the vegetable market that provide 100 rupees in the morning that have to be repaid with 10 rupees interest by dusk. More than 80% of registered moneylenders in Jadcherla, the nearby lending center for the district, launched their businesses after 2000, when the number of microfinance lenders began to skyrocket.

One lender, who wished to remain anonymous because his business is unregistered, gives borrowers short-term, collateral-free loans "as quickly as an ATM gives money," he boasts. Interest sometimes has to be paid on a daily basis and works out to an annual rate of 48%.

The poor use his loans as a stopgap when they can't make their weekly microfinance repayments because their income was less than expected, he says.

In Hanuman Nagar, a slum nestled under a highway, the moneylenders are virtually indistinguishable from the microlenders. They distribute knock-off versions of the microlenders' passbooks. Some use the same weekly repayment structure and door-to-door service as the microlenders do.

The difference, however, is that the moneylenders give loans faster, without asking the women to form groups and serve as each other's guarantors, as microfinance lenders do in order to ensure a higher repayment rate. They also charge significantly more than the four microlenders serving the neighborhood.

Baleshwari, 23 years old, and her sister Balamani, 40, started taking microcredit two years ago when their father, the sole breadwinner, died. Between the two of them, they have taken loans from four different microlenders and owe payments totaling 4,430 rupees, about $95, each month. During the monsoons, when their combined monthly income, drawn from selling bamboo baskets and catering food, dips to about $65, they turn to the local pawn broker for short-term loans to cover their microfinance debt. The interest rates she pays to pawn brokers range from 36% to 48%, she says, and she had to put up gold jewelry as collateral. Her microfinance loans have interest rates of 18% and 24%.

"Group pressure makes us go to moneylenders" to cover their microfinance loans, says Baleshwari, who goes by only one name, as does her sister. "We get small loans for 15 days to fill the gaps when we can't pay. If you lag behind, the rest of the group members can't get new loans."

This dynamic is why some analysts believe the village moneylenders are actually floating the microfinance lenders.

Microlenders disagree. They say the boom in traditional moneylending has been fueled by an increase in demand for credit, and that the share of debt owed to moneylenders is up because microfinance has yet to hit maximum penetration. Some doubt that microfinance is spurring moneylender growth. Although "microfinance institutions and moneylenders offer different products, and it would be quite possible for them to work side-by-side," it doesn't imply a causal relationship, says Rachel Glennerster, executive director of the Poverty Action Lab. She suggested some borrowers may not be paying one loan with another, but using additional funds to expand businesses.

Microfinance has "introduced the concept of income generation to poor women," and also encouraged them to spend on their children's education and health, adds Padmaja Reddy, managing director of Spandana, one of the largest microlenders in India. This has "increased the overall demand for credit."

But here in Mahabubnagar, few women have started their own businesses. Some of those in business have to rely on moneylenders. Microloan repayments begin the week after the loan is disbursed and continue with weekly payments. Most businesses don't produce instant profits, and many are seasonal, so moneylenders can help when funds are tight.

Where microlenders, relative newcomers to rural India, rely on peer pressure for repayment, private moneylenders have historically been conservative in their practices: extending loans based on an intimate knowledge of people's finances, and building their client bases over many years, says Sridhar Tadepally of Villages in Partnership, a Mahabubnagar-based development organization.

But since microfinance took off in Mahabubnagar, he has seen moneylenders start to "adopt the methods of microfinance" -- small loans, large volumes and regular repayments -- "to scale up their business."

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