MicroSave India Focus Note 55

The Andhra Pradesh Crisis: Three Dress Rehearsals … and then the Full Drama

Graham A.N. Wright and Manoj K. Sharma

December 2010

Introduction

The "Andhra Pradesh crisis" looks set to affect microfinance throughout India, and potentially even elsewhere in the world. Certainly, although it had been discussed for a long time, the timing of the introduction of a 27% interest rate cap in Bangladesh did not seem to be entirely coincidental. This note examines the build up to the Andhra crisis, the future prospects for Indian microfinance, the implications of interest rate caps and lessons that should be learned by microfinance worldwide.

In the four years prior to the Andhra crisis, Indian microfinance had three dress rehearsals for the final drama now unfolding. In Indian microfinance circles, these are known as the "three Ks", and each provided an important lesson and warning for the Indian microfinance industry … which studiously ignored all three.

3 Dress Rehearsals

The first rehearsal was in Krishna District in 2006, when the local government District Collector, responsible for the administration of the whole district,[1] shut 50 offices of leading MFIs including Spandana, Asmita and Share, and instructed clients not to repay their loans. This was done essentially on the basis that MFIs were charging usurious interest rates, making super-profits on the backs of the poor, co-opting the government self help groups and being coercive in their collection methods. In short, an abbreviated list of the charges now levelled at MFIs in Andhra Pradesh, and increasingly across the country. The intervention and active support of the Reserve Bank of India prevented prolonged closure of the MFIs' offices. The MFIs promised to reduce interest rates and introduce a code of conduct. This was done, but as soon as the controversy died down, effective interest rates soon began to rise … and the code of conduct largely remained only on paper.

The Krishna District crisis forced ICICI Bank to close its revolutionary "partnership model", under which MFIs acted as agents for the bank and the loans remained on the bank's balance sheet, thus obviating the need for a larger equity base in the MFIs. At the end of 2005, ICICI Bank had initiated about 100 partnerships, and its microfinance portfolio was $227 million lent to 1.2 million clients … until the Krishna District crisis the bank had ambitious plans to expand this off balance sheet lending programme to another 200-250 MFIs. After the Krishna crisis, the RBI prohibited this approach on the basis that the "know your customer" (KYC) requirements for the bank were not met under the partnership model. The MIS existing in MFIs, did not allow for real-time KYC and the partnership model was discontinued by banks, almost overnight. This move accelerated MFIs' search for equity that would allow them to leverage the massive term loan debt available as a result of the priority sector lending requirements mandated by the RBI … and thus the stage was set for the entry of the private equity investors.

The second rehearsal was in Kanpur (and other cities of Uttar Pradesh) in 2009, where a local MFI, Nirman Bharti defaulted on the loans it had received from a variety of banks and other financial institutions amid significant portfolio problems. The underlying problem was that Nirman Bharti had not developed the processes, systems of internal control and MIS to manage the rapid growth driven by the priority sector lending-based flood of debt financing.[2] *MicroSave* has long expressed concerns about the ability of Indian MFIs to manage their exponential growth – both in terms of maintaining the integrity of processes and systems,[3] and in terms of the real status of the portfolio (and how much of the remarkably good PAR rates reported is driven by multiple/rollover financing and/or disguised by the rapid growth of the denominator). The current crisis is likely to bring such issues, if they exist, to the fore.

In fact as early as April 2009, *MicroSave* had raised the red flag while conducting a Loan Portfolio Audit (LPA[4]) of one of the large MFIs. The MIS was clearly inadequate for the scale of operations, and (probably as a result) the reporting of non-performing loans was inconsistent at various levels. Furthermore, there was a marked absence of control systems over the maintenance of cash and cheques; many branches where the entire staff had less than one year of experience and branch managers being transferred and replaced in less than a month; lack of properly documented policies in HR, Operations and Accounts; … the list goes on. New field officers were being provided with 2 days of training followed by 2-3 weeks of exposure shadowing another field officer before being given the responsibility of managing a thousand clients or more.

---

[1] A district is a geographic administrative unit in India

[2] See *MicroSave*'s India Focus Note 42 "Microfinance In India: Built On Sales Targets or Loyal Clients?"

[3] See *MicroSave*'s India Focus Note 17 "Market Conditions for Microfinance in India: Lessons Learned from *MicroSave*'s Action Research Programme 2007-2009" and India Focus Note 11 "Capacity Building – Needs and Challenges in India".

[4] See *MicroSave* Briefing Note # 62 "Benefits of Loan Portfolio Audit".

These are clearly serious issues when the institution is dealing with a portfolio of nearly $250 million and has to manage nearly a thousand branches. The MFI's reaction was a combination of denial and a demand for a different consulting company to perform another LPA in the expectation that it would be less rigorous, and thus less critical, than the one conducted by *MicroSave*.

The third rehearsal was in Kolar district in Karnataka in 2009/2010, where a repayment strike instigated by the Anjuman committee, a local Muslim group paralysed repayments for many months affecting most of the major southern MFIs.[5] The underlying reasons for this strike were complex, but what was striking above all was how few clients resisted the strikes or defended the MFIs. One study concluded that "Client information from seven of the 9 MFIs operating in the town shows that at least 33% of them have more than one loan and around 20% have three or more loans".[6] Furthermore, problems in the local silk reeling industry reduced flows of income to service debts, pressure from clients' husbands to cut back on attending weekly meetings and the use of agents by MFIs to drive sales all created an environment that was highly risky for traditional, zero tolerance, group-based lending operations.

In response, 43 of the Non Bank Financial Company (NBFC) MFIs, (most of which have, or aspire to have, private equity investments), formed an apex organisation, MFIN, to represent their interests. MFIN's first steps were to initiate the development of a credit bureau to assess multiple borrowing, to promise transparent pricing and to encourage its members to limit their lending to a total of Rs.50,000 per client, with a maximum of three MFIs lending to any one client. The credit bureau remains work in progress, as do (with a few notable exceptions – particularly Equitas) moves to transparent pricing. Commentators have wondered how the MFIN members will limit lending to individual clients given their group-based systems and sales focus; or indeed if such a limit would make any difference given the importance of informal sector and SHG loans in most poor households' debt portfolio.

These three rehearsals, were clear enough warnings of each and every component of the current Andhra Pradesh crisis. But the larger MFIs were too busy focusing on rapid horizontal growth and sales to pause to examine the political and reputational risks that were written on the wall in large, neon, flashing letters. Indeed, in order to maximise returns for the MFIs' private equity investors (and indeed their promoters), the growth has been driven an almost exclusive focus on quantity of clients and portfolio, rather than quality of client relationships … and thus the portfolio.[7]

By the beginning of 2010, the government and RBI were already showing clear signs of disquiet with the way the MFIs were conducting their business, as well as their impact on the SHG movement that a variety of government agencies had so carefully nurtured. As the 2008 NABARD annual report had revealed, repayment rate by SHGs to the banks was already poor. But there were concerns that the stricter loan collection regimes of the MFIs would exacerbate this trend amongst households borrowing under both SHG-bank linkage programme and from MFIs. The stage was set, and it was easy to predict the tragedy that the first IPO would trigger.[8]

The Full Production Drama

The main allegations against the MFIs in Andhra Pradesh are that they are charging opaque and usurious interest rates as well as using strong-arm techniques for collections … and thereby are accused of profiteering at the cost of poor women. What started as a concern about the reported suicides by some harassed MFI borrowers soon grew into a major crisis that is now threatening the entire sector. The Government in the State of Andhra Pradesh has issued an Ordinance requiring MFIs to register with local government offices which will also monitor any incidents of harassment/complaints from MFI clients. In case the complaint is found to be *prima facie* tenable, criminal cases will be lodged against MFI staff members. Loan repayments are to be made monthly at the *Gram Panchayat* office – thus effectively taking away the convenience of small weekly repayments at meetings in clients' own villages, and levelling the playing field with the SHGs.

Yet no clients are coming forward to protest the closure of their MFIs or the torching of their branch offices … An ex-SKS Area Manager recalls, "*One time the local communist party threatened to close our offices because we would not hire their nominees. In response, our clients surrounded their party office to tell them to leave SKS alone as it was providing a valuable service … Where have those days gone?*"

As a consequence of the Ordinance and the silently brewing political/regulatory storm, interest rates may be capped, priority sector lending may be halted, registration under the new Ordinance seems set to significantly hinder operations … and worse may yet come. This is explored in India Focus Notes 56 - 58 "The Andhra Pradesh Crisis: So What Next?"

[5] See India Focus Note 25 "Dinosaurs and Rabbits – Indian Microfinance Market Evolution".
[6] EDA/CGAP, "Competition and the role of External Agents: The 2009 Delinquency Crisis in Microfinance in Southern Karnataka", EDA Rural Systems, 2010.
[7] See *MicroSave*'s India Focus Note 41 "Microfinance – Time to Get to Back to Basics?"
[8] See *MicroSave* India Focus Note 43 "Commercialisation of Microfinance in India: Is it all Bad?"

MicroSave