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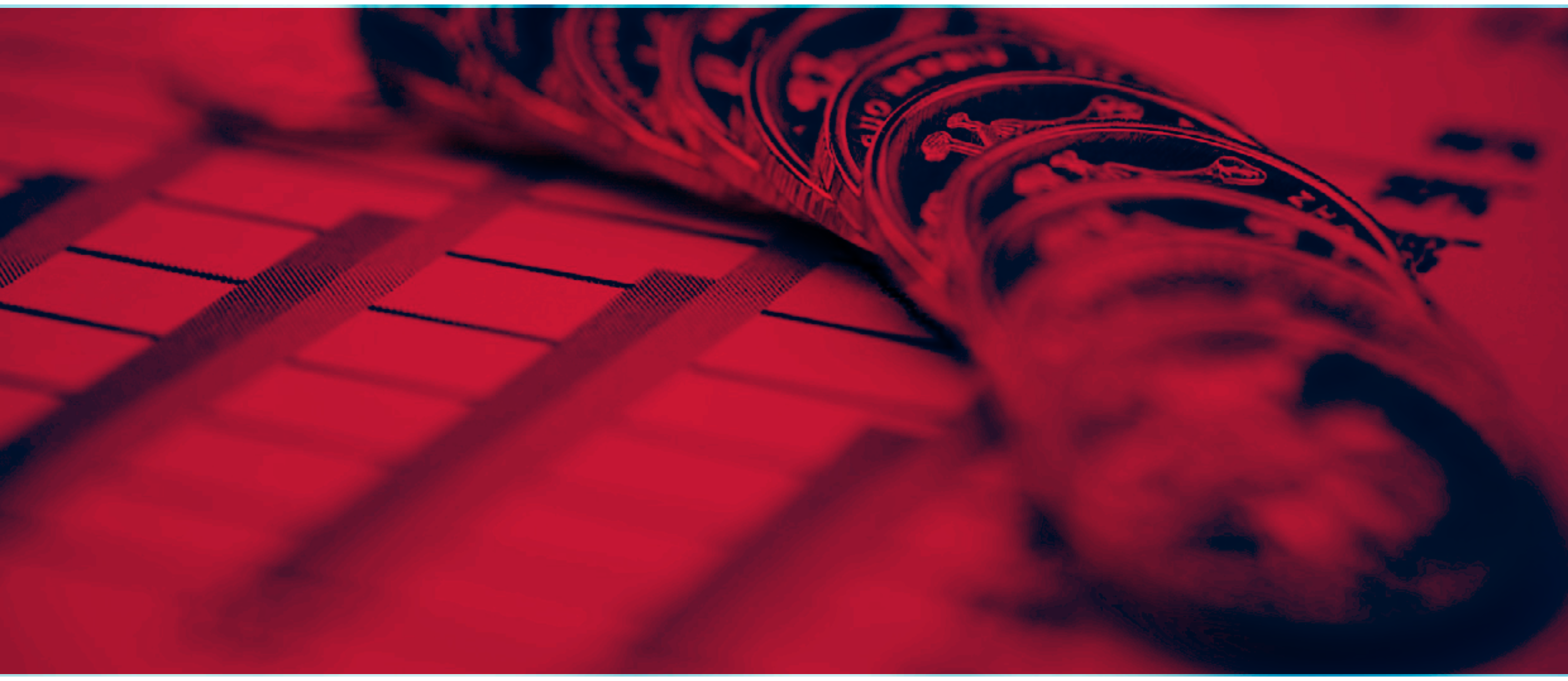

Working Group on Inclusive Finance in China

The Indian Microfinance Crisis 2010—Lessons for China

Pete Sparreboom

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This publication is supported by the members of the Working Group on Inclusive Finance in China:

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Foreword

This paper has been produced by the Working Group on Inclusive Finance in China. It forms part of a series of publications that seeks to deepen the discussion between regulators, investors and providers of financial services for rural people and the poor in China. The Working Group believes that research-based discussion will help to promote responsible investor behaviour and supportive government policies in the area of inclusive finance.

The Working Group was officially launched on the 14th of October 2010 during the China International Finance Forum in Shanghai. It is an initiative of the German Agency for International Cooperation (GIZ), the Graduate School of the People's Bank of China (PBOC) and the World Microfinance Forum Geneva (WMFG). It is funded by its Partners and Members, a list of whom is provided on the inside front cover of this document.

The Group owes its gratitude to Pete Sparreboom, Program Director of WMFG, for her diligence and productivity. Our thanks also go to the experts interviewed for the study, who kindly gave their time and provided an important part of the information. Their contributions provided several of the invaluable insights that serve to make this document what it is.

The author's opinions do not necessarily reflect the opinions of individual Partners and Members of the Working Group. While as much effort as possible has been made to be accurate, any errors remaining within the paper remain our responsibility. We hope you enjoy reading this work.

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Executive Summary

India's microfinance industry experienced a deeply disturbing rupture emanating from Andhra Pradesh (AP) in 2010. This rupture has important implications not only for Indian but also for worldwide microfinance operations. In this paper we examine whether the accusations made by the AP government towards the private sector microfinance industry are substantiated by evidence. We also investigate the causes and background that gave rise to the Indian crisis and review whether the same occurrence may happen in China.

The AP Government identified several issues against the microfinance industry including **multiple lending and over indebtedness, high interest rates and excessive profits**. In particular, the Government linked several suicides directly to Microfinance Financial Institution (MFI) practices. Several commentators have observed that this backlash against Indian microfinance may be politically motivated since Government-run Self Help Groups (SHGs) are in direct competition with privately run microfinance lending operations. Many MFIs "shortcut" the lengthy route to form lending groups by directly approaching established SHGs. Recently, SHG clients have notably drifted towards MFI services and local governments have felt they are losing "control" over valuable voters.

In response, the Government issued an Ordinance requiring MFIs to fulfil various criteria including district registration, gaining written approval before lending to Self Help Groups, limiting visits to client homes and businesses, and recovering loans near a specific government office. Collectively, such activities have made it very difficult for MFIs to operate effectively and loan recovery rates have fallen substantially, allegedly to levels as low as 5%. Loan recoveries have also been affected by local politicians verbally supporting client defaults.

Shortly after the issue of the Ordinance, The Reserve Bank of India formed an investigatory Committee under Y.H. Malegam. While commending the important role that private microfinance operators play in increasing financial inclusion, the Malegam Committee recommended creating a new institutional category called NBFC-MFI (Non-Banking Financial Company—MFI) to be regulated by the neutral and independent Reserve Bank of India (RBI) without interference from state governments. They also suggested detailed operational rules for these NBFCs, including a 24% cap on interest rates a 10–12% cap on margins. Industry actors think these recommendations, if adopted nationally, will result in a sudden and significant national contraction of the MFI sector.

However, are the three accusations made by the AP Government justified?

Multiple Lending and Over-Indebtedness: Estimates of the number of MFI and SHG loans per poor household vary widely, but 4 seems to be a reasonable average. This validates the accusation of widespread multiple lending. However, multiple lending is not in itself an issue unless clients are unable to service these loans. Then over indebtedness occurs. Research shows that AP has a higher combined average outstanding loan from MFIs and SHGs per poor household than any other Indian state. Thus, the accusation that AP may have a significant number of over- indebted poor people seems true.

High Interest Rates and Excessive Profits: Worldwide MFI portfolio nominal yield rates average 32.9% while in India the weighted average yield is 28.3%. Adjusting for inflation, worldwide yields are 25.9% and India's only 13.3%. Thus among international peers, the Indian Microfinance Industry does not seem to charge excessive interest rates. Even compared with rates charged by alternative providers, they do not seem excessive. If small bank loans cost between 24% and 36% and moneylender interest rates vary anywhere between 30% and 120%, the average Indian microfinance industry rate constitutes a competitive price for low income clients. Where any accusation may hold true is in excessive profits. An analysis of cost structures indicates that providing MFI loans in India is considerably cheaper than in other parts of the world. This is possibly due to scale economies but is also linked to MFIs easily identifying SHGs as ready-made customer groups and selling them services.

Suicides: AP is situated in India's 'suicide belt' and recorded 14,500 suicides in 2009 at a rate of 1.74 per 10,000 people. At this rate, an estimated 1,008 MFI clients in AP would have committed suicide in 2010. An analysis of the nationwide causes for suicide leads to the conclusion that a maximum of 337 of these deaths may have been related to the client's relationship to an MFI. Politicians and the press link 87 suicide cases directly to MFI related indebtedness. However, it is difficult to attribute these suicides purely to microfinance lending practices since multiple lending sources are common. Moneylenders are known to use coercive collection methods and SHG members can be quite harsh on one another to ensure group repayments. A forthcoming study on 44 of the 87 suicide cases allegedly linked to MFIs concludes that only 13 were clearly related to MFI loans. While any suicide rate is undesirable, compared with the overall rate, this number is very small.

Deeper causes: There is no evidence that MFIs were causing a rise in suicides in AP, or that multiple lending and high interest rates were causing exploitation of SHG members. However, there is general agreement that MFIs were becoming increasingly lax in their underwriting, they were contributing to growing over-indebtedness and some staff engaged in coercive collection practices.

Politicians and the media have generally held MFIs responsible for the reported excesses. However, it can be argued that the government, regulators and investors played an important role in the run-up to the crisis by introducing policies and taking actions that stimulated excessive levels of portfolio growth. For example, MFI and SHG growth were fuelled by a major government-incentivised injection of bank loans into the sector, as well as private equity investment from commercial foreign players. Regulators, supervisors, industry associations and investors did little to ensure MFI governance structures contained the necessary quality as well as the checks and balances necessary to ensure prudent decisions.

Relevance to China: India and China have risen quickly and in the process lifted millions of people out of poverty. However, these two giant economies both face an ever growing gap between rich and poor. Both countries view microfinance as a tool to address these inequalities. As in India, China hosts a variety of inclusive finance institutions but so far sector penetration has been low. Many institutions such as Micro Credit Companies (MCCs) and Village and Township banks (VTBs) in practice cater for wealthier clients requiring larger loans.

None of the alleged reasons that gave rise to the Indian Ordinance currently exist in China. However, China could eventually experience a similar crisis, because some of the conditions that caused the Indian crisis may yet arise. In particular, debt funding options available to microfinance providers are expanding, and governance structures are dominated by commercial interests and not strongly supervised. It is difficult to predict the reaction of politicians and administrators once private microfinance providers become serious competitors to publicly funded entities.

The explosive growth of MCCs, City Commercial Banks (CCBs) and Peer to Peer (P2P) providers may also give rise to concern. Such growth if left unchecked may encourage overly competitive practices that may result in lax underwriting, over-indebtedness and coercive collection, and may result in suicides.

The Chinese Government will no doubt examine the Indian situation closely. Taking note of the good parts of the Andhra Pradesh ordinance and the Malegam Committee recommendations, as well as the constructive recommendations made by MFIs and investors will be a sure-footed step forward.

1 Introduction

In the second half of 2010, India changed from being microfinance's most promising market to being the sector's basket case. August 2010 saw the largest and fastest growing Indian Microfinance Institution, SKS, listing on the stock exchange through a much lauded Initial Public Offering (IPO). Yet on 15 October 2010 the government of Andhra Pradesh (AP) issued an Ordinance that effectively stopped business for the Microfinance Institutions (MFIs) in the state. In parallel, the Reserve Bank of India (RBI) constituted the Malegam Committee, which has since come out with recommendations which, if adopted, could have the same effect on a national scale. India is currently facing its greatest ever crisis in microfinance, with worldwide implications.

Unsurprisingly, the crisis has created major concerns among Chinese investors and the Chinese government. Investors worry about the risks of government intervention. The government weighs heavily the risks associated with a market-based approach to microfinance against the benefits of involving private investors.

Media coverage of the AP crisis worldwide and in China has not always been objective. In many cases sensationalism has taken over from in-depth research and professional journalism. If the government and investors were to base their decisions on erroneous public reporting, this could do great harm to the poor and their long-term access to financial services.

This paper seeks to provide a balanced explanation of the crisis, and an analysis of its relevance for China. It is based on an analysis of the facts underlying the crisis, drawing from research by credible institutions as well as interviews with some of the actors involved. The paper identifies parallels as well as differences with the Chinese environment, and includes a set of recommendations for investors and the government.

2 History of Microfinance in India

India has a population of 1.2 billion, with more than three quarters of adults having no access to basic financial services.[1] Poor people in India have traditionally used informal savings and credit groups (chit funds) to obtain financial services beyond those provided individually by family and friends. For larger amounts, they have gone to moneylenders (rich villagers, pawn brokers, gold merchants and middlemen), whose small scale business model requires high interest rates. Since it is very difficult to supervise a large number of individual moneylenders, there have always been reports of abusive practices. For example, people have ended up bonded to moneylenders across generations, and moneylenders have developed entrenched patron-client relationships with local politicians.

In an effort to provide the poor with access to better financial services, in the beginning of the 20th century the Indian government set up cooperative financial institutions. In 1969, it nationalized the banking industry in an attempt to support the green revolution and industrialization, and a few years later it started requiring banks that wished to set up a new urban branch to establish four new branches in remote rural areas. As a further effort to reach rural areas, India established a specialized class of regional rural banks in the 1970s.[2]

To all these institutions, the government and international donors provided funds for giving subsidized loans to the poor. In practice, big landholders used connections and bribes to capture these cheap loans. Because bank employees were rewarded more for disbursing loans than for protecting the bottom line, they did little to enforce repayment. In other words, loans in practice were given neither on the basis of who deserved them nor who would repay them. This drained government coffers and destabilized lending institutions. No unsubsidized financial provider could compete with credit on such easy terms. Thus, most poor people remained excluded from the financial system.

In the 1980s social entrepreneurs and in some cases local governments started to set up Self Help Groups (SHGs), as a means to extend training and other non-financial services to rural areas.[3] Some of these groups, generally consisting of 10–20 women, would make regular savings contributions to a common pot, which would then be lent to one of the members. In 1991–92 the government started a pilot project of linking SHGs to banks, which would eventually turn into the SHG-Bank Linkage Programs (SBLP). The programs were supported by the National Bank for Agriculture and Rural Development (NABARD) and World Bank loans.[4] SHG access to outside funding was greatly enhanced by the government's decision to include microfinance in the banks' priority sector lending quotas. This led to an enormous growth in the number of groups. Several design features ensured that the SHGs effectively reached out to the poor rural population. However, outreach was still limited by the fact that most programs required substantive government subsidies to cover interest rate differentials. The programs also suffered from the adverse incentives for repayment commonly associated with subsidized, government-led programs.

It was only in the 1990s that economic reforms allowed NGOs to start to play a role in microfinance, using methodologies similar to the ones pioneered by the Bangladeshi MFIs. The MFIs aimed to achieve high outreach without the need for subsidies. In the 2000s many of those NGOs converted from non-profit societies into Non-Bank Financial Companies (NBFCs), as a way of increasing their access to funding from formal institutions. This transformation enforced an even higher degree of financial discipline. Their growth has been supported by the state-owned Small Industries Development Bank of India (SIDBI), loans from commercial banks under the priority lending quotas, and more recently equity investments from specialized microfinance investment vehicles and private equity funds.

1. *Consultative Group to Assist the Poor (CGAP), Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance, 2010.*

2. *CGAP, ibid.*
3. *CGAP (2010), ibid.*
4. *Johnson, D. and S. Meka, Access to Finance in Andhra Pradesh, Institute for Financial Management and Research—Centre for Microfinance, 2010.*

3 Size and Growth of the Sector

According to M-CRIL, a leading microfinance rating agency based in India, in March 2010 the financial sector looked as follows:

Table 1: Overview of India's Financial Institutions[5]

Type of institution	Number
Formal financial institutions	
Commercial banks	80
Regional rural banks/local area bank	86
Cooperative societies and banks	ca. 100,000
Non-bank financial companies	12,740
Microfinance providers	
Microfinance institutions	ca. 660
Self help groups	ca. 4 million
Informal financial institutions	
Moneylenders	Unknown
Chit funds	Unknown

Both the SBLP and the MFIs have grown very fast over the past few years, although reputable organizations and researchers disagree on the exact rate of growth. The table below shows annual growth rates calculated by M-CRIL based on data from the largest 24 MFIs. While M-CRIL does not find the 100% annual growth rate often quoted in the press, it is important to realize that these rates do signify a multiplication of clients and portfolio by a factor 7 and 12 respectively over a five year period.

Table 2: Annual Growth Rates for the 24 Largest MFIs in India[6]

	2009–2010		2005–2010	
Annual growth rates	Clients	Portfolio	Clients	Portfolio
24 largest MFIs	45%	76%	62%	88%

The National Bank for Agriculture and Rural Development (NABARD) gives the following rates for the growth in the number and volume of bank loans outstanding to SHGs and MFIs.

Table 3: Annual Growth Rates of Bank Lending to MFIs and SHGs[7]

	2008–2009		2009–2010	
Annual growth rates	Number	Amount	Number	Amount
Bank loans to SHGs	17%	33%	15%	23%
Bank loans to MFIs	73%	82%	-21%	102%

Clearly, in percentage terms bank loans to MFIs have recently been growing faster than bank loans to SHGs. According to N. Srinivasan,[8] in 2010 growth in MFI loans outstanding also overtook growth in SHG loans outstanding in absolute terms.

5. *Micro-Credit Ratings International Limited (M-RIL), Microfinance Review 2010: Microfinance Contributes to Financial Inclusion, November 2010.*
6. *M-CRIL, ibid.*
7. *National Bank for Agriculture and Rural Development (NABARD), Status of Micro Finance in India 2009-2010.*
8. *Srinivasan, N., Microfinance India: State of the Sector 2010, Presentation to ACCESS Microfinance India Summit 2010.*

4 Alleged Reasons for the Crisis in Andhra Pradesh

Considering that Andhra Pradesh is home to 7% of India's population, it is particularly well served both by MFIs and by the SHG-Bank Linkage Program. The table below, based on figures calculated by N. Srinivasan, shows that 23% of Indian MFI borrowers and 30% of bank-supported Indian SHG members live in Andhra Pradesh.

Table 4: Relative Number of Microfinance Clients in India and Andhra Pradesh[9]

	India	Andhra Pradesh	AP as % of India
Population	1,210.19m	84.67m	7%
Borrowers of MFIs	27m	6.25m	23%
Members of SHG groups served by SBLP	58m	19.11m	30%

This is partly due to the fact that several pioneering MFIs started in Andhra Pradesh, and currently 5 of India's largest MFIs are headquartered in the state. In addition, the Andhra Pradesh state government has always been particularly supportive of the SHG program, and gave it an extra push three years before the crisis. Andhra Pradesh is the only part of India that administers SHG programs only through the state, with considerable support from the World Bank.

On 15 October 2010, the Andhra Pradesh state government issued the *'Ordinance to protect the women Self Help Groups from exploitation by the Micro Finance Institutions in the State of Andhra Pradesh and for the matters connected therewith or incidental thereto,'* to be implemented immediately.

On the same day, the Reserve Bank of India constituted a *'Committee to study issues and concerns in the MFI sector'* chaired by Y.H. Malegam. This committee issued its report in January 2011 and proposed the implementation of its recommendations by 1 April 2011.

Politicians and the media have given several key reasons for the Ordinance:

- Multiple lending and over-indebtedness due to lax underwriting and piggybacking on SHGs
- High interest rates and excessive profits due to founder greed and private investment in the sector
- Suicides linked to multiple lending, high interest rates and coercive collection practices

Below we will first assess the validity of each of these reasons, to see whether the Andhra Pradesh Ordinance was justified. We will then proceed to a description of the Ordinance content as well as the Malegam Committee report, and analyse their effectiveness in addressing the root causes of the problems.

4.1 Multiple Lending and Over-Indebtedness

Multiple borrowing occurs when a person holds two or more simultaneous loans from one or several sources. Evidence of multiple borrowing is scarce; the only survey-based

9. *Srinivasan, ibid.*

information source is a study on access to finance in Andhra Pradesh by the Institute for Financial Management and Research (IFMR) Centre for Microfinance. According to this study a high percentage (93%) of rural households in Andhra Pradesh had a loan from some source. The table below shows the percentage of households that held a loan from each source.

Table 5: Share of Andhra Pradesh households with loans outstanding from different sources[10]

Source of loan	Share of households with loan from source
Banks	37%
SHGs	54%
MFIs	11%
Informal sources	82%
All sources	**93%**

The survey showed that 11% of participants had a microfinance loan and 54% had a loan from a SHG. Multiple borrowing was very common—an estimated 84% of rural households had more than one loan outstanding—but this number was primarily driven by households that had multiple loans from informal sources.

Having more than one MFI loan outstanding at a time was quite rare. Of those households that had an MFI loan outstanding 82% had other formal loans outstanding. This figure was 58% for households that had SHG loans and 74% for households that had bank loans.

It should be noted that the sample covered rural households, rather than just poor households. Since the survey the industry has grown rapidly and considering some sampling distortion, it is likely that the figures understate the level of microfinance penetration in the state.[11]

Srinivasan[12] estimates the number of loans outstanding to MFIs and SHGs per poor family at the time of the Ordinance at no less than 10. His calculations are based on a very conservative poverty definition. The table below shows our calculation based on less conservative poverty figures provided by the Indian Government and the World Bank. On this basis, the number of MFI and SHG loans per poor family is almost 4. This result does point to a high level of multiple borrowing in the state.

Table 6: Number of Poor Households in Andhra Pradesh

Population of Andhra Pradesh[13]	84'665'533
Percentage of poor people[14]	29.90%
Number of poor people	25'314'994
Number of people per household[15]	3.9
Number of poor households	6'491'024

10. *Johnson, ibid.*
11. *CGAP, ibid.*
12. *Srinivasan, ibid.*
13. *Office of the Registrar General and Census Commissioner, Census of India 2011, Provisional Population Totals – India – Data Sheet, Ministry of Home Affairs, 2011.*
14. *Tendulkar Committee, Report of the Expert Group to review the Methodology for Estimation of Poverty, Planning Commission, Government of India, 2009.*
15. *International Institute for Population Sciences, National Family Health Survey 3, Ministry of Health and Family Welfare, Government of India, 2007.*

Table 7: Number of MFI and SHG loans per poor household in Andhra Pradesh

Number of poor households in Andhra Pradesh	6'491'024
Total MFI+SHG portfolio outstanding (Rs)[16]	169'490'000'000
Value of MFI+SHG loans per household (Rs)	26'111
Total MFI+SHG number of loans outstanding[17]	25'360'000
Number of MFI+SHG loans per poor household	3.9

However, multiple borrowing is not necessarily a problem. Recent in-depth studies into the financial lives of the poor in India, Bangladesh and South Africa[18] conclude that poor people generally manage a complex portfolio of loans from different sources in order to meet their different needs. They feel they benefit from access to a variety of loans with different conditions, which they can access when needed. There is nothing wrong with people having multiple loans, as long as they are not over-indebted.

Individual or household over-indebtedness can be defined as a chronic inability to fully repay all debts on time.[19] Customer over-indebtedness in microfinance can be measured by comparing periodic debt obligations with net periodic household income. Unfortunately, such data has not been collected systematically for households or for the range of loan suppliers available to microfinance clients.

Akin to other countries, India has no reliable data on over-indebtedness. However, there are reasons to believe that over-indebtedness was high in Andhra Pradesh. We already saw that MFI clients and SHG members constituted a much greater proportion of the national total than would be expected based on the size of the state's population. In addition, according to Srinivasan,[20] Andhra Pradesh also had the highest combined average loan outstanding from MFIs and SHGs per poor household of any other state, in fact ten times the average national loan outstanding.

4.2 High Interest Rates and Excessive Profits

Since microfinance providers charge interest and several fees on a number of different products, a good way to compare effective interest rates is to look at the portfolio yield. This indicator measures the income actually earned by MFIs on their portfolio. According to M-CRIL, at the end of 2010, the weighted average nominal yield on MFI portfolios was 28.3%. This yield is higher than the 2009 average for Asia but lower than the average for the 1019 MFIs that reported to the MIX worldwide that year.

It may be argued that what matters in international comparisons is not the nominal yield but the inflation adjusted "real" yield. Some MFIs argue that India's real MFI interest rates are in fact the lowest in the world. The World Bank reports an annual percentage consumer price change for 2010 of 13.2%.[21] The calculations below show that from a real yield perspective, the effective interest rates charged by Indian MFIs are in fact very low.

16. *Srinivasan, ibid.*
17. *Srinivasan, ibid.*
18. *Collins, Daryl. e.a., Portfolios of the Poor: How the World's Poor live on $2 a Day, Princeton University Press 2010.*
19. *Kappel, V., A. Krauss and L. Lontzek, Over-indebtedness in Microfinance – constructing an early warning index, Centre for Microfinance, University of Zurich, 2010.*
20. *Srinivasan, ibid.*
21. *World Bank, World Economic Outlook, April 2011.*

It should be noted that while M-CRIL calculates average yields weighted by MFI portfolios, the MIX averages are unweighted. Also, M-CRIL includes securitized portfolios in its calculations whereas the MIX does not. These differences would influence the figures. Another caveat is that, according to research by Microfinance Transparency in India, the average percentage rates charged vary considerably by MFI.[22] However, it is probably safe to say that on average, the real interest rates charged by Indian MFIs are not exorbitant.

Table 8: Relative Average Nominal and Real Yield of MFIs in Andhra Pradesh

	Average nominal yield	Average real yield
India 2010[23,24]	28.3%	13.3%
Asia 2009[25]	27.6%	21.2%
World 2009[26]	32.9%	25.9%

Of course what matters more for clients is how MFI interest rates compare with alternative provider rates. M-CRIL argues that compared to the 24–36% effective costs of bank loans for small borrowers and moneylender interest rates ranging from 30–120% in various parts of the country, average yields of the order of 28% actually constitute a benefit for low income MFI clients.

However, it is true that profit margins were relatively high. The table below compares costs and yields of the 66 largest Indian MFIs reported by M-CRIL with those of the 1,019 worldwide MFIs reporting to the Microfinance Information Exchange (MIX).

Table 9. Relative average margin of MFIs in Andhra Pradesh

	India 2010[27]	Asia 2009[28]	World 2009[29]
Operating expense ratio	8.6%	14.1%	18.0%
Financial expense ratio	9.2%	5.7%	5.4%
Loan loss provision	0.8%	1.4%	2.6%
Total expense ratio	18.6%	21.3%	25.9%
Yield	28.3%	27.6%	32.9%
Yield minus total expense ratio	9.7%	6.3%	7.0%

The table shows that average margins were high primarily because Indian MFI total expenses were significantly lower than the world average, mostly due to very low operating expenses. This was partly the consequence of significant economies of scale. However, costs were kept artificially low by certain strategies. For example, the focus on a single, fully standardized product reduced costs significantly but did not benefit clients. Piggybacking on existing SHGs reduced group formation costs but increased the risk of overindebting clients. The rapid deployment of staff and the use of agents reduced training costs but increased the risks of sloppy underwriting and unethical collection practices.

22. Microfinance Transparency, http://www.mftransparency.org/data/countries/in/.
23. M-CRIL, ibid.
24. The real rate is calculated on the basis of the annual percentage change in consumer prices for 2010 reported in the World Economic Outlook above.
25. Microfinance Information Exchange (MIX), 2009 MFI benchmarks.
26. MIX, ibid.
27. M-CRIL, ibid.
28. MIX, ibid.
29. MIX, ibid.

Some industry actors argue that solid margins are necessary to raise equity capital from commercial players, since the volumes required are and will not be available from public sources. Others argue that the fact that some MFIs used their margins to pay executive compensation packages above those common in the banking sector indicate that margins were excessive.

4.3 Suicides

India has one of the highest suicide rates in the world. According to the Indian National Crime Records Bureau, in 2009 more than 127,151 persons in India lost their lives by committing suicide.[30] The national suicide rate in 2009 stood at 1.09 per 10,000. While the rate has marginally increased over the past 5 years, it is slightly lower than the rate recorded in 1999.

The state of Andhra Pradesh is considered part of India's 'suicide belt,' with a traditionally higher suicide rate than the national average. In 2009 it witnessed 14,500 suicides, and its suicide rate was 1.74 per 10,000. At this rate, one would expect there to have been 1,008 suicides among AP's 6.25 million MFI clients in 2010.

Table 10: Expected Number of Suicides Among MFI Clients in Andhra Pradesh

Number of MFI clients in Andhra Pradesh[31]	6,250,000
Suicide rate in Andhra Pradesh[32]	0.000174
Expected number of suicides among MFI clients in Andhra Pradesh	1,008

The fact that a microfinance client commits suicide does not mean that the suicide is related to the relationship with the MFI. NCRS details the major reported causes for nationwide suicides in 2009 as follows:

Table 11: Causes of Suicide in India[33]

Causes of suicide	Percentage
Family problems	23.7%
Illness	21.0%
Love affairs	2.9%
Bankruptcy	2.5%
Dowry dispute	2.3%
Drug abuse/ addiction	2.3%
Poverty	2.3%
Other causes	26.2%
Causes unknown	16.8%
Total	100%

Apparently, NCRS does not include 'over-indebtedness' in the list of causes that people select when reporting a suicide. Of the causes they do include, 'bankruptcy,' 'poverty' and 'other causes' may be related to unpayable debts. Since only 31% of suicides were the consequence of these causes, there is not more than a one third chance that a suicide by a microfinance client is due to over-indebtedness.

30. National Crime Records Statistics Bureau (NCRSB), Accidental Deaths and Suicides in India 2009.
31. M-CRIL, ibid.
32. NCRSB, ibid.
33. NCRSB, ibid.

Following this argument, it can be calculated that in 2009 approximately 337 clients of MFIs in Andhra Pradesh committed suicide because of reasons that were possibly (but not necessarily) related to over-indebtedness. According to the Microfinance Institutions Network (MFIN),[34] in 2010 politicians and the press linked 87 suicide cases to indebtedness to microfinance institutions. There is not enough evidence to conclude that suicides because of indebtedness have been on the rise.

It is indeed possible that some recent suicides are due to over-indebtedness and coercive collection practices by MFIs. Due to the high growth of the sector in some cases management lost control of its staff. However, people borrow from a variety of sources; moneylenders have a history of using coercive collection practices and members of SHGs can be quite harsh on each other in order to ensure repayment to the bank and the acquisition of a next loan.

An upcoming study by MFIN on 44 of the 87 suicide cases allegedly linked to microfinance concludes that only 13 were clearly related to MFI loans.[35] Compared with the overall suicide rate, this number is very small.

5 Underlying Causes of the Crisis

We saw above that there is no concrete evidence that microfinance was leading to an increase in suicides in AP, and the crisis could also not be blamed on the presence of multiple lending or the charging of high interest rates. However, there is general agreement that MFIs were becoming increasingly lax in their underwriting, they were starting to cause over-indebtedness and sometimes employed unethical collection practices.

How is it possible that institutions with a social goal were ending up harming their clients? It is likely that this has happened because of the excessive growth experience by the sector. Fast growth can result in all kind of ills:

- The wish to rapidly grow the portfolio has led MFIs to streamline their underwriting practices by reducing personal contact with clients and skipping essential checks, sometimes resulting in loans to the wrong clients or lending above their clients' repayment capacity
- The need to rapidly deploy new staff has led MFIs to be less selective in their recruitment procedures, to cut down on training hours and to give new staff responsibilities before they are ready and tested, sometimes resulting in unethical collection practices
- The need to be more efficient has led MFIs to try and take shortcuts by approaching SHGs (thus reducing the time needed to form groups), and employing agents (thus reducing the time needed for direct client contact)

Politicians and the press put the blame for these developments and the responsibility for the crisis and the policy intervention squarely on the shoulders of MFIs. In order to judge whether they are justified in blaming the MFIs, we will analyze the deeper reasons behind the crisis. We will show that the government, regulators and investors played an important role in the run-up to the crisis, by supporting, actively or tacitly, policies and actions that stimulated excessive portfolio growth.

34. Alok Prasad, CEO of MFIN, personal communication.
35. Alok Prasad, CEO of MFI, personal communication.

5.1 Access to Capital

MFI growth was fuelled by extremely easy access to debt funds, particularly from banks.[36] In the beginning of the decade a few (mainly private) commercial banks, both Indian and foreign, started lending to MFIs. They were encouraged by the good repayment on loans to MFIs made by the state institution SIDBI. When the government included microfinance in the approved list for priority sector lending, it also became a way of meeting the government's obligatory quotas. As microfinance proved itself a good investment, over the course of the decade more and more banks became interested in lending to MFIs, and started competing with each other for opportunities. Finally, towards the end of the decade large numbers of public banks joined the party. Competition among banks for opportunities to lend to MFIs led to a fall in lending standards.

The global crisis that started in 2008, coupled with an increased popularity of microfinance as a responsible and relatively uncorrelated investment, led to international financial institutions and microfinance investment vehicles accumulating piles of cash and being unable to place it in viable institutions. By the end of the decade, international investors were clamouring for an opportunity to invest in the apparently healthy Indian microfinance market. This also led to reduced lending standards.

Growth would likely have been more controlled if the government had allowed strong MFIs to mobilize deposits instead of providing them with a flood of loans. Deposit mobilization has many advantages. First of all, deposits are an attractive source of funds: they are cheaper than loans; they are more stable; and their availability is less sensitive to world markets and the capriciousness of the government. Secondly, deposit services offered to loan clients improve portfolio quality: clients who have access to attractive savings services are less likely to overborrow, and find it easier to repay.

Theoretically, growth should have been constrained by the capital adequacy ratio imposed on NBFCs by the government, which stood at a reasonable 15%. However, regulations did not require MFIs to report securitized portfolios or count them towards their prudential capital to risk weighted assets ratio (CRAR).[37] This encouraged MFIs to sell large parts of their portfolio to banks who were eager buyers because this allowed them to meet their priority sector lending targets.

Finally, growth was further fuelled by the MFIs' need to raise equity to meet their capital requirements, and the scarcity of public or socially oriented equity funds to meet this need. MFIs therefore looked towards private, commercially oriented funds, and high growth rates and high margins were required to attract those funds.

5.2 Governance

Another fundamental reason for the high growth rates lay in MFIs' governance. While most MFIs started off as non-profits, many transformed into Non-Bank Financial Companies (NBFCs) in order to get access to bank priority sector lending funds. The transformation from non-profit to for-profit was complicated.[38]

36. M-CRIL, ibid.
37. M-CRIL, A Financial Inclusion Approach to Microfinance Regulation - Supplementary Suggestions on the Recommendations of the RBI Sub-Committee of the Central Board of Directors to Study Issues and Concerns in the MFI Sector, 2011.
38. CGAP, ibid.

Contrary to other countries, in India non-profits that created an NBFC could not become shareholders of the company. In theory, clients could become shareholders via so-called mutual benefit trusts, but in practice, these trusts were often run by the managers of the NBFC. Thus, boards often missed the kind of broad stakeholder representation that ensures balanced decisions and were dominated by the founders.

Many Indian MFIs were strongly dominated by their CEOs, with few effective checks and balances. CEO dominance is more likely to result in extreme decisions, such as increasing margins and pursuing extremely high growth rates.

More recently, decisions became influenced by shareholder composition changing as a consequence of the entry of commercial equity investors. Even if the new shareholders did not exert pressure, MFIs and their CEOs no doubt felt obliged to try and achieve the high growth rates and margins that drove higher valuations. In addition, the new shareholders encouraged practices like providing CEOs with stock options, thus giving them a financial interest in the company. This may have further fuelled high margins and growth.

Supervisors did little to ensure good governance. The RBI was not prepared for the explosive growth of the sector, and had neither the training nor the capacity to supervise the sector. For example, even though NBFC boards were supposed to meet 'fit and proper' requirements, in the case of MFIs these were not rigorously enforced. And even though RBI categorized increasing numbers of MFIs as institutions of 'systemic importance' it did not identify the risks involved in the extremely high growth rates, and did not take any action to ensure the continued stability of the sector.

Microfinance networks had developed codes of conduct, but the easy availability of funds caused MFIs to focus on the quantity rather than the quality of their growth. Since neither regulators nor investors required monitoring of adherence to these codes, the networks had no way to enforce their application.

5.3 Politics

Growth was also the result of competition between MFIs and SHGs. Some MFIs and analysts allege that politicians favoured SHGs because the SBLP effectively provides a vote-buying machine. In 2007 the Andhra Pradesh government began a program that greatly expanded the SBLP, through a five-fold increase in the upper limit for loans to SHGs. Members had to pay 12% interest on loans but could get 9% returned from local administrators in case of good repayment. This set-up offered ample opportunities for administrators to bestow financial benefits upon the poor in return for their support.

MFIs have purposely stayed away from politicians and administrators in an effort to stay clean. Since politicians and administrators had no power over MFIs, they experienced their growing presence as a threat. This feeling got gradually worse when MFIs increasingly started to offer their services to SHGs, and came to a climax in 2010 when MFI disbursements to clients started to overtake SBLP disbursements to SHGs.

This situation was exacerbated by the highly charged political environment concerning a possible state bifurcation. This environment led the governing parties and the opposition to compete vigorously for sounding more pro-poor in an effort to gain their votes. The opposition's call for not repaying loans to the MFIs was threatening to increase their popularity. This was swiftly countered by the government issuing the Ordinance that essentially had the same effect.

6 The Andhra Pradesh Ordinance

6.1 Nature of the Ordinance

The Ordinance dictated rules in four areas:

- Registration: MFIs are expected to register their institution in every district, and provide a monthly report detailing all operations
- Approval of loans to SHGs: MFIs are expected to request written approval from the registering authority before lending to SHGs; no person can be a member of more than one SHG
- Methodology: MFIs are expected not to require security for any loan, charge no more interest than the principal amount, recover loans near a specific government office, and not use any coercive action to recover loans including visiting the house or business of the borrower
- Transparency: MFIs are expected to display their effective interest rate in their offices and provide borrowers with loan statements and payment receipts

6.2 Analysis of the Ordinance

Registration: There is no objective reason for MFIs to be registered in every district. This simply adds a layer of bureaucracy and provides local administrators with the power to take politically motivated decisions. Besides, local administrators do not have the capacity to supervise MFIs. Supervision should be the role of an independent regulatory authority.

Two months after the Ordinance the Microfinance Network of India (MFIN) reported that MFIs were not able to register.[39] All MFIs had filed registration applications, as required by the Ordinance. But the registration requirements were very detailed, such as requiring MFIs to give new ration card numbers and SHG names for their members. As a result, all MFI registrations were conditional.

Approval of loans to SHGs: As argued above, poor people benefit most from access to a variety of financial products that allow them to satisfy different needs. Thus, it is not in the interest of clients to be limited to a single SHG and have no access to alternative sources of loans. The local administration does not have the capacity to issue written approvals with the necessary speed and efficiency. This rule effectively provides the government with the monopoly to serve the poor.

Two months after the Ordinance MFIN reported that MFIs were not able to disburse loans.[40] The Ordinance requires MFIs to obtain prior approval from the registering authority before giving a loan to any SHG member. There is no time limit given on registering authority giving the approval. As the majority of MFI clients are SHG members, this means MFIs can give virtually no loans.

39. *Microfinance Institutions Network (MFIN), MFIN Seeks Amendments to the AP Microfinance Ordinance to be Tabled in the Legislative Assembly, December 2010.*
40. *MFIN, ibid.*

Methodology: Government rules on loan conditions stifle innovation as well as competition between MFIs. A variety of security requirements for different products increases clients' choice as well as the possibility for MFIs to reach sustainability. Lower interest rates are good for clients but worldwide evidence shows that caps on interest rates are not the most efficient way of achieving this goal. Meetings near to the homes of borrowers are an essential feature of microloans offered by MFIs, which lower the costs for customers and increase the likelihood of timely repayment. Visits to homes and place of business are not necessarily the same as coercive collection practices.

Two months after the Ordinance was passed, MFIN reported that MFIs were unable to collect repayments.[41] In March 2010 industry participants estimated repayment rates to have fallen from nearly 100% to 4–5%.[42] The Ordinance states that repayments should be monthly or longer, but most borrowers have repaid MFIs on a weekly basis because they earn wages on a daily or weekly basis. It also states that repayment can be collected only at the Gram Panchayat office, yet many borrowers live over 10-12 km from this office. In addition, the promulgation of the Ordinance led to a negative environment. For example, politicians and officials had reportedly asked borrowers not to repay their loans. In addition, police had registered cases against MFI staff.

Transparency: The Ordinance obliges MFIs to provide transparency on their effective interest rates and issue statements and receipts, as long as these are simple enough not to interfere with the efficiency of operations. Better information allows clients to make informed choices and defend their rights.

As we saw above, the ordinance was politically motivated, seeking to promote SHGs. It deals with the symptoms of excessive MFI growth through detailed regulation and does not address the fundamental causes of this growth.

7 Malegam Committee Report

7.1 Nature of the Report

The Malegam Committee was a Sub-Committee of the Board of RBI whose task it was to study issues and concerns in the microfinance sector in so far as they related to the entities regulated by the Bank. The Committee's terms of reference included:

- To review the **definition** of microfinance and MFIs for the purpose of regulating NBFCs undertaking microfinance
- To examine prevalent **practices** of MFIs in regard to interest rates, lending and recovery practices
- To delineate the objectives, scope of and framework for **regulation of NBFCs** undertaking microfinance
- To examine the **applicability of other laws** such as the moneylending legislation by the States
- To examine the appropriate **role of MFI associations** and bodies in enhancing transparency and best practices
- To recommend a **grievance redressal machinery** for ensuring adherence to the regulations
- To examine the conditions under which loans to MFIs can be classified as **priority sector lending**

Its 64-page report with detailed recommendations is summarized in **Box 1.**[43]

Box 1. Summary of Malegam Committee Recommendations

1. **Constitution of a new institutional category called NBFC-MFI**
   a. NBFC-MFIs need to have at least 90% of their assets in the form of loans whose permitted terms and conditions are described in detail
   b. An NBFC which does not qualify as an MFI should not lend more than 10% of its assets to the microfinance sector
2. **Pricing and transparency**
   a. NBFC-MFIs are to observe a margin cap of 10–12% and a pricing cap of 24%, with permitted components of this price prescribed in detail
   b. MFIs should provide borrowers with standard loan agreements, loan cards and receipts, and prominently display prices
3. **Multiple lending, over-borrowing and ghost borrowers**
   a. Group lending is mandatory, a borrower can only be a member of one group (Joint Liability Group or Self-Help Group) and borrow from not more than two MFIs
   b. All sanctioning and disbursement should be properly supervised at a central location
   c. Credit bureau(s) should be established and MFIs required to become members
4. **Coercive methods of recovery**
   a. MFIs should recover loans at the group level at a central place and not at the borrower's residence or work; they should have proper grievance redress procedures
   b. The Regulator should monitor MFI codes of conduct, mandate the observance of a client protection code and examine the institution of Ombudsmen
5. **Efficiency and risk**
   a. MFIs should review their back office operations and make the necessary investments to achieve better control, simplify procedures and reduce costs
   b. SBLP and MFIs should devote more resources to group formation and skills training
   c. All NBFC-MFIs should have a minimum net worth of Rs 150 million, adequate provisions for loan losses and a capital adequacy ratio of 15%
   d. Corporate Governance requirements to be determined
6. **Funding**
   a. Bank lending through SBLP and directly to MFIs should be increased, and should continue to enjoy Priority Sector Lending status
   b. MFIs should disclose securitized portfolios in their financial statements and take them into account in a prescribed manner in capital adequacy calculations
   c. The creation of one a more domestic social capital funds should be examined
   d. MFIs should be encouraged to issue preference capital with a coupon rate ceiling
7. **Compliance**
   a. Monitoring should be shared between MFIs, industry associations, banks and RBI, subject to severe penalties
   b. RBI should considerably enhance its capacity to supervise NBFC-MFIs
8. **Consistency**
   a. NBFC-MFIs should be exempt from state Money Lending Acts
   b. Proposed national Microfinance Bill (2010) should be consistent
   c. Need for separate Andhra Pradesh microfinance act (2010) does not survive

41. MFIN, ibid.
42. Sajeev Viswanathan, CEO of Bhartiya Samruddhi (BASIX), personal communication.
43. Malegam, Y, Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector, January 2011.

7.2 Analysis of the Recommendations

The Malegam committee **recognises the importance of MFIs**. The report recommends the constitution of a new institutional category called NBFC-MFI, which is to be regulated by the neutral and independent RBI without interference from state governments that can be subject to political pressures. It also recommends investment in the RBI's supervisory capacity and a sharing of monitoring with industry associations and the banks that lend to the MFIs.

The committee also **recognizes the need for better information and communication** in order to ensure client protection. It includes recommendations on the obligation for more transparency, a code of conduct and procedures for its monitoring, and the set up of help lines, grievance redress procedures and ombudsmen. It also recommends the establishment of one or more credit bureaux with a concomitant obligation for MFIs to report to these bureaux and use their services.

The report goes beyond the AP ordinance focus on symptoms in that it **recognizes the role of funding in the stability of the industry**. It recommends continued priority lending status for the sector, the inclusion of securitized portfolios in an NBFC MFI's risk capital, and the creation of a domestic social capital fund.

Despite these good aspects, the implementation of the report's recommendations is **likely to result in a substantial contraction of the MFI sector, and a move away from those clients who most need its services**. This is because the report surpasses the Ordinance in its efforts to prescribe loan terms and conditions (including an interest rate cap), to define lending procedures and to regulate operations. According to M.S. Sriram,[44] it is trying to control all that can be controlled. Its recommendations are inconsistent with recent efforts towards liberalization and better choices for the poor. The proposed definitions for microfinance, rules on asset composition and requirements on minimum capital will lead to the demise of small and innovative MFIs, increased concentration, lower efficiency and eventually, less outreach to the poor.

Like the Ordinance, the Malegam Committee has fallen short of addressing some of the fundamental causes behind the excessive growth that caused the crisis.

The Committee has invited the sector to react to its recommendations, and this has given rise to a multitude of comments and proposals from scholars, practitioners and service providers to the sector.[45] **Box 2** offers a selection of comments on the likely effects of the Malegam recommendations, if implemented.

Box 2. Examples of Concerns About the Recommendations of the Malegam Committee

1. **Definition of microfinance clients as those with annual income of less than Rs 50,000—***Will exclude large numbers of low-income people who are above that threshold but who currently don't have access to financial services, including households with one member working full time at the minimum wage*
2. **Cap of Rs 25,000 as the maximum loan amount—***Will provide some people with loans that are below their needs, forcing them to continue to borrow from moneylenders; will reduce MFIs' long term interest in their clients*
3. **Fixed loan terms of 12 or 24 months according to loan amount—***Restricts ability of MFIs to tailor products to client needs*
4. **Cap of only two lenders per client—***Causes the poor to have less choice than the less-poor, who are not limited by such a rule*
5. **Pricing cap of 24%, margin cap of 10-12%—***Leads to increasing financial exclusion of the small customer who is more costly to serve, especially in the absence of interest caps on bank loans to MFIs*
6. **Net own funds of Rs 150 million—***Forces smaller MFIs out of business, closes the door on new entrants and becomes an invitation to commercially minded large companies to enter the business*
7. **NBFCs-MFIs should hold >90% of assets in form of microloans—***Forces diversified MFIs out of busiess, reduces ability of MFIs to spread their risks and serve clients better with more products*
8. **No deposit-taking by NBFC MFIs—***Limits MFI ability to serve clients, keeps clients dependent on MFIs, makes MFIs depend on more expensive and less stable sources of capital*

Below are a number of suggestions that have been made.

Symptoms:

- Increased financial inclusion by defining microfinance by loan value, linked to CPI and region
- Reduction of multiple lending through insistence on proper analysis of repayment capacity
- Reduction of over-indebtedness through better communication with clients and credit bureau
- Reduction of aggressive collection through more measured growth and code of conduct
- Reduction of margins and interest rates principally through increased transparency

Capital:

- Diversity and innovation through flexible asset composition and capital requirements
- Institutional stability and better service through possibility to mobilize limited deposits

Governance:

- Reduction of extreme decisions through strict government supervision of governance
- Steady growth through better investor due diligence and active engagement with MFIs

Politics:

- Reduction of political interference through regulation and supervision by central bodies
- Competition between public and private institutions through methodological freedom

44. Sriram, M.S., Microfinance: misunderstood, Malegamed, January 2011.
45. See Malegam Committee Microfinance Report – Summary of Reactions from MFI Sector, http://indiamicrofinance.com/malegam-committee-microfinance-report-summary-mfi-sector.html.

8 Relevance to China

China and India are the two large countries in the developing world that are generally regarded as the success stories of globalisation.[46] This success has been defined by the high and sustained rates of growth of aggregate and per capita national income, and the substantial reduction in income poverty. These results are viewed as the consequence of a combination of a prudent yet extensive program of global economic integration and domestic deregulation, as well as sound macro-economic management.

Despite their obvious differences, both China and India face rather similar economic problems at present, especially with respect to the sustainability of growth and the emerging inequalities. Both countries view microfinance as a tool to address these inequalities.

There are parallels as well as significant differences between microfinance in China and in India. As in India, China has is a variety of institutions that are mandated to serve the financially excluded. However, so far the sector has not reached a large number of poor people with appropriate services. It is commonly known that many institutions that are supposed to serve the excluded such as Micro Credit Companies (MCCs) and Village and Township Banks (VTBs) in practice tend to cater for somewhat better-off clients with loans that are larger than many would consider micro. While NGO MFIs serve a distinctly poorer clientele, their outreach is very limited.

There is however one parallel that may be cause for concern: the explosive growth in the number of MCCs. Also, some City Commercial Banks (CCBs) and Person-to-Person (P2P) microfinance providers have recently displayed very high growth rates. In our previous India analysis we elaborated the risks of explosive growth. Chinese regulators and investors would do well to watch this growth carefully and ensure sufficient and careful supervision and due diligence.

We saw above that the crisis in India was preceded by concerns over multiple loans, over-indebtedness, coercive collection, high interest rates and high margins, all of which may contribute to higher rates of suicide. While there may be pockets in China where these situations occur, they are certainly not generalized problems,[47] and there should therefore be no concern over an impending crisis. This is a comforting situation. However, as we will see below, there are reasons to believe that these conditions could appear in the long run, because of the existence of some of the same deeper lying problems that exist in India.

The table in Annex B gives an overview of the parallels and differences between microfinance in India and in China.

8.1 Access to Capital

In China the various institutional models have different access to capital. All except NGO MFIs have access to equity, but the sources of equity are restricted and return expectations often drive the microfinance providers away from their social goal. While CCBs and VTBs are allowed to mobilize deposits, MCCs, P2P lenders and NGO MFIs are not. This reduces their ability to service clients and increases their portfolio risk; the resulting dependence on debt also increases their cost of funds and increases their funding risk.

Access to debt funds varies greatly. VTBs have easy access to loans from their mother bank, and CCBs to local government loans. NGO MFIs and MCCs face regulatory restrictions on leverage and sources of funds. The recent increase in portfolio sales to trusts[48] is a dangerous development if not properly supervised. China Development Bank (CDB)[49] and Agricultural Bank of China (ABC) are lending increasing amounts to microfinance providers, and commercial banks are being encouraged to lend to microfinance providers through tax and other incentives; plans to establish specialized wholesale funds and guarantee funds are at different developmental stages. There are also instances of private domestic and foreign loans to microfinance providers.

When combined with lower restrictions on certain lender types, these facilities may provide the debt necessary for measured growth. It is important to prevent the easy debt funding problems that resulted from the quota system implemented in India.

8.2 Governance

As in India, there are reasons to worry about the governance of microfinance providers in China. NGOs are generally set up by people whose primary concern is poverty alleviation and financial inclusion, whereas most commercial entities are started by people with a strong profit orientation. For example, some banks establish VTBs to comply with the government's requirement to deal with San Nong, i.e., agriculture, rural areas and farmers while meeting their shareholders expectations on returns; some MCCS are set up by moneylenders wishing to legalize their business. The transformation of a non-profit into a for-profit company is complicated. Consequently, the governance structure of the new entity tends to be dominated by commercially oriented people with limited knowledge about the methods and technologies for effectively serving the poor while achieving a good rate of return.

The same pressure for growth and high margins that CEOs of Indian MFIs experience exists in China but differs by type of institution. For example, some MCC investors want their institutions to grow and increase their margins in order to reap higher returns, as well as to attract additional equity investors. They are constrained by regulations on geographic outreach and interest rates. The mother banks of some VTBs and CCB microfinance departments, on the other hand, do not necessarily want them to grow for fear that they become a burden, especially if they have no understanding of microfinance or SME technologies that permit a good return.

The external monitoring of microfinance provider governance, weak in India, again differs by type of institution in China. CBRC imposes strict requirements on CCBs and VTBs, which partly explains the relatively slow growth in their number. The requirements on MCCs and P2P providers are much less strict, largely because they do not mobilize deposits. Besides, the provincial financial offices responsible for registration and supervision are not as well qualified nor as well placed as the county CBRC offices for judging financial institution governance. Because NGO MFIs are not legally recognized, their boards experience little scrutiny.

46. *Ghosh, J., Poverty reduction in China and India: policy implications of recent trends, United Nations Department of Economic Affairs Working Paper No. 92, 2010.*

47. *Cheng Enjiang, Associate researcher, International Poverty Research Centre China, personal communication.*

48. *PlaNet Finance, Facing Difficulties in Financing, MCCs Turn to Trust Companies, Postings from the Field, July 2010.*

49. *PlaNet Finance, China Development Bank Establishes Strategic Alliance Agreement with MCCs in Jiangsu Province.*

8.3 Politics

Since the political systems in India and China differ enormously, there are few direct parallels to be drawn. Chinese politicians and administrators cannot gain votes by using lending programs as patronage, by pleasing moneylenders or by influencing the press. They can however gain standing through success in achieving the government's goals, in particular on the three rural issues.

As long as private microfinance providers cover a small part of the market and continue to focus on urban and semi-urban areas, local politicians and administrators will not see them as tools for achieving the government's goals. This could change once they start reaching out significantly to rural areas and achieving significant scale. It will be interesting to see whether politicians and administrators will treat the private microfinance providers as complementary or competitive to government supported lenders such as RCCs.

9 Conclusions

The microfinance ordinance issued by the state government of Andhra Pradesh has caused a major crisis in Indian microfinance, and made many people worldwide question the future of this development tool. The alleged reasons for the ordinance include suicides, high interest rates, over-indebtedness and coercive collection practices. This paper argues that there is no evidence that MFIs were to blame for a large number of recent suicides. It also finds that Indian MFI interest rates were low by both international and domestic standards. However, high and growing indebtedness together with increasingly frequent reports of coercive collection practices constituted good reasons for an intervention.

In order to prevent a similar crisis from happening elsewhere, it is important to understand the deeper causes of the crisis, which lie in the excessive growth due to easy access to debt capital and weak governance. Politics also played an important role in bringing the situation to a head.

The Andhra Pradesh Ordinance and the subsequent recommendations of the RBI Malegam Committee tried to address the symptoms of the crisis, and did little to address the deeper causes. While both documents contain some useful clauses and recommendations, they largely try to solve the problem through overregulation on lending methodology and capital adequacy. The measures and proposed measures stifle diversity and innovation, and result in large numbers of MFI clients being thrown back into the hands of moneylenders.

The situation in China differs greatly from that in India, in that none of the alleged reasons for the ordinance currently exist. However, there are reasons to believe that China could eventually run the risk of a crisis in the sector, because it does contain the seeds of some of the conditions that caused the crisis in India. In particular, the options for debt funding to microfinance providers are expanding, and governance structures are dominated by commercial interests and in some cases not strongly supervised. It is difficult to foresee the reaction of politicians and administrators once private microfinance providers become serious competition for publicly funded entities.

In order to avoid problems in the long run, the Chinese government and investors interested in supporting inclusive financial service providers should look carefully into the deeper causes of the crisis. While they should take note of the good parts of the Andhra Pradesh ordinance and the Malegam Committee recommendations, they should pay particular attention to the analysis provided in this paper. It is worth studying the constructive comments and suggestions made by Indian MFIs and investors, aimed at ensuring an efficient yet responsible industry that contributes significantly to financial inclusion.

10 Questions for Discussion

The following are a number of questions to consider in planning how to avoid a crisis in microfinance in China in the long run:

- At what speed should the microfinance sector grow?
- What are the best measures for controlling microfinance growth?
- What should be done to ensure the right amount and type of capital is available?
- What should be the role of regulators in lending methodology?
- What is the most effective way to minimize interest rates for clients?
- How should a code of conduct/ client protection code be monitored and enforced?
- What is the best way to ensure transparency?
- How best to guarantee good governance?
- How to make sure that investors act responsibly?
- What should be the role of national versus local authorities?
- How to ensure a level playing field for all providers of financial services?

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Annex A. Differences and Parallels Between Microfinance in India and China

	India before AP Ordinance and Malegam Cttee	India after AP Ordinance and Malegam Cttee	China
Situation for all MFIs			
Many types of institutions	+	–	+
High number of clients	+	–	–
High average client debt	+	–	–/+
High portfolio growth	+	–	–/+
Symptoms			
Suicides	–	–	–
Multiple loans	+	–	–
Over-indebtedness	–/+	–	–
Coercive collection	–/+	–	–
High interest rates	–	–	–
High margins	–/+	–	–
Access to capital			
Easy access to debt funds because of bank quotas, active DFIs and liquid MIVs	+	+	–/+
Possibility to circumvent	+	–	+
Prohibition to mobilize deposits	+	+	–/+
Difficulty to find sufficient social equity	+	+	+
Governance			
Transformation of non-profit into for profit complicated	+	+	+
Concentration of power and ownership in hands of founders	+	+	–/+
Pressure for growth and high margins to attract necessary equity	+	+	–/+
Weak external monitoring by central and local supervisors	+	–	–/+
Politics			
Local politicians/administrators compete on their pro-poor/ rural stand	+	+	+
They need public lending programs/ institutions to buy votes	+	+	?
They need local moneylenders to buy votes	+	+	?
They need support from local press to buy votes	+	+	?

Legend:

+ *True/expected to be true*

- *Not true*

-/+ *True for some institutions and not for others*

? *No information available to the author*

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