Indian Microfinance: Looking Beyond The AP Act and its Devastating Impact on the Poor

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 microfinance Bill and 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.

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.

Over 9 million households in AP have been affected as access to finance has dried up and lending by MFIs in AP has dropped to virtually zero from INR 7,494 crore (Cr.) (USD 1.5 billion[1]) in the year prior to the AP Act. This means that millions of people that 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 eliminated private sector microfinance by making it impossible for MFIs to collect outstanding amounts or provide fresh loans to clients. As of today, over INR 6,000 Cr. (USD1.2 billion) of uncollected loans remain outstanding in AP. Because the MFIs are not permitted into the field, they cannot collect the outstanding amounts nor make fresh loans to the millions of poor households that depend on them as their primary mainstream source of credit. And since MFIs cannot collect the funds 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 imperilled 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.

---

[1] For consistency, exchange rates are assumed to be INR 50 = USD 1 throughout this paper

Indian Microfinance: Looking Beyond The AP Act and its Devastating Impact on the Poor

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 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.

And 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.

CONCLUSION AND RECOMMENDATIONS

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.

Indian Microfinance: Looking Beyond The AP Act and its Devastating Impact on the Poor

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.