Credit Market Failures and Microfinance: From Promise to Practice - A Case Study of the Andhra Pradesh crisis

What is the first word that comes to your mind when you hear the word “microfinance”? Did you say “Grameen Bank”, “Professor Mohammed Yunus” or “Nobel Prize”? Perhaps you immediately thought of information asymmetries, joint liability contracts and group lending. Maybe you also thought of small loans, micro-entrepreneurs, universal access to financial services for poverty alleviation in rural and urban areas, or other catch phrases such as the double bottom line and profits at the bottom of the pyramid.

Microfinance is all this and more. The practice of microfinance draws on innovations in credit assessment and provision to effectively serve a segment of the population largely ignored by the formal financial systems across the world. The early emphasis on access to credit has widened to include savings, insurance, pensions and other financial services. Since Professor Yunus handed out the first few dollars to a group of villagers in 1970, the Grameen Bank has grown to serve 7.01 million people in 75,950 villages disbursing a total amount of Taka 314.48 billion (US$ 6.07 billion). Across the world, nearly 130 million people benefit from the services of 10,000 MFIs.

But if we played the word association game for “microfinance in India”, at the top of the list, we would expect to hear one local name—“Vikram Akula”, named one of Time Magazine’s 100 most influential people—and one local event “AP crisis” (see map of the the state of Andhra Pradesh at the end of these notes). While both news items of 2006 are credited with spurring microfinance into the mainstream consciousness of the nation, a

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1 These notes were prepared by Annie Duflo, Rati Tripathi and Michael Walton and are solely for teaching purposes.
closer look at the troubles in the southern Indian state of Andhra Pradesh (AP) provides a useful setting to understand when and in what ways the promise of microfinance can break down in practice.

**Analytical context**

We give a brief account of the analytical issues around credit market failures and how microfinance helps to solve them: for further formal treatment see in particular Bardhan and Udry (1999) and Ghatak and Guinnane (1999).

**Information asymmetries and imperfect markets**

If markets were perfect, with full information, no contracting problems, and zero transaction costs, everyone, including poor people, would be able to save and borrow at the equilibrium, market-determined interest rate, for either investment, working capital or consumption-smoothing needs. Decisions would be made solely on the basis of returns on investment projects and preferences over the inter-temporal allocation of resources.

Yet a major theme of microeconomic theory is precisely that credit and insurance markets are highly imperfect in developing countries, and that these imperfections are typically particularly pernicious for the poor. There are widespread problems of both information asymmetry and contracting. Lenders have incomplete information on the value of investment projects, on the effort of borrowers and of their characteristics. We focus on two classic problems here. First, lack of information on effort is a classic example of hidden action and the potential for moral hazard: once a loan has been given, there are incentives not to use it for the purpose intended, but for other “lower effort” activities, and default if returns are low. Lack of information on borrower characteristics is, similarly, a classic problem of hidden information on the type of borrower raising the possibility of adverse selection: lenders cannot tell whether borrowers are a “defaulting type” or “repaying type”. When borrowers have problems with payments, lenders cannot tell if this is due to bad luck, lack of effort, or the borrower’s character, that is whether default is strategic or because of circumstances. Finally there are enforcement problems, or, more subtly, borrowers cannot credibly commit to repay in a future period.

We first illustrate the underlying issue with a simple set of models (drawn directly from Bardhan and Udry, 1999, Chapter 7.) Take a simplified situation of a farming activity with costs normalized to 1, that yields return \( R>1 \) in a good year, and 0 in a bad year. Crucially, the probability of a good year is a function of farmer effort, and is given by \( \pi(a), a \in [0,1] \); assumed to be strictly increasing and concave (increased effort increases the probability of success, but a diminishing rate). A farmer lacks wealth and needs to borrow for working capital, at an interest factor (that is 1 plus the interest rate) of \( i \leq R \). There is disutility of effort, valued at \( D(a) \); this function is assumed to be increasing and strictly convex.
The farmer thus earns $R - i - D(a)$ in a good year, and $-D(a)$ in a bad year, assuming limited liability (no payments in a bad year.) Her expected utility can be expressed as $U(i,a) = \pi(a)(R - i) - D(a)$.

The lender earns $i$ in a good year, and 0 in a bad year, assuming there are no enforcement problems in collecting the loan. His expected return is $\Pi(i,a) = \pi(a)i$.

Assume the farmer has an alternative activity, say of unskilled work, at wage $W$, that provides her reservation utility. The lender can borrow money in a risk-free capital market at $\rho$, that provides his reservation price. Now we can illustrate some of the features of the market under alternative assumptions.

**Moral hazard**

We can illustrate the problem of moral hazard by comparison with the benchmark case of a competitive loan market with complete information.

If the loan market is competitive, and lenders can observe effort, then they can write contracts that specify both the interest rate and the effort level. An equilibrium exists if there is a solution that meets the participation constraints of farmers and lenders, and is preferred by farmers to all alternative contracts (with different mixes of interest and effort). This is a solution to the following:

$$\max_{i,a} \pi(a)(R - i) - D(a)$$

subject to $\pi(a)i \geq \rho$

and $\pi(a)(R - i) - D(a) \geq W$

Figure 1 illustrates the implications of alternative interest rates and effort levels for the lender and borrower. For lenders, the constant return curve is downward sloping and convex--at a lower interest rate, higher effort is required to achieve the same level of $\rho$.) All outcomes above the lowest curve $\Pi(i,a) = \rho$ satisfy the first constraint.

Indifference curves for borrowers are concave, with welfare higher for lower curves (with lower interest and/or effort). They are at a maximum with $0 < a < 1$, given the assumptions on $\pi(a)$ and $D(a)$. The participation constraint is represented by the highest curve shown, that is $U(I,a) = W$.

Given competition and complete information, if there is a solution (that occurs if the $\Pi(i,a) = \rho$ and $U(I,a) = W$ curves cross) the equilibrium will be when $\pi(a)i = \rho$ and at
the maximum level of utility ($W^*$) that satisfies this: at point 1, when $D'(a) = \pi'(a) R$.

Figure 1. Credit market outcomes with and without complete information: moral hazard

If, however, lenders cannot observe effort, they cannot specify effort in the contract, and instead have to offer contracts in which the farmer chooses $a$, given $i$. This involves the addition of a third constraint to the maximization problem, that now becomes:

$$\max_{i,a} \quad \pi(a)(R - i) - D(a)$$

subject to

$$\pi(a)i \geq \rho$$

$$\pi(a)(R - i) - D(a) \geq W$$

and

$$\pi(a)(R - i) - D(a) \geq \pi(a')(R - i) - D(a), \forall a' \in [0,1]$$

If a solution exists (as before, the first two constraints have to be satisfied), this will involve a lower level of effort, a higher interest rate, and a lower level of utility for farmers. Why is there lower effort? Since the farmer’s utility function is continuously differentiable and strictly concave, a necessary and sufficient condition for the third set of constraints to be satisfied is a necessary and sufficient condition for the third constraint to be satisfied is $\pi'(a)(R - i) - D'(a) = 0$. If there is a solution $[a_2, i_2]$ this then implies $D'(a_2) = \pi'(a_2)(R - i_2) < \pi'(a_1)(R)$ and so $a_2 < a_1$ and $i_2 > i_1$. This is shown as point 2 in Figure 1: given $i_2$ this is where the farmer maximizes her utility.

Bardhan and Udry also show that a local monopolist who has complete information is able to write contracts that maximize his returns, through offering contracts with with the
optimal effort level $a_i$ but force farmers down to their reservation utility, $W$, with an interest rate $i_3$, at point 3 in figure 1.

**Adverse selection**

Let’s now turn to the case of more than one type of borrower. Differences could be due to different qualities of land owned, or different attributes of the farmers—including different skills and attitudes to repaying. The interesting case is when riskier types also have higher returns. For simplicity assume no effort is required, and suppose there are two types of farmer, (1) and (2): the first type faces a lower but more secure return: if the return to the farmer of type $t$ in a good year is $R(t)$ (and zero in a bad year) and the probability of success is $\pi(t)$, then $R(1) < R(2)$ and $\pi(1) > \pi(2)$. For clarity of the results assume expected returns are the same, $\pi(1)R(1) = \pi(2)R(2)$.

If a farmer borrows at interest rate $i$, her expected utility is $U(i, t) = \pi(t)[R(t) - i]$. Since there is no payment in the case of harvest failure and $\pi(1) > \pi(2)$, this is lower for type 1 (more secure) borrowers for any given interest payments.

The expected return to a lender for a loan to a borrower of type $t$, $\Pi(i, t) = \pi(t)i$. This is higher for type 1 borrowers for any given interest payments, since they are more likely to repay.

In a competitive market with complete information, different contracts could be written for type 1 and type 2 borrowers, that satisfied the participation constraint for the borrowers and were above the cost of funds for lenders.

Where information is limited, lenders can only offer one contract. The key results are illustrated in Figure 2, again drawn for cases where an equilibrium exists. Type 1 farmers will take loans up to a threshold interest rate $i^*(1)$, at which $\pi(1)(R(1) - i) = W$, their expected returns equals their reservation utility. They then drop out of the market. This causes a discontinuous fall in the expected profits of lenders, since type 1 borrowers are more profitable for them (at given interest). Above this they can still lend to type 2 farmers, up to their threshold of $i^*(2)$, at which $\pi(2)(R(2) - i) = W$. After that there is no lending.

Figure 1 is shown for a competitive market at two loan rates: at $\rho_a$ only type 2 farmers borrow, and the interest rate is $i_a$; at $\rho_b$ both types borrow and the interest rate is $i_b$.

In this set up there is no rationing. The famous Stiglitz and Weiss result of credit rationing can occur with an upward sloping supply curve for loanable funds—for more detail see Bardhan and Udry or the original article.
Figure 2. Credit market outcomes with incomplete information on borrower types: adverse selection

![Graph showing credit market outcomes](image)

**Solutions**

Formal and informal financial systems have developed many ways of solving these informational and contracting problems. These include the use of collateral and the deployment of resources to screen potential borrowers, monitor their use of funds and assess debt repayment problems. But neither of these help poor people access formal financial resources: they lack the type of collateral that can be legally appropriated in the event of default, and screening and monitoring costs are prohibitively expensive for small borrowers. Illiteracy and difficulties in managing the financial flows required of formal banks are further barriers to access. Informal finance—family, friends and moneylenders—can make use of social sanctions and the in-depth knowledge of small groups. But this is also high risk and costly for lenders, so interest rates are typically very high—even where “markets” are reasonably competitive.

The consequence is that poor people face a much higher hurdle rate for investment projects, and face much higher costs of inter-temporal consumption-smoothing and risk management. This makes poverty worse in the short run, and makes it harder to escape from poverty—and indeed can be sources of poverty and inequality “traps”.

**The micro finance solution**

The micro finance approach addresses these problems through innovations in contract design, that make use both of local knowledge and social networks and of adaptive organizational structures.
Joint liability: A common approach in many microfinance institutions is the group lending. All borrowers are asked to select 5-10 other people and form a small group popularly known as a Joint Liability Group (JLG) before they can take a loan. Group members act as co-referees at the time of application and later as co-guarantors for each other’s loans. This gesture is formalized as a clause in each member’s loan contract: it is each group member’s responsibility to cover for each other if any member is unable to make an installment or the entire loan. The two underlying assumptions here are that borrowers are well acquainted with each other from previous social or business interactions, and that like borrower types will attract others of similar type i.e. ‘good faith’ borrowers will only permit other ‘good faith’ borrowers into their group (see Ghatak and Guinnane for a formal treatment of this). Lenders do gather background information on occupation, income level, gender, age, and housing situation to make sure micro credit is reaching the intended socio-economic segment of the population. But in essence the information problem has been outsourced to the group.

- **Adverse selection** – it is thus up to the borrowers to exploit existing personal relationships and select trust worthy members into their group.

- **Moral hazard** – borrowers meet often, and may well live close to each other and therefore can easily monitor general economic well being, how group members are using the loan, verify individual or local economic shocks and make a fair determination of members’ “efforts” and ability to pay installments.

- **Enforcement** – each borrower has a vested interest in helping loan officers collect installments in a timely fashion because borrowers are contractually obligated to pay on behalf of group members when so required.

Dynamic incentives: Joint liability contracts become even more effective when combined with a carrot and stick tactic universally used by credit suppliers. Micro credit borrowers are told that if they default on a loan, not only will they be denied another loan; all other members of their group are bound to this common fate. If borrowers wish uninterrupted access to credit, they must maintain a clear repayment record by their whole group. Note that such dynamic incentives also work for individual loans, but are reinforced by interactions with the joint liability structure. (And indeed some microfinance institutions do make individual loans, that are not guaranteed by the group.)

Savings: In some cases, borrowers are asked to regularly keep small sums of savings with the lender. These savings, often compulsory and inaccessible during the tenure of the loan, play the role of collateral in the absence of formal documents such as property titles or other assets. This can be useful for borrowers, since the rhythm of savings and borrowing needs can be quite different.

Repayment schedule: The standard micro credit contract sets the loan tenure of one year, payable in 50 weekly installments. Smaller and more frequent installments
make it easier for borrowers, often daily or weekly wage earners, to manage household expenditure. (Note there is active exploration in India of how to design more flexible repayment reschedules to deal with unexpected shocks, without re-introducing problems of moral hazard.)

In addition, there are some aspects of the organizational structure of the microfinance institutions (MFIs) themselves that helps them provide micro credit in a way formal credit suppliers usually cannot.

- **Strict monitoring:** The frequent repayment schedule serves a crucial purpose in putting the MFI in constant touch with borrowers. Indeed, the central activity of the MFI is visiting borrowers to disburse loans and collect installments at their place of residence. As originally conceived, micro credit is a doorstep delivery product. Borrowers need never visit the offices of the MFI. In the context of scant infrastructure in developing countries, especially in rural areas, doing so would normally mean missing a day’s work or arranging for expensive private transportation. The high cost of these practical conveniences is borne by borrowers who are willing to pay interest rates that are typically two to three times higher than bank charges, but nearly always cheaper than local moneylenders or pawnbrokers.

- **Local presence:** Furthermore, MFIs are locally situated and rooted organizations. MFIs have branches close to their borrowers, hire field workers from local communities and gradually become a part of the economic landscape in that area.

- **Staff incentives that encourage them to reach to poor people:** Perhaps the most poignant difference between MFIs and banks is the difference in the staff’s attitude towards poor people. Financiers across the world are notorious for spurning penniless credit seekers and opening the floodgates as soon as you make your first million rupees, taka, dollars etc (insert your favorite currency here). MFIs hire field workers whose socio-economic background is not too distant from their clients. Employees can speak the local dialect and are willing to listen to clients. They become familiar with local agricultural and business conditions. The pay scale for field officers is often attuned to numbers on client outreach and portfolio size. This variable component makes the major part of the field officer’s monthly salary.

It can seem puzzling that microfinance borrowers are willing to pay such high interest rates (albeit lower than rates charged by informal moneylenders). This suggests that rates of return earned by micro-entrepreneurs would be very high, at least equal to MFIs’ interest rates. Although there is no good empirical data on the rates of returns of micro-enterprises undertaken by micro-borrowers, Stiglitz et al (2006) provide an interesting theoretical explanation of why micro-borrowers are able to repay with such high interest rates in some circumstances. If the labor market for women is close to inexistent, the opportunity cost of labor is valued as close to zero, and the selling price of labor is therefore lower than its buying price. As long as the micro-business is small enough and does not require outside labor, the rate of return can be very high
Microfinance has clearly been a remarkable innovation (or series of innovations) that seeks to effect organizational change to tackle the market failures that are so central to the lives of poor people. But, there is still a lot that is not known about the impact of microfinance, with few studies that have carefully documented the effects with convincing controls. (This is an active area of research, notably in the Centre for Micro Finance at the Chennai-based Institute for Financial Management and Research.)

The Indian context

According to official estimates, the Indian economy grew at an astounding rate of 9.2% in the most recent fiscal year 2006-7, to reach a gross domestic product at current market prices of Rs.4,100,636 crores ($930 billion), making it the tenth largest economy and second fastest growing major economy in the world. The second most populous country in the world, India is home to approximately 1.1 billion people living on an annual per capita income of Rs.37,180 (US$845). The latest official poverty estimates based on large sample surveys by the National Sample Survey Organization (NSSO) in 2004-5 put 22% of the population under the national poverty line.

After securing independence from British colonial rule, the first sovereign Indian government decided to adopt a centralized approach to managing the economy to achieve its core political goals of equitable social development. The central government drew up five-year plans to direct all major financial and industrial activity. During 1951-85, all commercial borrowing was influenced by these five-year plans. Private sector growth was fettered by burdensome regulation, dubbed the License Raj. India’s mixed economy grew at the infamous “Hindu” rate of growth of 3.5% in the post-independence years up to 1980. Some reduction in regulations began in the 1980s. Then in the face of a balance of payment crisis in 1991, the Indian government embarked on a set of comprehensive, but gradual, economic reforms, reducing government control on foreign investment and trade, opening up markets and allowing greater private participation in domestic financial markets, including permitting the entry of foreign banks and insurance companies. An active debt management policy was put in place and efforts were made to broaden and deepen financial markets to make it more efficient. According to the World Bank Development Indicators (2005), India registered an average annual growth rate of 5.9% during the years 1990-2003.

India’s central bank, the Reserve Bank of India (RBI) was constituted in 1935 to regulate the issue of banknotes, maintain reserves with a view to securing monetary stability. It was nationalized in 1949 and played an important role in the planned development of the

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3 The Economic Times. December 4, 2006. “India sees rising living standards, as poverty ratio declines” http://economictimes.indiatimes.com/articleshow/702850.cms. Note that the Indian poverty line is low by international standards—actually less than the PPPUS$1 per person per day that is commonly used.
country, especially in agriculture. The RBI was instrumental in building the Indian financial landscape, setting up institutions such as Unit Trust of India, the Industrial Development Bank of India and the National Bank for Agriculture and Rural Development (NABARD). With economic liberalization in 1991, the RBI’s focus has shifted back to core central banking functions, including monetary policy, bank supervision and regulation, overseeing the payments system, and developing the financial markets.\(^4\)

In 1969, the Indian government took over the 14 largest private banks, followed by another seven in 1980. It was felt that private banks had failed to contribute to a young country’s social and economic development goals. The stated purpose of nationalization was to direct credit flow to neglected sectors such as exports, agriculture, small industries and small scale borrowers in rural areas. The government introduced the concept of “priority sectors” and made it a rule for all banks to provide 40% of net credit to businesses engaged in these activities\(^5\). Nationalization led to an impressive expansion of banks’ branch network, especially into rural areas. In 1976, a new set of low cost institutions called Regional Rural Banks (RRB) were created to meet credit demand in rural areas, particularly from socially and economically underprivileged sections of society. By 1991, there were 196 RRBs with over 14,000, predominantly rural, branches in 476 districts with an average coverage of three villages per branch. From only 8261 in June 1969, the number of branches of commercial banks increased to 65,521 in 2000.\(^6\) Thanks to these two major policy initiatives, the population per rural bank branch fell from over 200,000 in 1969 to about 20,000 at present. The proportion of borrowing of rural households from institutional sources rose from 7% in 1951 to about 60% at present.\(^7\)

But things did not go quite according to plan. RRBs struggled to become financially viable, grappling with grim recovery rates, estimated as low as 25-33% on loans sanctioned under the Integrated Rural Development Programme (IRDP), India’s twenty-year long flagship poverty alleviation scheme. The main internal reasons for the failure of RRBs were weak monitoring and supervision, apathy towards loan recovery, and failure to link lending with development and ensure sound end use of the loan. External factors included political interference, willful default, drought and floods, underdevelopment, lack of legal and administrative support from the state government in the matter of recovery, etc.\(^8\)

\(^4\) For more information see http://www.rbi.org.in/History/Brief_History.html
\(^5\) The list of activities includes agriculture and allied activities, small scale industries and housing.
http://www.macroscan.com/cur/jul05/cur210705Bank_Nationalisation.htm
\(^7\) All India Debt and Investment Survey (2003).
http://www.macroscan.com/fet/jul05/pdf/RRB_Debate.pdf
As of March 31, 2006, 36% of gross bank credit was given to the priority sector. But the share of credit from all scheduled commercial banks to agriculture and allied activities stands at 12% today against 16% in March 1990. The credit share of small scale industries over the same period has shrunk by half to 6.5%.

And there is a long way to go. At present, there are approximately 310 million savings accounts in India. Close to 60 per cent of rural households do not have a bank account and only 21 per cent have access to credit from a formal source. In December 2006, only 24% of total deposit accounts and 18% of total credit accounts at all scheduled commercial banks were held by rural and semi-urban households.

The financial sector reforms of the early 1990s motivated policy planners to search for new strategies for delivering financial services to the poor in a sustainable manner with high repayment rates. Over the last decade, microfinance has slowly but surely gained prominence among policy circles, capturing space in the Finance Minister’s Union Budget speech regularly in recent years.

**The microfinance sector in India**

There are two models of microfinance in India. In 1992, the government started a national programme through the National Bank for Agriculture and Rural Development to support NGOs that were organizing poor people in rural areas into Self Help Groups (SHGs) and helping open savings accounts and get loans at the nearest bank, usually a public sector or regional rural bank. This became known as the SHG-Bank linkage programme—see Figure 3.

SHGs are a homogeneous group, typically of 15 to 19 poor people, and mainly women. According to Indian law, the SHG may continue to meet as an unregistered association as long as the size of membership is less than 20. SHGs elect three office bearers and usually function according to an NGO’s advice or guidelines set by NABARD. Each member of the SHG saves a small sum regularly, typically Rs.10-30 per month. SHGs use pooled savings to give interest-bearing loans to members through group decision. Depending on the maturity of the SHG, often after six months, banks open a savings account in the name of the SHG. A SHG federation or NGO usually incubates the SHG and helps it deal with a bank. Banks sanction a loan to the SHG as a multiple of the pooled savings at normal bank rates for loan tenure of one to two years with a monthly repayment schedule. The average group loan granted to an SHG in 2006 was Rs.50, 913.

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9 Tamal Bandyopadhyay. December 1, 2005. “Rural banking without roots”
http://in.rediff.com/money/2005/dec/01guest3.htm


11 For more information on NABARD’s microfinance activities, see
www.nabard.org/roles/microfinance/index.htm

12 A SHG federation is a registered body of office bearers that represent a large number of SHGs from a particular locality.
The SHG divides up the group loan between members, often charging individual members higher interest rates than the bank charges.

NABARD refines these loans at a low interest rate to encourage banks to lend more. As of March 31, 2006, 2.2 million SHGs representing 32.9 million poor households had been linked to a bank and received cumulative loans of $2.5 billion from 545 commercial banks working with 4741 NGO partners across 583 districts.\(^{13}\) Currently, the bulk of micro credit in India is funneled to poor people via the SHG-bank linkage programme.

In this model, the interest rate does not reflect the cost of forming the groups, since this is borne by the NGO—and would generally be financed by grants. The NGO has no financial liability since the lending contract is between the SHG and the Bank directly.

A second model that also emerged in the 1990s is financial intermediation by Micro Finance Institutions (MFIs)—see Figure 4. MFIs are professionally run institutions specialized in delivering credit with low-cost staff and local knowledge. Most MFIs in India replicate the methodology pioneered by the Grameen Bank of Bangladesh\(^ {14}\). This model is implemented by NGOs and private organizations, whose growth was facilitated first by grants and subsidized debt from international donors and government agencies such as the Small Industries Development Bank of India (SIDBI). In recent years, we have seen increased involvement of private commercial banks due in part to the priority sector lending rule, in part as a gesture of corporate social responsibility and in part to

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\(^{13}\) There are 602 administrative districts in India.

\(^{14}\) See www.grameen-info.com
global attention turning to microfinance as a demonstrably successful private sector approach to poverty alleviation. MFIs now borrow at commercial rates from public and private banks to lend onward to clients organized into SHGs or joint liability groups (JLGs) and, under some circumstances, to individual borrowers. The operational cost incurred by MFIs translates into the higher interest rates ultimately paid by the end user.

The microfinance sector in India is largely unorganized and is not yet officially recognized under a uniform regulatory framework. As a consequence, there is no aggregate data on MFI activities. According to estimates from NABARD, there are about 800 MFIs in India, ranging from small NGOs with a client base of a few thousand to large private companies with nearly a million clients across the country. Expert estimates suggest that the top 15 MFIs account for about 70% of the credit supply through MFIs. In its 2006 annual report, Sa-Dhan, the national association of MFIs, estimated that MFIs covered over 3 million active clients with an outstanding portfolio of $243 million in 2004-5. In the last three years, India’s largest private bank, ICICI Bank has shown a new interest in microfinance and a broader commitment to financing rural development through a variety of creative financing techniques that included working with new partners. One simple statistic demonstrates how ICICI Bank single-handedly changed the contours of the fledgling sector. From March 2005 to March 2006, ICICI Bank achieved a growth rate of 239% on microfinance loans, reached an outstanding portfolio of $511 million for 3.2 million clients managed by 102 MFI partners. In comparison, the total increase in credit flow to SHGs nationwide during this period was 56%.

In this model, the MFI takes the loans on its balance sheet, and bears the entire risk, or the Bank shares the risk with the MFI – this is called the partnership model. In both

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15 For more information, please refer to www.sa-dhan.org

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cases, the interest rates are higher than in the previous model since MFIs have to cover all transaction costs incurred, and there is no subsidy at all. In addition, the loan size is not bound by the savings size as in the previous model.

The crisis in Andhra Pradesh

On the night of March 8, 2006, the local administration of Krishna district in coastal AP ordered a raid on branch offices of two leading MFIs, Spandana Sphoorty Innovative Financial Services Ltd. and SHARE Microfin Ltd., uncovering incriminating evidence of questionable practices such as blank papers bearing client signatures. The administration ordered the raid in response to a demonstration led by a local politician against SHARE. Borrowers threw stones complaining that SHARE had improperly taken original house title deeds as security for housing loans. The district collector promptly confiscated records and closed down about 57 branches in the district. Offices of two smaller MFIs in the district were also shut down. The administration announced that borrowers need not repay because the MFIs had broken several laws. Indeed, about 300 cases were reportedly filed by revenue authorities during the next few weeks. Borrowers were told their loans would be taken over by public sector banks or ‘Velugu’, the World Bank funded state government’s micro credit program that hands out substantial direct subsidies on bank loans to Self Help Groups (SHG). Repayment rates to MFIs instantly dropped to 10-20% in Krishna district. Many branches opened within a few weeks but in view of the general unfavorable climate, field officers did not start collections for a while longer. Borrowers awaited further government orders.

The vernacular and national media caught on to the story with great gusto. Over the previous few months, public complaints of misbehavior and malpractices, such as hidden charges and effective annual interest rates of 35-50 per cent against microfinance institutions (MFIs), had surfaced in four rural districts of AP. The press exposed common MFI practices such as quoting flat interest rates, adding insurance premiums to the loan amount, taking 5-10% of the loan amount as a security deposit and charging opaque miscellaneous fees without issuing receipts. However many reports were factually incorrect and blatantly biased. The insurance premium goes to the insurance provider and, in case of death, the loan is waived and payments returned to the borrower’s spouse. Security deposits are refundable to the client at the end of the loan tenure after full repayment. Several media reports erroneously included such charges in the calculation of the effective interest rate, arriving at eye-popping headlines. Newspapers printed different figures every day for the number of suicides caused by abusive behavior and harassment by loan officers.

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18 Eenadu (Vijaywada). March 20, 2006. “Micro-loan leading to misery”. This article talked about the high interest rates (around 50% to 60%) charged by microfinance institutions. The burden of these loans allegedly led 50 women to commit suicide in Krishna, Guntur and Prakasam districts.
The national association of MFIs, Sa-Dhan held a press conference to publicize a voluntary code of conduct addressing the main concerns raised by the AP government.

- MFIs will not compete with SHG-Bank linkage programs and avoid over financing the same household.
- MFIs will not take public savings unless legally permitted to do so. MFIs will charge fair rates on a declining basis as per the interest rate schedule drawn up by Sa-Dhan.
- MFIs will not take original documents as collateral security for loans. MFIs will dismiss any field officers engaging in abusive language or intimidation tactics to recover loans.
- MFIs will adopt a high standard of corporate governance, financial transparency and public accountability.

Since the biggest MFIs in the country, including Spandana and SHARE are legally registered with the RBI, the regulator stepped in to play the role of mediator. On April 20, at the maiden meeting of a Coordination Forum, RBI noted that ‘Velugu’ staff reportedly told MFI clients their loans would be assumed at the highly subsidized interest rates of 3% and encouraged them to default. A heated argument took place between state government officials, bankers and RBI representatives over the functioning of MFIs. The RBI reportedly rejected the allegation of frequent harassment of borrowers by the MFIs, characterizing excessively harsh tactics as isolated incidents. The RBI asked MFIs to come up with an action plan to execute their promises to cut interest rates. Spandana and SHARE had already assured the AP state government that they would charge only 15 per cent on a diminishing interest basis with effect from April 1st, 2006. The new interest rate would apply to all outstanding loans as well as new loans. Only one MFI stood firm and recorded its dissent at the meeting making forceful arguments against capping of interest rates. Stressing the high transaction costs associated with microfinance practices, the industry leader said rates below 21-24% were not financially sustainable and reminded the gathering that the state government could not impose interest rate caps because MFIs did not fall under the purview of state moneylender laws.¹⁹ The threat of artificial caps on interest rates brought more attention to the microfinance sector in the mainstream financial press.²⁰

Meanwhile, the state government appointed a one-man enquiry commission, that returned findings of gross human rights violations and excessive profits by MFIs. The special secretary heading the commission recommended capping interest rates at 12 per cent,

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¹⁹ MFIs in India operate as legally registered organizations regulated as per various central and state authorities including the RBI, Registrar of Companies, State Registrar of Cooperatives, Registrar of Societies and Trusts.
increasing loan tenure up to three years and changing the frequency of repayment from weekly to monthly.\textsuperscript{21}

The government commissioned further study of harassment and suicide claims and constituted a High Level Committee headed by the state finance minister. The Chief Minister made several high profile speeches over the summer reiterating the threat that a moneylenders’ act would enforce interest rate ceilings on MFIs. Such an act is not yet in place and no formal outcome of the Committee has been announced.

In May, RBI issued new instructions to all MFIs under its jurisdiction to follow ethical practices. The most ambiguous of alleged MFI excesses in AP were unethical loan recovery practices. Borrowers reported a variety of tactics commonly employed in various combinations - seizing ration cards or house documents, locking up the house, forcing clients to stand in the sun until they repay, advising clients to commit suicide, asking clients to pay for additional petrol costs incurred by loan officers and forcing clients to prepay before the end of the loan tenure. However, there are no statistics on how widespread these tactics are.

It is hard to pinpoint exactly when and why theory and practice untwined in AP. There are a number of factors that played a role in the chain of events in AP.\textsuperscript{22}

The First Competition Story. The top MFIs in India have been working on an accelerated expansion strategy, rushing towards loan portfolio volume and client outreach targets. Two of the four leading MFIs of AP (and India), Spandana and SHARE have roughly doubled in size in the last few years. This sudden spike in the growth trajectory of the sector as a whole can be traced back to the new interest and commitment to microfinance as a means to achieve financial inclusion from private investors and commercial lenders in India and worldwide. ICICI Bank has been a leader in using innovative financing techniques to remove bottlenecks and unleash copious amounts of inexpensive capital into the sector\textsuperscript{23} Coastal AP in particular, is saturated with microfinance operators; new and old, big and small. Informal moneylenders locally known as ‘girigiri’ bankers remain widely present and active in these areas. A survey of 130 borrowers in Krishna district conducted by APMAS, a Hyderabad-based research organization specialized in SHGs, immediately after the crisis, found that 18% of respondents borrowed from moneylenders to make payments to MFIs. Yet 80% also felt that they were less dependent on moneylenders since the arrival of MFIs. 82% reported taking loans from more than one microfinance lender (Spandana, SHARE or Velugu).

In the face of competition, ground principles of credit assessment may have been overlooked. The fixation on rapid expansion gives field officers incentives to enroll new

\textsuperscript{21} The Times of India. May 9, 2006. “Probe throws human rights rap on MFIs”

\textsuperscript{22} See also HSS Hylendra in Economic and Political Weekly. May 20, 2006. “Microfinance Institutions in Andhra Pradesh: Crisis and Diagnosis”

\textsuperscript{23} See Deccan Herald (Hyderabad). April 9, 2006. “Banks aggravate micro finance crisis”. For more information on how ICICI Bank finances MFIs, see Bindu Ananth (2005).
clients and hand out larger loans without worrying too much about portfolio quality. Competition along these lines results in lending too much or too quickly, thus weakening the powerful group mechanisms of selection and monitoring. It is tricky to enforce contractual obligations if both parties know legal recourse is too expensive and impractical, so the promise of continued access to larger loans usually works very well for microfinance institutions. But dynamic incentives falter when MFIs do not share credit information and clients have no trouble taking loans from a competitor. Most MFIs practice a policy of zero tolerance of defaults. This results in harsh tactics and unsympathetic attitudes to all late payments, whatever be the reason. With such politically susceptible complaints, it is hard to later distinguish between willful defaulters and rightfully irate borrowers. The question of how to introduce flexibility in lending practices without destroying credit discipline is an important area of experimental research in the Indian microfinance sector right now.\textsuperscript{24}

The Second Competition Story. The state of Andhra Pradesh leads the microfinance sector in India. As already noted, AP is saturated with microfinance in various garbs – credit cooperatives, small NGOs working with SHGs, government-promoted SHGs, SHG federations, small and large MFIs. The government is a major promoter of SHGs and has made cheap credit one of its important policy initiatives. The Velugu program covers well over 90\% of all poor households in the state. But SHGs are unattractive vis-à-vis MFI lending for several structural reasons. MFIs dole out larger loan amounts more quickly and are not bound to savings size. Perhaps more importantly, borrowers get individual loans (with joint liability) instead of a group loan. Membership to both programs carries different benefits so clients usually prefer to maintain dual membership rather than quit any one.

The state government is very sensitive to the political importance of the Velugu program and was not pleased with the success of MFIs charging seemingly exorbitant and exploitative interest rates. Members of Velugu SHGs were taking loans from MFIs and paying those back first. The state government reacted in the manner of an offended but powerful godfather. Many people feel it is not a coincidence that the biggest vernacular daily is owned by one of the most prominent chit fund\textsuperscript{25} operators in the state. Politicians and government officials in India have ruled over the destinies of the poor rural populace

\textsuperscript{24} The Center for Microfinance is engaged in several academic research projects on this topic partnering with leading MFIs in India. For more information, see \url{www.ifmr.ac.in/cmf}

\textsuperscript{25} Chit funds or chitties are similar to the rotating savings and credit association (ROSCA) seen in other parts of the world. A group of 10-20 people meet regularly for a predefined length of time to pool together a fixed amount of money. A lottery or bidding process allocates the group savings to any one member to use as she sees fit and repay (with or without interest) within the period of the fund. Each member has a turn so the last person who wins the group savings is indifferent between saving on her own or with the ROSCA. Indeed, ROSCAs are a useful way to inculcate savings discipline. In India, both informal chitties and registered chit operators exist. Thanks to high interest rates paid to savers, transparent participation rules and strict enforcement, formal chit funds are fast becoming a popular alternative to bank loans and savings accounts. Housewives and salaried professionals tend to be net savers and small businessmen tend to be net borrowers.
since Independence and for private lenders to barge in without so much as a letter of introduction was unpardonable. Indeed, the biggest learning for the fledgling microfinance sector from the AP crisis was the failure of rapidly expanding MFIs to recognize and manage their own impact on the political and economic order of the state.

Policy questions

You are advising the RBI. One of the solutions strongly advocated by the newspapers and other stakeholders is to put a cap on interest rates for MFIs, as it has been argued that MFIs charge excessively high interest rates. The fact that MFIs have reduced their interest rates after the crisis seems to confirm this point of view. Should you put a cap on interest rates?

You are advising the World Bank. Within the World Bank, there are two camps: one advocating interest rates that allow MFIs to recover their costs, and minimum intervention from government in these matters. The other camp advocates the Velugu program as a success. After the huge crisis, how would you advise the WB to react? Should the WB stop the subsidized interest rate project? Should the WB decide that micro-credit should not be a matter where government should be a party, and therefore stop this project altogether, and if anything finance government actions that would allow to manage the competition (such as credit bureaus)?

You are advising the State government and/or the RBI. The State government and the RBI realize that competition between MFIs, even though it might have benefits and result in improved services and prices can be harmful. Especially, the competition between the “private” model and the government model seems very harmful and the government should be helping manage the competition rather than be a party in the competition. Clearly, some actions need to be taken to manage the competition. What steps would you advise?
References

Theory


Microfinance in India


Map of Andhra Pradesh