Indian Microfinance Crisis of 2010: Finding the Silver Lining

An Update to the Intellecap White Paper Released on October 25, 2010

Introduction

On 15 October 2010, the Government of the state of Andhra Pradesh (GoAP) in India promulgated an Ordinance[i] attempting to regulate the microfinance industry in the state. Intellecap, the India-based social business advisory firm, released a White Paper[ii] which sought to provide an overview of events leading up to the promulgation of the Ordinance, an assessment of the implications of its provisions, and an impartial evaluation of its impact on the industry.

Industry reactions to the Ordinance were initially uniformly negative. However, events in the last three weeks have significantly changed stakeholder perceptions. Anecdotal evidence from the field appears to be moderating extreme positions in both government and industry. The Government appears to have toned down some of its rhetoric, and the industry has begun to acknowledge that the Ordinance provides the basis for some desirable cleaning-up. It is possible that the current crisis could become a turning point, leading to a more balanced, better-governed and better-understood microfinance industry. This Update to Intellecap's White Paper offers a view on the changing perceptions of industry stakeholders.

Clean-up After the Storm

The abruptness of the GoAP's action in promulgating the Ordinance, with no consultation, took most industry stakeholders by surprise. The passage of the Ordinance significantly influenced the perceptions of global investors (and global media) of risks in India, and in private sector involvement in services to the poor – not good for India, or for poverty reduction. Indian media reacted initially with characteristic sensationalism, but that has now given way to relatively balanced and, more importantly, productive action on the ground.

To address some of the "procedural and other" controversies, on 28 October the GoAP announced the formation of a working group, including leading microfinance institutions (MFIs). It is headed jointly by the CEO of the Government's Society for Elimination of Rural Poverty (SERP) and the CEO of the private-sector Trident Microfinance. Its aim is to establish a completely self-regulated mechanism by January 2011 and share credit information on borrowers amongst the members of the industry association MFIN, thereby helping to address multiple lending and over-indebtedness. It is also discussing proposals to reduce interest rates (to around 24% by April 2011), restructure loans for distressed and overburdened borrowers, and to lend to SHG Federations at interest rates nearly 8-9% lower than currently offered.

Separately, the Reserve Bank of India (RBI) has also appointed a sub-committee to look into MFIs and make recommendations relating to regulation of microfinance activities of NBFCs. The RBI is expected to publish its findings by end-January 2011.

The MFIs themselves have moved on from sometimes confrontational positions to complying with the Ordinance. There have been over 120 registrations covering all the major MFIs in the industry. Data on interest rates and other charges has been submitted as part of the registration process. It is still being consolidated, but initial reports suggest that the *effective*[iii] interest rates charged by MFIs are commonly around 31%. It should be noted that there is no standard formula governing how interest rates are computed and published, even in the mainstream financial services industry in India, and it is clear that some MFIs (like some mainstream financial institutions) had been publishing rates that understated the true repayment burden.

Meanwhile there have been calls to investigate allegations linking the large number of suicide cases in AP to harassment by MFIs. A recent report by the gender unit of SERP lists 123 alleged cases of harassment, including 54 deaths, involving some of the largest MFIs. The list does not provide the basis for verification, but simply states against some cases that harassment by MFIs prompted the deaths. Without undermining the tragedy of any death, it should be noted that over 22,000 people have committed suicide in Andhra Pradesh over the past 10 years; and in past years suicides have been classified as related to agricultural failure, or grief at a political development, in order to qualify for compensation[iv]. MFIN has called for an independent investigation to objectively establish the extent to which the suicides should in fact be attributed to MFI harassment.

Current Impact on the Ground

There is no question that the Ordinance has seriously damaged credit discipline, and adversely affected collections in the field. According to Anand Advani, CEO of Emfin, repayment rates have fallen to 30-40% as "*local aspiring leaders are taking full advantage in provoking borrowers to stop repayment*." He notes that "*even the good borrowers are defaulting because of peer pressure*."[v] The Telugu Desam Party, currently in Opposition, has further appealed to women not to pay back their loans until the rates come down to 3%. However, there are also anecdotal reports from the field suggesting that many borrowers have privately assured the MFIs that they fully intend to repay, in order to qualify for further loans, once the current pressures die down.

Media and public responses to the crisis clearly demonstrate poor public understanding of the industry. Clearly, MFIs have failed to adequately explain their practices to the media, Government and general public. To obtain a better understanding it will be essential to understand the effective interest rates that MFIs are currently charging their clients. MFIs will need to "*ensure that there is transparency in interest rates and they should not be camouflaged in the name of fees"* as Baskar Babu, CEO of Suryoday notes[vi].

Due to the high risk perceptions in the market, funding from banks has been seriously affected. Commercial banks have halted credit lines to MFIs and are expected to await further developments, including the Working Group's and subcommittee's decisions. Other States are also facing the effects of the AP Ordinance, as some banks are withholding loans to the sector. For the time being, therefore, there is a significant slowdown in the extension of microcredit. However public sector banks have not yet shown any reluctance to extend funds.

The Silver Lining: Investors, Industry and Government

In the current circumstances it is natural that many commercial **investors** are reluctant to invest in the sector and are awaiting some clarity. According to Vineet Rai, Founder of Aavishkaar Goodwell and Chairman of Intellecap, the sector will experience a drop in valuations in the short term; however this will offer a "*huge opportunity to invest at a low cost in real value deals*." Moreover he is convinced that this remains an issue specific to Andhra Pradesh and does not expect it to spread to other States.

Despite the turmoil in the market some large Foundations and development agencies investing with a long time horizon are still ready to commit substantial amounts to the sector. CDC, the UK Government's development finance arm, recently invested US$ 10 Mln in Lok Capital.

Within the **industry**, the crisis seems to have catalyzed a process that was initiated by MFIN a year ago, of putting a code of conduct in place, and tracking multiple lending through the establishment of a credit bureau. There has also been a realization within the industry that all was not well. A more open admission of some coercive practices, excessive interest rates and lack of transparency to the customer, augurs well for future improvements.

In addition, much anecdotal evidence has come in showing **Government** in a far more responsive light than usual. Inter alia, the GoAP has offered to share SHG data with the MFIN MFI borrower database, to help prevent multiple lending. The Government is also said to have worked overtime to provide a substantially web-enabled registration process, allowing the MFIs to register and upload data quickly and with less opportunity for localized petty harassment. Finally there is a faith-restoring anecdote of the State's Principal Secretary having responded to a request made late one evening with a resolution by the following morning. These anecdotes provide the best evidence yet, of an industry working out a perhaps-overdue accommodation with

Government. In a subsequent update, Intellecap will provide more details of this evidence.

In addition, there have been some calming statements by senior figures in Government, up to and including the Finance Minister[vii], recognizing the important role played by MFIs in Financial Inclusion.

Finally, while continuing to welcome long-term investors, there are many who feel it no bad thing that a certain type of quick-exit-seeking investor is no longer to be seen prowling the offices of MFIs.

Conclusion

The ongoing crisis has clearly demonstrated that there are grave misconceptions about microfinance, a need for the industry to be more open and a role for the media to educate the society. Further it has shown that more regulation and transparency are inescapable; principles that the best in the industry fully recognized, but were unable to implement fully through self-regulation. That being said, India's interests, and the cause of poverty reduction, will be best served by skilled and co-operative regulatory hands.

About Intellecap
Intellecap is a pioneer in providing innovative business solutions that help scale profitable and sustainable enterprises dedicated to social and environmental change. The company's unique positioning at the intersection of social and commercial business sectors, allows it to attract and nurture intellectual capital that combines business training of the commercial world with passion and commitment of the social world to create distinctive solutions that include best practices and principles of both cultures.

Intellecap operates in multiple capacities in the social-commercial space: facilitating investments, providing strategic consulting and business advisory services, supporting operational planning and implementation, and developing information-sharing and industry-enhancing platforms that promote and build SUSTAINABLE, PROFITABLE and SOCIALLY RESPONSIBLE enterprises.

For more information, visit www.intellecap.com.
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[i] Andhra Pradesh Micro Finance Institutions (regulation of money lending) Ordinance 2010 Source: http://www.serp.ap.gov.in/SHG/files/MFIOrdinance.pdf
[ii] White Paper Released by Intellecap on October 25, 2010 titled "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?"
[iii] There is no clarity on what the definition of 'Effective interest rates' is
[iv] At the most basic level, note that according to the National Crime Records Bureau, suicides in India occur at the rate of 10.8 deaths per 100,000 people every year (based on 2008 data). If we apply this rate to the 6 million clients who are members of SKS Microfinance, we might expect that there would be 648 clients succumbing to suicide every year. This reasoning, of course, is absurd; but so is drawing a link from borrower suicides to MFIs without evidence. (http://blogs.hbr.org/cs/2010/11/indias_microfinance_crisis_is.html)
[v] Survey by IntelleCash
[vi] Survey by IntelleCash
[vii] Pranab Mukherjee urges Andhra to soften Ordinance terms; http://www.dnaindia.com/money/report_pranab-mukherjee-urges-andhra-to-soften-ordinance-terms_1458326