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INDIAN MICROFINANCE CRISIS

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Suppose you were shot in the hand. The doctor gives you two choices: he can either remove the bullet and heal your hand with proper care, or he could amputate and remove the source of the problem. The Andhra Pradesh (a State in India) government would advise you to take the latter option.

The absurdity of the advice in the above case is evident, but when placed in the context of Microfinance the principle gets muddled. After the revolutionary 'group-lending' mechanism was introduced by the Grameen Bank, Bangladesh, Microfinance Institutions were no longer considered a loss making, unsustainable model and different versions of it were adopted across the world. India was not to be left behind.

Vikram Akula, the founder of SKS Microfinance in India, dreamt of making a microfinance firm that would not be based on donations or government grants, but on private investments. By developing a model that allowed them to not only help the poor, but also provide the investors with reliable returns, SKS was able to take the next step and form a completely self-reliant model. The insurgence of private investment allowed SKS to reach a lot more people and become the largest Indian Microfinance firm in a little over a decade. By 2010 SKS was serving more than 7 million people across the country and had been joined by numerous other companies.

Then the government stepped in. Citing several cases of suicides and complaints of 'coercive means of recovery'[1] the Andhra Pradesh government passed the MFI Ordinance Bill on the 15th October, 2010. The bill was implicitly designed to shut down the MFI industry in Andhra Pradesh. The MFIs were not permitted to recover their loans and a series of regulations were passed that rendered the business unsustainable. With no recovery of loans in the foreseeable future, banks stopped lending to MFIs, crushing their operations and hope of survival. MFIs portfolio in Andhra Pradesh amounts to 6000 crores rupees (1.2 billion USD) all of which will be lost with no one held accountable.

So did the MFIs have it coming? For many countries, 50 people committing suicide due to economic pressure is a cause of massive concern and an immediate sign of something being amiss. But in India these rates are part of everyday life. The crude honesty is that life in India is cheap. The National Crime Records Bureau stated that there were 16,196 farmers who committed suicide in 2008 alone, not including student suicides, domestic suicides, etc. This begs the question whether the 50 or so suicides that the Government of Andhra Pradesh cited were due to the new pressure of the MFIs or the already existing circumstances.

This does not mean that the MFIs are completely clean. The complaints of coercive recovery means cannot be baseless. MFIs always have to tread in the grey area when it comes to recovering loans and there is a good chance that they stepped too far. They should discipline their employees on the first sign of complaint. The fact is that this industry is extremely sensitive and quick to be judged and the MFIs have to look after their reputation.

That said, the ordinance was still too aggressive. The government, just like the doctor of our gun-shot victim, should have nurtured the industry and placed some carefully designed regulations to stop

[1] Andhra Pradesh MFI Ordinance, 15th October, 2010.

the mal-practices. Instead, the Andhra Pradesh government amputated its limb which will not allow it to function to its full capacity.

The MFIs have been researched and debated enough to leave no doubt as to their potential benefits and yet the government has chosen this course of action. Is it just their irrationality, or a lack of understanding of India's often uneducated leaders? Or maybe it's a political ploy. I think it is a little of everything.

It is often said that to enter Indian politics the basic prerequisites is a criminal record. In fact, close to 30% of the current MPs have criminal records. It should thus come as no surprise that most of them are quite uneducated. Most will not even try to understand the economics behind MFIs and how they function. Thus lack of understanding definitely plays a part. However with the massive literature in the support of MFIs, one can safely assume that this does not hold too much weight.

The more likely reason is the irrationality of the government in their distrust of the profit making MFIs. Conventional wisdom tells us that making money from the poor is wrong and unethical. This is why the SKS model is not universally accepted. This line of thinking however is flawed as SKS's model has allowed credit to reach many more people than the conventional model, of government grants and the benevolence of the rich, would permit. The need for credit is massive and cannot be sufficed by the latter model. Private investment was required and the only way to woo investors was by offering returns. The counter argument, however, is that the need for better returns pushes the MFIs employees to the coercive means of collecting repayments. This does make sense, yet once again one must ask whether to regulate the industry, or amputate it?

Then come the politics. This is the most likely reason. The cliché story of campaigns where the candidate hands out blankets to the homeless is quite popular in India. This is just another form of that. The ordinance, which effectively gives money away to people, can be viewed as just another round of blankets. The politicians probably hope to generate good will for themselves for the next set of elections. There is always the temptation of banking the short term benefits.

India has a history of forming policies based on individual cases. Instead of remedying that particular episode we just make a law which bans anything to do with it. As explained above, it could be for a variety of reasons, but that does not justify it. The Microfinance sector in Andhra Pradesh is struggling. Once the current loans die out and no future loans are provided, the people will feel the pain as well. US$1.2 billion is going to disappear. The MFI industry will be set back by years even if the government now revokes its ordinance. The damage is massive. But the biggest concern is that the government shows no signs of changing its mind.

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