# Indian Microfinance

*Looking Beyond the AP Act and its Devastating Impact on the Poor*

March 2012

# 1. Introduction

In December 2010 the government of Andhra Pradesh ("AP") passed a law (the "AP Act", originally conceived in October 2010) which effectively shut down private sector microfinance in the State. The AP Government stated that its goal was to protect the poor. Now, 18 months later, the impact of the AP Act is clear: rather than protecting the poor, it has had the opposite effect, harming the poor by starving them of access to credit and basic financial services.

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Over 9 million households in AP have been affected as access to finance has dried up[1] and lending by MFIs in AP has dropped to virtually zero from INR 7,494 crore (Cr.) (USD 1.5 billion[5]) in the year prior to the AP Act. This means that millions of people who depend on MFIs to finance their entrepreneurial pursuits and smooth household incomes have been left with no alternative, other than to return to the village moneylender.

The damage has not been limited to AP alone; indeed the impact already has and will continue to affect access to finance for the poor in other states, making this not just an AP problem, but rather a pan-India problem.

The AP Act has severely impacted the viability of private sector microfinance in India by making it impossible for MFIs to collect outstanding amounts or provide fresh loans to clients. Because the MFIs are not permitted into the field, over INR 6,000 Cr. (USD1.2 billion) of loans remain uncollected in AP today. For the same reason, MFIs cannot make new loans to the millions of poor households that depend on them as their primary source of credit. And since the uncollected funds are locked up in AP, they are unable to pay back their lenders, which include India's large public and private sector banks such as SBI, SIDBI, ICICI and others.

Despite the fact that the crisis was entirely created by the AP Government, to date India's banks and regulators have provided little in the way of relief to MFIs other than an onerous Corporate Debt Restructuring ("CDR") deal, usually reserved for companies that have caused their own downfall.

With no way to collect outstanding amounts and repay the banks, and with little assistance from regulators, many MFIs are now financially impaired, and some teeter on the brink of bankruptcy. Indeed, some MFIs have already failed, while others have scaled back their operations. All MFIs with operations in AP remain extremely fragile, including those that restructured their loans.

The fact that one state law can imperil an entire industry and put millions of households at risk has severely damaged India's reputation. More importantly, it has compromised India's financial inclusion agenda in ways that may not be readily obvious to observers. Given the fact that the AP Act was allowed to stand for 18 months, lenders and investors are understandably reluctant to provide debt and equity financing to MFIs. This has choked off MFIs' ability to grow, which will in turn reduce the number of poor households with access to credit and basic financial services.

The travesty of the AP Act is not only what is seen, but also the unseen. It is relatively easy to see the millions of households in AP that no longer have access to a key source of credit. They have suffered over the last 18 months with little hope in sight that the situation will be resolved. Also evident is the devastation of an entire industry, the loss of thousands of jobs, and the

2010
**₹7,494CR**

2011
**ZERO**

In the year before the AP Act was passed, MFIs disbursed ₹7,494 Cr. (USD 1.5BN) in Andhra Pradesh; since the Act, the disbursements have dropped to almost zero.

denial of MFIs' right to conduct lawful business, in direct contravention of Indian law.

What is perhaps less visible are the millions of poor households outside of AP and across India who will no longer receive a loan, be provided with financial literacy education, nor offered insurance as MFIs are unable to survive and grow to meet the massive demand for financial services at the bottom of the pyramid.

Also unseen is the very real damage to India's financial inclusion agenda that will be a dark and lasting legacy of the AP Act. In the space of just 18 months, the AP Act has helped to create the largest group of women in the world that will be blacklisted from accessing credit for years to come. A credit culture that has taken decades to build has effectively been destroyed in a matter of months. Historic repayment rates that were close to 100% have fallen to 5% in AP and the contagion is spreading to other neighbouring states.

Without access to formal microfinance products, India's rural poor have been thrown back into the arms of the village money lenders, whose interest rates can be five times higher than the rates of the MFIs, and whose payment enforcement techniques are not subject to any moral or institutional restraints.

In short, the small loans provided by microfinance companies facilitate the livelihoods of millions of families, whether buying seed and fertiliser, smoothing uneven incomes, paying for medical care or sending children to school. The long-term consequences of crippling the microfinance industry, even if invisible to many, will not be quickly undone, if ever. The desolation caused by the AP Act is felt in millions of lives, becoming more debilitated every day that this crisis is permitted to continue.

Parliament will soon vote on The Micro Finance Institutions (Development and Regulation) Bill, 2011 (the "Bill") which, if passed, will supersede the AP Act and create a federal framework for microfinance. This should hopefully lead to the repeal of the AP Act which will then allow MFIs to try to pick up the pieces of the industry.

The passage of the Bill would be a welcome development that will at least establish clear regulatory oversight for the microfinance sector based on market principles. However, it cannot even begin to undo the AP Act's long term damage to MFIs and certain provisions in the Bill will, if implemented, unfortunately ensure that MFIs remain permanently weakened, unable to fulfil their important role in advancing the financial inclusion agenda in India. The Bill is clearly well-intentioned, but will have unintended negative consequences for MFIs, and the millions of poor households who depend on their service.

### Objectives

This paper has three objectives: first to document the very real and disastrous impact of the AP Act upon the millions of poor Indian families and the microfinance institutions that serve them; secondly, to address the specifics of the proposed Bill and the recent RBI circular on NBFC-MFIs, with regard to the impact on the poor; and finally, to look forward and recommend a course of action for policymakers, bankers and the MFIs that will support a strong financial inclusion agenda and serve the best interests of India's poor in the future.

# 2. The Impact of the AP Act on Microfinance and the Poor

## I. HISTORY OF THE AP ACT

Microfinance in India has historically been provided through three channels: the government, the private sector and charities. These three channels, as large as they are, have only a small fraction of the capital and geographic scale required to meet the overwhelming need for finance amongst India's rural poor.

According to RBI estimates[3], there are over 450 million "unbanked people" in India, most of whom live in rural areas. The term "unbanked" refers to people who have no access to formal financial services, but rather must rely on either family, or informal providers of finance, such as the village moneylender. It is indisputable that access to finance is critical for enabling individuals and communities to climb out of poverty.

It is also generally agreed that relying on the limited resources of village moneylenders exposes the poor to coercive lending practices, personal risks and high interest rates, which can be as high as 150%[4]. Therefore the Indian Government and the RBI have created a policy of "financial inclusion". As part of this policy, the government requires Indian banks to lend to "priority sectors", one of which is the rural poor. Until recently, banks were happy to lend money to MFIs who would then on-lend funds, primarily to poor women across urban and rural India.

The banks have welcomed this policy because historically they tended to charge MFIs average interest rates of 12-13% and benefited from 100% repayment rates. Thus, by lending to MFIs, banks have been able to meet their "priority sector" lending requirements with what historically has amounted to a risk-free and very profitable arrangement.

In October 2010 the Government of Andhra Pradesh issued the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010 (passed into law in December 2010) which effectively shut down all private sector microfinance operations in the state. The passage of this Act dealt a major blow to the entire microfinance industry across India since Andhra Pradesh, which is widely regarded as the birthplace of private sector microfinance in India, accounted for 30% of all loans by MFIs across India according to some estimates[5].

Not only did this Act dramatically weaken the balance of the trinity of government, private sector and charities that serve the poor, it also posed a serious problem for public and private sector banks with non-performing loans and upset the broader national financial inclusion agenda.

### a. The "rationale" behind the AP Act.

The AP Government stated that the goal of the AP Act was to protect the poor, but from the evidence it is now clear that it was primarily directed towards stifling the operations of private sector MFIs. The AP Act specifically excluded the Self Help Groups (SHGs) that are run by the Society for Eradication of Rural Poverty (SERP), an Andhra Pradesh government-backed microfinance business, which has historically received significant support from organisations such as the World Bank, and which directly competes with private sector MFIs. The AP Act does not try to hide its anti-competitive aims: the text of the Act declares that its goal is "to [protect] the interests of the SHGs"[6]. As Vijay Mahajan, Chairman of BASIX, has noted[7], the AP Government "is an unfair referee as it is both player and referee".

The AP Government's claims that private sector MFIs have exploited India's poor by charging usurious interest rates and practicing coercive recovery techniques cannot be substantiated. Recently, old allegations of increased suicide rates among MFI borrowers resurfaced, but based on data from SERP itself, it appears

**1 in 3**

people in India have no access to formal financial services

that the actual rate is lower than the statistical average in the state of Andhra Pradesh, meaning that people who receive private sector loans are less likely to commit suicide than those who do not – an inconvenient truth for those opposed to private sector involvement in microfinance in AP.

b. **Misrepresentations of MFI operations have been debunked.**

A white paper published by Legatum in May 2011 – "*The Crisis at the Bottom of the Pyramid*"[8] – addressed the more egregious distortions of fact regarding private MFIs in detail. To summarise:

- **Usurious rates:** India's larger MFIs[9] generally charge average interest rates of between 23.6-28.1%, which are lower than the average interest rate of over 30% for consumer credit cards in India[10], and are also among the lowest rates for microfinance in the world, despite the high cost of providing value-added "doorstep services".
- **Coercive collection techniques:** There is little need for MFIs to employ coercive measures: MFIs adopt the group model that ensures on-time repayments and credit discipline; they require small, frequent payments and restructure loans to support clients when necessary; good credit is as valuable to the poor as it is to the wealthy. Severe and isolated cases of unacceptable collection techniques have resulted in immediate termination for employees of MFIs.
- **Suicide rates:** While suicide for any reason is a profound tragedy, it appears that, based on data provided by the gender unit of SERP[11] borrowers from private sector MFIs appear *less likely* to commit suicide than their fellow residents in Andhra Pradesh. This should, of course, come as no surprise given how MFI clients benefit from the services provided. Eric Bellman, writing in the Wall Street Journal in 2010, notes "If the state investigates suspicious debt-related suicides, it may well find that loan sharks, landlords and even family members are more often the ones that could be accused of harassing borrowers to death."[12]

It can be seen from the foregoing that the supposedly factual basis for the AP Act is, in fact, deeply flawed. Since the passage of the Act, the AP Government has been unwilling to substantiate these allegations; rather it has relied on anecdotal evidence to support its actions. This does not mean to say that the prevailing system, with thousands of staff and millions of clients, is perfect or without fault. All MFIs need to work hard to build a common culture and mitigate the risk posed by overzealous loan officers. A constant focus on the needs of the client is certainly necessary. Yet shutting down an entire industry because of anecdotal evidence of isolated problems would be like closing all hospitals because a few nurses provided poor or misguided treatment to their patients.

# 9.2 MM

women now form the largest bloc of blacklisted borrowers in the world thanks to the AP Act

## II. CONSEQUENCES OF THE AP ACT

Across the board, the AP Act has shattered confidence and trust in the microfinance model that took decades to build. Under the guise of protecting the poor, AP Government officials attempted to gain favour with rural microfinance borrowers by encouraging them to default on their loans to MFIs, thereby turning more than a billion US dollars in outstanding loans into grants. This giant government giveaway programme was, of course, involuntarily financed by private and public sector banks and equity investors across India and overseas.

In the short term the borrowers might have enjoyed unexpected relief from their obligations, and the AP politicians might have successfully increased their popularity amongst voters, but the longer term impact is already coming into focus. The credit discipline and culture of responsibility amongst borrowers, carefully nurtured over 20 years, have been severely damaged.

The AP Act has had a devastating impact specifically upon the 9.2 million women in AP who are now considered to be delinquent in their loan repayments[13]. These women now form the largest bloc of blacklisted borrowers in the world: with their credit histories recorded by the credit bureau they will find it nearly impossible to access credit for the rest of their lives.

Although the AP Act has affected Andhra Pradesh most acutely[14], the fallout has been widespread: clients in every state across the nation are now limited in their access to financial services; the industry's ability to act as a critical channel of allocating resources to the poor is now being openly questioned; and the image of microfinance has been tarnished globally[15].

Legatum's white paper[16] of May 2011 *"The Crisis at the Bottom of the Pyramid"* (which can be found at www.legatum.org/attachments/MIcrofinanceCrisis), correctly forewarned the impact of the AP Act if it was not swiftly repealed or overruled: it is a tragedy that many of these warnings have become a daily reality for millions of rural poor in the 9 months since the white paper was issued and no action has been taken.

a. **The microfinance sector is shrinking, reducing its ability to reach poor households across India.** According to MIX Market, the leading resource for data on the sector, overall loan portfolios for MFIs across India shrunk by 33% from INR 26,255 Cr. (USD 5,25 billion) to an estimated INR 17,591 Cr. (USD 3.52 billion)[17] and MFIs lost 1.8 million clients in AP alone, between March and December of 2011. Much of this loss can be attributed to the blockage of new loans in Andhra Pradesh, which accounted for about 30% of the gross loan portfolios of MFIs in the country in March 2011. While the impact has been greatest in AP, where MFIs have been unable to lend or collect since the AP Act, increased delinquency rates have spread to 12 districts in surrounding states; and because MFIs have been forced to divert capital from other states to shore up their AP portfolio, the value of loan portfolios in Maharashtra and Tamil Nadu, for example, has now fallen below levels last seen in March 2011[18].

   The worst is by no means over. Although current data show only an 18% shrinkage in loan portfolios in Andhra Pradesh, most MFIs have yet to write-off their "past due" loans in the state. Microfinance sector leaders predict that between 70-90% of loan portfolios[19] in AP will eventually be written off, amounting to INR 4,919 Cr. (USD 983.8MM) to INR 6,395 Cr. (USD 1.28 billion), or between 19 to 24% of the private microfinance sector's entire portfolio in FY 2011.

# 90%

of MFI loan portfolios in AP will likely be written off

The bigger picture for the poor across India remains grim: as of March 31 2011, the gross loan portfolio of the industry was meeting just 8% of the total demand for micro-credit in India; since then, this figure has declined by a further 25%[20], once again marginalising the poor who need access to finance the most.

Conclusion

*The AP Act has dramatically reduced access to financial services for the rural poor across India; with the result being greater poverty and hardship for millions of MFI clients who are now less able to run their enterprises or pay for basic necessities for their families, like healthcare, education or insurance.*

b. MFIs are facing severe financial duress, putting at risk the best, most proven actors in financial inclusion.

At the direction of the RBI, seven MFIs with major exposure in AP were driven towards Corporate Debt Restructuring (CDR) packages estimated to total over INR 5,411 Cr. (USD 1.08 billion). While many of these restructuring packages have been concluded successfully, the CDR packages may yet provide only brief respite from the full financial impact of the crisis, since it will be necessary to write off all of the underlying portfolios as of April 1, 2012. While only one MFI is reported to have defaulted on its bank loans thus far, write-offs are predicted to be as high as 90% in AP.

Until MFIs can start collecting outstanding loans in AP, they must rely upon generating profits elsewhere and directing proceeds to repay banks: this inevitably means that there will be fewer loans made in other states. As we shall discuss later, it is also noticeable that credit has been slow to reach non-AP portfolios since the AP Act was passed into law, further compounding the problem faced by MFIs.

Secondly, a weakening of credit discipline is resulting in higher delinquencies across the country. In AP, repayment rates have dropped to as low as 5%[21], and even outside the state repayment rates nationally continue to fall from a historic average of 99% down to 97%[22]. While at first glance this might not appear to be a significant drop, MFIs pride themselves on having established a virtually unblemished track record of repayment. A strong culture of the poor repaying their loans is crucial to the long term success of the model and for financial inclusion as a whole. In addition, MFIs with significant AP exposure are experiencing increased fraudulent activity by staff in other states, prompted by the declining loan portfolios and consequent lack of job security amongst field staff[23].

Thirdly, and most importantly, changes in capital adequacy requirements will have a dramatic effect upon both large and small MFIs. An increase in the minimum capital requirement for MFIs from INR 2 Cr. (USD 400K) to INR 5 Cr. (USD 1MM) represents an unreasonable 2.5 fold increase for an industry with historic repayment rates of almost 100%. Similarly, the requirement for capital adequacy of 15%[24] will have a significant impact for MFIs with AP exposure.

If the new RBI norms are applied on April 1, 2012, as expected, MFIs will all be forced to write off their entire AP portfolio, amounting to INR 6,000 Cr. (USD 1.2 billion), and resulting in the majority of these MFIs being unable to meet the RBI's new capital adequacy requirements. If lenders choose to convert their outstanding debt to equity in order to help MFIs to meet these requirements, then equity investors will be diluted overnight.

This is a lose-lose proposition for all parties: as a result of the AP Act, the potential value of MFIs to their equity or debt holders is minimal; until MFIs can start disbursing and collecting

# ₹6,000 CR

(USD 1.2BN) is at risk in uncollected loans in Andhra Pradesh

loans from their clients again, the likelihood of lenders recovering loans from MFIs is remote; equity investors around the world will take notice of any debt to equity conversion and the private equity markets will be closed to microfinance organisations for years to come. A shortage of equity capital will create a domino effect: MFI growth will stagnate, resulting in less access to credit and financial services across India, which will make the poor even worse off and compromise India's national financial inclusion agenda. Above all, the threat to the future viability of private sector MFIs will strike hardest at the poor: with fewer MFIs competing for their business, the free market forces that help to drive down costs and increase service for borrowers will be undermined.

Conclusion

*As a result of the AP Act and the RBI's capital adequacy requirements, many MFIs are on the brink of failure, which will negatively impact the financial inclusion agenda for India, and millions of poor households.*

### c. Lending to MFIs has dried up, eliminating access to credit for the poor both now and into the future.

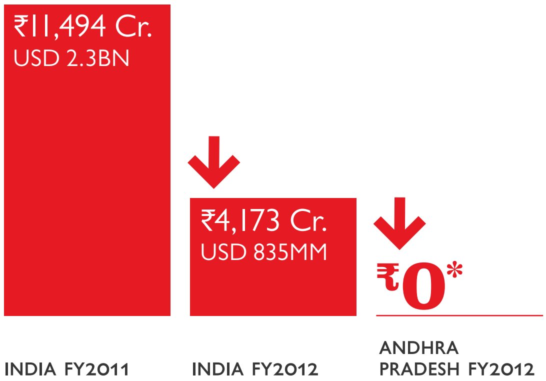
Indian banks have abandoned private sector lenders to the poor, offering them credit at unsustainable rates and on onerous terms. Prior to the AP Act, the average tenure for bank loans to MFIs was 37 months, with a 12.4% interest rate[25]. Since the AP Act, banks are protecting themselves by generally offering shorter term, 24 month loans with interest rates as high as 15%[26].

Across India it is now harder for MFIs to secure the funds to meet the demand for financial services to the poor. And when MFIs do take these loans, they must pass on the costs to the borrowers. In effect, the AP Act has driven up the real cost that the poor will need to pay for their loans, for a long time to come, by having introduced defaults, uncertainty and increased cost and risk for financiers.

Bank lending to MFIs in FY 2012 (until December) was limited to 12 MFIs, of which SKS was the only MFI with significant exposure to AP that received funding – all other MFIs with significant AP loan portfolios have so far been denied funds. Lending to the sector in FY 2012 has been a mere INR 4,173 Cr. (USD 835MM)[27], which is less than a third of disbursements to the industry in FY 2011. As the fiscal year end approaches at the end of March 2012, this may increase marginally as banks look to fill their priority sector lending requirements.

Although the largest private sector lenders, ICICI Bank and HDFC Bank, have not re-started lending to MFIs, a number of public sector banks, most notably SIDBI, have begun to disburse small amounts. These amounts, however, are a drop in the ocean compared to the demand for credit by the poor and the flow of funds to private sector MFIs prior to the AP Act. MFIs with AP exposure are urgently in need of financing for their non-AP portfolios if they are to survive the current crisis.

On December 2, 2011, the RBI opened up the external commercial borrowings (ECBs) channel for NBFC-MFIs, something that was previously open only to non-profit MFIs, and they raised the limit for borrowing from INR 24.9 Cr. (USD 5MM) to INR 49 Cr. (USD 9.8MM)[28]. While this appears to be a positive step in providing alternative sources for funding for MFIs, the RBI's decision merely provides a small patch over a gaping wound and begs the question of whether it is reasonable to expect foreign lenders to provide financing to MFIs in India when Indian lenders, themselves, are still reluctant to provide credit to the sector.




**TOTAL DEBT CAPITAL**

Lending to MFIs has plummeted across India and fallen to almost zero for MFIs with exposure in Andhra Pradesh

*excluding SKS

Conclusion

*The blockage of funds to MFIs is now systemic, hampering the government's financial inclusion agenda, and will likely contribute to the failure of private sector MFIs, ultimately leading to less access to credit for the poor, along with higher borrowing costs for the fortunate few who can find loans from someone other than the village moneylender.*

d. Regulatory uncertainty has eroded investor confidence, negatively impacting the prospects for future growth in the microfinance sector and access to credit for the poor.

The damage that has been caused by the AP Act extends beyond lenders, MFIs, and the poor. Equity investors, critical to the continued growth of the microfinance sector, have virtually disappeared. The for-profit microfinance model is heavily dependent on attracting large pools of equity capital, and the current uncertainty has led investors to seriously question whether capital invested in the sector can still meet their required risk-adjusted rate of return.

The impact is already being felt. The table below illustrates the dramatic reduction in equity capital invested in MFIs in recent years:

| | EQUITY CAPITAL INVESTED | |
|---|---|---|
| PERIOD | INR CR. | USD MM |
| FY 2009 | 1,342 | 273 |
| FY 2010 | 1,034 | 206 |
| FY 2011 (TO OCT 2010)* | 2,600 | 520 |
| OCT 2010 TO FEB 2012 | 472 | 96 |

* when AP Ordinance was issued

Just two transactions accounted for USD 60MM (INR 295 Cr.) in the Oct 2010-Feb 2012 period: the investment by IFC in Bandhan, and by FMO and Wolfensohn in Ujjivan. Apart from one venture capital fund, the investments were all made by Development Financial Institutions (DFIs) and Microfinance Investment Vehicles (MIVs).

A small number of securitisation deals were completed in the last year, but the first loss default guarantee rose from under 10% to over 15%, and while some MFIs were able to list Non-Convertible Debentures (NCDs) this was limited to those without significant AP portfolio exposure. Most investors have delayed or cancelled investment plans until regulatory certainty and overall stability is regained.

Conclusion

*Without greater clarity and regulatory support for a market-based microfinance industry, equity investors will abandon the sector to seek commercial rates of return on their capital elsewhere, placing the Indian Government's financial inclusion agenda in further jeopardy.*

e. The Government has not filled the financing gap caused by the AP Act, leaving the poor with no options for financing other than the village money-lender.

Following the passage of the AP Act, the AP Government indicated that it would help to bridge the funding gap by providing increased financing through their self-help group programme. Recent populist moves to offer interest-free loans[29] have only reinforced the fact that such programmes are financially unsustainable. The AP Self Help Group programme has demonstrated its deficiencies for years and once again proven itself unable to fill the vacuum created by the suffocation of the privately run MFIs. According to the October 2010 white paper from Intellecap[30], the government programmes have "…neither the discipline needed for long-term sustainability, nor a business model that can be scaled up effectively".


Since the AP Act, equity capital investments in the Indian microfinance sector have dropped 82%

It is instructive to compare the relative performance of MFIs against SHGs over the period 2008-2010:

Gross Loan Portfolio

| | GROSS LOAN PORTFOLIO INR CR | USD (BN) | GROWTH PA |
|---|---|---|---|
| **2008-2010** | | | |
| MFIs | 6,843-21,890 | 1.37-4.38 | 80% |
| SHGs | 18,648-27,500 | 3.73-5.50 | 21% |
| **MARCH 2010-APRIL 2011** | | | |
| MFIs | 25,831 | 5.25 | 18% |
| SHGs* | n/a | n/a | n/a |

Client Base

| | CLIENT BASE IN MILLIONS | GROWTH PA |
|---|---|---|
| **2008-2010** | | |
| MFIs | 9.9-26.8 | 64% |
| SHGs | 21-26.5 | 13% |
| **MARCH 2010 – APRIL 2011** | | |
| MFIs | 31.7 | 18% |
| SHGs* | n/a | n/a |

* Regrettably, SERP has failed to provide data since the AP Act was passed so it is not possible to quantify how the SHGs met the increased demand after the passage of the AP Act.

In explaining the growth of MFIs, Intellecap's October 2010 white paper noted, "the MFI's combination of doorstep service, easy credit, frequent small-value repayments and the group guarantee is attracting borrowers – who are no longer so naïve that they cannot weigh the attractions of these factors against the lower rates of government programmes"[31].

Additionally, a World Bank report[32] found that government loan administrators sometimes demand bribes of up to 20% of the loan amount before loan requests are granted. If true, this would help explain why borrowers prefer accessing loans through MFIs which are provided in a transparent public group forum, over the potentially coercive manner in which some SHG loan officers provide loans. Moreover, if a borrower must pay interest of 3% per annum (typical subsidised SHG interest rate) and a bribe of 20% of the loan amount, then the borrower's actual cost of capital can quickly become greater than the interest rates charged by MFIs.

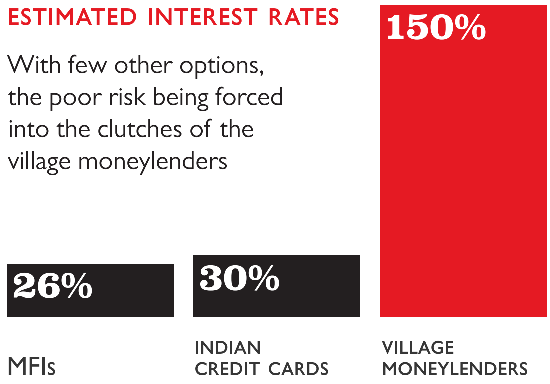
When one takes the better, client-focused service offered by MFIs into account, it becomes easy to understand why MFIs consistently took significant market share from SHGs until the passage of the AP Act effectively shut them down.

According to a recent industry study[33] it appears that the government SHGs were often making multiple loans to the same borrowers: SHGs disbursed more than three times as many loans as there were eligible households. At a minimum, it is reasonable to conclude that the SHGs were complicit helping to create the surge in multiple loans which was one of the issues that the AP Government claimed as justification for the passage of the AP Act (but which, notably, exempted the state's own SHGs from its provisions).

While SHGs have been shown to be generally uncompetitive in providing financial services profitably and sustainably, there is still a limited role for SHGs and government–backed entities in servicing those who are not reached by the private sector. Rather than being seen as a competition when there can only be one winner, the enormous challenge of providing financial services to 450MM unbanked people suggests that there are indeed complementary roles for SHGs, the private sector, and charity in providing financial services to the poor.

## Conclusion

*SHGs have their own failings and based on the evidence are no substitute for the private sector MFIs. The idea that the government, through SHGs or other programmes, can replace MFIs and serve India's 450 million unbanked is not only wholly unrealistic but it disregards and disserves the poor.*




## III. ADDITIONAL LEARNINGS FROM THE AP ACT

While the single overriding conclusion of the current crisis is that it was entirely contrived by the AP Government – and therefore avoidable – the broader implications of the AP Act should not be missed. As George Santayana, the philosopher, essayist and novelist noted, "Those who cannot remember the past are condemned to repeat it". In this case, the history of the Krishna crisis of 2005 – another politically motivated attack on MFIs in AP, albeit on a significantly smaller scale – has been repeated by the AP Act with the same punishing effect upon the poor, the destruction of an entire sector, resulting in massive layoff of workers and undermining the image of India as a global leader in financial inclusion. As we look forward to a new chapter in financial inclusion two further lessons should be heeded if we are to avoid the crises of the past.

> "Those who cannot remember the past are condemned to repeat it"
> George Santayana

a. History shows that borrowers in rural India are fundamentally responsible in managing their meagre finances and in meeting their obligations – except when given undue licence by politicians to default on their debts. Over two decades they have shown that they can receive loans, put the money to good use and repay the loans when due. Even today outside AP, borrowers continue to build up their credit history and climb the prosperity ladder.

   Such a record suggests that efforts to re-establish a well-regulated sector that genuinely protects the interests of the poor and provides ready access to a wider range of financial services are timely and will be rewarded with sustainable progression towards true financial inclusion nationwide.

b. The microfinance sector must do a better job of explaining the benefits a responsible for-profit approach to financial inclusion that is sustainable, scalable and uniquely satisfies the needs of the poor. In recent months, there has been a resurgence of sensational media stories in which the private microfinance sector has been unreasonably attacked.

   The leading players in the sector must vigorously contest the discredited accusations[34] and dispel the fog of misrepresentation, starting by setting a positive example themselves that embraces greater transparency, stronger governance, an increased focus on the specific needs of the poor, and strong adherence to an industry-wide code of conduct. It behoves the Microfinance Institutions Network ("M-FIN")[35] and its members to push back forcefully against unsubstantiated speculation, to redouble efforts to serve the real needs of the poor and to champion the smooth passage of the microfinance Bill which is shortly to be debated in Parliament.

# 3. The Micro Finance Institutions (Development And Regulation) Bill, 2011

The current provisions of The Micro Finance Institutions (Development and Regulation) Bill, 2011 (the "Bill"), are a welcome step in the right direction and its early passage is critical in restoring the Indian Government's plan to provide financial inclusion for millions of the poor across India. The profound uncertainty created by the AP Act is a strong disincentive to providers of capital. Most importantly, the Bill legitimises microfinance as an industry, appoints the RBI as the key regulator, and clearly removes regulation of the sector from the purview of state law regulating money lenders and usurious loans.

The Bill's objective to "facilitate universal access to integrated financial services for the unbanked population" is laudable. Its provisions will bring in standardised accounting and reporting, better standards of corporate governance and transparency, and ensure that adequate attention and funding is channelled to protecting the social development goals of the industry.

Nevertheless, there are a number of provisions in the Bill and in the RBI circular of December 2011 that may undermine the positive intentions behind the drafting of the Bill. We strongly urge that the following issues be considered in the Parliamentary debate around the Bill, and by the regulators during its implementation.

a. **Setting an annual income cap of INR 60,000 per household will arbitrarily exclude some current borrowers[36].**
   Limiting loans to households with less than INR 60,000 (USD 1,200)[37] in annual income encourages misrepresentation of true income by current loan recipients who may find themselves suddenly excluded from eligibility. Furthermore, such a cap disincentivises borrowers from increasing their income for fear of losing access to loans in the future. More discussion is needed to ensure that vast sections of India's poor are not denied access to financial services based on arbitrary levels of household income.

b. **Artificial caps on interest rates and profits will impede progress towards reducing the cost of financing for the poor[38].**
   Applying arbitrary, fixed caps on interest rates and profit margins is a backward step for a country committed to encouraging business-driven growth and de-regulation. The proposed 26% interest rate cap takes no account of the fluctuation in bank lending rates which have recently risen from 12% to 14-16% (despite a recent decrease in interest rates in India). Rate caps stifle the free competition which helps attract new entrants to the markets and which ultimately will drive down the cost of borrowing for the client. It is a fundamental rule of economics that price caps create shortages in supply, and in this case the real impact of an attempt to regulate the price of loans will be the dire inadequacy of available finance.

c. **Increased capital adequacy requirements will unnecessarily trigger MFI defaults and threaten lenders' ability to reclaim debt[39].**
   As already noted, the increased capital adequacy requirements risk creating further defaults amongst MFIs, reducing the ability of lenders to recover debt and will ultimately hamper the delivery of financial services to the poor. A grace period following the passage of the microfinance Bill would enable MFIs to recapitalise without threat of surrendering equity and reconsideration of the absolute capital requirements could allow for a reasonable operating cushion without constraining the ability of MFIs to conduct business.

d. **The limits on flexible loans will force MFIs to ignore clients' real needs[40].**
   The RBI guidelines also limit the ability of MFIs to provide flexible loans which are tailored to actual client needs rather than simply conforming to pre-defined amounts, tenures and repayment frequencies. When


The artificial cap on annual household income above which access to loans will be denied to many current borrowers

considering caps on loans and thrift[41] for clients, provisioning norms and other critical regulations, we recommend that regulators consult directly with the MFIs which have the most relevant first-hand experience in satisfying clients' real needs. Secondly, any proposed regulation should be field-tested with MFI partners before submitting to the legislative process.

e. **The inclusion of thrift in the Bill is a welcome step in building a model of financial inclusion beyond microcredit.**
Since limited detail is provided in the Bill on how MFIs would implement the collection of thrift[41], we recommend that beyond a limit, such as INR 50,000 (USD 1,000), MFIs accept deposits as banking correspondents (with appropriate safeguards), rather than directly, since MFIs are not covered by the Deposit Insurance Corporation Act.

Furthermore, the draft Bill does not mention the required statutory liquidity ratio. Once this is defined it will determine the viability of offering thrift, given the high transaction costs involved in collecting and servicing small savings. The draft Bill is also unclear as to whether thrift can be accepted only from "borrowers" or if fresh customers for "thrift-only" may also be serviced. Further clarification on this important initiative would be welcome.

f. **Advisory councils will benefit from the inclusion of senior representatives of MFIs, and representation from all important stakeholders in the sector including equity investors.**
The constitution of a council to advise the Central Government on formulation of policies and the development of State Advisory Councils are welcome proposals, in principle. However, the proposed committee will not necessarily include MFI CEOs, although provision is made for up to six members with significant microfinance, rural credit or banking experience. The voice of the experienced microfinance practitioner is crucial in evaluating and refining recommendations and we suggest that microfinance sector representation should be mandatory. The council should also have broad representation from other stakeholders in the sector including equity investors, and people with experience in the technology that will be crucial in helping to reduce cost and increase the effectiveness of the sector over the long-term.

g. **Delegation of RBI powers to NABARD creates a conflict of interest.**
The implementation of in-field monitoring provisions in the Bill may be hard for the RBI to execute, given the extensive reach of the sector. Proposed solutions include the RBI retaining the option to delegate its powers to NABARD and in its response to the draft Bill the AP Government has also suggested that "implementing the code of conduct in the field" be a matter for state jurisdiction.

We would caution against the RBI's delegation of this power to either NABARD or to state governments: the former could create a conflict of interest since NABARD continues to promote the SHG bank linkage programme, while the states themselves have a vested interest. In AP's case, the state has explicitly expressed an intention to promote the state SHG programme and to restrict MFI operations, using legislation ostensibly targeted at money lenders and usurious practices to achieve their ends. Clarity around the role of each of these parties (RBI, state governments, development banks, microfinance associations and practitioners) will mitigate apprehension regarding the long-term stability of the sector.

# 4. Conclusion

The actions of the AP Government have had a devastating impact on the microfinance sector. As a result of the AP Act, Andhra Pradesh is now home to one of the largest groups of black-listed creditors in the world with over 9MM women in default; the real cost of providing fewer loans to the rural poor across India has increased; many private sector MFIs are on the brink of collapse; and both lenders and shareholders are facing significant losses once MFIs with large exposure to AP write off their loans.

The AP Act was passed on the basis of allegations that to this day remain without substance or fact. Claims of usurious lending rates, coercive collection practices, and widespread suicides as a result of over indebtedness and a pressure to repay are inconsistent with the reality in the villages, as confirmed by the manner in which clients consistently preferred working with MFI's over state-run SHGs despite their nominally lower interest rates. While no one disputes that shortcomings can occur in any industry serving millions of clients every day and that the industry must therefore remain vigilant in meeting the needs of its clients, the greater risk today is that a critical channel that provides financial access to the poor will be permanently and needlessly cut off.

Without significant equity and debt funding, together with a clear and supportive regulatory framework overseen by the central government, private sector MFIs in India face a bleak future. Since the passage of the AP Act in December 2010, we have witnessed the virtual destruction of a credit culture that has taken decades to build.

- Borrowers have been told by the AP Government that they are no longer accountable for their loans and over INR 6,000 Cr. (USD 1.20 billion) will soon be permanently written off by MFIs and banks;
- many MFIs are on the verge of bankruptcy and as a result many of India's banks also stand to lose;
- the AP Government's SHG programme has failed to bridge the gap;
- lenders are no longer willing to provide significant capital to the sector; and
- equity holders are on the brink of massive dilution should lenders choose to convert their debt into equity as MFIs struggle to meet capital adequacy requirements.

In summary, the passage of the microfinance Bill has the potential to be a significant step forward to restore the credibility of the Indian microfinance sector and the government's commitment to achieving financial inclusion for India's 450 million "unbanked people." To achieve this however, it is essential that any regulations have the overriding principle of leaving the levelling and innovative forces of market competition and market pricing intact, while removing the impediments and uncertainty created by the AP Act.

We would strongly encourage the Indian Government to act upon the following:

1. Ensure the swift passage of the microfinance Bill through Parliament and ensure that the AP Act is repealed.
2. Facilitate the collection of all outstanding dues in AP.
3. To the extent that loans in AP cannot be recovered, the Government of Andhra Pradesh must be held accountable to repay MFIs and their respective lenders for the needless damage caused to the industry and its clients.
4. Extend a grace period to MFIs with large exposure to AP with respect to the capital adequacy norms expected to be introduced by the RBI on April 1, 2012.
5. Encourage banks to provide debt funding to the sector again, particularly to MFIs with significant AP exposure, or these MFIs will likely fail.
6. Reconsider the artificial cap on interest rates and profit margins that would impede growth, reduce competition, diminish the supply of credit and reduce the overall level of service to clients.
7. Establish a mechanism for stakeholder consultation before the passage of any new legislation.
8. Decline to impose an artificial threshold on borrowers' income levels in order to ensure broad access to finance and ensure MFIs can facilitate greater financial inclusion.
9. Clarify the rules around thrift and MFIs' ability to accept deposits as banking correspondents.
10. Relax the limits on flexible loans so that MFIs can continue to provide products adapted to meet clients' real needs.

## Notes

1. Business Standard Oct 16 2011: No Fresh Loans in AP A Year After Ordinance http://www.business-standard.com/india/news/no-fresh-mfi-loans-in-apyear-after-ordinance/149081/on
2. For consistency, exchange rates are assumed to be INR 50 = USD 1 throughout this paper
3. The actual number could be higher as these estimates do not account for multiple accounts by a single individual. Source: "Financial Inclusion – The Indian Experience" Speech by Smt. Usha Thorat, Deputy Governor, Reserve Bank of India at the HMT-DFID Financial Inclusion Conference 2007, Whitehall Place, London, UK on June 19, 2007.
4. http://www.livemint.com/2011/01/17213953/Moneylenders-push-up-interest.html?atype=tp
5. Intellecap estimates
6. AP Microfinance Ordinance – "Whereas these SHGs are being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery resulting in their impoverishment & in some cases leading to suicides, it is expedient to make provisions for protecting the interests of the SHGs, by regulating the money lending transactions by the money lending MFIs and to achieve greater transparency in such transactions in the State of Andhra Pradesh"
7. http://blogs.cgdev.org/open_book/2010/11/when-indian-elephants-fight.php
8. See www.legatum.org/attachments/MicrofinanceCrisis.pdf
9. For argument, SHARE Microfin and Asmitha are taken to be representative of the sector and are used as a reference point
10. Interest rates on credit cards in India range from 29.88% to over 45% p.a.
11. Microfinance Focus, October 2010
12. http://blogs.wsj.com/indiarealtime/2010/11/15/india-journal-microfinance-by-the-numbers/
13. Business Standard, July 8 2011: Andhra Pradesh MFIs get a Breather; quote by Vijay Mahajan http://microfinanceafrica.net/microfinance-around-the-world/india-andhra-mfis-get-breather/
14. Business Standard Oct 16 2011: No Fresh Loans in AP A Year After Ordinance http://www.business-standard.com/india/news/no-fresh-mfi-loans-in-apyear-after-ordinance/149081/on
15. CSFI Survey – Microfinance Banana Skins 2011 http://www.citi.com/citi/microfinance/data/news110125b.pdf
16. See www.legatum.org/attachments/MicrofinanceCrisis.pdf
17. Note that actual reporting to MIX Market in December 2011 represented only 56% of MFIs; actual reported Gross Loan Portfolio was INR 13,764 Cr. ((USD 2.81 billion) which would have been a 46% decrease in GLP. See http://www.cgdev.org/doc/blog/Roodman%20open%20book/India%20market%20numbers.xlsx
18. MIX data for MFI portfolios as of December 31 2011
19. Interviews with industry leaders conducted by MIX Market Regional Analysts
20. Total demand for microcredit estimated by Intellecap in "Inverting the Pyramid" 3rd edition, is INR 330,049 Cr. (USD 72 billion)
21. http://articles.economictimes.indiatimes.com/2011-10-09/news/30260268_1_microfinance-institutions-institutions-network-mfin
22. Industry leaders to MIXMarket
23. See http://businesstoday.intoday.in/story/sks-microfinance-staff-swindled-rs-1.6-cr-in-2010-11-auditors/1/16825.html
24. W.e.f. March 31, 2012
25. Reported to MIXMarket
26. Interviews with industry leaders conducted by MIX Market Regional Analysts
27. Intellecap estimate
28. See: http://rbi.org.in/Scripts/NotificationUser.aspx?Id=6857&Mode=0
29. http://www.thehindu.com/news/states/andhra-pradesh/article2617421.ece
30. http://intellecap.com/assets/82/Intellecap_Microfinance_White_Paper_Oct_2010_.pdf
31. http://www.intellecap.com/assets/82/Intellecap_Microfinance_White_Paper_Oct_2010_.pdf
32. Scaling-up Microfinance for India's rural poor' – World Bank Policy Research Working Paper 3646, June 2005
33. M-CRIL Microfinance Review 2011: Anatomy of a Crisis http://www.m-cril.com/BackEnd/ModulesFiles/Publication/Executive-Summary-Review-2011.pdf
34. http://blogs.hbr.org/cs/2010/11/indias_microfinance_crisis_is.html
35. http://www.mfinindia.org/
36. RBI Circular December 2, 2011
37. Loans given to rural households with income of less than INR 60,000 are considered as priority sector loans by banks http://www.indianexpress.com/news/rbi-sets-26-cap-on-microfinance-loans/785154/
38. RBI Circular December 2, 2011
39. RBI Circular December 2, 2011
40. RBI Circular December 2, 2011
41. Thrift is defined as regular and frequent savings of very small amounts. Thrift and Credit Societies typically are cooperatives in which members regularly deposit a fixed amount of savings with compounded interest (decided by the community members), which then becomes available to the members as loans with easy repayment schedules.

## About Legatum

Legatum is a private investment group with a 25 year heritage of global investment, allocating proprietary capital in the global markets and to businesses and programmes that promote sustainable human development. Find more information about the Legatum Group at www.legatum.com.

## About Legatum Ventures

Legatum Ventures invests private equity capital in businesses in the developing world that deliver both social and financial returns. Legatum Ventures is a leader in the creation of a new asset class within the global capital markets in which investors do well by doing good.

In 2007, Legatum Ventures invested USD 25MM (INR 123 Cr.) in SHARE Microfin – at the time, the single largest private equity investment in microfinance anywhere – to help the company scale its operations to reach more clients while also improving its governance and operations.

Also in 2007, Legatum Ventures invested USD 8.4MM (INR 41.3 Cr.) in Intellecap, a social-sector advisory firm serving corporates, non-profits, development agencies, and governments working in developing markets.

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