MicroSave India Focus Note 58

The Andhra Pradesh Crisis: What Should The Government Do?

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So What Should the Government Do?

Recognise And Build On The Success: The microfinance industry in India has grown by leaps and bounds and has managed to achieve in a decade what banks could not do in more than sixty years since India's independence. Outreach has expanded rapidly and large parts of the country have been provided with financial access, albeit only for credit and not for a suite of financial products. The banking industry has supported the growth of the microfinance sector in India, and its ready provision of the funds needed for the growth of the sector have enabled the horizontal expansion.[1] In a country still looking for greater penetration of financial services, the definition of microfinance as provision of credit of `50,000 or less should be maintained and maybe even enhanced. It is well known that banks find it very difficult to extend credit for enterprises in the informal sector with credit needs of `200,000 to `500,000. Microfinance institutions should be encouraged to fill this gap while maintaining levels of transparency and realistic pricing. Alternate channels of credit provision have to be developed for the informal sector, which otherwise has suffered apathy from the formal banking industry.

Enforce Transparency: Transparency is a pre-requisite in any business and more so in the microfinance sector as it deals with millions of poor. The Reserve Bank of India (RBI), which has till recently fought shy of closely regulating the sector, should take up the challenge. Reporting standards should be developed for microfinance institutions and to the extent possible, common reporting formats and measures for sharing of information should be adopted across banks. For too long it has been speculated that some MFIs are benefitting from reporting arbitrage, leading to unhealthy practices in the industry. A growing number of MFIs are examining options to cap the returns on equity that they make, and committing to reducing interest rates, or channelling any excess returns above the target cap into their social programmes. This too could play an important role in managing the nature of investors attracted, purely-profit-focused decisions in board meetings, and encouraging a truly double bottom-line approach to providing financial services to the poor.

Regulate For Responsible Lending: Group lending in its present form is a methodology that can only go so far. MFIs should be encouraged to provide a wider range of products, not only limited to credit. Even in terms of credit, a wider range of products should be encouraged. Providing artisans and farmers access to appropriate, and cost-effective credit products should be made eligible for priority sector lending. The challenge, of course, will be to have appropriate audit/end-use verification measures in place. In terms of recovery practices, strong arm tactics cannot be tolerated; however, action should be taken against errant microfinance institutions, and not against the industry as a collective. An Ombudsman-like institution should be created for MFI clients to be able to provide a forum for redress. Another means of fixing responsibility on banks extending credit to MFIs could be to adopt an area approach in bank lending to MFIs. Banks should extend credit to MFIs on the basis of portfolio of a certain number of branches. These banks could be held accountable for errors of omission and commission at these branches of MFIs. Such an approach would encourage banks to take greater responsibility and exercise greater care in the operations of MFIs.

The RBI has the option of regulating the microfinance sector comprised of Non Banking Finance Companies – MFIs (NBFC-MFIs) on its own, or through banks, or a combination of the two. RBI should probably enhance its own capacity to regulate and supervise NBFC-MFIs, and also entrust greater responsibility to banks extending credit to MFIs. Greater supervision and care by banks could have ensured a healthier growth of the sector, early adoption of transparency measures and possibly reduction in interest rates to the end clients. However, in pursuit of priority sector targets, banks turned a blind eye to the happenings in the sector and steadfastly refused to influence interest rates or the extraordinary growth rates. The consequences of this have been detailed in IFN 55 "The Andhra Pradesh Crisis: Three Dress Rehearsals … and then the Full Drama".

Use Priority Sector Lending Requirements To Manage Growth And Encourage Operations In Remote Areas: Managing the explosive growth of MFIs could play an important role in ensuring that these organisations develop in a client-responsive and sustainable manner – rather than focusing exclusively on sales and gross numbers. Priority sector lending (PSL) requirements played a key role in encouraging the unsustainable growth rates of MFIs.[2] They should be amended to temper the incentives for rapid growth and to encourage competition. One such approach might be to limit the

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[1] See *MicroSave* India Focus Note 43 "Commercialisation of Microfinance in India: Is it all Bad?"

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

amount of lending per MFI that can be counted towards PSL requirements as has been done in the case of direct agriculture credit eligible for PSL. This would both reduce the scope for MFIs to leverage PSL debt to attract aggressive private sector equity, and encourage banks to lend to a wider range of MFIs, thus enhancing competition amongst them. Furthermore, as in the case of banks, microfinance institutions should be encouraged to set-up operations in remote areas. Access to priority sector funds should be contingent on MFIs' presence in remote unbanked areas, transparency and provision of a wide range of financial services - not only credit.

Develop Union Level Legislation: The applicability of money lending legislation of various state governments and efforts to regulate the sector through a plethora of state level legislations will harm the industry, and the poor in the country. Different state level legislations would lead to the promotion of state-specific entities as pan-India institutions will find it difficult to navigate through myriad legislations. This will ensure smaller institutions and will preclude the options of economies of scale in the provision of credit and other financial services to the poor. Hence MFIs, in all regulatory formats, should be exempt from state-specific money lending and other legislation.

Interest Rate Caps: Similarly, attempts to cap interest rates in microfinance will be detrimental for the poor and will set back the agenda for financial inclusion by decades. Clients in remote areas, in difficult terrains such as sparsely populated hills and in high cost urban settings will be denied access to quality financial services. If the regulator is concerned about super-profits being made by some of the MFIs, it should look at capping RoE rather than capping interest rates. A case against this, and the possible loopholes that such a measure will present has been earlier elucidated in *MicroSave*'s IFN 56 "The Andhra Pradesh Crisis: So What Next?". The effects of interest rates on financial inclusion have been well documented, and are almost universally detrimental to the well-being of the poor.[3]

Enhance and Encourage Banking Correspondence: RBI should also facilitate movement from microcredit to full and comprehensive financial inclusion through the banking correspondent model. As of now, attempts are being made to enhance access to savings through e/m-banking channels. Such a model will continue to struggle to break-even unless a more comprehensive range of financial services are made available. Microfinance institutions have developed expertise in low-ticket size group lending, this can be very easily expanded to cover trade-specific individual loans, savings, remittance and insurance. Such an approach by MFIs, at least for some products, acting as agents of banks, will leverage the outreach and networks already created and will also be a step forward in bringing down costs.

Recognise, And Hold Accountable, An Industry Association: The microfinance industry collectives have also been struggling to maintain focus in a sector experiencing such rapid growth. Industry associations go into overdrive at the time of crisis, but lose their pre-eminence once the crisis is resolved. A clearer and more proactive role has to emerge for industry associations – or probably an industry association, singular. Coming up with codes of conduct, which remain voluntary, on paper and not adhered to by members in practice is clearly inadequate. The microfinance sector, (and the industry association collectives), has long known the black sheep within its fold – the question that arises is why were efforts not made to expel such players? The onus of such action lies on the entire sector. A few MFIs have in the past adopted grossly unfair and unacceptable practices, which have been topics for gossip, but on which no collective action has been taken. This will have to change or else, the entire sector will have to face the consequences - as has been demonstrated by the turn of events in the last couple of months. The RBI needs to recognise and hold accountable a credible, well resourced industry association.

Be Open And Honest About The SHG Movement: The events of the recent past should not encourage the illusion that the SHG model is the way, truth and light for financial inclusion in India. People involved in the sector admit that the SHG model is struggling, and will crumble unless rapid efforts are made to reengineer it.[4] Too much has been made out of the SHG model, and too many government programmes are made to ride on SHGs. It is time for an open and honest review of SHGs - analysing why MFIs had the space to lend to SHG members when MFIs were charging 24% (or more) and SHGs were charging just 3%. NABARD, as the custodian of SHGs, should conduct rigorous analysis of the model and arrive at ways and means of strengthening it. Given NABARD's deep involvement and ownership of SHGs, it can be safely said that the staff and officers of NABARD are aware of the problems and challenges, and are capable of addressing them. Indeed the SERP programme in Andhra Pradesh has already started sincere efforts to do this.

Conclusion: The Deputy Governor of the RBI, Mr. Subir Gokarn noted on December 8th, 2010 in Kolkota that, "MFIs constitute an important component of our financial inclusion strategy. The last mile that MFIs are able to cover is not something that the formal financial sector is able to. They remain an important part of the system". We hope that this foresight and forward thinking is maintained by RBI, and indeed the whole sector … and the poor of this country do not have to pay for the aggression of a handful of players or political expediency.

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[3] See for example CGAP Occasional Paper "Interest Rate Ceilings and Microfinance: The Story So Far"

[4] See *MicroSave* India Focus Notes 15 "Delinquency in Self Help Groups", 19 "SHGs Should Balance or Break" and 44 "Savings Mobilisation in SHGs: Opportunities and Challenges"