

## Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?

### An Intellecrap White Paper

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Social businesses like microfinance, due to their sensitive client base, need to walk a fine line to balance their commercial interests with the social and moral expectations of a wide variety of stakeholders. The range of stakeholders may include the State, investors, and the public at large, besides clients and regulators. Indian microfinance institutions (MFIs) have done an admirable job of managing the commercial side of their business; yet they have often struggled to manage the inherent contradictions of running such businesses at scale while satisfying non-commercial stakeholders, and have often run afoul of the media and the government. Recent allegations against MFIs by the media and the State include coercive practices, lack of transparency, and “usurious” interest rates. These accusations have resulted in the passage of an Ordinance by the State Government of Andhra Pradesh (AP). This white paper by Intellecrap, an India-based social business advisory firm, analyzes the buildup to the crisis in AP, attempts to revisit some fundamentals of the business, and questions the effectiveness of radical approaches to multiple bottom-line business by the State and the media.

#### Setting the Context – The Family Squabble

Microfinance in India originated in government programs that predated the Grameen model<sup>i</sup>, with a very distinct difference. While the Grameen model was being conceptualized in Bangladesh, the National Bank for Agriculture and Rural Development (NABARD) in India, and Aloysius Fernandez, the conceiver of Self Help Group (SHG) initiatives, were scripting another low-cost and effective technique of providing banking access to the poor, through a program now widely known as the SHG-Bank Linkage Program<sup>ii</sup>.

The SHG programs allow people (mostly women) to form groups of 11-20 members, develop savings and credit discipline and be formally linked to a bank for opening a bank account and accessing loans.<sup>iii</sup> The hope behind the SHG program was to build a credit history for the individuals through the group process of on-lending, so that over time each individual would have her own bank account and access to financial services thereby contributing to the vision of total financial inclusion. In the long term, the benefits to the borrower, and cheaper cost of capital allow SHG programs to outscore all other models in the field of microfinance, with a single but critical flaw:

There are no clear margins built into the program to take care of the cost of building, managing, and scaling the program, except through grants, subsidies and other provisions made by government. The SHG model, despite being a brilliant tool for financial inclusion and receiving the

backing of the central government, NABARD, and Public Sector Banks, has not entirely succeeded in retaining borrowers and providing universal financial inclusion.

The Indian government programs, despite being well-intentioned, had neither the discipline needed for long-term sustainability nor a business model that could be scaled up effectively. The more recent model adopted by Indian microfinance is that of the Joint Liability Group (JLG), adapted from the Grameen model. It has been widely embraced by Indian development professionals, and over time has become the major alternative to the SHG model. The JLG is not linked with a bank but is intermediated by the loan officer of a MFI who is responsible for formation and management of the group. Unlike the SHG model wherein the loan is given to the group and the bank does not track individuals’ credit history, in the Grameen-inspired JLG model the loan is given to the individual (usually by the MFI), backed by the group guarantee; and an individual credit history is created, even though it may be skewed by the group guarantee scheme.

If we may be permitted a whimsical moment, the Indian microfinance story offers an irresistible parallel to a familiar Bollywood plot: in the Indian microfinance potboiler, the SHG model is the elder brother in an Indian joint family while the MFIs play the part of an aggressive younger brother. The elder brother struggles to uphold tradition and retain his leadership position, while the maverick younger brother tries to break free (using new financial and technology tools),

often overenthusiastically, and sometimes recklessly, in pursuit of the same goals.

This script bears many similarities to a classic Bollywood family drama. Unfortunately, the conflict between the two brothers often leaves the family destitute. As the AP microfinance drama plays out in the national media and the world watches, it is mainly the poor, forced into choices not of their making, who will suffer.

### Andhra Pradesh: The Mother Land of Indian Microfinance

The state of Andhra Pradesh (AP) has a unique leadership position within Indian microfinance. The state government has not only made significant investments in subsidizing financial inclusion through SHG programs, but has, at least till now, also allowed the Grameen/JLG model to flourish. It is thus not surprising that the four largest MFIs in India are based in AP, alongside numerous other mid-sized MFIs.

The MFIs and the government-led SHG program have co-existed for many years. However, the first signs of conflict became visible in the period from 2005-7 when, buoyed by capital from a partnership model launched initially by ICICI Bank<sup>iv</sup>, MFIs started to finance customers more aggressively than before. A large number of these customers were members of existing SHGs, and the first sign of tension appeared during what is now referred to as the “Krishna Crisis.”<sup>v</sup>

### Customer-centric, but ...!

The Krishna Crisis demonstrated the potential for conflict between a well-intentioned but self-righteous state government, and ambitious commercial entities, as co-stars in the development sphere. The State believed that it was serving its poor by providing them low-cost loans in an organized manner. Yet they saw that the more organized commercial microfinance lenders, despite charging higher interest rates, were able to attract clients and achieve a better repayment rate.

In this view, over time the State began to believe that the MFIs must be following coercive business practices to achieve such success. The State believed that it had a better product and lower costs, and refused to see any logical or business reason why poor people still borrowed from MFIs.

In 2006, the conflict between the State and the MFIs reached a fever pitch, and district authorities closed down dozens of branches of two major MFIs, after allegations of usurious

interest rates and coercive loan collection.

The Krishna Crisis was resolved largely through compromises made by the MFIs in Krishna district. However, the resolution may in fact have sowed the seeds of a larger conflict that has shades of a turf war.

### The Scale Phenomenon: Private Equity, Professionalization and Commercialization

Between 2005 and 2007, while some regions experienced moments of crisis, the larger Indian microfinance sector was seeing a period of commercial renaissance. Private equity entered microfinance in a big way. Large equity infusions in MFIs such as SKS, Share, and Spandana provided them the capital to scale up, and fueled their ambitions to move beyond state boundaries. The period also saw the emergence of new talent, local and global, trained and willing to try fresh approaches, new technology and innovative financial transactions.

Commercial MFIs started to compete with each other and soon out-paced government-backed programs in terms of reach. Along with commercialization came stiffer competition for client ownership between the state and private players. With many of the largest, fastest-growing, commercial MFIs based in AP, it might have been possible to predict the beginning of a potentially wider conflict.

### Making of the Crisis: Text and Sub-Text

The AP Microfinance Ordinance<sup>vi</sup> was promulgated on October 15, 2010 by the Andhra Pradesh Government. The ordinance was built on the basis of four premises:

- a) MFIs charge usurious interest rates;
- b) If clients fail to pay on time, MFIs use coercive methods to collect the interest;
- c) These practices are forcing the poor to commit suicide;
- d) MFIs make huge profits and have no social mission to help the poor.

Through its allegations, in the extraordinarily-phrased Preamble, the Ordinance strongly suggests government dissatisfaction with, and even broad antipathy towards, the entire MFI industry. However, these premises may not tell the whole story. With the fullest respect, it is possible to read into these allegations signs of a state government unhappy that its programs (and perhaps the individual influences of some members of government) are being undercut by the MFIs.

The Andhra Pradesh government believes that the loans it provides to SHGs serves the needs of the poor adequately;

indeed, it has a mandate to disburse INR100,000 Crores (US\$ 22.2b) bank loans to SHG women members by 2014 to bring 10 million families out of poverty<sup>vii</sup>. And yet, the growth and reach of MFIs seems unstoppable. The MFIs' combination of door-step 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 programs. Is it presuming too much, to conclude that the government feels the need to save these borrowers for themselves?

We do believe the government has the best of intentions. But in promulgating this Ordinance, it has challenged the fundamental right of an individual to make choices – and perhaps even the rights of law-abiding MFIs to run businesses.

### Andhra Pradesh MFI (Regulation of Money Lending) Ordinance

The ordinance issued by the Government of AP is ostensibly intended “to protect the women Self Help Groups”, who, the preamble states, “are being exploited by private microfinance institutions through usurious interest rates and coercive means resulting in their impoverishment and in some cases leading to suicides.” The Ordinance makes it mandatory for all private institutions engaged in micro-lending to register with the district Registering Authority, the Project Director (PD) of District Rural Development Agency (DRDA) for rural areas, and the PD of MEMPA for urban areas by November 15, 2010 (one month from the issuance of the ordinance). MFIs have to specify their areas of operations, the rate of interest, and their system of operation and recovery. Further, they cannot seek security from a borrower by way of pawn or any other means. The Registering Authority may, at any time, either *suo moto* or upon receipt of complaints by SHGs or the general public, cancel the registration after assigning sufficient reasons. All repayment collections will take place at the *Panchayat*<sup>viii</sup> Offices.

The microfinance sector responded by submitting petitions to the state High Court (one of which resulted in an interim grant of relief on October 22)<sup>ix</sup>, and is also in ongoing discussions with the Central Government.

### Analyzing the Ordinance

The Ordinance explicitly states that its objectives to rein in MFIs that are exploiting SHGs. The preamble of the Ordinance appears to presume guilt on the part of the MFIs until proven innocent.

**Provision:** *No MFIs, operating at the commencement of this Ordinance or intending to start the business of lending money to SHGs, after the commencement of this Ordinance, shall grant any loans or recover any loans without obtaining registration under this Ordinance from the Registering Authority.*

**Implication:** This administrative step gives the state powers to severely restrict microfinance operations. While a time limit has been set for MFI registration, the state has no obligation to complete the registration within a given time frame

**Provision:** *All MFIs operating in the State of Andhra Pradesh as on the of MFIs date of the commencement of this Ordinance, shall within thirty days from the date of commencement of this Ordinance, apply for Registration before the Registering Authority of the district specifying therein the villages or towns in which they have been operating or propose to operate, the rate of interest being charged or proposed to be charged, system of conducting due diligence and system of effecting recovery and list of persons authorized for conducting the activity of lending or recovery of money which has been lent.*

**Implication:** Procedures have been drafted and have now been published; there is a view that they are somewhat onerous however High Court judgment on October 22 permits MFIs to continue operating on an interim basis.

**Provision:** *'Registering Authority' means the Project Director District Rural Development Agency for the rural areas and Project Director MEPMA for urban areas; or any other person appointed by the District Collector to perform the functions of a registering authority under this Ordinance for such District.*

**Implication:** The Customer is king, but only nominally. The Ordinance requires that MFIs must, in effect, register with the government at district level, which is the same level of government which administers the government's SERP and MEPMA programs. Is it only conspiracy theorists who might conclude that this appears to protect the interest of SERP more than it seems to be interested in protecting the poor? Also in the Ordinance NBFCs are defined as those formed under Section 58A of the RBI Act which also is not the case with most MFIs.

**Provision:** *All loans in respect of which an MFI has realized from the borrower, whether before or after commencement of this Ordinance, an amount equal to twice the amount of the principal, shall stand discharged and the borrower shall be entitled to obtain refund and the MFI shall be bound to refund the excess amount paid by the borrower.*

**Implication:** Provision 9(2) includes stipulations that are retroactive in nature. This is likely to cause concern beyond the microfinance sector, as it suggests to investors that

Indian business regulation is not stable. However, we believe this provision will have few applications to mainstream MFIs as their interest rates rarely exceed principal, at least for the one-year tenor loans which constitute the bulk of their assets. (There may be unregistered institutions styling themselves MFIs which approach or breach this level; they are unlikely to be recognized members of MFIN or Sa-Dhan.)

*Provision: The Registering Authority may, at any time, either suo moto or upon receipt of complaints by SHGs or its members or by members of the public cancel the registration of an MFI after assigning sufficient reasons for such cancellation.*

**Implication:** Such discretionary provisions are often prone to abuse and applied haphazardly.

*Provision: All tranches of repayment shall be made by the group at the office of the Gram Panchayat only.*

**Implication:** This provision effectively prevents the MFI service model from functioning effectively. It should be noted that a key element of microfinance operations is door-step delivery.

*Provision: No member of an SHG shall be a member of more than one SHG, provided that where a member has, at the commencement of this ordinance, become a member of more than one SHG, she shall have the option to retain the membership of one SHG and to terminate her membership in other SHGs and for that purpose, she shall issue a notice to such SHGs about her option to terminate her membership, settle and pay the amount payable to the MFIs which had lent monies to such SHGs, within a period of 3 months from the date of commencement of this Ordinance.*

**Implication:** This provision clearly puts the client at risk by asking her to return a year-long loan within three months.

### Looking Beyond the Turf War: Real Challenges for Indian Microfinance

The AP crisis holds long-term lessons for social businesses and more specifically for large-scale mass businesses such as microfinance, micro-insurance and micro-housing and especially those that cater to the low-income population with services and products similar to those provided by the State. Commercial MFIs must learn to accept the State as a key actor and factor in such businesses because of the overlap of responsibility. While it would not be unreasonable to expect the State to exercise greater restraint than was the case in AP recently, it appears that MFIs did not give adequate focus to securing buy-in from this important stakeholder. They have not adequately educated government about their role, nor have they worked with

government to allay their fears.

While we believe that the AP Ordinance demonstrates certain mistaken perceptions on the part of the state government, we also believe there have been some failures by the microfinance industry, in terms of how MFIs conduct themselves and how they manage relationships with internal and external stakeholders.

Through this white paper, we intend to present our position on underlying issues that have the potential to incite a new crisis, if the sector does not prepare itself and educate the other key stakeholders.

### The Media Frenzy

In 2006, during the Krishna Crisis, the industry was not even a quarter the size it is today. News reports from that time are eerily similar to today's, with the same hot-button phrases: "usurious rates", "forced recovery", and allegations of suicides. Today, however, the security of a much larger sector, and a much larger number of the poor, hangs in the balance. It is with this awareness that we reflect on the most recent news articles. We believe they are having a harmful effect not only on MFIs, but also on the people that they are striving to assist.

In 2010, SKS's plans for an IPO sparked unusually intense debate, widely covered in the media. This included some coverage, only partially relevant, of the personal lives of promoters. Also widely covered were the overwhelming market response and the 'big-bang' listing, a first for an Indian MFI. Most coverage carried a distinct tinge of apprehension, related to the positioning of the IPO as a profitable investment, rather than as the logical next step for a financial services provider to raise the capital required to reach even more millions of unbanked people.

While some of this apprehension was contained by SKS' very successful stock market debut, the unexpected and sudden dismissal of its CEO in early October resulted not just in their stock losing value but also a new round of questions on governance and transparency in the microfinance sector.

In recent weeks, there has been a frenzy of media coverage based on allegations of suicides by microfinance clients in AP, contributing to one of the most turbulent times in the history of Indian microfinance.

It should be noted that these suicides, while worrisome and tragic, are difficult to attribute to a specific cause without more evidence. Did the victim have a bad harvest and suffer

economically? Was there a medical emergency in the family that was financially impossible to pay for? Was there a tragedy in the community? These articles provide only a slight correlation to the victim's relationship with an MFI in the region—but only an in-depth investigation (which mainstream MFIs have been among the first to call for) would prove or disprove the allegations of MFI coercion being responsible for these suicides.

### Managing the Media

The microfinance sector has been around for over three decades, but the media has only begun to cover it with any frequency in recent years. While business newspapers and magazines have reporters that focus on "mainstream" topics like mutual funds, technology companies, or retail, very few if any have reporters dedicated to covering microfinance. As a result, coverage is often incomplete or ill-informed, due to a lack of knowledge about the space.

The media does carry some of the blame for this state of affairs. However, leadership within the sector can do a better job of creating relationships with reporters and editors, so that a variety of perspectives on issues can be shared. As a result, more informed articles will be written.

Individual investors, MFIs and members of MFIN (Micro Finance Institutions Network) have made a concerted effort to liaise with the media this year, but it will take regular outreach and proactive engagement to ensure that reporters are better informed about the issues and even the terminology.

### Value Creation or Valuation

MFIs have attracted investors and investment capital as never before. This is a welcome trend and we believe has the potential to create a very good story for commercial investments creating social good or impact investing. However, in the past, the uncontrolled flow of capital has created serious risks even for mainstream commercial businesses, because unrestrained capital does have a tendency to create perverse risks.

Private equity and specialized microfinance investors invested in 17 deals in FY 2009, valued at INR 867 Crores. In the first half of 2010, 14 deals have already raised over US\$ 300m. Much of the private capital is backed by aggressive growth plans laid out by the promoters of MFIs with a clear focus on financial bottom lines.

The microfinance industry must question whether it believes in value creation or just valuation. A short-sighted view at this juncture will only ensure that these crises cannot be

wished away.

### Commercialization: Towards What End?

The microfinance sector needs to clearly articulate its objectives – even its dual objectives – publicly and frequently. This may not be as simple as it sounds, but it is an entirely necessary exercise, in order to give clarity to all stakeholders about the objectives of microfinance.

While the authors of this paper themselves represent a for-profit organization and clearly believe that there is no need to apologize for making profits, we do also believe in the necessity to clearly set guidelines and industry benchmarks. Indian microfinance has made major concessions in the past, which benefit clients by reducing interest rates collectively. However, as critics point out, that seemed to happen – or at least, to be publicized – only at the behest of government during the Krishna Crisis, and seems likely to happen again as a response to the current crisis. It may be useful for industry associations like MFIN and Sa-Dhan to build a clear consensus from the members to come up with a better long-term strategy to monitor their business models, and undertake such steps at clearly-defined milestones, rather than as a reaction to a regional crisis.

### Interest Rates: Usurious or Real

Despite widespread hype over "exorbitantly" priced microloans, the effective interest rates charged by mainstream MFIs in India range from 28% to 32% annually, which are among the *lowest* rates of microfinance globally.

With a median Operating Expense Ratio of 11.8%, Indian MFIs are amongst the most cost efficient in the world.<sup>x</sup> Larger MFIs are able to charge slightly less than the smaller ones because their operating costs as well as their financing costs are, on average, 200-300 basis points lower. This allows the larger MFIs the leeway to lower their lending rates, but most of the early stage players would struggle to sustain themselves if an immediate reduction of interest rates was imposed upon them.

The table below presents a cost analysis of MFIs (Calculated as a % of Loans Outstanding)

GLP (INR)	< 50 Cr	50-500 Cr	> 500 Cr
Branch Cost	11%-12%	6%-8%	4%-6%
Area Office and HO Cost	4%-5%	3%-4%	1%-1.5%
Loan Loss Provisions	1%-2%	1%-2%	1%-1.5%
Total Cost of Operations	16%-19%	10%-14%	6%-9%
Cost of Financing	13%-15%	12%-14%	11%-13%

Total Cost	29%-34%	22%-28%	17%-22%
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*Return on Assets and Equity:* The recently-released Sa-Dhan report indicate that the median ROA and ROE of all MFIs in their sample of 264 MFIs stand at 1.6% and 11.5% respectively. These are not significantly different from the reported ROA and ROE figures for banks in India. The Median ROA and ROE of the 10 largest MFIs (GLP >INR 500 Crores) are 4.3% and 29.5%, which are significantly higher than those of any other size category. The smallest MFIs have *negative* median ROA and ROEs, which means that they are currently loss-making.

The perceived high ROE and ROA of MFIs has been a contributor to their ability to attract private capital to the mission of poverty alleviation. There may be a need to balance this consideration with the industry's mission of serving the poor.

Other characteristics of the MFIs' business model, which affect their cost structures and interest rates, include the following:

- Many MFIs sell or assign most of their loan portfolio during the last quarter of their financial year, primarily to maintain their capital adequacy or debt to equity ratio at required levels. This raises their nominal profitability;
- It is worth reiterating that the MFIs' lending models, which usually puts the onus on a small group for repayment, incentivize repayment more effectively than the banks' usual models;
- It is also worth reiterating that one major constraint for MFIs in India is that they cannot (as banks can, and as MFIs can in some other countries) accept deposits, or borrow money from the central bank. In addition they do not, for the most part, collect collateral. These factors raise the MFIs' cost of funds significantly.

### Addressing Concerns: Need of the Hour

While it is right and proper that there should be concern about regulation, interest rates and profits, over-indebtedness, ethics and transparency within this sector, some of the commentary on these points has not always been effectively informed. We believe there is a need for some background on these points to be more effectively disseminated than has been the case so far. In this section we attempt to provide some background on these points.

#### Need for supervision or regulation

Most of the large MFIs in India today operate as NBFCs and fall under RBI regulation. Among others, the RBI regulates Revenue Recognition; Provisioning and Asset Classification; Capital Adequacy; Securitization and or Assignment; Shareholding changes pertaining to NBFCs. The RBI has

given no indication of any failures in any of these areas, in the last few years.

In addition the microfinance industry has taken some significant steps towards systemic regulation. Recognizing the need for better governance practices, and in the absence of formal regulation, several MFIs came together in 2009 to constitute the previously-mentioned Micro Finance Institution Network (MFIN). MFIN is a self-regulatory organization created by 44 NBFC MFIs in India, who share an interest in protecting and building the integrity of the sector. This was in response to controversies such as multiple lending and lack of transparency by MFIs. MFIN has already taken some steps such as building a credit bureau, creating task forces for transparency and establishing a code of conduct.

#### Geographical concentration and over-indebtedness

AP has the highest penetration of microfinance in the country. Per available data, as of March 2010 the total microfinance portfolio outstanding in the state is close to INR 9,000 Crores and the total number of borrowers in AP is above 6 million. This has led to suggestions that the state is over-penetrated by MFIs, giving rise to the phenomenon of multiple loans. Given that the state population is nearly 8.27 Crores<sup>xi</sup> and microcredit demand is nearly INR 30,000 Crores, we consider that the validity of this suggestion is questionable. However, it has almost certainly contributed to the sense of conflict between government and MFIs.

#### Ethical practices and code of conduct

The microfinance industry has, through its industry bodies MFIN and Sa-Dhan, drawn up codes of conduct for participants, which do in fact address most of the issues of controlling over-indebtedness and coercive collection. However, MFIs will acknowledge that they have not yet built a mechanism for enforcing the code or penalizing violators. In any case the Indian Penal Code has sufficient provisions to penalize any organization or individual resorting to violence.

In our view enforcement of the industry's code is essential, both in its own right, as well as being a demonstration of the industry's determination to oversee itself. As with much else in India, we believe the need is not for more laws or regulatory bodies – the need is for effective implementation and enforcement of existing laws.

#### Perceived lack of transparency

Among concerns about lack of transparency is the point that published interest rates do not fully capture the costs that a borrower incurs. There are charges, insurance premiums, and sometimes implicit deposit requirements imposed by

some MFIs. In addition, some MFIs have tinkered with the formulae used to define published rates (e.g. quoting monthly instead of weekly rates, and computing rates against flat balances rather than declining balances). There is perhaps a need for a convention similar to the US “Truth in Lending” Act<sup>xii</sup>, which defines exactly how interest rates are computed and publicized.

Among other accusations of lack of transparency, many commentators have cited the dismissal of the CEO of SKS Microfinance. It is not clear to us that the termination of a CEO is necessarily a matter for the public domain, unless the cause of the dismissal has to do with malfeasance that affects the statutory position of the company. Company law does not require details of Board meeting discussions to be made public; only for decisions to be communicated to the stock exchange. However, in the case of SKS particularly, given the conditions of IPO timing and public attention, it may have been in SKS’s own interest to have been more forthcoming than required by the letter of the law.

### Coercive loan recovery practices

The human tragedy of borrower suicides is undeniable. However, the link with MFI practices needs to be treated carefully. A combination of factors including the lack of viable income opportunities, failure of investments, lifestyle issues and health problems all contribute to suicides. To blame all suicides on debt stress and recovery practices is not always accurate. (In 2005, another spate of suicides in AP, Karnataka and Maharashtra was attributed to debt stress; but a special relief program co-ordinated by the Prime Minister’s office found several other contributory factors.) The failure of livelihoods and lack of income opportunities certainly play a role, and may have little to do with debt.

However, on the subject of loan recovery practices, it is entirely possible that some MFIs (or their agents) have resorted to coercive practices which cross the line of legality (just as some mainstream banks did, some years ago). Some reports have also indicated the presence of other organizations, not registered with either of the industry bodies but describing themselves as MFIs, which issue loans, charge very high rates of interest, and collect repayments aggressively and sometimes violently. In our view it is critical for the microfinance industry to publicly repudiate, and penalize, organizations whose practices cross the line. Recent statements to this effect by Vijay Mahajan, Chairman of MFIN, are welcome<sup>xiii</sup>. We understand that similar commitments have been made by Sa-Dhan as well, at a meeting on October 21 in Hyderabad. Enforcement must be visible and public.

### Impact on the future

Most sector stakeholders including MFIs themselves, lenders, and investors, are deeply unhappy with the Ordinance as it stands. MFI CEOs are unanimous in their view that the ordinance in its present form is not implementable, and the suspension of operations damaged credit culture and recovery prospects with every day that it lasted. This damage will impact negatively not only on the microfinance industry, but also on the entire banking industry, including public-sector banks. Overseas investors and lenders, while remaining supportive at the level of their representatives in India, are deeply concerned at the adverse impact of the government’s actions on India’s image as a well-regulated investment destination. Public sector financial institutions are unwilling to be quoted currently, but it is probably fair to say that outside government institutions it hard to find a stakeholder who is not deeply apprehensive about the impact of the ordinance.

### In Conclusion

In our view, the current crisis has its roots in the centrality of AP to the microfinance industry, the growth of MFIs in the state, and the adversarial consequences of their success in recruiting clients impacting on a sensitive demographic for government. The state government, which undoubtedly deserves credit for earlier schemes which in a sense prepared the ground for MFIs, reacted with a measure of absolutism that does not augur well for any of the parties involved.

In our view, the most disturbing element of this crisis is that government appears to be ready to throw away all the gains to the Indian social fabric that have been brought about by MFIs – which serve exactly those sections of society that have been hitherto excluded from the giant strides the Indian economy is taking. This would be a classic case of throwing out the baby with the bathwater, and we add our voice to those asking government and the media to recognize the adverse, unintended consequences of such actions.

The media’s role has not been above criticism, and parts of the media appear to have aligned themselves with reporting agendas that can only be described as irresponsible.

As in any other sunrise sector, microfinance companies are regarded with some awe, but that awe is definitely mixed with apprehension. Sector participants should invest more time with other stakeholders (government, media, people at large), educating them about the microfinance business, the benefits it brings, the need for private capital, and (all-important in this context), why interest rates are at the levels they are.

The industry associations, Sa-Dhan and MFIN, both need to play a more pro-active role in engaging with all stakeholders on an ongoing basis. There is clearly a need to establish stronger ethical practices, reporting and compliance rules, and to encourage transparency, in a sector which has the potential to create positive impact for millions of people in some of the poorest corners of India. Importantly, there must be industry-owned and industry-administered channels to penalize transgressors – it is likely that most of the larger mainstream MFIs, particularly those with ethical investors and responsible boards, will follow good practices anyway; it is necessary that transgressors be penalized, immediately, visibly, and sufficiently painfully to act as a deterrent.

Finally, the industry should consider some introspection. The allegation that some MFIs, in pursuit of growth at any cost are pushing unaffordable loans and then using unethical measures to recover them, represents a very real issue. It also segues to a larger question on industry direction: Has the quest for commercial capital for scaling up, and for higher valuations, overtaken the mission of meaningful social impact through microcredit?

These are issues that merit discussion and debate. But wholesale closure of the industry, even as the unintended consequence of an ineffective piece of legislation, damages India more than it punishes irresponsible or criminal lenders. In our view it should not be contemplated.

<sup>i</sup> [http://www.grameen-info.org/index.php?option=com\\_content&task=view&id=43&Itemid=93](http://www.grameen-info.org/index.php?option=com_content&task=view&id=43&Itemid=93)

<sup>ii</sup> <http://www.nabard.org/microfinance/designfeatures.asp>

<sup>iii</sup> [http://agritech.inau.ac.in/ngo\\_shg/shg\\_faq.html](http://agritech.inau.ac.in/ngo_shg/shg_faq.html)

<sup>iv</sup> Financing Microfinance – The ICICI Bank Partnership Model, Bindu Ananth  
([http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file\\_id=646440](http://www4.gsb.columbia.edu/null/download?&exclusive=filemgr.download&file_id=646440))

<sup>v</sup> Microfinance Institutions in Andhra Pradesh – Crisis and Diagnosis, HS Shylendra, Economic and Political Weekly - May 20, 2006  
(<http://www.apmas.org/pdf%5Cn.pdf>)

<sup>vi</sup> Andhra Pradesh Micro Finance Institutions (regulation of money lending) Ordinance 2010 Source:  
<http://www.serp.ap.gov.in/SHG/files/MFIOrdinance.pdf>

<sup>vii</sup> <http://www.microfinancemonitor.com/2010/03/08/ap-govt-unveils-grand-shg-plan-on-womens-day/>

<sup>viii</sup> Village government

<sup>ix</sup> <http://www.livemint.com/2010/10/22193213/High-court-interim-order-permi.html>

<sup>x</sup> *A Quick Review, 2010*, report on the financial performance of Indian MFIs, Sa-Dhan

<sup>xi</sup> As on March 2007, AP government website

<sup>xii</sup> [http://www.uslaw.com/library/article/bbktlact.html?area\\_id=11](http://www.uslaw.com/library/article/bbktlact.html?area_id=11)

<sup>xiii</sup> Quoted in <http://profit.ndtv.com/news/show/mfi-ordinance-effect-borrowers-in-ap-stop-repaying-loans-110191>

Quick conversions  
1 Crore = 10 million  
US\$ 1 = INR 45

#### About Intellecrap

Intellecrap 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.

Intellecrap 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, please visit [www.intellecrap.com](http://www.intellecrap.com).