CHAPTER 1

Microfinance in India: Lessons from the Andhra Crisis[*]

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1 The Two-Model Microfinance Industry in India

The Indian economy was able to witness high levels of economic growth following the economic reforms that were introduced in the 1990s. The GDP grew at the rate of 8.45 % per annum between the years 2004 till 2011[1]. Despite this, India continued to see high degree of poverty and low human development. While growth did create zones of prosperity, and reduce poverty and hunger, the residue was still very large – 37.2 % of the Indian population continued to be poor[2], while 77 % of the population remained vulnerable to income shocks[3]. This proportion was even higher for the socially disadvantaged groups such as the Scheduled Castes, the Scheduled Tribes and Minorities. India continued to occupy a low rank – 134 – in the UNDP Human Development Index which takes into account health, education, income, inequality, poverty, gender, sustainability and demographic indicators[4]. With an estimated 385 million employed population, unemployment in India was estimated to be about 9.4 %. [5]

The post independent Indian state adopted various means for addressing poverty and livelihood challenges. This began with land reforms, followed by increasing

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[1] Planning Commission: Indian Economy: Some Indicators (as on 1st June, 2011).

[2] Tendulkar committee puts the figure at 37.2 % based on the NSSO study 2004–05.

[3] India's Common People: Who are they, How many are they and How do they live, EPW March 15, 2008, Arjun Sen Gupta, KP Kannan, G Raveendran.

[4] Human Development report 2011: Sustainability and Equity A better Future for all.

[5] Report on Employment & Unemployment Survey (2009–10), GOI, Ministry of Labour & Unemployment, Labour Bureau, Chandigarh.

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the area under irrigation, culminating in a dramatic rise in agricultural production through the introduction of high yielding varieties of wheat and rice, dubbed the "Green Revolution" of the late 1960s. But this only exacerbated inequalities between the large and the small farmers, the landed and the landless, and irrigated and rainfed regions. Thus, the then Prime Minister, Indira Gandhi launched a "direct attack on poverty" in the mid 1970s, with large government funded programs of wage employment in public works and self-employment through credit-based asset acquisition. These two strategies have remained the main planks of poverty alleviation, with names changing from NREP to Food for Work to JRY to NREGA for wage-employment programs and from SFDA to IRDP to SGSY to NRLM for self-employment programs.

The need to enhance agricultural production, and promote self-employment for the landless, led to the role of credit becoming significant. Banks were nationalized in 1969 and used throughout the 1970s and 1980s as instruments of development. But once again, it became clear that despite the priority sector lending obligation and the mandated credit for schemes for self-employment of the poor like the IRDP, banks did much less than what was needed. Then, in 1990s, with economic reforms redrawing the banks' priorities in favour of sustainability, they turned their backs to the poor. It was left to NGOs to work out new modalities for providing the poor with access to credit[6]. This is what led to the emergence of the two predominant microfinance models in the last two decades. In both, banks play the lenders' role, but the front-end is tackled either by a "self-help group" (SHG) or by a microfinance institution (MFI).

Access to credit has for ever been a major constraint for the poor in India. Traditionally the poor depended on large farmers, merchants and middlemen, pawn brokers and moneylenders for meeting their credit needs. Unable to pay high interest rates, the poor often ended up forfeiting their land and eventually becoming bonded labourers to money lenders. Many attempts were made to break dependence on money lenders through provision of institutional credit, starting from the British colonial period. The need to produce enough food to feed the growing population was a priority for the newly independent India. In the initial two decades 1947–67, cooperatives became less and less important as an answer to provision of credit for agriculture. In 1969, the then Prime Minister Indira Gandhi nationalized the top ten banks and mandated them to open a large number of rural branches. Then in 1975, after money-lending was abolished during the Emergency, the government set up a network of Regional Rural Banks to reach out to the rural poor, specifically small and marginal farmers, rural artisans and agricultural labour. With a focus on physical expansion of banking services the branches grew rapidly during 1969 to 1990.

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6 The others included building large scale infrastructure projects for irrigation and power, creating large scale extension network and promotion of modern agricultural practices, community development works, integrated development projects, area level development projects based on specific geographies etc.

Table 1. Expansion of Banking Services

Year	Rural branches	Total branches	Population per branch (in 1000s)	Priority sector credit as % of total credit
1969	1833	8262	64	14.0
1980	15105	32419	21	33.0
1990	31114	55410	14	43.8
1995	33004	62367	15	33.7
2000	32734	65412	15	35.4
2010	32624	85393	13.8	35.1

Source: Progress of Commercial Banking at a Glance – RBI Statistical Returns

Though the last column in the table above looks impressive, the fact is that the so-called priority sector includes many non-poor sectors, such as large farmers, commercial agriculture, small-scale industry, self-employed professionals and exports. The banking system had limited ability to reach the small borrowers as was evidenced by the fact that in 2004, only about 5 percent of bank credit went to small borrowers.

1.1 Self Help Group – Bank Linkage Model – Achievements and Shortcomings

In order to enhance access to credit to the poor, since the mid 1980s, NGOs started experimenting with credit groups. MYRADA, an NGO in Karnataka since 1986 and PRADAN in Rajasthan since 1987, began setting up Self Help Groups (SHGs) for encouraging savings and credit and training on the principles of self help[7]. The German technical agency, then called GTZ, took many Indian officials from the Government of India (GoI), the Reserve bank of India (RBI) and the National Bank for Agriculture and Rural Development (NABARD) to Indonesia to show them the possibilities of lending to the poor through groups. In 1992, the RBI approved a pilot project of linking SHGs to banks, which eventually led to the SHG-Bank linkage program (SBLP) in 1996. The SBLP received major policy and promotional support, both from the central and various state governments, in particular, Andhra Pradesh. It was scaled up nationwide through support from NABARD and World Bank loans[8]. By March 2011, around 7.46 million SHGs

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

8 Johnson, D. and Meka, S., Access to Finance in Andhra Pradesh, Institute for Financial Management and Research—Centre for Microfinance, 2010.

around India have been linked with banks in what is the world's single largest microfinance program. About 4.78 million SHGs have loans outstanding worth INR 312 billion[9] (about Euro 4 billion). In the following year, 2011–12, banks disbursed INR 84 billion in AP and INR 165 billion all over India, including AP.

The direct benefit of the SBLP, in terms of income enhancement of poor households, and the indirect benefit in terms of women's empowerment, has been enormous. Though a great leap forward in terms of enhancing credit access by the poor, the SHG model suffers from a major lacuna – it is subsidy driven, with at least three types of subsidies –

First, is the cost of organizing the SHGs. In the early days, this was done by NGOs, a role increasingly taken over by government agencies as the scale went up. But both required subsidies. In AP, the funding largely came from World Bank loans of USD 600 million to the AP government run Society for Elimination of Rural Poverty (SERP).

The second subsidy comes in the form of lower interest loan funds. While in the early years, banks lent to SHGs at 12 % per annum, successive state governments tried to subsidise the rate at which SHGs got funds. In AP it came down successively from 12 % in 1996 to 9 % before the 1999 state elections, to 3 % after the 2004 elections in which the SHGs were promised "*paavla vaddi*" (quarter percent per month interest or 3 % pa). In 2011, the subsidy was increased to cover the full interest, so the cost of funds to SHGs has been reduced to 0 %[10].

The third subsidy is in the form of bad debts that banks have to write off. The recovery rates of SHGs in early years were 95 % plus and have steadily fallen as the poor sensed the program becoming one of political patronage. In the wake of the MFI Ordinance in AP, which led to mass default of MFI loans, initially SHG loan repayments increased but have in a year fallen to 60–70 %. The increasing subsidy has also led to increasing cornering of credit by the better-off members, corruption and reduction in repayment rates in expectation of loan waivers.

1.2 Emergence of MFIs After Banking Sector Reforms Were Launched

The introduction of financial sector reforms since 1992 saw a reduction in the share of small borrowers (below Rs. 25,000) to total bank credit decline from 18.3 % in 1994 to 5.3 % in March 2002 and 1.3 % in March 2010. Even the number of small borrower accounts reduced from 55.8 million to 37.3 million in March 2002 to merely 1.9 million in March 2010[11]. This is partly because most

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9 National Bank for Agriculture and Rural Development (NABARD), Status of Microfinance in India, 2010–11, Mumbai.

10 http://www.serp.ap.gov.in/AWFP/FrontServlet?requestType=BudgetLineReportRH&actionVal=Budgetline1&Year=20122013&FunctionalHead=-1&District=-1&Mandal=-1&CostCentre=-1.

11 Mahajan, Vijay and Ramola, Bharti Gupta, Microfinance in India – Banyan Tree and Bonsai – A review paper for the World Bank, 2003.

small loans are now being given through SHGs or MFIs rather than directly by banks. After rising for three decades from 1951 onwards, the share of institutional credit to total credit declined during the period 1991 till 2001. It reduced from 64 % to 57 % for rural areas. Over 70 % among the poorer households (less than Rs. 60,000 assets) were dependent on non-institutional sources for meeting their credit needs[12].

The need for physical collateral, high transaction costs involved in processing small amounts and concerns related to loan recovery discouraged banks from lending to small borrowers. This demanded an alternative system to meet their needs. The Grameen Bank, Bangladesh (GBB) demonstrated a successful model of microcredit steadily since 1976. Initially donor subsidised, the GBB model reached a volume where it could help meet the financial needs of the poor in a sustainable manner. By the mid 1990s, the GGB model was being seen with great interest by other countries.

The then Finance Minister of India, Dr Manmohan Singh announced in 1995 that India should have a bank for the poor like the GBB. Indian financial institutions, led by NABARD, however, rejected the GBB model in favour of the home-grown SHG model. Many Indian NGOs, however, experimented with both the models and found that using the GBB model, they could themselves become sustainable. Once SIDBI and later private sector banks like the ICICI Bank started funding NGOs in a big way for microcredit, the GBB model was widely adopted by most Indian MFIs, with a few exceptions like BASIX.

1.3 International Development Policy Thrust on Sustainability

The success of the Grameen Bank, Bangladesh led to demands for its replication all over the world and this was first done systematically at the Microcredit Summit in Washington DC in February, 1997. Thousands of organisations from developing countries joined the movement, and worked towards increasing outreach. Microcredit was also beginning to find favour among the donors such as the USAID, DfID of UK, Canadian CIDA, the German, the Dutch and the Scandinavian donors and European donors all began to give substantial amount of funding to promote microfinance in developing countries. In India, apex lenders such as Small Industries Development Bank of India (SIDBI) and the Rashtriya Mahila Kosh (RMK) turn gave wholesale loans to MFIs, most of which began as developmental NGOs but quickly adopted the mantra of sustainability.

The private sector arm of the World Bank, the International Finance Corporation (IFC) and other development banks like the German KfW, the Dutch FMO and the British CDC all began to develop an interest in microfinance and began to invest in more commercially oriented MFIs, such as banks and non-bank finance

[12] All India Debt and Investment Survey, 59th Round, National Sample Survey Organization, December 2005.

companies. They also invested in a whole range of new funds, specializing in lending to and investing in the equity of microfinance institutions. These bodies, the earliest of which were set up in 2000, were called “microfinance investment vehicles” (MIVs) and there were as many as 150 MIVs listed on the Mix Market data base in 2012. Many of them raised funds from socially motivated investors who were willing to take a lower return if they saw their money helping the poor. By 2005, investors in microfinance had a motley mix of motivations, all way from those seeking no returns to those seeking high returns.

The year 2005 was declared by the United Nations as the ‘International Year of Microcredit’ and the Nobel Peace Prize for 2006 was awarded to Prof Mohammed Yunus and the Grameen Bank of Bangladesh. Compartamos, a Mexican MFI which had begun as an NGO and transformed first to a non-bank credit company and then to a microfinance bank, made on Initial Public Offer and the IPO was 13 times oversubscribed and considered a huge success by any financial market standards. This led to an upsurge of investment in MFIs and new classes of investors came in – those willing to take on structured debt obligations and private equity investors. They brought with them lots of expertise and funds, but also lots of expectations of high returns. They also spawned the ambitions of several MFI promoters who realised they could make a lot of money by offering high growth rates and high profitability in their MFIs.

2 Achievements and Shortcomings of MFIs in India

The growth of MFIs was supported by state owned Small Industries Development Bank of India (SIDBI) and loans from commercial banks under the priority lending quotas since 2000. Initially they leant to NGO-MFIs but within a few years, as the amounts outstanding increased, they sought some equity as a risk cushion. This is when the larger NGO-MFIs began transforming into for-profit NBFCs. In the next step, by 2006, these NBFCs started attracting equity investments from specialized microfinance investment vehicles and private equity funds[13]. For example, SHARE got equity from Legatum, Spandana from JM Financial and SKS from Sequoia, by 2007, within a few years of having been NGOs. By 2010 the MFI growth in India had reached its peak growing at 80 % per annum and the outreach had reached around 27 million.

2.1 Achievements of MFIs

MFIs could achieve what the banking sector could not achieve over the years. Within a short period of 15 years borrowers from MFIs increased from merely

[13] Sparreboom, Pete, Indian Microfinance crisis, 2010, Working Group on inclusive finance in China, April 2011.

3,000 in 1995 to 31.7 million in 2010. In the corresponding period, the banking sector with its huge infrastructure only showed a decline in terms of lending to small borrowers[14]. MFIs brought down dependence on money lenders. MFIs offer a variety of loans for agriculture, animal husbandry and non-farm activities as well as for housing needs. MFIs introduced micro-insurance for life and health cover of borrowers, and some innovative ones also added weather insurance for crops and livestock insurance.

In the run up to the SKS IPO in August 2010, a few MFIs participated in a reckless rush to build portfolio and the resultant multiple and higher ticket lending led to over-indebtedness in a small proportion of the borrowers. Many poor families were overwhelmed by the repayment obligations. As they began to skip installments, MFI staff, accustomed to near 100 % on-time repayment, increased pressure on recoveries. Reports of coercive recoveries and in some cases, suicides by borrowers, began to appear in the media. This led to a political backlash and the AP state government enacted a law in October 2010 to curb MFIs.

2.2 Shortcomings of MFIs

Indian MFIs, particularly the four in AP – SKS, Spandana, SHARE and Asmitha – witnessed high levels of growth from 2006 onwards and could not manage that process well. A vast majority, with the exception of SEWA and BASIX, were following the Grameen Bank, Bangladesh model, offering a single product – a year-long loan repayable in 50 equated weekly instalments. They recruited a large number of people, but did not train them or monitor them adequately. The only parameters to which the MFI managements and Boards seemed to pay attention to were growth in and health of the loan portfolio, and reduction in operating costs. The field staff quickly learnt to respond to that which was being monitored and incentivised and ignored all the rest, including, going to remote villages, searching for the really poor clients, handholding and training of client groups before giving them the powers to approve each other's loans, and ensuring client education, or even adequate disclosure about interest rates and other terms.

3 The Politics Behind the Microfinance Crisis in Andhra Pradesh

The microfinance crisis in AP can be traced to the simultaneous expansion of SHG Bank Linkage Model promoted by the State and the MFI model by private players. By 2010, it was estimated that there were about 6.25 million MFI borrow-

[14] Figures derived from MIX Market Data.

ers in Andhra Pradesh and 19.11 million SHG Bank Linkage members[15]. Clearly, in percentage terms bank loans to MFIs had been growing faster than bank loans to SHGs. According to N. Srinivasan, in 2010 growth in MFI loans outstanding also overtook growth in SHG loans outstanding in absolute terms[16]. The growing pace of expansion of MFI meant that it could outpace SHG as a popular model for microfinance.

This was not acceptable to the political class as they would lose hold over an important vote bank. The civil servants were in agreement with the political leaders as they would lose hold of a major program and the related budget if MFIs occupied the dominant space. The hostility of the staff of the government sponsored Andhra Pradesh Society for Elimination of Rural Poverty (SERP) towards MFIs is largely based on this anxiety.

While the SHG movement was initially a grass root driven movement in Andhra Pradesh, it was sought to be co-opted by political parties. Since 1999, when the then incumbent Chief Minster Chandrababu Naidu of the Telugu Desam party (TDP), used women's SHGs as his vote bank and returned to power, microfinance has become increasingly important to the electoral politics in Andhra Pradesh. Beginning with the TDP, women's SHGs were seen as a political constituency, a potential vote bank[17]. Mr Naidu persuaded banks to lower interest rates on loans to women SHGs to 9 % from 12 % before the 1999 elections. The Congress, under the leadership of late YS Rajashekhar Reddy (YSR) sought to win the game of electoral politics during 2004 elections by offering to provide women loans at 3 % pa interest[18], a promise which he kept on coming to power, with the *Pavala Vaddi* scheme[19].

In 2009 elections, the interest rates again became an issue of populist politics. TDP sought to win back the women vote base by agreeing to offer interest free loans upto a ceiling of Rs. 25,000 and 3 % loans for loans above Rs. 25,000[20]. However, in the face of the popularity of the YSR, Naidu could not make much impact. The recovery rates for bank lending to SHGs declined during the period.

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15 Srinivasan, N., Microfinance India: State of the Sector 2010, Presentation to ACCESS Microfinance India Summit 2010.

16 Srinivasan, N., Microfinance India: State of the Sector 2010, Presentation to ACCESS Microfinance India Summit 2010.

17 http://telugudesam.org/cbn/velugu.html.

18 Andhra Pradesh Congress Committee Manifesto 2004.

19 G.O.Ms. No. 271, G.O.Rt.No.5, PR&RD (RD III) Department, Dated 17.09.2004. Pavala refers to quarter of a rupee i.e., quarter rupee interest per month which equals 3 % interest per year.

20 TDP Election Manifesto, 2009.

While recovery was over 95 % in 2007–08, by 2010–11 this had declined considerably to a reported 60–70 %.[21]

Unfortunately, YSR died in a helicopter crash within six months of getting re-elected in 2009. His son Jagan Mohan Reddy was widely expected to become the Chief Minster, but the Congress High Command decided to appoint old loyalist Rosaiah. This led Jagan to rebel. He kept looking for issues to raise and the one about microfinance borrowers feeling so harassed that some committed suicides caught his attention. He found the perfect issue to embarrass Rosaiah and the High Command in Delhi – a picture of Rahul Gandhi sitting with Vikram Akula in a SKS women borrowers' group meeting, which was carried in the media in 2006. There was also a photo of Smt Sonia Gandhi, the Congress party president, presenting Akula with an award for Social Entrepreneur of the Year at the World Economic Forum's India Economic Summit.[22] Jagan's newspaper *Sakshi* and his TV channel by the same name hammered the point – "Why would Rosaiah's government act against MFIs, when the Gandhis are their friends?". The other media picked up the issue. This led to acute embarrassment for the Congress and they even issued a denial but the charge stuck[23].

In October 2010, when media criticism against the MFIs was at its peak, the statements by leaders of political parties had its affect and the Congress government in AP had to enact a harsh law curbing MFIs. The Government of Andhra Pradesh brought in the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010[24] which was later passed as the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Bill 2011. This law had several features which effectively made it impossible for MFIs to function in the state. For example, MFI staff could not go to the residence or workplace of the borrower for recoveries, but instead had to go and sit at a central public place, hoping for borrowers to come and repay. No additional loans were permitted without prior approval by the government.

Though the law was ostensibly aimed to protect MFI borrowers from coercion and over-indebtedness, it virtually stopped MFIs from functioning in AP, Two crucial provisions were – visits by MFI staff to the residence or work place of the borrowers for recovery could be construed to be a coercive practice, so instead they had to sit in a "central place" hoping for borrowers to come there. Second, no further loans were allowed with government permission for each individual loan. This by itself slowed down recoveries drastically. But Opposition leaders, particularly former Chief Minister Chandrababu Naidu, used this as an opportunity to

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21 Based on the Status of Microfinance Survey, NABARD Reports 2008, 2009, 2010 and 2011.

22 http://blogs.ft.com/beyond-brics/2010/11/01/indias-microfinance-crisis-the-rahul-gandhi-factor/#axzz1sqxBojDc.

23 http://www.ysryouthcongress.in/2011/06/blog-post_23.html.

24 G.O.M.S. 356, Panchayat Raj & Rural Development (RD-1), 19th October 2010.

win popularity by saying the law had not done enough and told people not to repay MFI loans[25]. Similar statement was also made by Narayana of Communist Party of India[26].

This led to a mass default. Over 9.2 million loans worth Rs 72000 million (about USD 1.5 billion at that time) became overdue and 90 % remain unpaid till Apr 2012. Banks panicked and stopped lending to MFIs all over India and the outstandings of the MFIs shrank by half.

People took the convenient interpretation and stopped repaying MFI loans. In the aftermath of the AP MFI Act, 2011, the credit flow from banks to SHGs in AP also came down. This led the AP government to set up a special institution. Titled Sthree Nidhi[27], this is an apex cooperative credit society that has been formed to provide interest free loans to women[28]. Using a high-tech platform, it disbursed Rs 660 crore in loans to members of women's SHGs. But this has had hardly any impact on the overall credit availability as bank credit became tighter and money lenders continued to be the main source of funding at 5–10 % per month (60–120 % per annum) interest rate. Thus, in a last act of political desperation, to make itself look like the champion of the poor, the AP Government announced "*vaddi leni runam*" i.e., interest free loan[29].

4 Emerging Scenario – Responsible Finance

The AP crisis led to several regulatory reforms and operational improvements. The larger MFOIs, which are NBFCs, formed as self-regulatory organisation – the Microfinance Institutions network (MFIN) and all of them joined the RBI approved credit bureaus, contributing over 70 million loan records and following a code of conduct, which prevented over and multiple lending. MFIN also systematically started interacting with political and administrative leaders to obviate crises before those arose.

4.1 RBI Upgraded the Regulatory Framework for MFIs

Following the AP Microfinance crises, the RBI appointed the Malegam Committee to study the MFI regulatory environment in India. The Malegam Committee after a consultative process with all stakeholders, including the Government of

25 http://www.indianexpress.com/news/dont-repay-microfinance-loans-tdp/706093/.

26 http://www.siasat.com/english/news/cpi-leader-tells-mfi-borrowers-not-repay-loan.

27 https://www.sthreenidhi.ap.gov.in.

28 G.O.Ms.No. 285, PANCHAYAT RAJ & RURAL DEVELOPMENT (RD-II) DEPARTMENT, Dated:26.08.2011.

29 G.O.Ms.No. 403, PANCHAYAT RAJ & RURAL DEVELOPMENT (RD.II) DEPARTMENT, Dated:26.12.2011.

India, select State Governments, major NBFCs working as MFIs, industry associations of MFIs working in the country, other smaller MFIs, and major banks etc., recommended (i) defining microfinance loans as up to Rs 50,000 per household, of which no more than 25 % could be for consumption purposes and placed an income limit of the clients (Rs. 50,000 pa); (ii) imposed a margin cap and an interest rate cap on individual loans; (iii) transparency in interest charges; (iv) lending by not more than two MFIs to individual borrowers; (v) creation of one or more credit information bureaus; (vi) establishment of a proper system of grievance redressal procedure by MFIs; (vii) creation of one or more "social capital funds"; and (viii) continuation of categorisation of bank loans to MFIs, complying with the regulation laid down for NBFC-MFIs, under the priority sector. The Committee also made a number of recommendations regarding MFI supervision, corporate governance etc.[30] The RBI accepted the broad framework of regulations. Loans to MFIs will remain under the classification of priority sector lending provided they fulfil the Malegaon conditions. Besides a limit has been placed on the maximum income of the clients (Rs. 60,000 for rural and Rs. 1,20,000 for urban), size of indebtedness (not to exceed Rs. 50,000), extent of loan that can be used for consumption (maximum 25 %), etc. The RBI also imposed both a cap on interest rate (max 26 %), as well on the net interest margin (12 %). The acceptance of the framework of Malegam Committee by the RBI provided much needed orderliness to the sector.

4.2 Microfinance Institutions (Development and Regulation) Bill 2012

The GoI introduced the Microfinance Institutions (Development and Regulation) Bill 2012 in the Parliament to further strengthen the regulatory framework in the microfinance industry. Drafted with extensive inputs from MFIs, SIDBI and NABARD, features of the Bill include: (i) defining microfinance broadly – beyond just lending, to include savings, insurance, money transfers, etc.; (ii) inclusion of NBFC MFIs in its purview, in addition to NGO-MFIs; (iii) recognition of the RBI as the sole regulatory of NBFC MFIs and exclusion of MFIs from the purview of Money Lender Act; and (iv) Strengthened client protection norms – establishment of advisory councils at the central, state and district levels and restrictions on pricing and profitability; and an Ombudsman system. Greater insistence of transparency in pricing and fees.

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30 Ramesh S Arunachalam, http://microfinance-in-india.blogspot.in/2011/05/rbi-acceptance-of-malegam-committee.html.

5 Conclusion

The current phase of microfinance sector could be viewed as the beginning of a period of qualitative transformation. While the first phase (1996–2010) could be characterized as a period of rapid expansion of the MFI sector with a quantum jump in micro-lending to small borrowers, the current phase (2011– onwards) could be seen as a period of qualitative consolidation of the microfinance industry with the strengthening and increased clarity on regulatory framework and consumer protection norms – in other words, the phase of "responsible finance".

While the first phase placed a larger emphasis on micro-credit, the second phase will expand the range of financial services offered by MFIs to also include thrift, insurance, pension services and money transfer. In the second phase, consumer protection norms are stronger. With Credit Information Bureaus having access to over 70 million MFI loans, instances of multiple lending and over-indebtedness will reduce sharply. With the institution of Ombudsmen, the instances of misbehaviour with customers and coercive recovery practices are bound to get minimised. The high growth, high profit regime prevailing from 2006–10 has been curbed by the RBI capping interest margins on the one hand, and the banks squeezing the extent of credit they give to MFIs. Even the investor mania is long since over after the SKS shares plunged from a high of INR 1400 to a low of Rs 60. But more sober investors are coming back and investing in more solidly run MFIs.

The AP crisis was not caused either by the reckless actions of a few MFI promoters not by over-zealous bureaucrats out to protect SHG women from coercion. It was the failure of the complete eco-system – from the rich investor in Europe to the poor borrowers in AP villages. All played their part in the unfolding of this tragedy. The investors saw microfinance as a way of doing good while doing well, expecting high returns when this was unrealistic. The MFI promoters, CEOs and managements, desperate for capital to grow, fell in line to fulfil these expectations. Banks fuelled this growth with a lot of leveraged loan funds, as they found this to be an easy way to meet their priority sector lending obligation, with a high margin. MFI field staff were incentivised to lend more and recover tightly. Borrowers could not resist the temptation of easy loans till they realised that repaying one loan by taking another gets them into more and more indebtedness. The regulator, RBI, followed a policy of benign neglect.

But there is still a lot to be learnt by all these stakeholders. MFIs have to learn that they cannot deal with the poor – the vote bank of the politicians – on just their own terms. Banks have to learn that they will never be able to reach the poor as efficiently as dedicated MFIs and so they must support this channel instead of setting up their own mimic channels. Multilaterals like the World Bank have to learn that they cannot help the poor by providing funding which is used by politicians to subsidise interest rates to unsustainable levels. Its investment arm, the IFC and other investors must learn to curb their expectations of returns or seek those elsewhere. Most importantly, politicians have to learn the simple principle that they cannot drive down the price (interest rate) of a commodity and yet expect its supply to go up.