

MICROFINANCE IN INDIA: A CRISIS AT THE BOTTOM OF THE PYRAMID

How the Government of Andhra Pradesh has severely damaged private sector microfinance and put 450 million of India's rural poor at risk



A Crisis at the Bottom of the Pyramid

I. Introduction

The microfinance industry in India is in the midst of the most severe crisis in its 25 year history. The genesis of the crisis lies with the actions taken by the government of the southern state of Andhra Pradesh in October 2010, when it passed legislation effectively shutting down all private sector microfinance institutions ("MFIs") operating in the state. In the first half of FY2011, MFIs in Andhra Pradesh disbursed Rs 5,000 crore (\$1.13 billion) to borrowers; in the second half of FY2011, these same MFIs could only disburse Rs 8.5 crore (\$1.9 million)!. The Andhra Pradesh Government's stated aim was to protect the poor and yet its actions have resulted in financing to the very poorest of India's citizens shrinking by 600%. This should make everyone pause. The rural poor depend on access to consistent and dependable finance to help smooth patchy income streams and avert financial crises. The AP government's actions have effectively shut off finance to these most vulnerable of India's citizens. Indeed, as this paper discusses, the very premise of the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 (the "AP Act") was fundamentally flawed. Quite apart from protecting the poor, the AP Act does just the opposite and risks creating a near term financial and human crisis amongst the rural poor in Andhra Pradesh, while also potentially jeopardizing the Indian government's broader financial inclusion agenda.

II. Executive summary

- The direct effect of the enactment of the AP Act has been to deny millions of India's poorest citizens access to basic financial services. The impact of the AP Act has the potential to affect 450 million people. Since the AP Act was adopted, MFI disbursements in AP alone have diminished from Rs 5,000 crore (\$1.13 billion) to a mere Rs 8.5 crore (\$1.9 million), creating a severe shortage of much needed finance to the rural poor, India's most vulnerable citizens.
- The rationale for the AP Act is not to protect the poor, but to protect the uncompetitive government-backed Self-Help Group ("SHG") program run by the Society for the Elimination of Rural Poverty ("SERP").
- The AP government's claims that private sector MFIs are exploiting India's poor by charging usurious interest rates and practicing coercive recovery techniques cannot be substantiated and, based on numbers from SERP, it appears that the suicide rates amongst MFI borrowers are dramatically lower than the statistical average in the entire state of Andhra Pradesh.
- Private sector MFIs have demonstrated to be the most scalable and sustainable way of helping the Indian government meet its stated policy of encouraging "financial inclusion" for the 450 million people in India who are currently "unbanked", i.e., with no access to basic finance.
- If the World Bank provides the much discussed \$1 billion in funding to the government-backed SHG program in AP, it will be complicit in snuffing out the private sector from Indian microfinance.
- The Reserve Bank of India ("RBI") and central government must take immediate and decisive action to supersede, suspend or repeal the AP Act and introduce sensible legislation on a federal level which allows the private sector to grow and flourish.
- The Malegam Committee's recommendations and their broad acceptance by the RBI give rise to a number of concerns, and the constraints proposed around loan limits, interest rates, provisioning norms and capital requirements must be revisited to avoid unintended and deleterious consequences that could permanently impact private sector MFIs.
- MFIs represent the only viable way for lenders to recover their loans to MFIs, given their relationship with the end customers. MFIs must be given the time to undo the damage inflicted by the AP Act and to recover the loans from borrowers.

A Crisis at the Bottom of the Pyramid

III. Microfinance background

History

Microfinance in India can trace its origins back to the early 1970s when the Self Employed Women's Association ("SEWA") of the state of Gujarat formed an urban cooperative bank, called the Shri Mahila SEWA Sahakari Bank, with the objective of providing banking services to poor women employed in the unorganised sector in Ahmedabad City, Gujarat. The microfinance sector went on to evolve in the 1980s around the concept of SHGs, informal bodies that would provide their clients with much-needed savings and credit services. From humble beginnings, the sector has grown significantly over the years to become a multi-billion dollar industry, with bodies such as the Small Industries Development Bank of India and the National Bank for Agriculture and Rural Development devoting significant financial resources to microfinance. Today, the top five private sector MFIs reach more than 20 million clients in nearly every state in India and many Indian MFIs have been recognized as global leaders in the industry.

The Government of India and the RBI have a stated goal of promoting financial inclusion.

According to recent RBI estimatesⁱⁱ, there are over 450 million "unbanked people" in India, most of whom live in rural areas. The term "unbanked" refers to people who have no access to formal financial services, but rather must rely on either family, or informal providers of finance, such as the village moneylender. It is undisputed that access to finance is critical for enabling individuals and communities to climb out of poverty. It is also generally agreed that relying on the limited resources of village moneylenders exposes the poor to coercive lending practices, personal risks and high interest rates, which can be as much as 150%ⁱⁱⁱ. Therefore the Indian Government and the RBI have a policy of "financial inclusion". As part of this policy, the government requires Indian banks to lend to "priority sectors", one of which is the rural poor. Until recently, banks were happy to lend money to MFIs who would then on-lend funds, primarily to poor women across rural India. The banks have welcomed this policy because historically they tended to charge MFIs average interest rates of 12-13% and benefited from 100% repayment rates. Thus, by lending to MFIs, banks have been able to meet their "priority sector" lending requirements with what historically has amounted to a risk-free and very profitable arrangement.

The goal of financial inclusion must include the private sector.

Microfinance in India is currently being provided by three sectors: the government, the private sector and charities. These three sectors, as large as they are, have only a small fraction of the capital and geographic scale required to meet the overwhelming need for finance amongst India's rural poor.

The top 10 private sector microfinance providers in India together serve less than 5% of the unbanked population of India – approximately 20 million clients^{iv}. For example, SHARE Microfin Limited ("SHARE") and Asmitha Microfin Limited ("Asmitha"), two of the five largest MFIs in India, have almost Rs 4,000 crore (\$900MM) loaned to over 5 million poor women in 18 Indian states (prior to the crisis, the combined outstanding loan portfolio had been as high as Rs 6,750 crore (\$1.525BN)). Yet, despite the size of MFIs like SHARE and Asmitha, only a fraction of the overwhelming need is being met.

Private sector MFIs have an essential role to play if the goal of financial inclusion is to be realized, as neither the government nor charities have the capital nor business model required to meet the insatiable demand for finance in rural India. As the public listing of SKS Microfinance underscored, private sector institutions are able to attract increasingly large amounts of private capital, in order to accelerate the growth of the industry, which is essential to expanding financial inclusion as far and as fast as practicable.

IV. Legatum Ventures' contribution to the microfinance sector in India

Legatum is a multi-billion dollar investment organization with a 25 year heritage of allocating capital successfully around the globe. Legatum has been one of the largest private portfolio investors in India since 2005. Legatum has invested billions of dollars in some of India's leading companies, primarily focusing on banks and other financial institutions. In addition to its investment business, Legatum has a very active philanthropic arm, the Legatum Foundation, which has since its inception provided over \$100 million to over 1,200 humanitarian projects in over 100 countries, including India. The Legatum Foundation supports local grass-roots community-based initiatives that focus on issues ranging from health, education, financial inclusion and human trafficking. Our investment in the microfinance sector was an effort to combine our investment and philanthropic efforts to demonstrate that "good business is good development".

A Crisis at the Bottom of the Pyramid

In 2007, Legatum Ventures invested \$25 million in SHARE, which was at the time the single largest private equity investment globally in microfinance, to help the company scale its operations to reach more clients while also improving its governance and operations. At that time, SHARE was in distress due to the “Krishna crisis” (where local politicians told borrowers they no longer needed to repay MFIs). With Legatum Ventures’ equity infusion, SHARE was able to survive the Krishna crisis and grow. Over the last four years, SHARE, together with its sister organization, Asmitha, has expanded from under one million clients to over five million. The combined company has grown from operating in 3 states to 18 across India. As of the beginning of March 2011, the combined company had an outstanding loan portfolio of almost Rs 4,300 crore (\$970MM) and 10,000 employees.

Legatum introduced world-class corporate governance standards and ensured that SHARE’s operations met with the highest ratings from CRISIL and other agencies, while also overseeing SHARE’s transition to a “Big Four” audit firm (S. R. Batliboi & Co., a member of Ernst & Young). SHARE has historically had one of the lowest interest rates of the large MFIs in India and also one of the lowest operating expense ratios of just 7%.

V. The microfinance crisis in Andhra Pradesh – analysis of the AP Act

The Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010

In October 2010, with no warning or consultation with stakeholders, the Government of Andhra Pradesh issued the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Act, 2010 effectively shutting down all private sector microfinance operations in the state. The AP Act does not however apply to AP’s government-backed microfinance business which directly competes with private sector MFIs. This was a major blow to the entire microfinance industry as Andhra Pradesh, widely regarded as the birthplace of private sector microfinance, accounts for over 40% of all loans by MFIs across India according to some estimates^v.

To justify its extraordinary action against private sector microfinance, the AP government claimed to be protecting the poor from what they claimed to be rapacious lending practices by the MFIs. But, as discussed below, the facts prove otherwise. Moreover, by its own terms, the AP Act aims to protect the government’s own microfinance programs which had been losing market share to the more efficient and better run MFIs:

“Whereas these SHGs are **being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery** resulting in their impoverishment & in some cases **leading to suicides**, it is expedient to make provisions for protecting the interests of the SHGs, by regulating the money lending transactions by the money lending MFIs and to achieve greater transparency in such transactions in the State of Andhra Pradesh”^{vi}.

No-one would object to protecting the poor from exploitation by institutions charging usurious rates, practicing coercive recovery techniques, or driving clients to suicide. However, was there ever any real substance behind these alarming claims? Indeed, when one looks for evidence to substantiate these allegations, it quickly becomes apparent that the services being provided by private sector MFIs are valued by their clients, and are neither usurious nor violent. On the contrary, given the size of the MFI sector, tales of exploitation are remarkably rare.

Let’s consider each of these three allegations in turn, again using SHARE and Asmitha as our case study:

I. Do private sector MFIs charge usurious interest rates?

SHARE and Asmitha, two of India’s largest MFIs, charge average interest rates of between 23.6-28.1% depending on the maturity of the market in a particular state. These rates are *lower than the average interest rate of 30% for consumer credit cards in India*^{vii}. They are also among the lowest rates for microfinance in India and the world. These rates are offered despite the high cost of providing “door-step services” (i.e., sending loan officers to meet the borrowers in their villages), which allow clients to remain close to their homes, children, fields, livestock and livelihoods. This is in contrast to the AP government’s SHG program which requires borrowers to pay at the local or regional office behind closed doors.

Conclusion: MFI interest rates are commercial, reasonable and competitive.

A Crisis at the Bottom of the Pyramid

2. Do MFIs (need to) employ coercive collection practices?

By design, MFI processes have a number of in-built mechanisms to ensure repayment. From identification to repayment, a larger group of borrowers is engaged in appraising MFI members and in ensuring on-time repayments. The group pledges to cover for members and ensures credit discipline. In addition, the small, frequent payment structure eases this process. In a few instances where repayments have posed a hardship for clients, MFIs have restructured loans to support clients. Thus, there is little need for MFIs to employ coercive measures. Finally, clients rely on ongoing access to finance in the same manner as any borrower in the formal banking sector; and the failure to repay results in the client's inability to take future loans which can be important for business and other needs. A good credit history is as valuable to the poor as it is to the wealthy.

Established MFIs such as SHARE and Asmitha have strict policies against physical coercion being used to force repayment, and the consequences for doing this can be severe and result in immediate termination. In addition, both the Sa-dhan and MFIN code of conduct have clauses on fair recovery practices which all major MFIs in India have signed and are committed to.

Conclusion: loan repayments are professionally managed and humanely carried out.

3. Are MFI clients being pushed to commit suicide?

Suicide for any reason is a profound tragedy. In a report published in Microfinance Focus in October 2010, the gender unit of SERP asserted that 54 microfinance borrowers residing in AP had tragically committed suicide as a consequence of MFI lending practices^{viii}. Although 54 deaths may seem a substantial number to be allegedly caused by MFI lending practices, it is not until one contrasts this number with the suicide statistics for the state of Andhra Pradesh as a whole that one can begin to put these numbers into perspective. There were over 14,500 people who committed suicide in Andhra Pradesh in 2009 alone, most being attributed to agricultural failure or grief over political developments^x. Based on an estimated population of 75 million in Andhra Pradesh, for every 6 million AP residents, 1,160 of them might be expected to commit suicide in any given year based on statistical norms. Given the estimated 6 million microfinance borrowers in AP, SERP's assertion that there were 54 deaths allegedly caused by MFI lending practices therefore appears not to be unusual, based on what national statistics demonstrate.

Additionally, based on the numbers from SERP (formally a non-governmental organization, but it receives its funding from the AP government and the state's Chief Minister chairs its governing board), it appears that the suicide rates amongst MFI borrowers are dramatically *lower* than the statistical average in the entire state of Andhra Pradesh. In other words, *borrowers from private sector MFIs appear less likely to commit suicide than their fellow residents in Andhra Pradesh*. This should, of course, not be very surprising, given the manner in which MFI clients benefit from the services provided.

Conclusion: there is no proven correlation or causal link between MFIs and suicides.

It can be seen from the foregoing that the factual basis for the AP Act is, in fact, deeply flawed. This does not mean to say that the prevailing system, with thousands of staff and millions of clients, is perfect. All MFIs need to work hard to build a common culture and mitigate the risk posed by overzealous loan officers. Yet shutting down an entire industry because of anecdotal evidence of occasional problems would be like closing all schools because a few teachers provide poor or misguided teaching to their students.

Additionally, this raises the question: what was the real reason that such draconian measures were taken to stifle private sector MFI activity in Andhra Pradesh? It will be seen in the next section that, rather than doing a bad job, private sector MFIs have been doing their job too well – too well for their competition within the state of AP. Regardless of the motivation behind the AP Act, serious damage has already been done to the microfinance sector, as well as to the climate for business and investment in AP and India.

A Crisis at the Bottom of the Pyramid

VI. The source of the AP Act and the microfinance crisis

Where did the allegations of suicides and violence come from?

If the extremely serious assertions of MFI wrongdoing are in fact not true, then this demands an answer to the question "Where did these allegations come from?" Who could possibly gain from shutting down the private sector MFI industry in Andhra Pradesh, and from denying the rural poor access to their services? The answer is not difficult to find. The number one competitor of private sector microfinance in AP is the state-run microfinance business, SERP.

Behind the scenes, the AP Act was written and championed by **SERP**, the agency responsible for running the AP government-backed microfinance SHG program. Evidence shows that SERP has been losing the struggle to compete with private sector MFIs.

The effect of the AP Act is not to protect the poor, but to protect the uncompetitive government-backed SHG program run by SERP.

The AP government-backed SHG program competes directly with the private sector MFIs. The SHG program however is failing to keep up and has lost significant market share to the MFIs. Why? According to the October 2010 Intellectap White Paper, the government programs have "...neither the discipline needed for long-term sustainability, nor a business model that can be scaled up effectively"^x. Additionally, there is a widespread belief that the World Bank is on the point of providing an additional \$1 billion^{xi} in funding support to SERP or a successor program. The case for this extension is believed to be strengthened if the commercial MFI industry is weakened.

An AP Act that eliminates law-abiding private sector participants in the market and directly benefits the government-backed provider is unfair at best and illegal at worst. Given that it will negatively impact millions of borrowers amongst India's rural poor, it is also unconscionable. As Vijay Mahajan, Chairman of BASIX, has stated, the AP government "is an unfair referee as it is both player and referee." The AP Act does not try to hide its anti-competitive aims. The text of the Act states that its goal is "to [protect] the interests of the SHGs"^{xii}. If the World Bank provides the much discussed \$1 billion in funding to the SHG program in AP, it will be complicit in snuffing out the private sector from Indian microfinance. According to David Roodman of the Center for Global Development in his blog on the crisis in AP, "World Bank money has...beefed up a political economy hostile to private sector solutions"^{xiii}.

VII. The superior performance of private sector microfinance

Private sector microfinance has grown dramatically because it offers the best products and services to meet the massive demand for credit amongst India's rural poor.

Between 2008 and 2010 the number of clients of MFIs grew by an average of 61% each year, with loan portfolios growing 85% per year. The AP government-backed microfinance SHG program, on the other hand, only grew its client base by 13.6% during the same period and its loan portfolio by 28%^{xiv}. As an October 2010 White Paper by Intellectap stated "the MFI's combination of door-step service, easy credit, frequent small-value repayments and the group guarantee is attracting borrowers – who are no longer so naïve that they cannot weigh the attractions of these factors against the lower rates of government programs"^{xv}.

Additionally, a World Bank report found that government loan administrators sometimes demand bribes of up to 20%^{xvi} of the loan amount before loan requests are granted. If true, this would help explain why borrowers prefer accessing loans through MFIs which are provided in a transparent manner, over the potentially coercive manner some SHG loan officers provide loans. Moreover, if a borrower must pay interest of 3% per annum (typical SHG interest rate) and a bribe of 20% of the loan amount, then the borrower's actual cost of capital is similar to (if not greater than) interest rates charged by MFIs. When one takes the better service offered by MFIs into account, it becomes easy to understand why MFIs are taking market share from SHGs.

A Crisis at the Bottom of the Pyramid

VIII. The Krishna precedent – having been here before, MFI clients in Krishna choose to continue to pay.

Industry observers who have been following the microfinance sector in India for some time will recall the politically motivated attacks on MFIs in the AP district of Krishna in 2006 (where local politicians essentially told clients of MFIs they were no longer required to repay their loans) which almost destroyed a number of MFIs. A little known fact that has emerged since the issuance of the Andhra Pradesh Microfinance Institutions Ordinance^{xvii} in October 2010 is that, within AP, the Krishna district is currently reporting the highest recovery rates (approximately 40% vs. 10-20% for other districts across AP).

How can this be explained? One plausible explanation is that during the time of the 2006 crisis when MFIs were no longer actively providing fresh loans, clients were forced to return to other avenues for financing - essentially either the government-sponsored SHGs or the village moneylenders. Like everyone else, the poor have long memories when it comes to facing less attractive choices.

IX. Consequences of the AP Act

Unless repealed or overruled immediately, the AP Act will continue to cause irreparable damage to the wellbeing of the rural poor by destroying a large part of the private sector microfinance industry, cause large write-offs for public and private sector banks in India and put the policy goal of financial inclusion in jeopardy.

The AP Act made it illegal for MFIs to collect outstanding loans in the field in the manner in which they and their client base had become accustomed to. It provided that all MFIs must now register at the district level and require prior approval from the respective District Authorities to disburse any loan. At the same time, repayments must now only be collected at government notarized locations, a big departure from the village center meetings designed to maximize efficiency and benefit for the client. Previously, MFIs were able to conduct weekly meetings in small groups of 40 women, which formed a critical aspect for building and maintaining a strong credit culture and financial discipline. With MFIs now only able to collect loans monthly as opposed to weekly, this strong repayment culture has eroded significantly. As a result, there has been a complete standstill of disbursements and repayments in the state of AP, with adjoining states now also witnessing a spillover effect. While this puts MFIs and banks in jeopardy, the ones who lose the most, of course, are those with no voice: the millions of poor families across India with no access to finance in the planting season.

It is possible to get a sense of the extent of the consequences that would flow from the collapse of the private sector MFIs by looking at the position of SHARE and Asmitha alone:

- **Five million poor women in 18 states across India will lose access to finance.** Without private sector MFIs, these clients will need to rely on the limited resources, inefficiencies, and frequently unethical practices of other sources of rural finance. Most states outside AP do not have government-backed competing microfinance institutions, leaving these borrowers with no alternative other than the village moneylender. Five million of India's poorest citizens would be impacted by the collapse of SHARE and Asmitha alone - a broader collapse of private sector MFIs across India would cause this number to multiply, putting many millions more at risk.
- **Indian private Sector MFIs will ultimately fail.** Due solely to the AP Act, SHARE and Asmitha are prevented from collecting the amounts owed to them, and are therefore unable to repay these amounts to their 40 lenders. As per recent news reports, the Corporate Debt Restructuring ("CDR") Cell of the RBI admitted loans in excess of Rs 6,000 crore (\$1.35BN) for restructuring in March 2011, involving five MFIs. However, such is the depth of the prevailing crisis in AP that even the most forgiving of CDR packages is only likely to provide a temporary fix. It seems clear that the effects of the AP Act on MFIs have been extremely severe. Unlike other companies that typically end up in the CDR process, the current plight of the private sector MFIs was attributable to external factors, i.e. the passing of the AP Act, rather than any credit weakness or operational negligence committed by the MFIs themselves. It seems incredible and tragic that an ill-advised law passed by a state government in India can cause the demise of several otherwise healthy and productive companies, and potentially imperil an entire sector.
- **The financial inclusion agenda will suffer.** To fulfill the vision of financial inclusion, billions of dollars must be lent and collected across India. There is room for all providers of microfinance given that the needs are so great. The AP

A Crisis at the Bottom of the Pyramid

Act has the underlying potential to kill leading private sector providers of microfinance, cause massive write-offs for the banking sector and reduce the supply of both debt and equity capital to this “priority sector”, turning the clock back 20 years when finance for the poor was primarily provided by moneylenders, poorly managed government agencies of questionable governance and charitable organizations with limited capital. Not having been able to conduct its normal business since October 2010, and with planting season approaching, SHARE and Asmitha are now seeing large numbers of women coming to its branches demanding loans but who, due to the AP Act, must leave empty-handed.

- **Indian private and public sector banks will suffer substantial losses.** SHARE and Asmitha alone have over Rs 2,100 crore (\$475MM) in loans made to borrowers in AP. The AP Act has made it impossible for SHARE and Asmitha to collect the amounts due for repayment. The repayment rate in AP for all MFIs is down to an average of 15%, from 98% before the Act was passed. While the terms of the CDR packages remain to be seen, the potential for future default by SHARE and Asmitha remains material and any such default would lead to significant write-downs at 40+ lenders of the two MFIs. Defaults by other MFIs are also a real possibility. With SKS Microfinance the only likely large survivor of the crisis (ironically, given how much equity was raised in its IPO, SKS can afford to write-down its entire AP portfolio without wiping out all of its equity), it is highly doubtful that lenders will ever again extend credit to the microfinance sector.
- **Thousands of people employed in the microfinance sector will lose their jobs.** SHARE and Asmitha together employ approximately 10,000 people across India. Remarkably, private sector microfinance provides employment to more people in AP than the Information Technology industry. It is noteworthy that the IT industry as a whole was not forced to close down when the \$1 billion Satyam scandal came to light; no more so should the microfinance industry be forced to close down, especially when, unlike Satyam, MFIs have not committed any malfeasance.

X. The Malegam Committee Recommendations:

Even if the AP Act fails to quickly destroy private sector microfinance, the Malegam Committee recommendations, if adopted without change, will likely achieve the same result, albeit more slowly.

The RBI is responsible for regulating non-banking financial companies (“NBFCs”), not the state governments. As a first step toward resolving the jurisdictional breach caused by the AP government’s purported regulation of NBFCs, the RBI set up the Malegam Committee to study the issue and make recommendations. In its draft report, the Malegam Committee thankfully legitimized MFIs and the private sector’s involvement in microfinance and called for continued priority sector lending support to MFIs. However, the Malegam Committee’s recommendations also gave rise to a number of concerns, as discussed below.

- **Loan limits.** A limit on loans of Rs 25,000 to borrowers with household income of less than Rs 50,000. This could result in a disincentive for these clients to state their true income, or even to increase their household income for fear of losing access to finance from MFIs. And the millions of borrowers who now cannot avail themselves of microcredit will have limited alternatives, most likely needing to return to the village moneylender.
- **A cap on interest rates and margins.** It is well known that price controls create benefits for the few and shortages for the many - in this case, the result will be a shortage of available finance. To make broad-based financial inclusion a reality in India, the sector will need to attract billions of dollars from global capital markets. If the RBI chooses to set pricing and margins, instead of letting competition and the market set prices, this will dramatically reduce the amount of investment capital flowing to these MFIs, especially the equity capital they will need to maintain minimum capital adequacy going forward while still growing.
- **Provisioning norms.** The report recommends much higher provisioning norms than are currently in place. If these are implemented, because of the current situation in AP, many of the large MFIs will have to provide for and write-off their portfolios in AP which would ultimately lead to bankruptcy.
- **Increased capital requirement.** An increase in the minimum capital requirement from Rs 2 crore (\$450,000) to Rs 15 crore (\$3.4MM), represents a 7.5 fold increase for an industry with historical repayment rates of 98% and higher. Such a draconian and arbitrary requirement will make it nearly impossible for new companies to start or survive, therefore reducing competition and ultimately denying potential borrowers access to financial inclusion.

A Crisis at the Bottom of the Pyramid

The framework of regulations recommended by the Malegam Committee has now been broadly accepted by the RBI in its monetary policy statement for 2011-2012. Some of the parameters recommended by the Committee have, however, been adjusted. For example, the RBI has increased the annual income limits for eligible households to Rs 60,000 in rural villages and to Rs 120,000 in urban or semi-urban districts. The limit on loans has also been increased to Rs 35,000 in the first cycle and Rs 50,000 in subsequent cycles, and the interest rate cap has been raised to 26% (compared with 24% recommended by the Committee). Detailed regulations are expected in due course.

While these adjustments are welcome, they do not go far enough - it is estimated that more than 50% of the clients of private sector MFIs in India are above the Rs 60,000 income bracket, and the concerns around provisioning norms and capital requirements remain. These concerns must be addressed by the RBI and central government, as the Committee itself recognized the dangers of crippling the flow of funds to borrowers "...The Sub-Committee has cautioned that while recognizing the need to protect borrowers, it is also necessary to recognize that if the recovery culture is adversely affected and the free flow of funds in the system interrupted, the ultimate sufferers will be the borrowers themselves as the flow of fresh funds to the microfinance sector will inevitably be reduced"^{xviii}.

XI. Equity investment needed for financial inclusion

Legatum is hopeful that the RBI and the Ministry of Finance will take an active role in resolving the crisis and in bringing much needed clarity to the regulatory landscape for microfinance. It is encouraging that the Malegam Committee has conducted significant research and invited many industry participants to provide feedback on its draft recommendations. It is concerning, however, that both the Committee and the Ministry of Finance may not have had the opportunity to hear from one key stakeholder – equity investors.

Given Legatum's significant experience in the microfinance sector, we believe it might be helpful for policymakers to hear equity investors' perspective on the crisis and the current recommendations. Legatum is, of course, concerned that it may lose 100% of its investment in SHARE in a very short time. But this pales in comparison to the loss of the real victims of the crisis – the millions of clients who no longer have access to credit to purchase seed or fertilizer in the planting season, or to run their small enterprises which provide for their families or to send their children to school. Legatum is also focused on the potential long-term consequences of the AP crisis and the regulatory response, and we would like to do everything possible to ensure that as the sector recovers it can continue to avail itself of the significant amount of equity capital required to attain the goal of financial inclusion.

XII. What is to be done?

Prior to the enactment of the AP Act prohibiting the normal operations of the private sector MFIs, repayment rates were over 98% and the industry was healthy and growing rapidly. The source of the current crisis is also the solution to the current crisis – namely the repeal of the AP Act.

1. **Urgently repeal the AP Act.** Immediately supersede, suspend or repeal the AP Act, which is the source of the crisis. The only way to address the extensive damage being done by the Act's effective prohibition against private sector MFI operations is to remove it. Removal would achieve the following goals:
 - Allow MFIs to collect the amounts owed to them in AP
 - Allow the MFIs to meet their commitments to lenders
 - Avoid the wholesale destruction of several leading MFIs
 - Avert a banking crisis
 - Aid the rural poor by ensuring that they retain access to microfinance services
2. Removal would also redress the current balance of power issue, ensuring that regulation of those MFIs classified as NBFCs is returned to its rightful controller, namely the RBI.
3. **Consult with equity stakeholders to ensure the new regulations do no harm.** The RBI and central government must take the time to do a full analysis with input from all stakeholders to ensure that the regulations ultimately introduced are beneficial and that any unintended consequences have been identified and fully considered. A cautionary tale regarding investment in India has unquestionably already been written and how the RBI and central

A Crisis at the Bottom of the Pyramid

government craft the new regulations will ultimately determine whether the flow of equity and debt capital to the microfinance sector is severed for years to come.

4. **Facilitate fair restructuring of loans to MFIs to allow time for recovery.** It is clear that if any meaningful recoveries are to take place, lenders and MFIs must work together through a mutually supportive approach to achieve a mutually beneficial outcome. With an exposure of over Rs 6,500 crore (\$1.470BN) outstanding in AP, MFIs represent the only viable way for lenders to recover their loans to MFIs, given their relationship with the end customers. MFIs must be given the time to undo the damage inflicted by the AP Act, and to recover the loans from borrowers. In this regard, the terms and conditions applicable to the repayment of loans admitted by the CDR Cell for restructuring must be favorable to the MFIs to ensure they are not penalized due to the external business factors created by the AP Act.

XIII. Conclusion

The social and economic consequences of the AP Act are stark and disquieting. Millions of poor people across India are presently denied their fundamental right to make their own financing choices and are without access to basic financial services, thousands of people employed in the microfinance sector have lost their jobs, countless MFIs are on the brink of financial ruin and the long-term fate of some of the largest MFIs in India is hanging in the balance. Private sector MFIs have an essential role to play if the goal of financial inclusion is to become a reality for the millions of India's "unbanked", and the RBI and central government must take immediate action to supersede, suspend or repeal the AP Act and introduce sensible legislation on a federal level which allows the private sector to grow and flourish.

The Malegam Committee has proposed a number of welcome recommendations and indeed affirms the value that MFIs bring to the microfinance sector in rural India. These recommendations have now been broadly accepted by the RBI, subject to certain adjustments. However, the constraints proposed around loan limits and interest rates, as adjusted by the RBI, together with those around provisioning norms and capital requirements must be revisited to avoid unintended and deleterious consequences that could permanently impact private sector MFIs. The one thing that the RBI and central government would benefit from at this stage is being afforded the time to further develop, modify and refine the Malegam Committee recommendations in collaboration with stakeholders to ensure that the new regulatory framework introduced allows the sector to continue in its quest to meet the burgeoning social and economic needs of a rapidly growing India.

A Crisis at the Bottom of the Pyramid

About Legatum

Legatum is a private investment group with a 25 year heritage of global investment, allocating proprietary capital in the global markets and to businesses and programs that promote sustainable human development. Legatum Ventures invests private capital in growing enterprises that promote prosperity in the developing world by delivering both a financial and social return. Find more information about the Legatum Group at www.legatum.com

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ⁱ <http://www.livemint.com/2011/04/25212545/Six-months-on-loan-defaults-m.html?atype=tp>

ⁱⁱ The actual number could be higher as these estimates do not account for multiple accounts by a single individual. Source: "Financial Inclusion – The Indian Experience" Speech by Smt. Usha Thorat, Deputy Governor, Reserve Bank of India at the HMT-DFID Financial Inclusion Conference 2007, Whitehall Place, London, UK on June 19, 2007.

ⁱⁱⁱ <http://www.livemint.com/2011/01/17213953/Moneylenders-push-up-interest.html?atype=tp>

^{iv} Consolidation of data on Indian MFIs at www.mixmarket.org.

^v Intellecap estimates.

^{vi} <http://indiamicrofinance.com/wp-content/uploads/2010/10/Andhra-MFI-Ordinance.pdf>

^{vii} Interest rates on credit cards in India range from 29.88% to over 45%.

^{viii} <http://www.microfinancefocus.com/content/exclusive-54-microfinance-related-suicides-ap-says-serp-report>

^{ix} 14,500 suicides occurred in Andhra Pradesh in 2009 according to the National Crime Records Bureau

^x http://www.intellecap.com/assets/82/Intellecap_Microfinance_White_Paper_Oct_2010_.pdf

^{xi} http://blogs.cgdev.org/open_book/2010/11/when-indian-elephants-fight.php

^{xii} AP Microfinance Ordinance - "Whereas these SHGs are being exploited by private Micro Finance Institutions (MFIs) through usurious interest rates and coercive means of recovery resulting in their impoverishment & in some cases leading to suicides, it is expedient to make provisions for protecting the interests of the SHGs, by regulating the money lending transactions by the money lending MFIs and to achieve greater transparency in such transactions in the State of Andhra Pradesh"

^{xiii} http://blogs.cgdev.org/open_book/2010/11/when-indian-elephants-fight.php

^{xiv} Intellecap analysis of data on MFIs at www.mixmarket.org and NABARD's data on SHGs

^{xv} http://www.intellecap.com/assets/82/Intellecap_Microfinance_White_Paper_Oct_2010_.pdf

^{xvi} 'Scaling-up Microfinance for India's rural poor' - World Bank Policy Research Working Paper 3646, June 2005

^{xvii} The Ordinance became law in December 2010 with the enactment of the AP Act.

^{xviii} <http://indiamicrofinance.com/wp-content/uploads/2011/01/Malegam-Report-Issues-Microfinance-India.pdf>