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Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance

The crisis that erupted in the Indian State of Andhra Pradesh in early October 2010 hit at the epicenter of microfinance in India and has implications there, across the country, and globally. As events continue to unfold in Andhra Pradesh, this note provides background and context on the situation, which raises important questions about the evolution of microfinance markets more broadly.

Financial Inclusion in India

India has a population of 1.2 billion, with less than one-quarter of adults having access to basic formal financial services. Financial inclusion initiatives are not new to India. Over the past century, a range of innovative approaches to expanding access to finance for poor people has been pursued. Early in the 20th Century laws were passed to create cooperative financial institutions to serve people living in rural areas. Following independence in 1947, much of India's financial sector was nationalized. Part of the rationale was to ensure access to finance to a much larger number of Indians, especially those living in rural areas. As a further effort to reach rural areas, India established a specialized class of regional rural banks in the 1970s. And in the 1980s social entrepreneurs created the self-help group (SHG)–bank linkage program, whereby commercial banks were encouraged to lend funds to groups of 10 to 20 women.

Indian SHGs were initially formed as a means to extend training and other nonfinancial services to rural areas; some also mobilized savings and made loans to members. But through the bank linkages program, the SHG model began to incorporate credit from the banks thus allowing for much larger lending volumes. Today there are 4.5 million SHGs receiving credit nationwide, with 58 million members.

The SHG movement received considerable national policy support led by the National Bank for Agricultural and Rural Development (NABARD). The role of NABARD combined with priority sector lending policies stimulated the banking system to lend to SHGs. This approach became widely embraced and grew much larger in the 1990s. The Indian SHG model remains unique for its sheer size and reach to poor people, though with varied levels of sustainability. Some SHG–bank linkage programs are low cost and financially sustainable[1] while other SHG programs do not cover all costs, have low repayment rates, or rely on ongoing subsidies. SHGs continue to offer a range of livelihoods and empowerment services that go well beyond financial services.

The Rise of MFIs

By the 1990s economic reforms in India opened up space for the private sector to play a larger role in the banking system. Amid these reforms a new breed of private microfinance provider emerged: microfinance institutions (MFIs), which originally operated as nonprofits (societies and other ownerless legal forms), but soon transferred their operations into for-profit nonbank finance companies (NBFCs). The transformation from nonprofit to for-profit NBFCs was complicated, often leaving the nonprofits and other often newly formed entities (such as mutual benefit trusts for the benefit of clients) with unclear voting rights or influence over the newly formed NBFCs. Most often influence was concentrated in the hands of the original founders (Sriram 2010). In more recent years the dominant practice has been to form start-up MFIs as NBFCs from the outset, obviating the need for transformations.

By 2010 there were at least 30 MFIs operating as NBFCs, many with substantial growth trajectories.

1 See Isern et al. (2007).

This new breed of NBFC MFI has been supported by government policies and direct investment. The state-owned Small Industries Development Bank of India (SIDBI) has steadily increased its lending to MFIs as a part of its mission to support small enterprises. Loans by commercial banks to MFIs also count toward priority sector lending quotas. In the last few years MFIs were also capitalized by equity investments from specialized microfinance investment vehicles (MIVs) and, more recently, mainstream private equity funds.

By 2010 these new MFIs were expanding at an annual rate of 80 percent, and had reached 27 million borrowers across India (Srinivasan 2010), nearly all this outreach achieved through a standard group-based loan product common to South Asia. Importantly, these MFIs are effectively barred by regulation from taking any deposits and instead rely heavily on debt with commercial banks to fuel their growth.[2]

The Capital of Microfinance: Andhra Pradesh

Andhra Pradesh in southeast India is the fifth most populous of India's 28 states, with 75 million inhabitants. Recent state governments in Andhra Pradesh have invested in progressive policies and programs focused on growth and building a sizeable information technology industry around the city of Hyderabad. Andhra Pradesh has also undertaken a series of large-scale projects to fight poverty, the most prominent being the Society to Eliminate Rural Poverty (SERP).

SERP is a service delivery program under the Rural Development arm of the state government that offers far reaching livelihood promotion programs, including employment generation, vocational training, and access to savings and credit through SHGs. SHGs have a long and important history in Andhra Pradesh and have deeper penetration there than in any other state, with a total of 1.47 million SHGs reaching 17.1 million clients statewide (Srinivasan 2010). Within the broader SHG approach in Andhra Pradesh, SERP (and other Andhra Pradesh government programs) has a significant presence, directly working with 9.5 million of these SHG clients.[3] The federal government is looking to expand this approach to other states, most notably to Bihar, a state with a less developed microfinance market than the one in Andhra Pradesh and significantly less outreach.

One reason households have large amounts of credit from the SHG–bank linkage program supported by SERP is the "total financial inclusion program" the Andhra Pradesh Government began three years ago. Traditionally SHGs were based on member savings, and rules generally capped bank loans to the SHGs at three to four times this savings base, effectively limiting borrowings to Rs. 100,000 or less. But under the new program, banks began to lend up to Rs. 500,000 to targeted SHGs. Additionally some loans to SHGs had a five-year repayment period, up from one year, and any amount of interest paid by SHGs above 3 percent would be reimbursed to the SHG by the Andhra Pradesh Government if the group did not default on its bank loan. SERP encouraged SHG members to repay moneylender and MFI loans, but evidence suggests that instead members kept multiple loans from multiple sources.

In the late 1990s some of India's first MFIs got their start in Andhra Pradesh. Today, five of India's largest NBFC MFIs are headquartered in Andhra Pradesh making it the epicenter of the microfinance industry in India. Over the last five years MFIs in Andhra Pradesh were among the first to attract significant investment from specialized MIVs as well as mainstream private equity players. These capital injections have provided the equity capital for growth but they have also created strong incentives for continued levels of high growth and profitability to drive higher valuations. All of this has fostered a perception of MFIs as being primarily profit-oriented organizations. While most MFIs have acted responsibly, a few have generated unusually high returns on assets, compensated executives lavishly, and remained nontransparent in ways that only furthered a negative stereotype of MFIs.

2 Indian banks have an exposure of around Rs. 270,000 million to MFIs in Andhra Pradesh, according to the microfinance industry body, MFIN.
3 MFI Registration Data November 2010, Rural Development Department, Government of Andhra Pradesh.

In recent years MFIs across India have diversified geographic coverage, and Andhra Pradesh's share of the total national MFI outreach has dropped to less than one-third. Nevertheless, a few of the largest MFIs remain heavily focused in Andhra Pradesh where growth has been rapid.

The combined presence of the large and well-funded state-backed SHG program and five of India's largest and fastest growing MFIs has resulted in a rapid proliferation of credit across Andhra Pradesh and wide use of multiple loans by borrowers. And levels of household debt are high. In Andhra Pradesh, the average debt outstanding per household is Rs. 65,000 as compared to a national average of Rs. 7,700 of outstanding microfinance debt per poor household.[4]

The parallel growth of two approaches to delivering credit has expanded the reach of credit substantially over the past several years, as has competition between the state-supported SHGs and private MFIs. SHG lending reaches 17.1 million SHG members with Rs. 117 billion outstanding (Srinivasan 2010). By November 2010, MFIs were reaching 9.7 million borrowers with Rs. 72 billion outstanding, according to the government. But MFIs, while still somewhat smaller in total outreach than SHGs, had been growing more rapidly over the past 18 to 24 months as SHG disbursements were slowing. Also, the repayment tenor of many SHG loans is considerably longer and often more flexible than those of MFIs, reducing the size of repayment installments and thereby the debt servicing burdens on borrowers. Nonetheless, the combined outreach and continued growth has meant that the borrower accounts of SHGs and MFIs together on a per capita basis is over four times the median of Indian states. Srinivasan (2010) compares five Indian states with high levels of microfinance penetration and finds that the average loan amounts per poor household in Andhra Pradesh is triple the size for the next largest state. By any of these measures the provision of credit in Andhra Pradesh has reached much greater proportions than in any other state in India. Reports also suggest that many households have multiple loans significantly increasing their overall debt.

This current supply side penetration data are partly corroborated by a demand side survey conducted nearly a year and a half ago by IFMR's Center for Microfinance. Johnson and Meka (2010) show that 83 percent of households had loans from more than one source, including from moneylenders, with many households managing as many as four loans at a time.[5]

The study found high levels of penetration of SHGs into rural households, with just 11 percent of households borrowing from MFIs. However, sampling covered all rural households (rather than just poor households) in Andhra Pradesh. With the growth since the time of the survey and some sampling distortion, it is likely that the 11 percent figure significantly understates the level of penetration of MFI loans, though no current demand side survey data exist to offer an exact figure.

In sum, there is much higher penetration of microfinance in Andhra Pradesh than in any other state in India. Household dept comes from several sources, not just MFIs. The picture that emerges from the data suggests that households in Andhra Pradesh have too many loans and too much debt than seem to be supportable considering their income levels and ability to repay.

October 2010—A Crisis Emerges

In 2005–2006 one of Andhra Pradesh's 23 administrative districts experienced a crisis when the district government closed 50 branches of four MFIs following allegations of unethical collections, illegal operational practices (such as taking savings), poor governance, high interest rates, and profiteering.[6] On that occasion, the dispute was calmed by the

4 Srinivasan (2010) estimates the total number of microfinance clients in Andhra Pradesh at 25.36 million (19.11 million SHG members and 6.25 million MFI customers), with a total debt of Rs. 165 billion.

5 Data from a study conducted by the Centre for Microfinance in 2009. The study, which included 1,922 rural households, gathered information on use of informal and formal financial products within these households. Data sets can be found under "Access to Finance Data" at http://ifmr.ac.in/cmf/resources.html. See also, CGAP Microfinance Blog at http://microfinance.cgap.org/2010/11/11/who%e2%80%99s-the-culprit-accessing-finance-in-andhra-pradesh.

6 For further information, see Ghate (2007).

MFIs agreeing to abide by a Code of Conduct alongside support from the national government and the Reserve Bank of India (RBI), which recognized the useful role MFIs played in providing credit for low-income households.

But a rivalry between competing MFI and SHG models for serving the poor, often reaching into the same villages, has been simmering ever since. The SKS initial public offering (IPO) earlier this year highlighted both the enormous scale potential of the MFI model and the considerable opportunity it provides to improve financial inclusion, while at the same time highlighting potential high profits and lavish executive compensation.[7]

The press picked up on the SKS IPO, with different media outlets taking different angles on the story. Further reports over the summer cited links between MFI practices and some suicides in Andhra Pradesh. The situation came to a head in early October when Andhra Pradesh's chief minister passed "An Ordinance to protect the women Self Help Groups from exploitation by the Micro Finance Institutions in the State of Andhra Pradesh," which sought to place a range of new conditions on MFIs, including district-by-district registration, requirements to make collections near local government premises, a shift to monthly repayment schedules, and other measures that affect how MFIs operate. This ordinance has contributed to a general environment where MFI ground-level operations are impeded, and loan collections for MFIs in Andhra Pradesh dropped dramatically.

In the face of low loan collections, MFIs with proportionally larger exposures in Andhra Pradesh could find it difficult to refinance their loans with commercial banks or to raise new equity. MFIs unable to effectively negotiate their financing could become illiquid and insolvent. Even MFIs that are well capitalized and have a geographically diversified portfolio beyond Andhra Pradesh might have to absorb large losses in Andhra Pradesh, impacting their growth elsewhere. It is possible that a few MFIs might have to close or dramatically downscale their operations in Andhra Pradesh. And the result could be the removal of a credit service that poor people have come to view as reliable in their otherwise uncertain lives.

The nonrepayment of loans by clients has gained momentum as politicians at the state level have seized upon the opportunity to make populist pronouncements, while MFI staff are still intimidated and are not resuming normal operations in many parts of Andhra Pradesh.[8] This environment is encouraging clients to question their obligations to repay, with potentially far reaching consequences for both MFI and SHG repayment rates.

Stakeholders outside Andhra Pradesh have also reacted to the conflict between the state government and MFIs, and the intense media coverage. Though it has not made any public statements to date, RBI, the regulator of NBFC MFIs, has formed a subcommittee tasked with looking into a wide range of microfinance issues nationally, including a re-examination of MFI loans' classification as priority sector lending. The Ministry of Finance has supported the continued presence and value of MFIs while at the same time it has pushed for improved MFI practices, lower interest rates, and stricter regulation. The financial markets have taken notice, SKS's share price dropped steeply, and it is unlikely there will be follow-on MFI IPOs very soon in the current environment.[9]

In recent years, the levels of profitability and private gain have caused political concerns and have exposed issues of reputation management for an industry whose very existence is based on doing good by serving poor people. The potential for large returns made by the promoters of MFIs and their investors—vividly illustrated by the headlines about the SKS IPO from late July onwards—has served to exacerbate the issue of interest rate levels, which are a chronic political and public relations flashpoint.[10]

7 See Chen, Rasmussen, Reille, and Rozas (2010).

8 According to Sa-Dhan, Andhra Pradesh accounts for more than a quarter of the total loans outstanding of MFIs in the country, with Rs. 52351.4 million. DNA India (2010) reports that the unrecovered loans are anywhere between Rs. 500 million and Rs. 750 million.

9 According to the Deccan Chronicle (2010) banks have already stopped the disbursal of around Rs. 1750 million to Rs. 2000 million to around 44 MFIs.

10 See *The Economist* (2010a).

As we write this, the microfinance industry and various stakeholders are negotiating first ways to ensure the viability of the microfinance industry in Andhra Pradesh and then ways for a constructive path forward. As part of the ongoing dialogue with the state government, MFIs have offered to lower interest rates and restructure debt. Negotiations have enabled MFIs to resume some disbursement and collection operations, but staff are still largely unable to carry out usual loan collection activities.

Finding a speedy resolution is of paramount importance so that the important work of ensuring that poor people have access to responsible financial services can continue. It is critical for poor people that the financial services infrastructure survive, which entails the resumption of collecting and disbursing loans throughout Andhra Pradesh as well as banks continuing to provide liquidity to microfinance providers of all kinds.

Going forward, the microfinance industry as a whole needs to be serious about implementing a responsible finance agenda, including transparency about interest rates charged to clients. Before the crisis, the MFIs had already begun a process that will lead them to report their interest rates publicly early next year through a third party, Microfinance Transparency.[11] In 2009 the MFIs had decided to invest in a credit bureau. Though it might take some time to be fully functional, the credit bureau will be important to help MFIs lend more responsibly. Serious discussion is underway about new regulations for the microfinance industry, both to help ensure that acceptable standards are met but also to create regulatory certainty for MFIs, and about deepening MFI relationships with clients by providing a range of financial products instead of relying heavily on small-group loans.

The Way Forward

A decade ago, the central preoccupation of the microfinance industry was the search for scalable and financially sustainable models for delivering financial services to low-income people. Today, we see huge progress on that front. Across the globe, including in India, the microcredit movement has proved that it is possible to deliver financial services to poor people living in rural areas at a large scale, free from any reliance on subsidies. As a result, millions of poor households today have access to credit, and also increasingly to savings, insurance, and money transfer services that they use to manage household finances more effectively. And yet there are still 2.7 billion people in the world without access to formal financial services that are less expensive and safer than informal alternatives. It remains a priority to ensure that previously unreached low-income population segments gain access to these services, including in large swathes of India.

Even within this wider context, though, we see important limitations of the microcredit-only delivery model and the ramifications of the strains caused by very rapid growth. Developments in Andhra Pradesh shine the spotlight on some of the same issues that have emerged in other high-growth microfinance markets in recent years.[12]

In India, investors' emphasis on growth and the higher valuations generated from high growth rates have created strong incentives for fast expansion. These incentives are transmitted from the top managers of MFIs down through middle management to the frontline loan officers. These cascading incentives can drive behavior that distorts basic good banking principles and can lead to vulnerabilities that need to be addressed:

- Rapid expansion of credit in highly concentrated markets and loss of credit discipline can lead to much greater risk of stress from higher levels of indebtedness. Growth can undermine credit discipline, driving unhealthy rises in loan amounts, cutting corners in the underwriting process, and resulting in an excessive supply of credit. Incentives at the field level are often based solely on disbursements and collection volumes, with insufficient incentives for sound underwriting or customer care.

11 http://www.mftransparency.org
12 See Chen, Rasmussen, and Reille (2010).

- Growth that outpaces the internal controls of financial service providers makes them more vulnerable to inadequate technology and systems and unhealthy rates of staff attrition and turnover.
- Relying on credit-only services makes Indian MFIs particularly vulnerable on asset quality since borrowers have no deposit relationship to the MFI. And the MFIs' heavy reliance on basic bank debt (plus a mix of capital markets instruments) leaves Indian MFIs vulnerable to refinance risks in times of market stress.

All of this raise key issues for the microfinance community to address. First, at the institutional level:

- How do we assess financial service providers' shareholders, management, and staff incentives to ensure long-term viability, understanding that viability comes not just from shareholder value, but from a strong value proposition to clients?
- How sustainable is the specialized microcredit institution model?
- What can investors and institutions do to ensure sustainable growth and avoid market saturation or clients' over-indebtedness? How can socially motivated investors be encouraged to redirect investments from the few, but high-profile saturated markets, to the many financial services "deserts" worldwide?

Then at the market level:

- Can self-regulation work when it comes to sharing credit information and establishing codes of conduct on issues around culturally acceptable collection systems, dispute settlement systems, etc.?
- What kind of formal market infrastructure is needed to support growing providers and protect clients? What are reasonable levels of productive debt for poor people to carry?
- How can the focus be shifted to credit crisis prevention? What will it take to increase focus on understanding clients' financial service needs? What is the role of regulators and policy makers to ensure client protection and consumer financial capability that leads to better household decision making? How should policy makers balance ensuring broad-based access to finance and safeguarding client interests?

These questions speak to the bigger issue of how to deliver high-quality services to more people while ensuring appropriate safeguards for clients. A vision of financial inclusion that truly addresses the needs of poor clients dictates that responsibility lies not just with the providers, but also with policy makers, donors and investors, and the global microfinance community to ensure appropriate governance, operational policies, and incentive structures at all levels, with appropriate client safeguards, to offer high-quality services. As local markets mature, the delivery model for financial services for the poor must evolve to support healthy outreach and the growth of a broad range of products that poor people need.

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