

Loan sharks are circling for poor Indian debtors failed by microfinance

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A growing body of research suggests that micro-credit, the darling of international development, costs borrowers dear

It's still a week or so until Diwali, but the market in Thol, a village in northern [India](#), is already bustling with shoppers perusing cheap Chinese-made electronics, sweets, presents and decorations.

"Diwali shopping season seems to start earlier every year," says Rashmi, 36, who opened a small sweet shop last year with a loan from a local microfinance institution that is repayable in weekly instalments. A recent increase of her existing loan allowed her stock up ahead of Diwali.

It sounds like a success story: a poor woman is able to take a microfinance loan to grow her small business to match seasonal demand. But Rashmi's debt is making her stressed, as she worries about the future of her shop, the wellbeing of her family and her reputation.

Modern microfinance began with economist [Muhammad Yunus](#) who in 1976 lent \$27 (£21) to 42 women in Bangladesh. Each of the women used the money to develop their small businesses and repaid Yunus in full. The experiment paved the way for expansion of microfinance, which became a darling of international development, backed by [Bill Gates](#), [Bono](#), and [Hillary Clinton](#). The UN declared 2005 the year of microcredit, and Yunus and the Grameen Bank won the 2006 Nobel peace prize. Over the last decade, microfinance has boomed – by 2015 several thousand micro-organisations had around 200 million clients, with loans amounting to \$100bn.

But now there is a growing body of research suggesting that [microfinance doesn't work for some communities](#) – apart from generating income for lenders. It may have worked well in Bangladesh in the 70s, but it has failed to keep up with the changing needs and behaviours of business owners. One reason, say critics, is that repayment terms are unrealistic and old-fashioned. Inflexible contracts fail to meet the investment needs of poor borrowers such as Rashmi, whose income fluctuates over the year: "It can be extremely busy around the festival, and, then afterwards, there are some weeks when I can't sell a piece of barfi [traditional Indian cake]," she says.

Even though Rashmi's income is irregular, the microfinance institution demands fixed weekly repayments starting immediately after the loan disbursement. This means she cannot use all the money to give her supplier a downpayment for her order of Diwali sweets. She needs to retain 15% to make sure she can meet the repayments before she generates income. "It will take weeks to sell enough sweets to make a profit – weeks in which I still have to make regular repayments on the loan. This adds to the borrowing costs," she says.

It's a cashflow disconnect. Rashmi has had to sell stock below retail cost just to meet the repayment deadlines and pay rent for the shop. Poor borrowers also describe skipping meals, falling behind on

other bills, and going without household necessities, as well as describing classic symptoms of stress. “Finding money for the repayment every week causes me real worry and stress. Until I have money for the instalment, I feel anxious and agitated all the time,” says Rashmi.

In the past, some lenders have resorted to coercion and high-pressure tactics, and in India, [debt stress has reportedly led to some suicides](#). “Defaulting a loan is not an option, it doesn’t just mean being barred from future loans but also barred from society through humiliation, hostility, shame and harassment,” says another borrower from Rashmi’s village.

Until now, microfinance lenders have largely ignored the demand for flexible financial products, claiming they might weaken the repayment discipline of borrowers and could increase default and fraud. However, there is substantial [evidence that it this is not true](#). The high rates of repayment success trumpeted by the microfinance industry don’t necessarily mean customers are doing better, nor does it reflect the struggles faced by clients repaying debts through rigid instalments.

One recent [study funded by UKAid](#) found that flexibility in microfinance contracts led to higher repayment rates, higher business sales, and greater investment in high-risk and high-return business activities without undermining the repayment rates. Another [study by Durham University](#) found that flexible contracts can greatly improve the impact of the loan by increasing both the level of business investment and the amount borrowed by clients.

Rashmi does have other options. If she is prepared to pawn her wedding jewellery, local informal or back-street lenders will advance her the money she needs – at high interest. “The [interest] rate may be sky-high, but you can pay back whenever you have the money. It’s less stressful, and you can invest all of your loans without keeping anything for the initial instalments.” Many of her peers are considering moving to other sources for their financial needs after experiencing too many close calls when they find themselves short of money to make their microfinance repayments.

What borrowers like Rashmi want is a repayment structure that is harmonised with the cycle of investment returns to ensure they can use their loan profitably. [Microfinance](#) institutions can also benefit from taking a flexible approach to lending by reducing the transaction cost by having fewer meetings, and fewer collections. The challenge rests with the microfinance institutions to make use of the untapped potential of microentrepreneurs such as Rashmi by curating products to their needs.

The question remains: does microfinance really help poor people? “It does, at least I am not working in the fields on a hot summer’s day. I just wish there was more space to breathe between payments,” says Rashmi, closing her shop for the day. She is happy; it was a good day. But, these happy days can only continue if Rashmi’s business determines the structure of her loan, rather than the loan structure determining the success of her business.

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