Credit Market Failures and Microfinance

Dr. D. Srinivasa Rao, Associate Professor
KL University, Vaddeswaram,
Andhra Pradesh, India, Pin:522502

ABSTRACT: Microfinance is an innovative financial service that has emerged during the last three decades to cater to the specific needs of the poor as formal institutions need collateral requirements that exclude most of the poor from their scope. Problems related to Information asymmetry and contracting in credit markets are believed to be theoretical explanations for this market failure. With an active role of the State Government, Andhra Pradesh has emerged as leading state in microfinance sector in India but the recent crisis in this sector with allegations that MFIs are resorting to illegal and unethical practices resulting in violent incidents with political ramifications caught the attention of both National and International Media. In this context the present paper makes a moderate attempt to analyze the problem from a theoretical perspective.

Key Words: Adverse Selection, Government Intervention, Information Asymmetry, Moral Hazard, Market Failure.

1. INTRODUCTION:

The concept of Microfinance in rural credit markets originated with the pioneering work of Dr. Mohammad Yunus in 1970s in Bangladesh. The basic idea behind microfinance is to provide the poor who are largely ignored by the formal financial systems across the world with tiny microloans and allow them to establish or expand very simple income generating activities thus helping them to escape from poverty. Across the world nearly 130 million people benefit from the services of 10,000 MFIs. Since Independence, Indian Government is making conscious efforts to provide financial services to the poor and underprivileged and lending to the poor is perceived to be a part of normal business of banks. With Economic Liberlisation during the early 1990s and the subsequent attempts towards financial sector reforms, the Indian policy planners searched for new strategies to deliver financial services to the poor that ensures high repayment rates and at the same time are sustainable. In this context microfinance gained prominence in India and the state of Andhra Pradesh became a pioneer in this sector due to the active role of the government. The state government was instrumental in forging a link between Self Help Groups (SHGs) and banks during the 1980s with the active support from National Bank of Agriculture and Rural Development (NABARD) and World Bank. With the entry of Commercial Micro Finance Institutions (MFIs) in to the state during the last two decades the sector grew at an incredible rate of almost doubling its portfolios every year which is believed to be the root cause for the crisis. In this context the present paper aims at analyzing the economic causes and consequences of market failure in credit markets which provides the theoretical framework for understanding the crisis of microfinance in practice in Andhra Pradesh. The paper is organized as follows: Section 2 of the paper provides a brief review of literature; Section 3 defines market failure and discusses the various reasons for market failure with special reference to credit markets in developing countries. Section 4 is on the role of Microfinance as a solution to rural credit market failures. The causes of microfinance breakdown in the AP form a market failure perspective were analysed in section 5 and section 6 concludes the paper.

2. REVIEW OF LITERATURE

The analytical issues related to credit market failures and the role of microfinance as a solution to these failures was subject to intense research. Analysis of credit markets under conditions of adverse selection was the theme of papers by Jaffee and Russel (1976), Stiglitz and Weiss (1981). The competitive equilibrium of credit markets in the context of Government intervention was studied by DeMeza and Webb(1987). The moral hazard problems of credit markets were investigated by Stiglitz and Weiss (1986), Dixit (1987), Kaushik Basu (1989). Modeling of credit markets and the role of microfinance in the context of credit market failure was presented by Bhardhan and Udry(1999) and Ghatak and Guinnane (1999). Besley(1994) argues for government intervention in rural credit markets in Developing Countries. Stiglitz(2006) provides a theoretical explanation for the high interest rates prevalent in microfinance sector. In the Indian context the case studies by Rajashekar
Markets and escape from the clutches of poverty. The poor borrowers face many challenges to access the formal credit markets. But none of them could mitigate the problem of market failures both formal and informal financial systems have devised many innovative mechanisms which are leading to credit market failures both formal and informal. Theoretically speaking market failure occurs when a competitive market fails to allocate the scarce societal resources optimally to achieve the maximum possible social welfare. Credit market failures lead to inefficient allocation of credit among the members of the society which is particularly pernicious to the poor and underprivileged. Rural credit markets in developing countries have certain characteristic features leading to market failures: scarcity of collateral security, underdeveloped complementary institutions, and covariant risks. The poor in developing countries do not have any assets that could be collateralized against a loan and also under developed property rights in such countries makes it difficult for the lender to appropriate the collateral asset in case of default. Illiteracy, ill developed communications and the virtual absence of insurance markets in rural areas of developing countries increases the risk of default for the lenders. As agriculture being the main source of income to the poor in rural areas of developing countries and factors like weather fluctuations and instability in commodity prices can create income shocks to poor farmers which may lead to group default.

Apart from the above specific features, rural credit markets also suffers from the classic problems of information asymmetry and contracting which may cause market failure. The two main categories of asymmetric information are adverse selection and moral hazard. Adverse selection occurs when lenders have incomplete information on the value of investment projects, the risk bearing capacity of borrower and his characteristics. Moral hazard is a problem that can arise when the lender is unable to discern the true intentions of the borrower leading to the possibility of adverse selection. Regarding enforcement problems in rural credit markets, the borrowers’ commitment to repay in the future may not be credible.

To tackle the informational and contracting problems which are leading to credit market failures both formal and informal financial systems have devised many means. But none of them could mitigate the problems faced by poor borrowers to access the formal credit markets and escape from the clutches of poverty. The case for government intervention in rural credit markets lies in this context. These interventions have taken different forms: Government ownership of banks, Rural Banking and Priority Sector Lending, subsidization of credit, etc. However most of the economists are of the view that these interventions lead to financial repression leading to misallocation of savings and credit. Other criticism on government backed loan programs is that the default rates are very high and that most of the beneficiaries appeared to be the wealthy borrowers. Criticism of existing polices has lead to the search for alternative means for tackling rural credit market failures in developing countries. The Microfinance is a novel approach which tries to addresses these problems by adopting innovative practices in contract design and adaptive organizational structures.

4. THE RESEARCH PROBLEM:

Market mechanism under ideal conditions ensures everyone including the poor to save and borrow at the market determined equilibrium rate of interest either for consumption or for investment needs. But credit markets are highly imperfect in developing countries as result many borrowers does not have access to credit and the poor are the most vulnerable. Imperfections in credit market ranges from asymmetric information to Contracting. Micro finance is considered to be an innovative mechanism which can address these market failures and provide the poor the necessary access to formal credit markets. In this context India has also been experimenting with microfinance model for the last three decades. The Southern State of Andhra Pradesh witnessed phenomenal growth in microfinance activities during this period. However during the last two years the microfinance sector in the state witnessed a severe crisis leading to the promulgation of an ordinance by the state government to regulating the MFIs. What are the factors that lead to the failure of microfinance mechanism in the state where it is considered to be most successful initially. The present paper aims to investigate this problem from a theoretical perspective.

5. HOW MICROFINANCE CIRCUMVENTS INFORMATION AND CONTRACTUAL PROBLEMS OF RURAL CREDIT MARKETS?

Microfinance refers to small scale financial services to help the poor to develop new income generating activities or to strengthen the existing activities to enable them to get out of poverty trap. Microfinance institutions lend to group rather than individual so that there is joint liability for borrowers which can to some extent answer
the problems of collateral security and information asymmetry. The borrowers in the group are well acquainted with each other and generally they select trust worthy members in to the group thus the lender can pass on the information problem to the group in the context of adverse selection and Moral hazard. Regarding enforcement of contract each barrower has a vested interest in repayment of loan within a given time schedule because of joint liability. Micro finance institutions have adopted the policy of a new loan immediately after repayment of existing loan and denial of loan for all members of the group in case of default to make joint liability contracts more effective. In place of collateral security the forced savings of the group of borrowers is substituted by some of these institutions. Similarly smaller but frequent repayment installments are found to be more suitable for borrowers having daily or weekly earnings. Also the local presence of these institutions enables them to be in constant touch with the borrowers there by reduces the transaction costs of borrowing.

5.1. THE MICROFINANCE CRISIS OF ANDHRA PRADESH

Microfinance activities in India began in the 1980s with the formation of pockets of informal Self Help Groups (SHGs) and are largely concentrated in southern region of the country and the state of Andhra Pradesh being the leader. During the early 1990s the State Government established the Self Help Group - Bank linkage program with the help of NABARD and World Bank loans and the government has facilitated in building up an impressive microfinance portfolio for the state. However with the emergence of Microfinance Institutions like BASIX, SHARE, SKS, SPANDANA, etc which replicate the methodology pioneered by the Grameen Bank of Bangladesh the scenario changed drastically. Compared to government sponsored SHG - Bank linkage these institutions grew at rapidly and reached far more borrowers. This created a rift between them because each of them believes that they should be the only source of finance for the poor. The government complaint is that MFIs charge exorbitant rates of interest and adopting coercive collection practices leading to the incidents of suicide of some borrowers. The government put a halt to the MFIs operations in the State by bringing in the AP Microfinance Ordinance in 2011and allowing the borrowers to stop repaying their loans. The announcement of the Ordinance stressed the need to protect the poor but the move seems to have made them far worse off in the long run.

5.2 WHAT ARE THE CAUSES AND CONSEQUENCES OF THE CRISIS?

Given that microfinance being theoretically viewed as a panacea for the problems associated with rural credit markets, it is interesting to see what went wrong in its practice in AP. It seems that a number of factors played a role in the chain of events that lead to the crisis.

1. The fundamental assumption that microfinance promotes income generating activities for the borrowing poor in rural areas on a sustainable basis may be true at micro level but surely not at macro level. In other words, local demand for the simple items and services produced using a microloan does not automatically elastically stretch to ensure that everyone starting a new microenterprise will also find enough customers to earn an income and survive. Given the pace at which MFIs expanded their operations in the state it is no surprise that the ability of the poor households to repay the loans is under severe strain, which seems to be the root cause of the crisis.

2. The success of MFIs has attracted more players into the sector who competed to lend to the poor with few checks and balances overlooking the ground principles of credit assessment. Competition along these lines resulted in too much lending within a short period there by weakening the powerful group mechanism of selection and monitoring leading to the problem of adverse selection.

3. The commercialization of MFIs and their consequent drive towards high profits in the wake of demands from the various stake holders is the other side of market mechanism that lead to this crisis. Charging high interest rates and adopting coercive methods of loan recovery are some of the factors in this context.

4. Another interesting factor in this crisis is the role of the state government which is a major promoter of SHGs among the poor itself as mentioned above and is not pleased with the success of MFIs which are disbursing larger loan amounts more quickly to the SHGs. This competition between government and MFIs to finance the poor with different objectives seems to have blown the crisis out of proportions. With the promulgation of AP Ordinance on MFIs it seems that the government is determined to remove the borrowers’ access to MFIs. What is interesting in this context is that none of the adjacent states of AP experienced microfinance crisis.
5. The role of media in projecting the crisis is another dimension of information asymmetry, as many reports are factually incorrect and blatantly biased. Thus Media management is going to be an issue for future success of MFIs. Also politics and media linkage is going to challenge the supremacy of market mechanism in rural credit markets in the future.

These are some of the areas where theory and practice of microfinance seems to have untwined in AP and lead to the crisis.

6. CONCLUDING REMARKS

This paper has reviewed the phenomena of credit market failures especially in rural areas of developing countries and examined the role of microfinance as a solution to the rural credit market failures due to information asymmetry and contracting. Later the factors that lead to the deviation of practice from theory in the context of Microfinance crisis in the state of AP were anlaysed. These conclusions are hypothetical and are subject to empirical verification which provides the scope for further research.

REFERENCES