The Andhra Pradesh microfinance crisis in India: manifestation, causal analysis, and regulatory response

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Abstract

The microfinance sector in India's state of Andhra Pradesh was recently marred by a series of mishaps that occurred due to extensive lending, which resulted in over-indebtedness and ultimately, defaults. Lending institutions resorted to coercive measures for loan recovery that led to suicides amongst borrowers. In this paper, we explore the reasons that led to such circumstances. We will consider how the widespread operations and omnipresent Self-Help Groups, together with their linkages with banks, attracted private microfinance providers. This, coupled with the absence of adequate regulatory mechanisms, resulted in over-lending to the poor. The paper discusses policy implications of the various regulatory measures that the Government subsequently took to harness and regulate micro-lending practices in the state. It is argued that the regulatory measures initiated to address the issue do not focus on the social structures, i.e., the unequal distribution of the community institutional infrastructure base for delivery of microfinance among different states, and the singular focus of private-sector MFIs on maximizing profits in an inefficiently regulated environment, that gave rise to the current circumstances.

Keywords: self-help groups, microfinance, poverty, microfinance crisis, Andhra Pradesh, India

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1. Introduction

Increased efforts to fight poverty have led institutions to devise and implement various poverty reduction programmes. Amongst others, the sudden increase in specialised NGOs such as Microfinance Institutions (MFIs), particularly over the last two decades has made it possible for many impoverished people to gain easier access to finance and related services. Microfinance has been one of the key models in combating poverty as it provides a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and their microenterprises (ADB 2000).

In India, microfinance products are disbursed through two broad mechanisms: (a) Microfinance Institutions, which may be operating in the form of NGOs, or Non Bank Finance Companies (NBFCs); and (b) Self Help Group (SHG)-bank linkage. Over the decades, despite significant growth of institutional microfinance, estimates show that depth and breadth of outreach in the country has been considerably low, with just a fraction of the potential clients being served. Imai *et al.* (2010:2) argue that despite the vast network of banking and cooperative finance institutions and strong micro components in various programmes, the performance of the formal financial sector in India still fails to adequately reach, or reflect and respond to the requirements of the poor. According to Latifee (2006), even though South Asia is home to the largest number of MFIs and MFI outreach, millions of poor people still have no access to formal or semi-formal financial services. Microfinance reaches only an estimated 10 to 12 percent of the poor in India including the outreach of SHGs, NGO MFIs, NBFCs, commercial banks and cooperatives. Basu and Srivastava (2005) contend that India's rural poor have very little access to finance from formal sources.

Microfinance approaches have tried to fill the gap. Among these, the growth of SHG-Bank Linkage has played a significant role, but even then outreach remains modest in terms of the proportion of poor households served. A survey on membership of microcredit groups in the country by Dewan and Somanathan (2007) found evidence that participation among the poorest households was relatively low, whereas in terms of depth of programme outreach, estimates by Ghate (2007) reveal that there were about 2.2 million SHGs with about 31 million members, only about half of which were poor. Latifee (2006) reports on the breadth of programme outreach and concludes that almost three-quarters of the total microfinance clients in India are concentrated in just four southern states, namely Andhra Pradesh, Tamil Nadu, Karnataka and Kerala. Large parts of Northern and North Eastern states have remained underserved by the sector. Basu and Srivastava (2005) claim that in an economy as vast and varied as India's; there is substantial scope for diverse microfinance approaches to coexist. Private sector microfinanciers need to acquire greater professionalism, and the government can help by creating a flexible architecture for microfinance innovations, including through a more enabling policy, legal and regulatory framework (*ibid.*).

While outreach has been poor, over the past few years the microfinance sector in India has morphed from being a saviour of the poor to the whipping boy of the press, and a poster child of exploitation of the vulnerable. According to Indian politicians and many in the press, the exploitation of the poor has been led by profit-making companies which have quickly grown to dominate an industry that was once populated by non-profits (Whalan 2010).

Recent events relating to MFIs in the Indian state of Andhra Pradesh (AP) have been in the news, whereby microfinance, which had been hitherto promoted as a solution to various poverty problems over the past few decades, was seen as exploitative of the poor by a large section of Indian media and the people in Andhra Pradesh.

The root cause of this persistent decline lies in MFIs having lost sight of why microloans were introduced in the first place: providing credit to those who could not access mainstream financial services and thus faced difficulties in borrowing at low interest rates, thereby having to resort to borrowing from moneylenders at exorbitant rates. As the sector grew and expanded over the years, MFIs gradually "turned from 'non-profit' to 'profit-making' institutions, finding 'for-profit' microfinancing, in some cases, quite lucrative" (Lenz 2010). 'When they start looking for profit, they become loan-sharks' states Yunus (2011), who argues that the ultimate objective of micro-financiers is to ensure financial inclusion and not making profit.

In this paper, we analyse the causal factors that led to perhaps the biggest existential crisis the microfinance industry in India has faced since its inception. Following this brief introduction, we examine how a series of factors led to rapid and substantial growth of the Self Help Group movement in Andhra Pradesh and how various other 'private' MFIs took advantage of such a mature presence, causing an inundation of the market, and ultimately to the crises being witnessed today. Responses of the AP Government as well as the Reserve Bank of India are examined at length and finally the paper concludes by arguing that regulatory measures subsequently initiated to deal with the issue are focussed more on the symptoms as opposed to the root cause that led to the crisis in the first place.

2. Development of the microfinance sector in Andhra Pradesh

Compared to other states in India, the growth and development of the microfinance sector followed a unique course in AP. Although all states in the country experienced initiation and growth of the SHG movement, the mainstay of Indian microfinance, the state government of AP systematically nurtured and deepened the institution of SHG through the use of public resources due to a number of political motives. The AP government constituted an autonomous body, named Society for Elimination of Rural Poverty (SERP), which is implementing the Indira Kranthi Patham (IKP) project in all the 22 rural districts of AP. The project methodology involves mobilizing and organizing rural women in the SHGs consisting of ten to fifteen members. Activities of the SHGs revolve around regular savings by their members, credit (from both internal and external sources) and regular meetings (weekly excepting in case of newly-formed SHGs). The SHGs have been federated at village levels into Village Organisations (VOs). The VOs have been further federated as Mandal Samakhyas or Mandal Organisations (MOs) at mandal (sub-district) levels. All SHGs in a village contribute two members to their VO (one member in case of more than twenty SHGs in a village), while every VO in a mandal sends two of its members to the concerned MO. All the MOs have organised themselves into Zila Samakhyas or District Organisations (DOs) at the district levels (Government of Andhra Pradesh, 2009). The SHGs, VOs, MOs, and the

DOs are being increasingly involved in implementing and monitoring various government development programmes through IKP.

In AP, this network of SHGs at different levels is the largest such network among all the states in India and constitutes a critical infrastructural base for microfinance activities including those of private sector MFIs in the state. According to a publication by the National Bank of Agriculture and Rural Development (NABARD 2010: 3), AP has 14,482,16 SHGs out of a total of 69,53,250 SHGs in the country, thus accounting for 20.83 percent of the total SHGs in India, while it houses only 7.37 percent of India's population according to the 2001 census (Government of India, undated). Due to this rich infrastructure base, the MFIs do not need to invest in organising the poor and generating awareness on microcredit in Andhra Pradesh, unlike in other states. Microfinance, as a lending model plays an inherent and vital role in organising the poor for two fundamental purposes: reducing transaction costs and joint liability. High transaction costs limit the number of people who can be provided with access to formal financial services, especially those who are very poor or live in remote rural areas, which are relatively expensive to reach, making MFIs less efficient and therefore, less sustainable. Organising the poor helps to reduce transaction costs and studies have demonstrated that the intermediation of NGOs and SHGs helped banks to reduce transaction costs by between 21 and 41 percent when compared with the benchmark situation (that is, of direct lending) (Puhazhendi 1995), and as stated by Llanto and Chua (1996), in the 'Bank–NGO–SHG–Poor' linkage, the agency in each of the successive layers has comparative advantage over its principal in lending to the poor, thus minimising transaction costs. This, in turn, contributes to the viability and sustainability of lending to the poor. In terms of joint liability, studies have noted that regular payment behaviour is encouraged by the group-based lending model, in which group members, although not jointly or individually responsible for others' payments, are subject to certain social stipulations that ensure timely payments. The closely-knit social fabric in rural areas and the social ties between borrowing group members translates into internal group pressure to repay loans. Such 'peer monitoring' significantly affects the borrowing groups' performance through stimulating intra-group insurance (see for instance, Conning 1999; Wydick 1999; De Aghion and Gollier 2000; Hermes and Lensink, *et al.* 2005; Setboonsarng and Parpiev 2008).

The presence of such, existing organised groups of the poor resulted in the largest concentration of MFIs in AP among all the states in India. Thus, while AP households had much better access to microfinance than all the other Indian states through the state-sponsored microfinance programme, private MFIs flocked in to AP to leverage on the SHG network already existing in the state. It was much easier for private MFIs to start their businesses in AP than in other states which led to an oversupply of microfinance, more specifically of microcredit, to AP households and eventually resulted in the events and crisis that was witnessed subsequently.

3. Oversupply of microcredit, aspiration paradox and state intervention

As stated above, microcredit in AP was supplied to an extent of saturation. This oversupply could sustain itself due to a phenomenon called 'aspiration paradox', a concept that originated from the writings of Thorstein Veblen and was subsequently expanded and elaborated by Pierre Bourdieu (Bourdieu, 2005). 'The aspiration paradox in western life is said to occur when a family invests in holidays, a fancy car, housing or consumer goods – often using a credit card – without realising that the debts piling up are going to cause them to go bankrupt' (Olsen, 2008: 6). The paradox is also observed in the case of poor households as they very often fail to accurately assess and quantify their repayment capabilities due to aspiration paradox. Thus, many poor households in AP took advantage of the easy availability of credit and borrowed far beyond their repayment capabilities from various microfinance sources. The MFIs, for their part, offered multiple loans to the same borrower household without following due diligence, as it served their business interests. Worse still, some MFIs collaborated with consumer goods companies to supply consumer goods such as televisions as part of their credit programmes. As the poor aspired to own such goods, they were happy to receive them. Possession of such goods only exacerbated their already worsening indebtedness as such investments did not generate any income. The poor borrowers therefore started defaulting in repayment and the MFIs resorted to coercive methods for loan recovery. Many borrowers were forced to approach moneylenders to borrow at exorbitant rates of interest to repay to MFIs. When the situation became impossible, some of these borrowers committed suicide and the matter caught the attention of media. The issue became political. A Minister in the government of AP admitted on 3rd December 2010 that 75 suicide cases had come to the notice of AP government by that date (FullHyd.com, 2010). Even microfinance practitioners such as Yunus acknowledged that microfinance in India had 'taken a wrong turn' and the private sector MFIs were treating microcredit as money-making proposition solely to earn profits for themselves (The Economic Times, 2011: 14). Yunus argues that while he is not against making a profit, he denounces firms that seek windfalls and pervert the original intent of microfinance: helping the poor (Lee and David, 2010).

The state has a major role and responsibility to play in terms of providing and managing the infrastructural support to make financial services available to a large majority of people, including the poor. Besley (1994) opines that it may be a better idea for the state to intervene in credit markets to support the poor rather than adopting measures aimed at asset-redistribution. According to Lapenu (2002), financial systems require state interventions to correct market failures. The state needs to intervene to correct market failures and strive for deepening and broadening of financial infrastructures through measures aimed at institution-building, as well as promulgation and implementation of enabling regulatory and legislative mechanisms. One important aspect requiring state intervention is the institutional innovations to improve the outreach of financial systems, described by Lapenu (2002: 299) as 'public good'.

The responsibility therefore lies with the state to intervene and correct the current microfinance delivery situation which excludes a majority of the poor in India. Such intervention may include providing a more enabling legislative and regulatory framework, or involving suitably located and relevant state institutions in the delivery of microfinance as 'the presence of a publicly owned banking structure can enhance the breadth of microfinance outreach' (Lapenu, 2002: 309). An example of such state intervention is the highly successful state-owned Bank of Agriculture and Agricultural Cooperatives (BAAC), which reaches 80 percent of the 5.6 million rural households in Thailand (Yaron *et al.,* 1997). Lapenu (2002: 316) points out that 'in the rural financial system, state-owned institutions may achieve considerable outreach compared with most NGOs and private commercial banks *not yet involved in microfinance* [emphasis added]'. Lapenu (2002) argues that the presence of such institutions can also facilitate growth of private MFIs, as the financial and technical infrastructure thus created will improve the profitability and outreach of such MFIs to poor households.

Given the existing infrastructure of MFIs in the country, it would have been more desirable from the industry's perspective as well as from the perspectives of the poor if the states other than AP had also devised their own models of developing appropriate infrastructure for the (micro) finance industry to grow and improve the access to financial services for the poor. This would have perhaps caused more equal distribution of MFIs in other states and the pressure of supply may not have been so intense in AP. In fact, for want of development of such infrastructural support, poor households are faced with an acute short supply of credit even within microfinance programmes in states other than AP (Priyadarshee *et al.,* 2011).

4. Addressing the crisis: regulatory measures and their implications

The Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010 was promulgated by the AP government in order to harness the situation of oversupply of microcredit and coercive practices to recover loans (Government of AP, 2010), which was implemented with effect from 15 October 2010. The ordinance mandates all MFIs to register themselves with the government authority while specifying the area of their operations, the rate of interest and their system of operation and recovery. The ordinance also specifies stiff penalties for 'coercive action' by MFIs while recovering their loans. In addition, it prohibits them from extending multiple loans to the same borrower and limits the total interest charged to the extent of the principal amount.

Although the measures taken by the AP government, such as limiting the interest charged by MFIs may safeguard the interests of the clients based in AP, it may have severe repercussions on borrowers across other states. MFIs in such states may choose to serve only non-poor to reduce their transaction costs and totally ignore the poor. Moreover, studies on the subject reveal that if the interest is not charged according to the market rates, the credit results in income transfers to the borrowers. As the bigger farmers receive larger amounts of loans, the income transfers are greater in their case. Thus, subsidised credit increases the already existing income inequality. Information asymmetry further worsens the situation as it leads to credit rationing. Big farmers are never rationed, while the middle-level farmers are rationed, and the small and marginal farmers are mostly screened out. When the inflation rates are high, cheap credit becomes even more attractive to the better-off of the society. High demand for the cheap credit causes it to be allocated in return for political benefits or doled out as favours, rather than being disbursed on the basis of actual need or efficiency (Mohan and Prasad, 2005; Mahajan and Ramola, 1996; Yaron, 1994; Braverman and Guasch, 1986; Stiglitz and Weiss, 1981).

Experience of microcredit interest rates in AP suggests that an absence of regulations on the interest rate charged by MFIs tends to lead them towards charging exploitative interest. MFIs in AP charged an effective interest rate of 50 percent to 84 percent per annum if all the hidden charges are duly accounted for (India Microfinance Business News, 2010). The Economic Survey of India for 2010-2011 also expressed concerns for non-transparency in declaring terms and conditions of loans extended by MFIs (Times of India, 2011). Studies on MFIs in other states corroborate this as one of the authors observed in case of an MFI operating in another Indian state of Gujarat. The MFI was found to be offering loans to the members of the SHGs at an interest rate of 18 percent per annum. There are however hidden charges in terms of a non-refundable amount of INR 501 (including document fee of INR 200, assessment fee of INR 200, enrolment fee of INR 51, and risk coverage for INR 50 that ensures the waiver of the loan in case of death of a borrower). There is also a provision of a security deposit to the tune of 15 percent of the loan amount. It is either adjusted in the last instalment or is repaid to the borrower after she clears the loan. All such costs taken together make the loans averaging about INR 5,000 much more costly than the advertised costs of the loans. Moreover, as the clients were either not explained the costs of the loans fully or did not understand the concept of document fees etc., they felt cheated by INR 501 in each case of loan (Priyadarshee, 2010).

Indian's Central Bank, Reserve Bank of India (RBI) appointed a committee to 'study issues and concerns in the MFI sector'. The committee recommended 'a "margin cap" of 10 percent in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of 100 crores (1 crore = 10 million) and a "margin cap" of 12 percent in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding 100 crores' (RBI, 2011: 14). The committee also recommended a cap of 24 percent per annum on interest to be charged on the individual loans (RBI, 2011). In order to prevent MFIs from preferring loans to richer clients the committee has recommended that at least 90 percent of total loan portfolio should include loans advanced to the clients with total household income less than INR 50,000 per annum, with the amount of such loans not exceeding INR 25,000 (RBI, 2011). A number of suicides were reported (75 in AP) that resulted primarily from the various coercive practices that MFIs adopted for loan recovery. A number of provisions were made to prevent such practices, one of which mandates the recovery of loans to be carried out at public places and not at the doorsteps of the borrower. This is aimed at protecting the poor and powerless borrowers from unscrupulous elements hired by MFIs to recover loans through coercive means, as has been observed in the past.

5. Concluding remarks

The recent turmoil witnessed within the microfinance sector in the Indian state of Andhra Pradesh was watched the world over as incidences unfolded to reveal weaknesses in regulatory and policy mechanisms. This paper explored the causal factors that led to such happenings and argues that the richness of Self Help Group infrastructural base developed as a result of certain state-sponsored programmes attracted private-sector MFIs. Such MFIs, in an attempt to maximize their profits oversupplied credit to the poor. Easy availability of credit made the poor households victims of a social phenomenon called aspiration paradox due to which they could not adequately assess their repayment capabilities. The situation was compounded due to some MFIs offering credit in terms of consumable items such as televisions that did not generate income and further worsened their indebtedness. The poor borrowers thus started defaulting on repayment and the MFIs resorted to coercive methods to recover their loans. This series of events led to some borrowers taking extreme steps to end their lives, thus drawing greater attention to the crisis.

The government subsequently adopted certain regulatory measures in order to address the issue. These, however appear to focus on the symptoms and not on the root cause of the malaise. As discussed at length above, the situation arose primarily due to the social structures, i.e., the unequal distribution of the community institutional infrastructure base for delivery of microfinance among different states, and the singular focus of private-sector MFIs on maximizing their profits in an inefficiently regulated environment. These, nonetheless do not seem to be on the policy agenda of the government. The absence of such policy measures, may lead the private microfinance sector in the future to face similar circumstances in different Indian states.

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