

# Microfinance Institutions in Andhra Pradesh

## Crisis and Diagnosis

*District authorities in Andhra Pradesh recently closed down 50 branches of two major microfinance institutions in the state following allegations that they were charging usurious interest rates and indulging in forced loan practices. The crisis can be seen as a conflict between state and civil society organisations vying to capture the popular space on one hand, and the structural problems of MFIs on the other.*

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### The Crisis

A major crisis broke out in March 2006 for microfinance institutions (MFIs) operating in the state of Andhra Pradesh (AP) when the district authorities closed down about 50 branches of two major MFIs in Krishna district. The action of the administration followed a complaint lodged by some of the borrowers of these MFIs against their alleged “usurious interest rate” and “forced loan recovery” practices. There were also a few protests staged by the borrowers of these MFIs in some of the places of their operation. The crisis has attracted the attention of both local and national media. The local media, especially, carried many stories which were highly critical of the role played by MFIs.

The issue also came up before the State Level Bankers’ Committee (SLBC) meet held on March 17, 2006. The chief minister (CM) of AP who chaired the meet took a tough stand against the MFIs by alleging that they are exploiting the poor by charging exorbitant rates of interest and adopting unethical means of loan recovery. He expressed the view, “MFIs were turning out to be worse than moneylenders by charging interest rates in excess of 20 per cent” (*The Hindu*, March 18, 2006).

Further to the development, there was even an allegation that 10 borrowers of MFIs in Krishna district committed suicide because they were unable to repay the loans taken from MFIs. The state government has constituted a working group consisting of government officials and bankers to tackle the “menace” fast spreading in

rural areas. In an official review meeting held subsequently (March 20, 2006) over the issue, the CM ordered an official inquiry into the affairs of the MFIs in Guntur, Krishna and Nalgonda districts and asked the district collectors to stop the “unethical” practices of MFIs by whatever steps possible.

Following the incident, there was almost a panic reaction from all the major MFIs operating in AP. The action of the administration was perceived by these MFIs as a major threat to their very existence, leave alone an implement in their goal of massive expansion. All the major MFIs in AP came together under the umbrella of Sa-Dhan, a national level association of MFIs in the country, and took some damage control measures to continue their operations as well as restore some of the credibility lost during the entire episode. They made strong appeals to the state government and other concerned agencies not to pursue the matter further as it was detrimental to the interests of the poor being served by them (‘AP MFIs Update’, email communication, Vijay Mahajan, March 27, 2006).

The MFIs claimed that the allegations made against them were not true. They felt that some of these allegations related only to stray incidents, involving mainly fly-by-night operators with no accountability of any kind. They decided to have a dialogue, proactively, with various authorities to explain their point of view about the allegations made against them regarding usurious interest rates, coercive practices, poaching of self-help groups (SHGs) and illegal collateral. They argued that MFIs were strictly following the guidelines of RBI and asked officials not to take

any unwarranted penal action against them. In order to bring out the truth, they agreed to conduct a public audit of different models of microfinance by a credible organisation. The MFIs have adopted a Voluntary Mutual Code of Conduct pertaining to interest rates, savings, recovery and governance practices.

The MFIs also blamed banks and financial institutions as being equally responsible for the problem, as they were pumping huge funds into some MFIs without looking into their credentials. In order to allay fears about the negative impact of the crisis on their financial position, they decided to widely circulate the rating update released by CRISIL after the AP incident in relation to two MFIs (BASIX and SHARE), reiterating the earlier position. Further, the MFIs have released an indicative schedule of interest rates that could be possibly charged by MFIs (21-24 per cent), arrived at based on the prevailing cost structure for MFIs and other agencies (*ibid*). The efforts of the MFIs have helped them temporarily to tide over the crisis. The closed branches of the two MFIs have been reopened. But the crisis has thrown up many valid questions about the role and credibility of MFIs and the regulatory measures applicable to them. It would be worthwhile to examine here the nature of the crisis and the causes which have led to the situation. A meaningful way forward for the MFIs requires that the problem is understood from a proper perspective.

### A Diagnosis

There were three major allegations against the MFIs that came up during the crisis: (i) MFIs are charging exorbitant rates of interest. Not only that MFIs charge absolutely high interest rate (upwards of 20 per cent), but their practices like forced savings, applying a flat rate method and adding service and other charges, over and above the annual interest rate, further exacerbate the cost. This is leading to an overall high cost of borrowing for the poor, making MFIs’ rates look almost usurious. Further, MFIs lack transparency with regard to their interest rate practices, which is helping them to transfer various costs on to gullible borrowers; (ii) MFIs are resorting to unethical ways of recovering loans by confiscating title deeds, using intimidation and abusive language, and combining multiple products like savings, insurance and loan to ensure prompt

recovery; and (iii) MFIs are aggressively poaching from government and banks to capture their borrowers. They are luring the members of government supported SHGs by liberally financing them, leading to multiple financing.

Because of such practices, it is argued that MFIs are causing a huge burden on the poor, leading to a vicious cycle of debt, poverty and even deaths [Kumar 2006]. Though there is no clear evidence to prove these allegations against the MFIs in AP; there is however some evidence from studies carried out elsewhere, which indicate that these allegations are to some extent true about MFIs in general [Hulme 2000; Mitra 2005; Rhyne 2001; Shylendra 2003; Sinha and Matin 1998]. The decision of MFIs to conduct a public audit of MF practices hence is a welcome stand, which may help in probing the allegations made against MFIs in AP. Meanwhile, it would be worthwhile to look at the nature of the problem and the causes which have led to it.

*State-civil society conflict:* At one level, the crisis can be seen as a typical conflict between state and civil society organisations vying to capture the popular space, by using a common intervention. MFIs are the result of civil society initiatives. They have played a major role in bringing microfinance to the forefront. In AP which is the leading state in the country under SHG-bank linkage, a state supported programme, MFIs have been able to scale up their operations in a significant way. The domain of MFIs largely falls outside the SHG-bank linkage programme. Banks and donors are approaching these MFIs to channelise their funds to the sector despite the widespread nature of the SHG movement in AP. Some of these MFIs have also attracted the attention of high level political and other dignitaries who make frequent visits there. Such visits have attracted good media attention. Buoyed by the support, these MFIs have come out with huge expansion plans.

In a parallel way, the SHG movement also has been growing fast in AP. The successive governments in AP have played a major role in promoting SHGs in a big way as instruments of poverty alleviation and empowerment. This, in fact, is the major reason as to why AP is a leading state in the country under the SHG-bank linkage programme. The state governments while promoting SHGs as financial intermediaries for the poor have also seen them as potential instruments for their own political gains. The previous government

of AP led by Chandrababu Naidu undertook a massive SHG formation drive under the World Bank-supported poverty alleviation programme called Velugu. In order to claim credit for the SHG movement, the new state government has not only renamed the Velugu programme, it has also come up with a scheme ('pavalavaddi') of providing low interest rate loans to SHGs. Meanwhile, AP has been plagued by continuous farmer suicides, tarnishing the image of the state government. On the other hand, the continued popularity and

spread of MFIs seems to have annoyed the political parties and state government. The MFIs, which charge relatively high interest rates, appear to have become the target to transfer part of the blame for the continued failure of the state government to prevent suicide deaths of farmers and their dependence on moneylenders. It is said that some of the early protests organised against MFIs were instigated by some political parties. Under such a circumstance, the formal complaint lodged by some of the women members of MFIs became handy

for the state government to take action against the “erring” MFIs. In a way, the state government through its action was trying to browbeat the MFIs for their alleged “usurious” practices and for competing with its own agencies in terms of expanding their space. Despite having RBI’s permission for their activities, some of these MFIs fell victim to the state’s action.

*From the point of view of MFIs:* The crisis also needs to be understood from the point of view of the MFIs who are being blamed. As mentioned earlier, there is evidence from elsewhere which suggests that the allegations made against MFIs could be true to some extent. What are the compulsions or motives of MFIs, supposedly working for the poor, to adopt such practices? Let us focus here on the major issue of high interest rates.

The interest rates prevailing in the microfinance sector are certainly much higher than the rates of formal agencies. Even SHGs which are linked to formal banks normally charge 2 per cent per month to their ultimate borrowers. With regard to MFIs, though the rates are much lower than the informal sector, they have ended up creating an interest rate structure which is only second best for the poor. At times it becomes difficult to estimate the effective rate of interest charged by the MFIs. Not many MFIs make it clear to their borrowers what the effective rate would be.

No doubt MFIs have dramatically improved access to credit for the poor, but they have not been able to provide the services at costs which are on par with the formal banking system. It is this problem which has basically given rise to the above crisis. At the same time, it must be mentioned that the interest rates of MFIs have come down recently, as compared to the earlier period, due to increased competition and availability of cheaper funds. Some of the MFIs are also making sincere attempts to reduce the cost of borrowing for their clients through various innovations. But still, the prevailing rates are much above the formal lending rates in the country. At least two reasons can be identified for the relatively high MFI interest rates.

*Limitations of on-lending:* Most MFIs are NGOs doing basic on-lending. Only recently have a few of them become transformed into non-banking finance companies (NBFCs) in order to take advantage of the formal regulation. The main source of funds for MFIs is borrowings from external agencies like banks and financial

institutions. Till the very recent entry of commercial banks, the cost of borrowing from financial agencies for the MFIs was well in the range of 11-13 per cent. Given such a high cost of borrowing, there was no way MFIs could provide cheaper financial services to their members after providing for their own operational cost and loan loss provisions. With the increased scale of operations, MFIs have also experienced a steady decline in the flow of zero or low cost funds from donors.

However, with the entry of commercial banks in the last two or three years as financiers for MFIs, the cost of borrowing has come down by at least 2 or 3 per cent. This is mainly because of the increased competition among banks. But even with this reduction, the cost of funds for MFIs remains relatively much higher than the average cost (estimated to be 5-6 per cent) incurred by commercial banks in mobilising public deposits. However, this cheaper route for funds under the current regulatory framework is not available to MFIs. Even those MFIs which have transformed themselves as NBFCs cannot mobilise savings unless they satisfy certain other rigid norms like having own capital of Rs 2 crore and being in operation for at least three years. To overcome the regulatory constraint, some innovative MFIs have floated another institution, like a cooperative or mutual benefit trust, just for the sake of mobilising deposits. This has resulted in fragmented intermediation, where one institution mobilises deposits and the other does the lending. The outcome is a circuitous flow of funds and higher transaction costs both for borrowers and the lender.

Recently, there is another innovation being tried out by private commercial banks with MFIs, called partnership lending. Under the model, an MFI does the lending on behalf of a commercial bank, which owns the portfolio. The MFI becomes a mere agent of the commercial bank and gets some commission for its efforts in lending and recovering the money. Since MFIs have resource constraints, the model is expected to help in scaling up MFI operations without a constraint in funds. The two MFIs in AP against whom action was taken by the authorities had a significant proportion of their portfolio under the partnership model. The model unfortunately seems to have been used by the commercial banks for their own advantage, to channelise the funds to priority sector areas utilising the MFI network. More than that, the model does not seem

to have helped in bringing down the cost for the ultimate MFI borrowers.

Overall, MFIs are faced with structural problems due to the absence of an enabling regulatory framework where they can carry out seamless financial intermediation at a reduced cost for their clients.

*Neoliberal approach:* The second main reason for the high interest rates of MFIs pertains to the policy approach adopted by them. Most MFIs, coming under the global neoliberal influence, have adopted interest policies which adhere to total cost recovery. MFIs are being advised by agencies like Consultative Group to Assist the Poorest (CGAP), a microfinance window of the World Bank, to adopt an economic rate of interest which would help them attain full financial sustainability [CGAP 2002]. Many donor and support agencies from whom the MFIs receive financial support advocate following the CGAP approach to interest rate. The main thrust of this approach is that MFIs need to reduce their dependence on subsidies to scale up [Robinson 2001]. They need to attract commercial funds for meeting their fund requirements. MFIs have to adopt the economics of commercial interest rates, which would enable them to recover fully all their costs. The approach advocates that MFIs attain two levels of sustainability. The first level is operational self-sufficiency (OSS) wherein MFIs would recover all operating costs through operating revenues. The second level of sustainability is about attaining financial self-sufficiency (FSS) under which MFIs would have to recover costs necessary not only for attaining OSS, but also to recover additional costs from their borrowers. This would help them to take care of the cost of inflation, cost of future growth and cost of foregoing all subsidies. This requires that MFIs charge sustainable interest rates, which would help them to attain both OSS and FSS simultaneously. The major assumption made under the approach is that the demand for credit by the poor is inelastic and the poor value regular access more than the cost of borrowing. The argument for removing interest rate caps comes from this approach.

Unfortunately, most MFIs in India and elsewhere seem to have come under the above influence. This is evident from the fact that most of them aim to attain FSS, as visible in their financial and other reports available in the public domain. As a result, MFIs have tended to charge interest rates which would help them attain

the goal of sustainability to the detriment of their own members.

It is largely because of the above two reasons that the structure of MFI interest rates has been relatively much higher than formal banking rates. The MFIs, as such, did not face much of a problem in following the above approach. But with their fast growth, they have come under the scanner recently. The assumption that loan demand is interest inelastic has turned out to be erroneous given the present socio-economic environment. Further, continued rural distress and competitive popular politics have made "sustainable interest rates" become unsustainable. This is what has precipitated the present crisis for MFIs in AP and also made the government of Tamil Nadu impose restrictions on MFI interest rates some time ago.

With the regard to other allegations about coercive methods of recovery and poaching of SHG members, the following could be said briefly. MFIs following the conventional grameen group model are known to follow rigid repayment schedules. The weekly repayment schedule normally followed by these MFIs puts a lot of pressure on the members to maintain regular repayment. The members even resort to borrowings from informal agencies to repay the MFI loans to retain their access [Sinha and Matin 1998]. Unlike the SHGs where members bear the onus for recovery, under the MFI model the staff take the major responsibility. It is possible that some of the staff may follow coercive methods as they are given recovery targets that make them eligible for some incentives. Even in SHGs, we see members being prescribed shorter loan periods due to fund constraints. The need is to follow a flexible recovery method and schedule which would ease the pressure on the members. About poaching, this is a common phenomenon which occurs when there is excess competition and lack of coordination among the lending agencies. A similar problem was faced by formal lending agencies under the earlier multi-agency approach to rural lending. The members themselves at times try to take advantage of such competition. Better coordination can help reduce the problem to some extent.

### Way Forward

It is NGOs and MFIs that have helped in bringing microfinance to the forefront. The crisis must hence have been quite agonising for the MFIs. The rationale for

the existence of MFIs comes from the fact that there is still a big gap in the provision of financial services demanded by the poor. Despite the increased participation of commercial banks, the SHG-bank linkage programme reaches only about one-third of potential borrowers and one-tenth of the estimated demand for credit. There is also a huge imbalance in the spread of the programme across states. Given their general reluctance, commercial banks may not be able to fully meet the needs of the poor despite having resources and networks. Hence, alternate agencies like MFIs have a major role to play. With their NGO background, MFIs can target poor households better than commercial banks. Further, MFIs provide scope for promoting institutions which are owned and controlled by the poor. Many MFIs in the country have come up as community-based institutions.

While it is necessary that commercial banks are made more accountable in terms of meeting the credit needs of the poor, MFIs need to be encouraged to emerge as supplementary channels. MFIs have to be helped in overcoming their structural problems, highlighted above, so that they can act as financial intermediaries more effectively for the poor. Even though MFIs are rapidly emerging, regulatory authorities have not been fully sensitive to their needs. MFIs are constrained by the existing rigid regulatory norms that prevent them from emerging as full-fledged intermediaries. The blame for allowing such an institutional structure to continue, which can offer only second-best option for the poor both in terms interest rates and financial services, lies squarely with regulatory authorities. The need of the hour is a clear recognition of the role being played by MFIs and creating flexible and layered regulatory norms for them [Shylendra 2005]. This may even require passing of a suitable law for MFIs, over which the central government and RBI have been vacillating for quite some time. While the governments have been proactive in helping industries and private businesses through flexible policies under the ongoing liberalisation, they have not been equally forthcoming when it comes to the needs of institutions like MFIs that are meant for disadvantaged sections. A good regulatory framework for MFIs could not only help to reduce the transaction cost but can also bring in much needed transparency and accountability. Since on-lending by MFIs has been identified as one of the

possible mechanisms for meeting the credit needs of the poor, the government has to ensure that MFIs get adequate refinance from agencies like NABARD and SIDBI at a much cheaper rate.

At the same time, MFIs on their own have to take certain measures which would help them to overcome their problems and shake off the charge of being unethical and charging usurious to interest rates. The voluntary code of conduct adopted by the AP MFIs is a welcome step and could be adopted by other MFIs in the country. The code needs to be followed in true letter and spirit. Further, MFIs which have emerged because of civil society initiatives have to be careful about their policies and approach. In the compulsion of doing the "business" of microfinance with the poor, they cannot allow themselves to become instruments for furthering a neoliberal agenda known for causing a negative impact on the poor. Many NGOs pursuing microfinance are in a crucial stage of transforming themselves into full-fledged MFIs. It is not uncommon to see many transformed MFIs in the country claiming to be fully commercial and for-profit organisations. It is necessary for these MFIs to tread a careful path lest they dilute in the process all their previous pro-poor development concerns. No doubt microfinance may require a different approach than other typical NGO activities, but as institutions basically promoted for taking care of the needs of the poor, MFIs have to strike a clear balance between development goals and business interests. The thrust on FSS needs to be changed till the time these MFIs reach a very mature stage.

To conclude, the future path for MFIs is bound be crisis ridden, similar to the one faced recently, unless they are enabled to come out of their structural constraints and from the influence of neoliberal agenda. **EW**

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