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Microfinance and Financial Inclusion in India

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Introduction

Access to financial services such as credit, savings, insurance, and remittance facilities is a necessity for the poor at least as much as it is for the affluent and the middle class. Research has shown that even households with incomes of less than a dollar a day per person rarely consumed every penny as soon as it was earned. Instead, they sought to "manage" their money by saving when they could and borrowing when they needed to. Since financial institutions in the formal sector were reluctant to lend to people in the low-income group, the microcredit industry stepped into fill the gap (Collins et al. 2009; Morduch 1999).

Efforts to deliver affordable credit to poor borrowers have a long history. For example, the usury laws and Islamic prohibition on interest were aimed at this goal. There have also been many attempts to set up

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institutions for directly supplying credit to the poor.[1] That said, modern microcredit, as an institutional mechanism for improving credit access for the poor, is unprecedented in its scale and visibility. In 2012, according to the Microcredit Summit, there were 204 million microcredit borrowers worldwide.[2] This expansion has been due to a combination of lower interest rates and a willingness to lend to people who have no previous connections to the formal financial system (Banerjee and Duflo 2011).

Most poor people borrow either from friends, neighbours, or from a professional moneylender if access to institutional sources of credit is not available. However, moneylender credit is expensive, although the data on this tends to be patchy and not necessarily representative. Robinson (2001) and Banerjee (2004) have found that moneylender interest rates go from 4 % per month (60 % annual, 50 % or so real) to simply astronomical rates such as 5 % per day and above. In countries where microcredit has had the greatest success, such as Bangladesh, Bolivia, India, and Indonesia, interest rates are significantly lower than 30 % per year. Few studies collect both moneylender interest rates and microcredit interest rates paid by the same households, but those that do find large differences: 3.8 % per month (nearly 60 % per year) charged by moneylenders versus 24 % yearly rates for microfinance institutions (MFIs) in urban Hyderabad, India (Banerjee 2013), and 103 % for moneylenders versus less than 30 % for MFIs in 156 Bangladesh villages (Mallick 2012; Banerjee 2013).

India was one of the developing economies where the microfinance industry took off in a big way. The prevailing wisdom in the development community was that by providing microcredit to the "poorest of the poor", the gap in the formal rural credit sector could be filled. However, in 2010, a spate of suicides in Andhra Pradesh's rural areas was blamed, rightly or wrongly, on certain unsavoury practices of the microfinance industry. Overnight, microfinance, especially those who were for-profit and looked to the market for funding, became villains in the eyes of the public. This gave the state government an opportunity to clamp down on the industry, through imposing restrictive rules on the industry through an ordinance, leading to a drop in the activities of the industry. Since then, the situation has improved with the industry slowly limping back, and the new regulatory

[1] http://www.globalenvision.org/library/4/1051.

[2] http://stateofthecampaign.org/2014-report-executive-summary.

framework put in place by the Reserve Bank of India (RBI) providing some much needed clarity to the regulatory landscape of microfinance.

In this chapter, we provide an overview of the microfinance movement in India, and underline its role in the broader financial inclusion challenge in the country. The chapter is divided into three parts. The next section provides an overview of the present scale and distribution of the microfinance industry in India. It attempts to take stock of the contribution and present status of microfinance within the broader policy goals of financial inclusion. Section 'Microfinance in India: A Brief History' sketches the broad history of the movement; from its roots in the pre-1970s to its meteoric rise in the 1990s, which hit a roadblock with the crisis in Andhra Pradesh in 2009, and the changes in the industry since the crisis. Its progression is divided into five phases: 1950–1970; 1970–1990; 1990–2010; the Andhra Pradesh crisis; and the postcrisis phase. The concluding section briefly analyses the key forces and determinants of the microfinance movement in India and provides lessons that other countries can derive from it.

Microfinance in India Today: A Snapshot

With a market size well in excess Rs. 50 thousand crores, India is one of the largest microfinance markets in the world. Figure 7.1 shows the volumes and growth figures of the Indian microfinance market broken down by its two dominant and distinct models, the Bank-Self-Help Group (SHG) model and the MFI model.

Three things are apparent from Fig. 7.1: first, during 2008–2013, the overall market witnessed a steady rise of about two and half times; second, much of this steady and impressive growth came from its dominant component—the SHG-Bank Linkage (SBLP) model; and third, the MFI model, underwent a massive swing in growth rates exceeding 160 % before being hit by the infamous Andhra Crisis, which actually halted its growth in its aftermath, but has now begun to show respectable growth. The crisis notwithstanding, the share of the MFI model has grown from about 10 % in 2008 to 25 % in 2013.

Table 7.1, using the MIX Market data, supplements the foregoing statistics with some figures on the number of borrowers and the gross loan

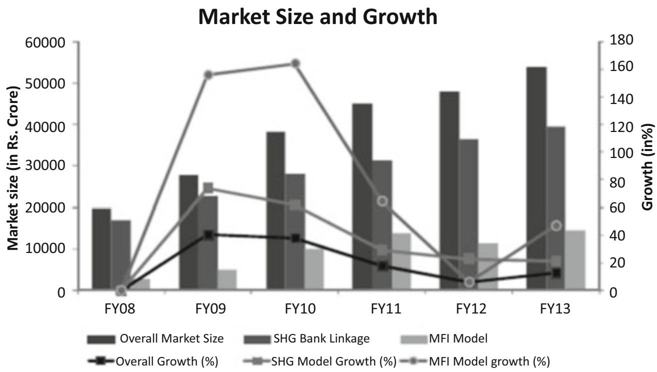

Fig. 7.1 Market size and growth.
Source: CARE Ratings (2014)

Table 7.1 Performance of MFIs in India

Year	MFIs	No. of Active Borrowers	Gross Loan Portfolio (in US$)
2006	106	7,327,960	773,298,527
2007	80	10,214,367	1,391,772,725
2008	98	16,747,173	2,239,946,498
2009	120	27,654,027	4,615,944,783
2010	127	32,618,491	5,379,559,879
2011	122	26,589,600	4,313,910,884
2012	98	27,792,571	4,523,432,969
2013	88	32,545,085	5,471,886,863

Source: Mix Market (data on India), http://www.mixmarket.org/profiles-reports/crossmarket-analysis-report?rid=Mhg4QACn

portfolio for MFIs. A seven-year (2006–2013) period reflects a rise in active MFI borrowers from 7.3 million to 32.5 million, roughly four-and-a-half fold rise, while the loan portfolio has climbed from US$0.8 billion to US$5.4 billion, nearly a seven-fold increase. Over the same period, the number of MFIs covered in the MIX data has shrunk from 106 to 88 after reaching a peak of 127, reflecting consolidation during the period. Table 7.2 shows the growth of the SHG sector after the crisis.

The skewed regional distribution of the MFI loans in India is an equally important and interesting subject. Hyderabad remains the capital of microfinance in India, though its relative stature has been diminished

Table 7.2 Growth trends in SHG-bank linkage programme

Particulars	2010	2011	2012	2013	2014
No. of SHGs with outstanding bank loans	4,851,356	4,786,763	4,354,442	4,551,434	4,197,338
Loans disbursed to SHGs during the year (Rs. billion)	144.53	145.48	165.35	205.85	240.17
Average loan disbursed during the year per SHG	91,081	121,625	144,048	168,754	175,768
Total bank loans outstanding to SHGs (Rs. billion)	280.38	312.21	363.41	393.75	429.27
No. of SHGs with savings accounts with banks (million)	6.95	7.46	7.96	7.32	7.42
Total savings of SHGs with banks (Rs. billion)	61.99	70.16	65.51	82.17	98.97
Average savings of SHGs with banks (Rs)	8915	9402	8230	11,229	13,321

Source: Status of Microfinance in India 2013–2014, NABARD; Inclusive Finance India Report 2014, Tara Nair, Ajay Tankha, ACCESS 2015

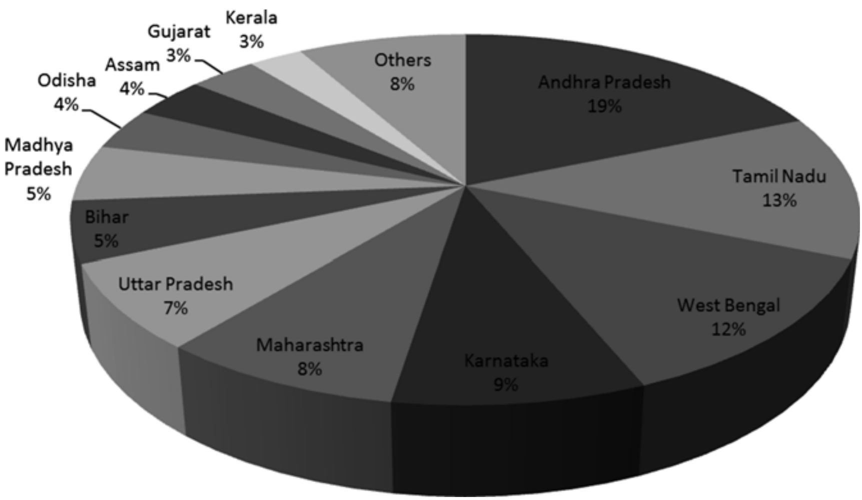

Fig. 7.2 Distribution of outstanding MFI loans

by the Andhra Pradesh crisis. As Fig. 7.2, shows, the top 11 states in the country account for about 92 % of MFI lending with the three southern states and West Bengal accounting for more than 50 % of the MFI loans.

A similar, if not even more extreme, picture emerges on the distributional nature of the other approach, the SBLP model. Figure 7.3 shows the regional distribution of bank loans in 2013–2014 and is indicative of this model being dominated by the southern states.

How sustainable is this skewed distribution? Figure 7.4 presents the penetration statistics of the SBLP model, capturing information on the coverage of savings-linked SHGs as a fraction of potential SHGs. It is apparent, the southern districts are now, without exception, 80 % plus linked; whereas districts in the far poorer Uttar Pradesh, Uttarakhand, and Bihar states in the north and northeast, have below 50 % linkage and appear to pose stronger growth opportunities.

What does the future portend for the microfinance sector in India relative to the rest of world? Estimation provided by the Swiss research

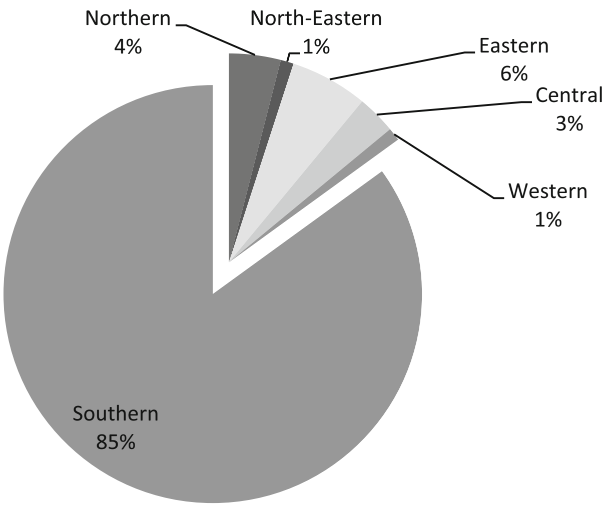

Fig. 7.3 Bank loans disbursed in 2013–2014 region-wise (SBLP). *Source*: Status of Microfinance in India 2013–2014, NABARD

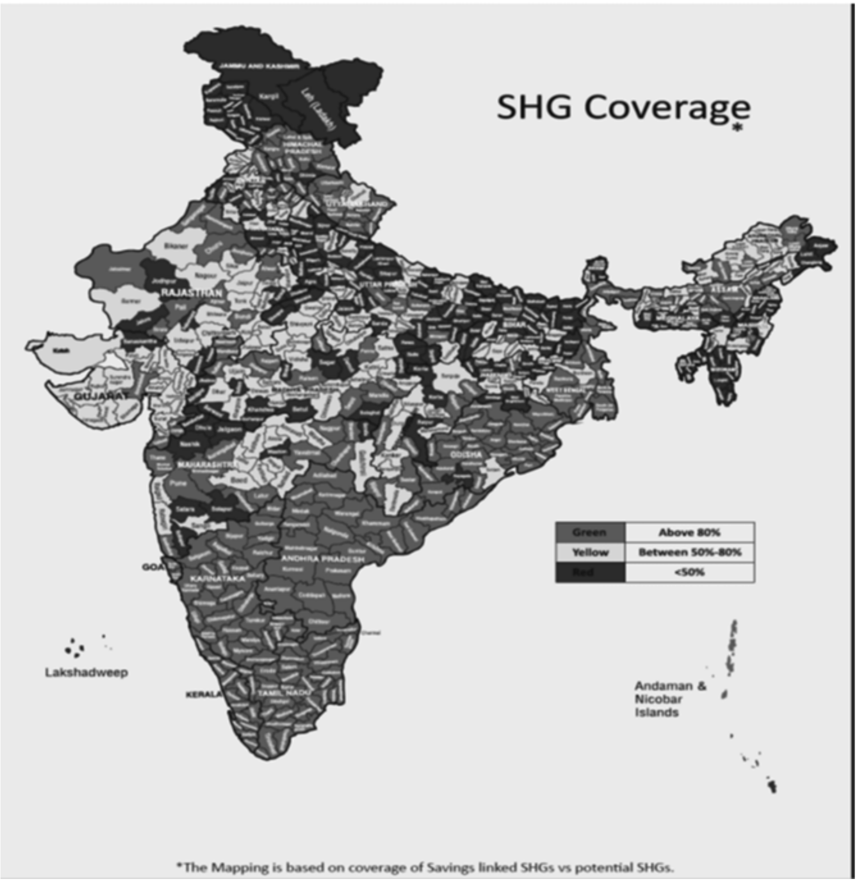

Fig. 7.4 SHG coverage in India.
Source: Status of Microfinance in India 2013–2014, NABARD

firm, responsAbility (see Fig. 7.5) puts the microfinance growth outlook for India, China, and a few Southeast Asian countries in the 25–35 % range, the highest in the world. So it does seem the high growth in Indian microfinance is here to stay, at least in the short run.

The next section attempts a brief sketch of the evolution of the Indian microfinance sector over the decades.

Fig. 7.5 Microfinance growth outlook for 2014 by region (year on year growth in gross loan portfolio)
Source: responsAbility Research Department

Microfinance in India: A Brief History

The evolution timeline of microfinance in India consists of five major phases: the background of the financial inclusion agenda since independence until the 1970s; the early but muted developments of microfinance from 1970 to 1990; the rapid growth phase from 1990 to 2010; the Andhra Pradesh crisis of 2010; and the recovery.

1950–1970 (Background)

Although India's relationship with microcredit began in the 1970s, the need to provide the poor with access to credit was brought home shortly after independence in 1947, when the first survey of rural indebtedness (All India Rural Credit Survey) prepared by the RBI documented that moneylenders and other informal lenders met more than 90 % of rural credit needs. The share of banks in particular was only about 1 % of total rural household debt (Basu and Srivastava 2005).

This survey highlighted the major problems with respect to providing credit to poor households: first, the inadequate supply of formal sector credit; second, high interest rates of informal sector loans; and third, the creation of an elaborate structure of coercion through terms and conditions attached to these informal sector loans.

Given the issues involved, the declared public policy objectives regarding rural credit in the postindependence period were, in the words of the RBI Governor, "to ensure that sufficient and timely credit, at reasonable rates of interest, is made available to as large a segment of the rural population as possible" (Rangarajan 1996).

To this end, between the 1950s and 1970s, India as well as the governments of most developing countries focused on providing agricultural credit to small and marginal farmers through state-owned development finance institutions, or farmers' cooperatives in some cases, that received concessional loans and on-lent to customers at below-market interest rates. While the share of banks in total rural household debt increased only slightly to 2.4 % in 1971, the share of formal sources of credit in rural areas increased to 29 % due to the rising share of cooperatives (Basu and Srivastava 2005).

In 1969, India nationalised 14 major commercial banks, the policy was known as "social and development banking," to extend banking services to unbanked rural areas, provide credit for specific activities and to certain disadvantaged groups. Targets were set for the expansion of rural branches, ceilings on interest rates were imposed, and guidelines were set for the sectorial allocation of credit. Specifically, a target of 40 % of advances for the priority sectors, namely agriculture and allied activities and small scale and cottage industries, was set for commercial banks (Ramachandran and Swaminathan 2001).

1970–1990 (Genesis)

From the late 1970s to 1980s, the two major policy instruments for tackling poverty were developed: first, loans-cum-subsidy schemes targeted at the rural poor; and second, state-sponsored rural employment schemes. The most important scheme of this phase was the Integrated Rural Development Programme (IRDP), a scheme for the creation of productive income-bearing assets among the poor through the allocation of subsidised credit.[3] Initiated as a pilot project in 1978–1979, it was extended to all rural blocks of the country in 1980 (Planning Commission, Government of India 1985). This period also involved an expansion and consolidation of the institutional infrastructure for rural banking especially through the introduction of Regional Rural Banks (RRBs) in 1972, which specialised in social and development banking in rural areas. These governmental initiatives did increase access to credit to rural areas[4] but were biased with respect to regions, crops, and classes (Basu and Srivastava 2005).

However, rural development banks suffered massive erosion of their capital base due to subsidised lending rates, poor repayment discipline, and the funds did not always reach the poor and often ended up concentrated in the hands of better-off farmers (World Bank 2002). In addition, there was an increase in Non-Performing Assets (NPA) of banks. IRDP also failed to create long-term income-bearing assets for a variety of reasons (PEO Study 1985). The design of IRDP included substantial subsidies, 25–50 % of each family's project cost, and this resulted in extensive malpractice and misuse of funds. Thus, the IRDP loans were viewed as a politically motivated hand-out, and the bankers largely failed to follow up with borrowers. The net result was that estimates of the repayment rates in the IRDP ranged from 25 to 33 %. Not surprisingly, the two decades experience with the IRDP, in the 1980s and 1990s, affected the credibility of microborrowers in the view of bankers, and ultimately, hindered access for the less literate poor to banking services (Sinha 2003). Similarly, the entire network of primary cooperatives in the country and the RRBs proved to be a colossal failure. Saddled with the burden of directed credit and a restrictive interest rate regime, the financial position of the RRBs deteriorated quickly, while the cooperatives suffered from

[3] IRDP covered small and marginal farmers, agricultural workers, landless labourers, rural craftsmen and artisans and virtually all the families of about five persons with an annual income level below Rs 3500. The main aim was to raise the levels of the BPL families in the rural areas above the poverty line on a lasting basis by giving them income generating assets and access to credit and other inputs. The implementation was to be done by the District Rural Development Agency with the assistance from block level machinery.

[4] Following bank nationalisation, the share of banks in rural household debt increased to about 29 % in 1981 while the share of formal or institutional sources in total debt reached 61.2 % until 1991.

the malaise of mismanagement, privileged leadership, and corruption born of excessive state patronage and protection (Sinha 2003).[5]

Meanwhile, beginning in the 1970s, innovative strategies were developed in many countries to extend financial services to the poor. The Grameen Bank in Bangladesh and BancoSol in Bolivia led the way for group liability lending, an extension of small loans to groups of poor women to invest in microbusinesses. These "microenterprise lending" programmes had an almost exclusive focus on credit for income generating activities, in some cases accompanied by forced savings schemes, targeting very poor, often women, borrowers (Morduch 1999). Other pioneers in unconventional lending included Bank Rakyat and Kredit Desa in Indonesia, Foundation for International Community Assistance (FINCA) in Latin America, India's Self-Employed Women's Association (SEWA) of India, Sahakari Bank in Ahmedabad, Annapurna Mahila Mandal in Mumbai, and Working Women's Forum (WWF) in Chennai.

Bank Rakyat Indonesia[6] (BRI), which began its operations in 1895 and acquired its present form in 1968, gives loans to low-income households through their *unit desa* programme, which was started in 1969 to provide subsidised credit and later reorganised into commercial microbanking (Robinson 2002). BRI did not follow the group lending method, and unlike most other similar programmes required its borrowers to put up collateral. It also charged commercial interest rates and started mobilising rural savings through *unit desas*, both to meet demand for savings services and to ensure that no government funding was required in the future. But operations remained small scale and "collateral" was often defined loosely and could include lesser certificates and land tax bills, allowing staff some discretion to increase loan size for reliable borrowers who might not be able to fully back the loans with assets. The bank centred on achieving cost reductions by setting up a

[5] Since 1990, the need for co-operative reforms was articulated by many committees that were headed by Chaudhry BrahmPerkash, JagdishCapoor, VikhePatil, and V. S. Vyas. The basic problem identified by these committees was that most co-operative societies lacked autonomy due to direct intrusion of the state in the governance and management of co-operative societies. The reason was that the co-operative movement in India was initiated by the government. In 1954, the All India Rural Credit Survey Committee Report not only recommended state partnership in terms of equity, but also partnership in terms of governance and management.

[6] See BRI website for more information (http://www.bri.co.id/articles/9).

network of branches and posts with an average of five staff members each. Loan officers got to know clients over time, starting borrowers off with small loans and increasing loan size conditional on repayment performance. The programme has proved to be profitable with high repayment rates, which often performed better than corporate clients in other parts of the bank (Morduch 1999; Robinson 2002).

FINCA, under John Hatch and his associates, started a network of village banks in the mid-1980s in Latin America. Non-governmental groups (NGOs) such as CARE, Catholic Relief Service, and Freedom From Hunger helped set up village financial institutions in partnership with local groups, allowing substantial local autonomy over loan decisions and management. In the standard model, the sponsoring agency makes an initial loan to the village bank and its 30–50 members. Loans are then made to members, starting at around $50 with a four-month term, with subsequent loan sizes tied to the amount that members have on deposit with the bank. Like Indonesia, the village banks successfully harnessed local information and peer pressure without using small groups along BancoSol or Grameen Bank lines. However, this model is difficult to scale, so the focus has been on outreach (Morduch 1999).

In India, Self Employed Women's Association (SEWA), Working Women's Forum (WWF), and Annapurna Mahila Mandal developed innovative strategies to tailor banking to the needs of economically weaker working women. The most well-known and successful of these initiatives was the SEWA Bank, undertaken by Elaben R. Bhatt, a lawyer and trade unionist. SEWA was established in Ahmedabad in December 1971, and registered as a trade union in April 1972. In 1974, 4000 self-employed women established the SEWA Bank[7] as a cooperative bank with the specific objective to provide credit to self-employed women to empower them and reduce their dependence on money sharks. Between 1974 and 1977, the SEWA Bank concentrated on attracting deposits from self-employed women and served as an intermediary to enable depositors to obtain loans from nationalised banks, which are required to lend to the poor. During this period, about 6000 members received nearly Rs 2,500,000 in credit. Initially, the nationalised banks charged 9–16 %

[7] For more information, see website of SEWA Bank: http://www.sewabank.com.

interest, but they reduced the rate to 4 % as a result of SEWA's lobbying with the government. In 1976, the SEWA Bank started to extend loans to its depositors from its own funds and gradually withdrew from the credit arrangement with the nationalised banks. SEWA Bank offers a range of services such as savings, loans, fixed deposits, and pensions to poor women but does not operate any group lending schemes in its urban operations. Loans can be secured based on physical collateral (jewellery, savings account), can be unsecured (requires a guarantor as 'social collateral'), and range in size between Rs 5000 and Rs 50,000. It has become a viable financial venture (Rose 1992; Duvendack 2010).

Around the mid-1980s, the first steps towards setting up SHGs was taken by Mysore Resettlement and Development Agency (MYRADA), and it built upon rural chit funds and informal lending networks with the goal of it evolving into a credit management group. Many of them had emerged from the breakdown of the large cooperatives organized by MYRADA. Members came in groups of 15–20 asking MYRADA to revive the credit system. When reminded of the loans they had taken out from the cooperative, they offered to return them to MYRADA, but not to the cooperative, which in their experience had been dominated by a few individuals. MYRADA staff suggested that they return the money to themselves, in other words to the members who had come in a group to present their case to MYRADA. After some hesitation, they decided to continue meeting in these smaller groups. MYRADA staff realised that they would need training: how to organise a meeting, set an agenda, keep minutes, and so on. Efforts were made to train the members systematically. On analysis, it emerged that the members were linked together by a degree of affinity based on relationships of trust and support; they were also often homogeneous in terms of income or occupation, for example, agricultural labourers, but not always (Pulley 1989; Adams and von Pischke 1991).

The government, in the meantime, decided to set up a new organisation that would focus solely on the credit issue in rural areas. The National Bank for Agriculture and Rural Development (NABARD) was set up in 1982, and it took up the credit functions of RBI and the refinance function of the then-Agricultural Refinance and Development Corporation.

National Bank for Agricultural and Rural Development (NABARD) and MYRADA joined hands to connect the SHGs with banks. A survey of 43 NGOs in 11 states was conducted by NABARD between 1988 and 1989 to study the functioning of SHGs, and the possibilities of collaboration between banks and SHGs. The results were encouraging. Consequently in 1992, MYRADA and NABARD together trained and expanded the savings groups, linking them to banks, and fostering the foundation of the SHG Bank Linkage Programme (SBLP). Other NGOs such as PRADAN and Development of Humane Action (DHAN), largely funded by NABARD, also pioneered the SHG model (Pulley 1989; Adams and von Pischke 1991).

1990–2010 (The Take-Off)

The 1990s was the turning point in India's economic history characterised by the liberalisation of the economy. The policy objectives of this phase were encapsulated in the Report of the Committee on the Financial System chaired by M. Narasimham. The report called for "a vibrant and competitive financial system…to sustain the ongoing reform in the structural aspects of the real economy" (RBI 1991). The Committee said that redistributive objectives "should use the instrumentality of the fiscal rather than the credit system" and accordingly proposed that "directed credit programmes should be phased out." It also recommended that interest rates be deregulated, that capital adequacy norms be changed to "compete with banks globally", that branch licensing policy be revoked, that a new institutional structure that is "market driven and based on profitability" be created, and that the part played by private Indian and foreign banks be enlarged. The reforms, following these recommendations, removed some of the constraints on the functioning of RRBs, easing their interest ceiling and allowing them to invest in the money market. The financial situation of the RRBs has improved since with declining losses, and now over 80 % of the RRBs are profitable. However, much of this turnaround has resulted from a shift to investment in government bonds that have gained with falling interest rates and loans to the non-poor in rural areas. The focus on financial sustainability has cost outreach dearly. Recent years have witnessed, perhaps predictably, a sharp decline in the share of rural and small loans in bank portfolios. The locational distribution of bank branches has also undergone a considerable shift away from the rural areas. The lending portfolio of scheduled commercial banks also reflects this shift away from rural areas (Chakrabarti and Ravi 2011).

This shift in policy created a vacuum of credit in rural India, which was partly filled by microfinance. Microfinance served as a means for financial inclusion because regular banks tended not to lend to the poor because of the high cost per individual loan and lack of collateral. In 1992, the NABARD sponsored the SBLP operations (Government of India 2008). Under SBLP, SHGs needed to save regularly for a minimum of six months, and maintain prescribed records and accounts to become eligible to be linked to local banks. Currently, this programme provides credit to over 73 lakh SHGs.[8]

The rapid rise of microfinance, to be precise, loans disbursed by specialised MFIs, in India began in the late 1990s, continuing the tradition of credit as a social policy. The liberalisation of India's economy and financial sector after 1991 provided the impetus for the government to allow private players to enter the sector to provide microfinance products and services. These private microfinance service providers were called MFIs and included NGOs, co-operative societies, and Non-Banking Financial Companys (NBFCs). This diverse set of MFIs provided a range of microfinance products and services using different delivery models. Microfinance gradually evolved into an industry with diverse market players, low competition, a huge clientele, excellent long-term growth prospects, and no regulation.

The model of their operation was as follows: commercial banks or apex institutions [NABARD, Small Industries Development Bank of India (SIDBI), Rashtriya Mahila Kosh] would lend to MFIs[9] for further lending to groups or individuals (Sanyal 2007).

The microfinance sector in India, as in most places in the world, originated out of private initiatives typically of not-for-profits, and thrived for a long while without direct government supervision, with one exception—the NABARD promoted SBLP. Until 1999, most of the MFIs were NGOs funded through grants and soft loans, and also adopted the Grameen model of group-based lending to women in rural areas. About 800–1000 NGOs were involved in mobilising savings and providing

[8] https://www.nabard.org/english/shgs.aspx.

[9] Private bodies based on the Grameen model of Bangladesh.

microloans to the poor (Sinha 2003). Initially funded through donor support in the form of revolving funds and operating grants, these NGOs later started getting bulk loans from NABARD, Small Industries Development Bank of India (SIDBI), and RMK. However, the outreach was still small as compared to the need, about 10 % of the 60 million poor families (Sinha 2003). This changed as some of the NGO-MFIs started growing and transforming into for-profit NBFCs, namely Spandana, SHARE Microfin, BASIX India, and SKS Microfinance. The sector also attracted professionals who set up for-profit NBFCs to provide financial services to people at the 'bottom of the pyramid'. To scale up, these NGO-MFIs needed to access capital, which was easier if they became a corporate entity regulated by the RBI. By 2010, there were 5 to 10 large and mid-sized NBFC-MFIs, which had transformed from NGO-MFI, and five to ten NBFC-MFIs promoted by professionals. There were also 800 NGO-MFIs operating in the sector but their outreach and loan portfolios were much smaller (Nasir 2013; Chakravarty and Padmapriya 2005).

Box 7.1: Experience of a Few Select MFIs

BASIX

One of the earlier MFI entrants, BASIX, was founded in 1996 in Hyderabad, Telangana. It started with the mission of establishing a link between the economically more prosperous world and the poor but the vibrant and talented part of the world. Basix was the brand identity of five closely integrated companies with the motto "Equity for Equity". Four of these five firms were for-profit firms. The five firms were as follows:

- Bhartiya Samruddhi Investments and Consulting Services Ltd. (BASICS Ltd)
- Indian Grameen Services
- Bhartiya Samruddhi Finance Ltd. (Samruddhi)
- Krishna Bhima Samruddhi Local Area Bank Ltd. (KBSLAB)
- Sarvodaya Nano Finance Ltd. (Sarvodaya)

(*continued*)

Box 7.1 (continued)

In August 1996, RBI came up with the concept of Local Area Banks (LABs) in an effort to reduce the demand supply gap of financial services in rural areas. This was created keeping in mind that the institutional framework had to be strengthened, too. BASIX was among the first few to be granted a license for opening a LAB. BASIX promoted the KBSLAB—Krishna Bhima Samruddhi Local Area Bank Ltd. The RBI regulations allowed LABs to open only one urban centre per district. The Rural Planning and Credit Department (RPCD) of the RBI had regulatory and supervisory jurisdiction over the LABs. The RPCD issued licenses to the LABs as per the provisions of the Banking Regulations Act 1949. Supervision of the LABs was undertaken by the Annual Financial Inspection of the Department of Banking Supervision. This included several functions such as inspection of management functions, function of the board and constitution of various committees, internal control system, internal audit and inspection, information system, deposit advance and investment portfolio, NPAs, profitability, capital adequacy, and maintenance of statutory norms such as Cash Reserve Ratio (CRR)and Statutory Liquidity Ratio (SLR).

LABs activities mainly concentrated in financing agricultural and related activities, certain small-scale industries, trading activities, and some non-farm activities. LABs were mandated to spend 40 % of the total bank credit on the priority sector. Of this 40 %, at least 25 % should be given to the economically weaker section of society. LABs also had to maintain a capital adequacy ratio of 8 % of their risk-weighted assets. LABs also had to comply with the norms of income recognition, asset classification, and provisioning from the outset. Later these norms were revised on the recommendations of The Working of the Local Area Bank Scheme Committee in August 2003. The committee also recommended the suspension of new licenses until the existing banks were able to show better performances— Capital Adequacy Ratio (CAR) 15 % and a net worth of INR 250 Mn. In April 2008, the Raghuram Rajan Committee suggested restarting the LAB license, but this was ignored by the RBI at that time and further licenses were not issued.

(*continued*)

Box 7.1 (continued)

Borrowers from BASIX had a choice of loan products, typically at an annual percentage of 24 %. The loans were mostly given to individuals, but sometimes group loans were also given to the clients to make them jointly liable. The average loan size was approximately Rs. 8800 with the loan tenure being around 11 to 24 months. The loan size has been decreasing as BASIX constantly reaches out to poorer people. Following economic liberalisation in India, an insurance policy has been launched by BASIX, which is bundled along with its standard loans.

SKS Microfinance

SKS was founded in December 1997 by Vikram Akula as a not-for-profit organisation, and went into operation in 1998 in Andhra Pradesh. SKS looked to getting debt from banking institutions. Soon SKS partnered with ICICI bank to receive big loans, which were used not only to provide loans, but also to improve the existing technology in place. With rapid growth it moved from not-for-profit to non-banking financial institutions. This happened in 2005, and from here the change from nonprofit to for-profit happened. SKS soon grew to be the largest MFI in India and second largest in the world. SKS microfinance offered eight financial products and services to its clients—income generation loans, midterm loans, mobile loans, sangam store loans, housing loans, funeral assistance, gold loans, and life insurance. The company lists some of the social benefits of its financial products and service offerings as "providing self-employed women financial assistance to support their business enterprises, such as raising livestock, running local retail shops called 'kirana' stores, providing tailoring and other assorted trade and services."

Microfinance is not suitable for those who need not just access to finance but livelihood training and social and health inputs. SKS has a unique "Ultra Poor" program for this group. Under the program, the beneficiaries receive training to run an income-generating enterprise, financial education, and assets. Over an 18-month period these beneficiaries are trained to become self-sufficient and graduate into regular microfinance. The first phase of the Ultra Poor program was

(*continued*)

Box 7.1 (continued)

conducted in the Medak district of Andhra Pradesh, where nearly 500 women were covered. In all, 426 women have successfully graduated from this program. In the next phase, the Ultra Poor program is being planned in some of the poorest districts of Orissa and Jharkhand.

SKS launched its initial public offering (IPO) in 2010. The motive of Vikram Akula was to mix profit making along with the social mission of microfinance. This was not endorsed by some of the stalwarts of microfinance, for example, Muhammad Yunus. To grow rapidly and expand at a very high pace, capital was needed, and had to be raised from the debt and equity market. The aid and donor money was drying up, and was not coming to the MFIs directly. This led to the need to tap the other capital markets. But the major requirement in the other capital markets was the need to have viable profit making business to access capital. To make sure this happened, SKS had to give money out at a higher interest rate. There were some repercussions to this; followed by the famous Andhra Pradesh ordinance, which is discussed in detail in the chapter. This created the crisis and the MFIs are trying to come out of this crisis.

Spandana

Spandana is another MFI based out of Hyderabad, Telengana. The Spandana startup team comprised a few like-minded people working for an NGO in planning and implementing development projects funded by government grants. Spandana started operating under the current name in 1998. Spandana began with the goal of being responsive to the low-income clients. Spandana faced similar problems in getting capital from the banks. Spandana tested and validated the MFI methods locally, built up efficiencies, removed bottlenecks to create viable model, and then moved to the banks to raise capital. Spandana broke even in the first formal year of operations. In the first two years of operations 1998–2000, Spandana crossed its first milestone of Rs. One Crore disbursements to roughly 2000 clients. By 2002, Spandana had reached out to almost 15,000 clients and achieved the critical mass. Around this time, the banks started looking

(*continued*)

Box 7.1 (continued)

at MFIs as a favourable and reliable banking entity. Rating agencies such as M-CRIL and CRISIL and other sector resource organisations played a critical role in critiquing and helping institutionalise the whole microfinance sector. With funds coming from banks, especially the ICICI bank, Spandana registered a Compounded Annual Growth Rate (CAGR) of 250 % over the next four years (Exhibit 6). By 2004, Spandana had reached out to over 1 lakh customers and had a loan portfolio of Rs. 5.5 Mn. Soon after, Spandana turned from being an NGO to a for-profit NBFC. Spandana faced the crisis after having a monumental growth during the Andhra Pradesh (AP) crisis. While Spandana had sought to move towards an IPO to raise capital after SKS, this did not occur as a result of both what happened to SKS and the fallout from the AP crisis.

SHARE

SHARE, one of the largest MFIs in India, started its operations in 1989 as a not-for-profit society, and was the first MFI in India to obtain a NBFC license. SHARE adopted a for-profit approach to create social returns by channelling funds from development institutions and commercial banks as collateral-free loans to Joint Liability Groups (JLGs). JLGs are central to the Grameen lending methodology that SHARE has replicated. SHARE currently serves more than 3.71 million members across 17 Indian states—AP, Chhattisgarh, Delhi, Karnataka, Maharashtra, Madhya Pradesh, Uttar Pradesh, Rajasthan, Bihar, Uttarakhand, Gujarat, Haryana, Tamil Nadu, West Bengal, Jharkhand, Kerala, and Assam. SHARE caters to the needs of poor rural women through its 3616 staff members spread across 798 branches, as of 31 March 2014. The total outstanding portfolio is about Rs 1758 crore. SHARE is another institution that had to delay the IPO plans due to the AP crisis.

Box 7.2: A Few Key Challenges for Indian MFIs

- **Reach**: MFIs are facing challenges in reaching the grass root level and lending money to trustworthy individuals. Scale has been a big problem. Achieving scale can be the one solution to most problems faced by the MFIs.
- **Lack of Collateral**: Often the villagers lack any collateral to pledge against the loan/finance they are borrowing from MFIs. Unlike traditional banks, MFIs do not take collateral because their target segment is poor, and would not have large enough assets to provide as collateral in general. Group lending and relying on JLGs has mitigated this problem to some extent.
- **Regulatory Issues**: Lack of regulatory frameworks makes it difficult for MFIs to get easy access to funds—equity and debt.
- **Operational Issues**: High fixed costs and operational inefficiencies can lead to higher operational costs. Reaching out to the grass root level requires significant capital. Moreover, trained officials would be needed to work at a lower cost.
- **Information Asymmetry**: Lack of credit history and credit worthy villagers could lead to adverse selection and moral hazard. Unlike banks that have access to credit history of an individual, the MFIs do not have this data, as it has yet to be built. Recently, MFIs are working on creating a credit bureau.
- **High Interest Rates of MFIs**: The high interest rate has been a perennial source of debate and discussion in the sector of microfinance. Some reasons for the high interest rates are listed below.

  – Default risk is high since the target segment is the economically weaker sections.
  – No collateral is taken for loans.
  – There is lack of economies of scale because of the size of the operation.
  – Transaction costs are high.

The growth of for-profit NBFC-MFIs attracted international private equity. Three private equity deals brought in US$52 million in 2008 followed by 11 deals the following year, which fetched US$178 million. This was followed by the spectacular IPO of SKS Microfinance, which made global headlines (Srinivasan 2010). On 28 July 2010, SKS became the first MFI in India to float its shares through an IPO. The IPO was successful by any financial market standard; the offering was 13 times oversubscribed and attracted leading investment groups, such as Morgan Stanley, JP Morgan, and George Soros' Quantum Fund. The company valuation reached the top of the offer band price at US$1.5 billion, and five weeks after trading began, the share price had risen 42 % (Singh 2013).

This was also the period in which tension started arising between NGO-MFIs and NBFC-MFIs, because there was a basic divergence in ideologies. NGO-MFIs continued to be driven by social objectives of poverty alleviation, women's empowerment, and capacity building, while NBFC-MFIs became more profit oriented in order to scale-up operations. Sa-Dhan, an industry body set up in 1999, had both types of MFIs as its members. Although NBFC-MFIs had larger market share, NGO-MFIs were more numerous, which allowed them to dominate the industry. This led the NBFC-MFIs to form their own association called MFIN in 2009.[10] There are 50 such MFIs, less than one-fourth of the MFIs that exist in India, but they account for at least 90 % of the business. Two key initiatives of MFIN were the creation of a code of conduct for the industry, and the development of a credit bureau. Both have received the status of Self Regulating Organisation (Bandyopadhyay 2014; Kumar 2015).

2010–2011 (Andhra Pradesh Crisis)

By June 2011, MFIs reached 31.4 million clients all over India. In terms of "client outreach—borrowers with outstanding accounts", there was growth of 17.6 % of MFI clients, and 4.9 % of SHG-Bank clients in 2010–11, highlighting that while both SHG and MFI models co-existed and flourished together, MFIs were growing at a much faster pace (Srinivasan 2012).

[10] Interviews with Matthew Titus (Sa-Dhan) and Alok Prasad (MFIN).

In FY 2011, the southern state of Andhra Pradesh had the highest concentration of microfinance operations with 17.31 million SHG members, and 6.24 million MFI clients. The total of microfinance loans in Andhra Pradesh, including both SHGs and MFIs, stood at Rs. 157 billion with the average loan outstanding per poor household at Rs. 62,527, which was the highest among all the states in India. This data implied that the state was highly penetrated by microfinance organisations, both MFIs and SHGs, giving rise to multiple borrowing. The World Banks Consultative Group to Assist the Poorest study indicated that the average household debt in Andhra Pradesh was Rs. 65,000, compared to a national average of Rs. 7700. This high penetration of both SHGs and MFIs also led to stiff competition for client outreach between the state-government sponsored SHG program known as "Indira Kranthi Patham (Velugu)" and large, privately owned MFIs resulting in wider conflict of interest (IFMR Investments 2014). Andhra Pradesh accounted for nearly 40 % of all microfinance activity in India. Hyderabad, the home of by far the largest number of microfinance giants, was virtually the capital of microfinance in India. Until a few months before the crisis, the state wore this distinction as a badge of honour. The sector also owed a lot to government support in Andhra Pradesh for its lead in this sector. In recent years, Andhra Pradesh has also been the home of a few of the fastest-growing for-profit MFIs, including the top two: SKS and Spandana (Chakrabarti and Ravi 2011).

SKS, which had made waves in the past by initiating the practice of private equity participation in the microfinance sector, had its headline-grabbing and hugely successful IPO, oversubscribed almost 14 times, in August 2010. To many it was the signal of the Indian microfinance industry coming of age, and several other capital issues were being planned even though many engaged in social sector activism, including Muhammad Yunus himself, were less than impressed by what they perceived to be a shift of focus from social impact to investor returns. The celebrations were short-lived however, and not just because of the top-level personnel changes happening at SKS soon after the IPO. Within weeks of the IPO, Andhra Pradesh was engulfed by a spate of close to 30 farmer suicides, allegedly linked to coercive collection methods of MFIs. More than half these unfortunate farmers were allegedly borrowers of SKS and/or Spandana (Chakrabarti and Ravi 2011).

The resulting crash in the stock of microfinance in Andhra Pradesh has few parallels in recent times. The political establishment swung into action following the suicides, and the MFIs were demonized in the media. Vandalism of MFI offices by political goons was followed by police interrogations. Overnight Andhra Pradesh's lauded sector and MFIs had become pariahs (Chakrabarti and Ravi 2011). Some suggest that the Andhra Pradesh government was not motivated by any desire to protect the poor, but to protect the uncompetitive government backed SHG programme run by the Society for Elimination of Rural Poverty (Legatum Ventures 2011).

This was not the first time that microfinance had been at the centre of negative media glare, not even in Andhra Pradesh. In 2006, a spate of suicides in the state's Krishna district had been linked to "barbaric" practices of MFIs. The government closed down 57 branches of the two largest MFIs (SHARE and Spandana) as well as those of few smaller MFIs because of unethical collection practices, illegal operational practices, poor governance, usurious interest rates, and profiteering. The near-saturation of Andhra Pradesh with microfinance was one of the most important enabling causes for the crisis (Kaur and Dey 2013). Borrowing from multiple sources like Velugu, the SHG scheme backed by the Andhra Pradesh government and assisted by the World Bank, resulted in the indebtedness of MFIs and moneylenders. The impasse ended with the state setting up village and Mandal-level vigilance committees to oversee the functioning of MFIs, the industry lobby proposing a code of conduct for MFIs, and the latter voluntarily reducing interest rates. This time the crisis was further precipitated by the promulgation of the Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance 2010, on October 15, later ratified by the Andhra Pradesh Assembly with some changes on December 15 (Chakrabarti and Ravi 2011).

The main features of the October ordinance included a requirement for MFIs to register themselves with government authorities, prevention of further lending in cases where loans were outstanding, and restriction of collection at a frequency no higher than once a month. The administrative bottlenecks made registration difficult and the widespread political campaign maligning the MFIs as loan sharks encouraged default. These factors brought the industry to a practical halt for several weeks in Andhra Pradesh. The reduction in collection frequency arguably affected saving discipline as well. In any case, the major players saw their recovery rates drop from above 90 % to below 30 % postordinance. Clearly, the activity became untenable for most players in Andhra Pradesh and threatened the very survival of the sector on its home turf. The biggest victims were the poor who would now be denied access to credit (Chakrabarti and Ravi 2011).

Highlights of the Andhra Pradesh Microfinance Institutions (Regulation of Moneylenders) Act, 2010

- All MFIs should be registered with the district authority.
- No person should be a member of more than one SHG.
- All MFIs should make public the rate of interest charged by them for the loans extended.
- There would be a penalty on the use of coercive action by the MFIs.
- All MFIs are supposed to maintain records, registers and a cashbook, which need to be presented when demanded.
- In case of dispute settlement between the SHGs and its members or the SHGs and the MFIs, fast track courts would be set up.
- Any person who contravenes any provision of the Act shall be punishable with imprisonment for a period of six months or a fine up to the amount of Rs 10,000, or both.

Source: PRS Legislative Research

As a result of the ordinance, the repayment rates of MFI loans reduced significantly. Due to low repayment rates, MFIs, with exposure to Andhra Pradesh, suffered significant losses. Banks stopped lending to MFIs all over India, for fear that a similar situation would occur elsewhere. This resulted in a liquidity crunch for MFIs, which are largely dependent on bank lending as a funding source. With the sector at a standstill, MFIs, microfinance clients, banks, investors, and local governments were calling for new regulation to address the sector's issues. It compelled the RBI into looking at developing a policy for MFIs to end the impasse and avert such situations elsewhere (Chakrabarti and Ravi 2011).

The Malegam committee was constituted towards this end submitted its recommendations in January 2011. The recommendations are quite far-reaching in nature and include creating a new class of NBFCs and NBFC–MFIs for regulatory purposes. These NBFC–MFIs, the committee proposed, should have a net worth of at least Rs. 15 crore with a minimum of 90 % of their assets being "qualifying assets". These "qualifying assets" or microloans are non-collateralised loans to households with annual income below Rs. 50,000, with loan size and/or total indebtedness not exceeding Rs. 25,000. Finally repayment should be monthly or less frequent. At least 75 % of the credit should be for income generating purposes. The NBFC–MFIs would be exempt from the Moneylenders Acts, and loans to these MFIs by banks would continue to enjoy priority-lending status. There needs to be a margin cap over cost of funds—12 % for MFIs with total loan portfolio size below Rs. 100 crore and 10 % for others—as well as an overall interest cap of 24 % on individual loans. Several provisions discourage over-borrowing, multiple-lending, and ghost-borrowing including measures making it the responsibility of the MFIs to ensure that a borrower is not part of more than one JLG until the time a Credit Information Bureau takes up the task. There are provisions for borrower protection including those regulating recovery methods, and the suggestion to formulate a client protection code by the designated sector regulator.

Box 7.3: Malegam Committee Report

Terms of Reference

- To review the definition of microfinance and MFIs for the purpose of regulating NBFCs undertaking microfinance by the RBI
- To delineate objectives and scope of regulation of NBFCs undertaking microfinance by the RBI
- To recommend a grievance redressal system that could be put in place to ensure adherence to the regulation recommendations
- To examine the prevalent practices of MFIs with regard to interest rates, lending and recovery to identify trends that impinge on borrowers' interest
- To examine conditions under which loans to MFIs can be classified as priority sector lending (PSL) and make appropriate recommendations
- To examine the role that bodies of MFIs could play in enhancing transparency disclosure and best practices

(*continued*)

Box 7.3 (continued)

Key Recommendations	
Classification of NBFC-MFI	• Create a separate category for NBFCs operating in the microfinance sector called the NBFC-MFI with the following features: (a) provides financial services predominantly to low-income borrowers, (b) with loans of small amounts, (c) for short-terms, (d) on unsecured basis, (e) mainly for income-generating activities, (f) with repayment schedules which are more frequent than those of commercial banks, and (g) which conform to the regulations specified. • An NBFC which does not qualify as an NBFC-MFI should not be permitted to give loans to the microfinance sector, which in the aggregate exceed 10 % of its total assets.
Interest rate	**Pricing of interest rate** • A "margin cap" of 10 % in respect of MFIs which have an outstanding loan portfolio at the beginning of the year of Rs 100 crore, • A "margin cap" of 12 % in respect of MFIs, which have an outstanding loan portfolio at the beginning of the year of an amount not exceeding Rs 100 crore, and • A cap of 24 % on individual loans. **Transparency in interest charges** • There should be three components in the pricing of the loan: (1) processing fee, not exceeding 1 % of the gross loan amount, (2) the interest charge, and (3) the insurance premium. • Only the actual cost of insurance should be recovered and no administrative charges should be levied. • Every MFI should provide the borrower with a loan card which shows the effective rate of interest and other terms and conditions. • There should not be any recovery of the security deposit. • There should be a standard loan agreement.

(continued)

Box 7.3 (continued)

Asset book conditions for NBFC-MFI	At least 90 % of its total assets (other than cash and bank balances and money market instruments) are in the nature of "qualifying assets". A "qualifying asset" shall mean a loan that satisfies the following criteria: • the loan is given to a borrower who is a member of a household whose annual income does not exceed Rs 50,000, • the amount of the loan does not exceed Rs 25,000 and the total outstanding indebtedness of the borrower including this loan also does not exceed Rs 25,000, • the tenure of the loan is not less than 12 months where the loan amount does not • exceed Rs 15,000 and 24 months in other cases with a right to the borrower of prepayment without penalty in all cases, • the loan is without collateral, • the aggregate amount of loans given for income generation purposes is not less than 75 % of the total given by the MFIs, • the loan is repayable by weekly, fortnightly or monthly instalments at the choice of the borrower The income it derives from other services is in accordance with the regulation specified.
Capital of NBFC-MFI	**Minimum net worth**: All NBFC-MFIs are required to have a minimum net worth of Rs 1.5 crores. **Capital adequacy ratio**: All NBFC-MFIs should be required to maintain a capital adequacy ratio of 15 %. Net owned funds should be in the form of Tier 1 capital.
Securitization and assignment	• Disclosure is made in the financial statements of MFIs of the outstanding loan portfolio, which has been assigned or securitized and the MFI continues as an agent for collection. • Where the assignment or securitization is with recourse, the full value of the outstanding loan portfolio assigned or securitized should be considered as risk-based assets for calculation of capital adequacy. • Where the assignment or securitization is without recourse but credit enhancement has been given, the value of the credit enhancement should be deducted from the net- owned funds for the purpose of calculation of capital adequacy. • Before acquiring assigned or securitized loans, banks should ensure that the loans have been made in accordance with the terms of the specified regulations.

(*continued*)

Box 7.3 (continued)

Provisioning of loans	• Provisioning for loans should not be maintained for individual loans but an MFI should be required to maintain at all times an aggregate provision for loan losses which shall be the higher of: (a) 1 % of the outstanding loan portfolio, or (b) 50 % of the aggregate loan instalments that are overdue for more than 90 days and less than 180 days and 100 % of the aggregate loan instalments that are overdue for 180 days or more.
Lending process	• MFIs should lend to an individual borrower only as a member of a JLG and should have the responsibility of ensuring that borrower is not a member of another JLG. • A borrower cannot be a member of more than one SHG/JLG. • Not more than two MFIs should lend to the same borrower. • There must be a minimum period of moratorium between the grant of the loan and the commencement of its repayment. • Recovery of loan given in violation of the regulations should be deferred until all prior loans are fully repaid. • All sanctioning and disbursement of loans should be done only at a central location and more than one individual should be involved in this function. • There should be close supervision of the disbursement function.
Recovery process	• MFIs should ensure that coercive methods of recovery are not used. In case of use of coercive methods, MFIs should be subject to severe penalties. • MFIs should have a proper Code of Conduct and proper systems for recruitment, training, and supervision of field staff to ensure the prevention of coercive methods of recovery.
Credit information bureau	One or more credit information bureaus should be established and be operational as soon as possible, and all MFIs should be required to become members of such bureau. In the meantime, the responsibility to obtain information from potential borrowers regarding existing borrowings should be on the MFI.

(*continued*)

Box 7.3 (continued)

Funding of MFIs	• Bank lending to the microfinance sector both through the SBLP Programme and directly should be significantly increased, and this should result in a reduction in the lending interest rates. • Bank advances to the MFIs shall continue to enjoy PSL status. However, advances to MFIs which do not comply with the regulation should be denied such status. • The creation of one or more "Domestic Social Capital Funds" may be examined in consultation with SEBI. • MFIs should be encouraged to issue preference capital with a ceiling on the coupon rate and this can be treated as part of Tier 2 capital subject to capital adequacy norms.
Monitoring of compliance	• The primary responsibility for ensuring compliance with the regulations should rest with the MFI itself and it should be penalized in case of noncompliance. • Banks should also conduct surveillance of MFIs through their branches. • The RBIs should have the responsibility for off-site and on-site supervision of MFIs. • The RBI should have the power to remove from office the CEO and/or a director in the event of persistent violation of the regulations.
Regulation	NBFC-MFIs should be exempted from the provisions of the Money-Lending Acts, especially since there are recommendations regarding interest margin caps and increased regulation. **Key Features of the Proposed Microfinance (Development and Regulation) Bill, 2010** • Should provide for all entities covered by the Act to be registered with the Regulator. However, entities where aggregate loan portfolio does not exceed Rs 10 crores may be exempted from registration. • If NABARD is designated as the regulator under the proposed Act, there must be close coordination between NABARD and the RBI in the formulation of the regulations. • The microfinance entities governed by the proposed Act should not be allowed to do the business of providing thrift services.

2011–2015 (The Slow Rebound)

The Andhra Pradesh crisis left microfinance companies such as SHARE Microfin, Asmitha Microfin, Spandana Sphoorty Financial, Trident Microfin, and Future Financial Services with negative net worth. According to norms, banks are not allowed to provide fresh loans to companies that have negative net worth. Since banks stopped lending to MFIs, they were not able to disburse fresh loans to their clients. Banks were also hit by crisis as 80 % of loans MFIs borrowed were from the banks. Of the Rs 21,000 crore that banks had outstanding to MFIs, roughly a third was borrowed from private banks. Banks and financial institutions lost their trust in MFIs credibility to repay the loans. Fresh lending to MFIs by banks during 2011–2012 declined by over 38 % as compared to the previous year. Loans outstanding against MFIs came down by almost 17 % during 2011–2012. Gross loan portfolios also shrunk by 14 % in FY 2011–2012, and were reduced to Rs. 172 billion. The crisis hit the operational self-sufficiency of Andhra Pradesh based MFIs badly as it fell from 150 to 40 % in FY 2011–2012. The crisis affected the portfolio quality of MFIs to the extent that they were the worst performer on the global platform. As pointed out by Srinivasan (2012), "The Andhra Pradesh regulation is right on intent, but wrong in its focus, coverage, and application. Inappropriate regulation produces long-term damage that is difficult to remedy" (Kaur and Dey 2013).

On the regulatory side, subsequent to the Malegam committee recommendations, the RBI came up with two significant notifications. One was to accord priority sector status to bank lending to MFIs, and the other was the NBFC-MFIs Directions 2011. While the former covers bank lending to all kinds of MFIs, the latter covers the NBFC-MFIs, which are recognised as a separate category of NBFCs. Both regulations define qualifying assets, income criteria for borrowers, limits for indebtedness, targets for income generation loans, pricing structure including margin cap and interest rate cap, lending practices, and so on. MFIs by and large are compliant with the regulatory prescriptions made by RBI (Sa-Dhan 2014).

A Credit Bureau

A key development after the RBI guidelines were implemented was that all MFIs have to report to at least one of the MFI-specific credit bureaus in the country (High Mark, Equifax, and more recently Experian), and have to check every loan application with the credit bureau to establish the level of indebtedness of the applicant. The following thresholds are prescribed by the RBI:

1. Total indebtedness of the borrower should not exceed Rs 50,000
2. The MFI should ensure that:

- Borrower does not have more than two NBFC-MFIs loans
- Borrower cannot be a member of more than one of its SHGs/JLGs
- It does not lend to a single person as an individual and group borrower simultaneously

These measures ensure that there is very low likelihood of a borrower becoming overindebted through microfinance loans as it limits both the exposure as well as the number of providers to a single borrower. However, the informal borrowings of borrowers (highly likely) and formal borrowings from banks (highly unlikely) are not captured here.

Drafting of a New Bill

The central government also swung into action with the Ministry of Finance constituting a committee in March 2011 to recommend a draft of a new law to regulate the sector. This committee had members from the Department of Financial Services, RBI, Indian Banks Association, NABARD, SIDBI, the State Governments (Bihar and Tamil Nadu), and State Level Bankers' Committee, Andhra Pradesh. The MFIs were represented by the MFIN and Sa-Dhan. The draft bill formulated by the committee was put on the website of the Ministry of Finance to invite comments from stakeholders. The Department of Financial Services organised a round table on the draft bill on July 28, 2011, where the representatives of the Andhra Pradesh government were also invited to express their views. After considering the comments received from various stakeholders, the government introduced the Micro Finance Institutions (Development and Regulation) Bill 2012, which was introduced in Lok Sabha on May 22, 2012, and referred to the Departmentally Related Standing Committee on Finance on May 25, 2012 (Standing Committee Report 2014).

The bill sought to establish the RBI as the regulator of the sector with powers to: (1) specify the maximum limit of the margin and annual percentage rate which can be charged by any MFI, sector-related benchmarks, performance standards pertaining to methods of operation, and set fair and reasonable methods of recovery of loans advanced by the MFIs; and (2) inspect the accounts of the MFIs and take necessary action.

Box 7.4: Comparison of 2007 Bill and 2012 Bill

Aspects	Microfinance Bill, 2007	Microfinance Bill, 2012
Scope and application	Only NGO-MFIs registered as societies, trusts, and cooperatives (i.e. excluding NBFCs and Section 25 companies)	All MFIs in all forms
Structure of the sector	One tier, MFOs only (apart from NBFCs and Section 25 companies, but no provisions applicable to them)	The sector is now covered under the provisions of the Bill in its entirety
Savings mobilization	Only 'thrift' for MFO from members	Thrift mobilization from public also permitted
Supervisor	NABARD	RBI—with powers to delegate to NABARD and to other agencies as may be deemed fit
Advisory council	Advisory, with majority consisting of officials representing specified agencies ex-officio	In addition to a national level council, provisions have been made for state level councils as well as district level committees for monitoring of functioning of MFIs

(*continued*)

Box 7.4 (continued)

Grievances handling and appellate authority	MFDC 'may' set up ombudsman	Ombudsman provided for
Capital norms	NOF of at least Rs. 5 lakh and a capital adequacy ratio of 15 %	Rs. 5 lakh as minimum entry capital—RBI to stipulate prudential norms
Instruments	Registration for thrift taking MFOs and information reporting for all	Registration for all, information reporting and interest rate caps
Customer protection	Through Ombudsman	Norms for customer selection, size of loans, interest disclosure, process controls and interest/margin ceilings. Also through District Micro Finance Committees
Powers of regulator	Minimal	Power to cancel registration, order for winding up, merger and acquisition, imposition of penalties, delegation of powers, issuance of directions

Different stakeholders had diverse views on the regulations. The NBFC-MFIs, under MFIN, believed that since NBFCs are governed by the RBI, they need not be subjected to more regulation. However, the standing committee rejected the bill in its present form, urged the Ministry to hold wider consultations and review its fundamental proposals. Since this bill sought to bring in unincorporated MFIs, which were few in number, under RBI's ambit, the committee suggested that the bill be reconsidered, and instead the states should be allowed to bring unincorporated

MFIs under the ambit of state money lending laws. Given the lack of concurrence of the RBI with this bill, the committee suggested the formation of an independent regulator, which would have representatives from all concerned agencies. Additionally, the committee felt that the government should persist in pursuing the bank-led model for financial inclusion. Lastly, the government should consider statutory rights for bank accounts. The bill lapsed with the dissolution of the 14th Lok Sabha (Standing Committee Report 2014).

Mor Committee Recommendations for Policy

Just after Dr. Raghuram Rajan took over as the new Governor of RBI in September 2013, he announced the formation of the 'Committee on Comprehensive Financial Services for Small Businesses and Low Income Households' under the chairmanship of Dr. Nachiket Mor. The committee drew heavily on people with international experience, the private sector, and those who had resorted to disruptive innovation. The report was submitted on December 31, 2013. The mandate of the committee was to frame a clear and detailed vision of financial inclusion and financial deepening in India. The committee has made recommendations related to the working of NBFC-MFIs, and set a number of targets to be achieved by January 1, 2016 and:

- Provide each Indian resident above the age of 18 with an individual, full-service electronic bank account
- Set up widely distributed Electronic Payment Access Points offering deposit and withdrawal facilities at reasonable cost
- Provided each low-income household convenient access to formally regulated providers that can provide suitable (a) credit products, (b) investment and deposit products, and (c) insurance and risk management products at a reasonable price
- Provide every customer the legally protected right to be offered suitable financial services.

Box 7.5: Mor Committee Report

The Report of the Committee on Comprehensive Financial Services for Small Business and Low-Income Households (Chairperson: Dr. Nachiket Mor, December 31, 2013)

Terms of reference

1. To frame a clear and detailed vision for financial inclusion and financial deepening in India.
2. To lay down a set of design principles that will guide the development of institutional frameworks and regulation for achieving financial inclusion and financial deepening.
3. To review existing strategies and develop new ones that address specific barriers to progress and that encourage participants to work swiftly towards achieving full inclusion and financial deepening, consistent with the design principles.
4. To develop a comprehensive monitoring framework to track the progress of the financial inclusion and deepening efforts on a nationwide basis.
5. Any other related issue/s the Committee may want to opine on.

Targets to be achieved by January 1, 2016

- Provide each Indian resident above the age of 18 with an individual, full-service electronic bank account
- Set up widely distributed Electronic Payment Access Points offering deposit and withdrawal facilities at reasonable cost
- Provide each low-income household convenient access to formally regulated providers that can provide suitable: (a) credit products, (b) investment and deposit products, and (c) insurance and risk management products at a reasonable price
- Provide every customer the legally protected right to be offered suitable financial services

Wide-spread payment network and universal access to savings	• Every resident should receive a Universal Electronic Bank Account at the time of registering for an Aadhaar card. • RBI should prohibit banks from refusing to open an account and make Aadhaar the universal basis for authentication. • Set up Payments Banks whose primary purpose will be to provide payments services and deposit products to small businesses and low income households. These banks will be restricted to holding a maximum balance of Rs 50,000 per customer and will be required to have a minimum entry capital of Rs 50 crore. • Set up wholesale banks that will lend to corporations and purchase securitized retail and small-business loans. These banks will only accept deposits larger than Rs 5 crore and will require minimum entry capital of Rs 50 crore.

(continued)

Box 7.5 (continued)

Sufficient access to affordable formal credit	• Steps should be taken to help banks manage their credit exposures effectively, including allowing banks to purchase portfolio insurance. • Universal reporting of information with credit bureaus should be mandatory for all loans, especially kisan credit cards and general credit cards. • Banks should price farm loans based on risk and any waivers should be provided by the government through direct benefit transfer and not through interest subsidies or loan waivers. • Establish a State Finance Regulatory Commission into which all state level financial regulators will be merged. • The Non-Performing Asset reporting provisions and other regulations for NBFCs should be aligned with those of banks. • In order to ease funding constraints of NBFCs, there should be relaxation of External Commercial Borrowings and equity investment rules. • Remove barriers to the transition of NBFCs into banks by including more sectors in the PSL classification.
Priority Sector Lending	• Investment by banks in bonds and equities and provision of guarantees to PSL beneficiaries should be counted towards meeting the banks' PSL targets. • Remove the cap on interest rate charged on loans to the ultimate borrower by the originating entity. The interest rate is capped at the base rate of the purchasing bank plus 8 % a year. • The PSL target should be revised from 40 to 50 % of credit provided. • RBI should constitute a working group to develop a framework for sharing data between telecom companies, electrical utilities and credit bureau. • Banks and financial institutions should verify land records of clients at the time of making loans. • Equity investment by banks in complementary infrastructure such as rural warehouses, market yards, godowns, silos should be eligible for PSL treatment.
Customer protection issues	• Financial service providers should be required to commit capital against customer protection risk. • Firms should be made liable to ensure suitability of products issued to customers and RBI should frame regulations regarding the same. • Establish a unified Financial Redress Agency that will handle customer grievances across all financial products in coordination with their respective regulators. • RBI should mandate all formal providers of financial services to households and small businesses to report on a quarterly basis. Also, two surveys of consumers should be conducted to measure financial inclusion.

Bandhan Gets Banking Licence

In April 2014, the RBI awarded Bandhan, a Kolkata based NBFC,[11] a banking license to act as a commercial bank along with the Infrastructure Development Finance Company (Economic Times 2014). These measures highlighted a way forward for the NBFC-MFIs, and gave the option to the MFIs to collect deposits, which would go a long way in reducing the cost of capital.

The industry also has taken precautions to ensure that MFIs do not indulge in malpractices. The Code of Conduct issued by the Self-Regulatory Organisation for MFIs in India, MFIN now requires member MFIs to participate in a forum to share qualitative credit information. Whenever any member MFI comes across incidents of high default/mass default, the MFI is required to inform MFIN so that the other member MFIs are made aware of it. However, whether any other MFI would further lend to clients in such an area would be the choice of each institution based on their credit policies, and transparency in sharing this decision with other member MFIs is encouraged. In case of any high default incidents faced by one MFI, all member MFIs are called upon to cooperate in a recovery drive and restrain lending in that area till the issue is resolved.

Recovery of the Sector

With these regulatory interventions, the MFIs have slowly started recovering with some improvement in the funding environment. Banks have resumed funding activity. Total debt of the MFIs has increased to Rs 11,001 crore in FY13 from Rs 6661 crore in FY12. The sector has also been attracting regular equity infusion from private equity investors reflecting the increasing confidence of the investors regarding the growth potential in the sector.

The sector has rebounded and shows encouraging growth trends. Client numbers have now reached 28 million for NBFC-MFIs alone, and

[11] Set up in 2001 by Chandra Shekhar Ghosh, Kolkata-based Bandhan began with a focus on working with "socially disadvantaged and economically exploited women". With 2016 branches across 22 states and Union territories, Bandhan had over 52.33 lakh borrowers as of February. It disbursed Rs 963 crore of loans in February and has total loans outstanding of Rs 5704 crore.

outstanding loan portfolio has crossed Rs. 279 billion. This represents historically the highest point in the industry's growth (IFMR Investments 2014; CARE Ratings 2014, Figs. 7.6 and 7.7).

The 2014 general elections brought the Narendra Modi led National Democratic Alliance government to power. The government has made financial inclusion a priority and has taken steps towards this direction. Prime Minister Modi launched an ambitious programme on financial inclusion called Pradhan Mantri Jan Dhan Yojana. This scheme seeks to: (a) provide bank accounts to every household in India (estimated at 6 crore in rural areas and 1.5 crore in urban areas); (b) open bank accounts with RuPay Debit Card and mobile banking facility; (c) cash withdrawal and deposits; (d) transfer; (e) balance inquiry; (f) mini statement. The RuPay debit card would have inbuilt accident insurance coverage of Rs 1 lakh. An overdraft facility of up to Rs 5000 would be provided after six months of satisfactory performance of saving/credit history. As of January 2015, 11.5 crore bank accounts have been opened against an original target of 7.5 crore

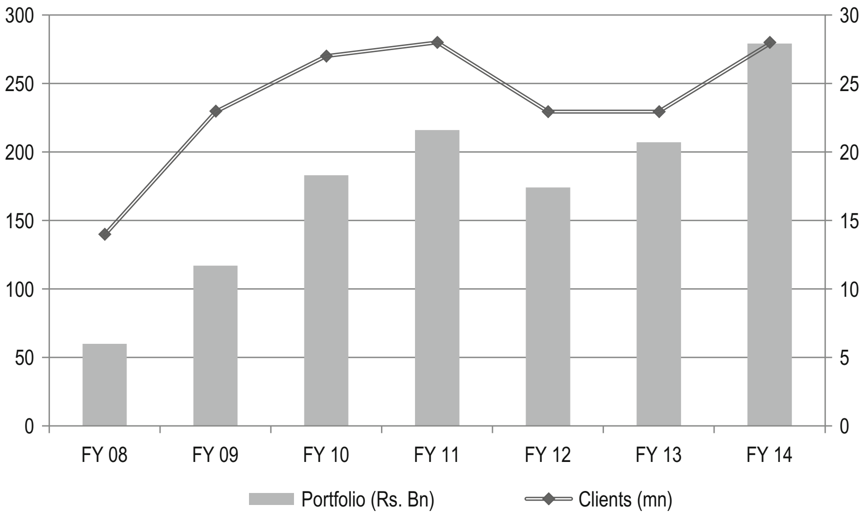

Fig. 7.6 Borrowers and portfolio outstanding of MFIs in India across years. *Sources*: MIX Market data until FY11, Micrometer data FY12–FY14: only includes NBFCs and NBFC-MFIs for FY12–14

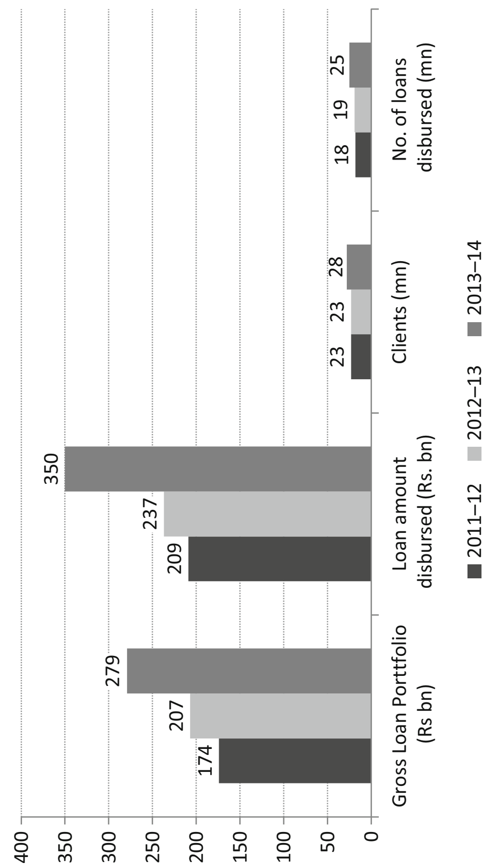

Fig. 7.7 Growth trends of NBFC-MFIs.
Source: Inclusive Finance India Report 2014, Tara Nair, Ajay Tankha, ACCESS 2015

(Press Information Bureau 2015a). Based on the Standing Committee of Finance's recommendations, the government has also started the consultative process for a new law to govern the microfinance sector.

Establishment of the Micro Units Development and Refinance Agency Bank

In its Union Budget 2015–2016, the government announced that it plans to set up a Micro Units Development and Refinance Agency (MUDRA) Bank through a statutory enactment. This bank would be responsible for regulating and refinancing all MFIs. The bank would partner with state level and regional level co-ordinators to provide finance to Last Mile Financer of small/micro business enterprises. It would act as a single regulator for all types of entities in the microfinance space.

The MUDRA Bank would primarily be responsible for the following:

- Providing policy guidelines for micro/small enterprise financing business
- Registration of MFI entities
- Regulation of MFI entities
- Accreditation and rating of MFI entities
- Providing responsible financing practices to ward off indebtedness, ensure proper client protection principles, and methods of recovery
- Development of standardised set of covenants governing last mile lending to micro and small enterprises
- Promoting right technology solutions for the last mile
- Formulating and operating Credit Guarantee scheme for providing guarantees to the loans which are being extended to micro enterprises
- Creating a good architecture of Last Mile Credit Delivery to micro businesses under the scheme of Pradhan Mantri Mudra Yojana
- In lending, priority will be given to SC/ST enterprises

A sum of Rs 20,000 crores would be allocated to the MUDRA Bank from the money available from shortfalls of PSL for creating a Refinance Fund to provide refinance to the Last Mile Financers. Another Rs 3000 crore would be provided to the MUDRA Bank from the budget to create a Credit Guarantee corpus for guaranteeing loans being provided to the micro enterprises (Press Information Bureau 2015b).

Since the enactment for MUDRA is likely to take some time, it has been proposed to initiate MUDRA as a unit of SIDBI in order to benefit from its initiatives and expertise.

Conclusion

Since the 1950s, the government and the RBI have implemented a host of measures to increase access to financial services for the poor including the nationalisation of banks, building up of robust branch networks of scheduled commercial banks, co-operatives and RRBs, and the introduction of mandated PSL targets. While there has been significant progress since the 1950s through the bank-led model of financial inclusion,[12] there is still room for improvement on both financial inclusion and financial depth. In 2012, an estimate suggested that close to 90 % of small businesses have no links with formal financial institutions, and 60 % of the rural and urban population do not even have a functional bank account (RBI 2013). The Census for 2011 held that only 58.7 % (rural: 54 %; urban: 68 %) of households are using banking services in the country. However, only 11 % of those who had accounts made savings, and only 8 % took loans (Ministry of Finance and Government of India 2014). The National Council of Applied Economic Research's National Survey of Household Income and Expenditure 2011–2012 survey indicated that on average, less than 30 % of those in the bottommost quintile have a bank account, and about 50 % of household falling in the second quintile have bank accounts. From 2007 to 2012, 37.5 % of agricultural credit was accounted for by the southern states despite their constituting less than 20 % of India's gross cropped area, while the eastern and

[12] As of March 2014, there are 115,082 Scheduled Commercial Banks branches across the country. Of these, 43,962 branches (38 %) are in rural areas. The ATM network in the country stands at 160,055 as of March 2014. The number of rural ATMs increased from 5196 in March 2010 to 23,334 (15 %) in March 2014.

north-eastern states accounted for only 7.71 %, despite having comparable gross cropped area (RBI 2013).

Although India's microfinance outreach is the highest in the world at 30.3 million borrowers in March 2014, this covers only a small proportion of the total unbanked, underserved potential in the country. Out of a potential market size of Rs 1.5 trillion, the current penetration is only around Rs 600 billion. India still has about 650 million adults who lack access to formal source of borrowing (IFMR Investments 2014).

Given this background, it is imperative that new avenues for scaling up access to finance for the poor be found and implemented. However, it also raises a number of questions. Is microfinance the only answer or are there other alternatives? What are the benefits and drawbacks of the microfinance model? What lessons can other countries draw from India's experiences with the microfinance movement? We conclude the chapter by grappling with some of these questions.

Proponents of the microfinance model assert that it contributes to the decline in poverty through higher employment and incomes, leading to improved nutrition and education of the borrower's children (Morduch 1999). The critics, on the other hand, point out that microcredit drives the poor into a debt trap since the money loaned is used for consumption activities rather than for business investments. The high interest rates charged by MFIs have also come under criticism. Also, new evidence from a meta-study conducted by JPAL suggests that access to microcredit did not lead to substantial increases in income nor did it have substantial effect on women's empowerment, or investment in children's schooling. However, the evidence did point to households having more freedom of choice in the ways they made money, consumed, invested, and managed risks (Innovations for Poverty Action and The Abdul Latif Jameel Poverty Action Lab 2015).

The microfinance model still plays a modest role in India. In terms of client outreach and overall loan portfolio outstanding, the south still dominates followed by the east, central and west. The north and north-east remain underserved by MFIs. Given the size of the Indian market, there can be little impact without scaling up, which requires substantial funds to be accessed through the capital market. This leads to the inherent tension between achieving social impact and ensuring profitability.

Scaling up addresses the issue of outreach and sustainability, but there is fear that the focus of the MFIs may shift towards bigger loans (Kumar 2015).

An analysis of the microfinance movement in India shows that while the size of the MFIs operations remained small, the need for regulation was not widely articulated. It was only when the sector witnessed high growth between 2006 and 2010 that the ill-effects of the unbalanced nature of the growth emerged. Since the growth was more intensive in certain geographies, including Andhra Pradesh, these areas became saturated leading to high competition and aggressive lending. Aside from the vested interest of the political elite, the Andhra Pradesh crisis was precipitated by the lack of regulatory clarity. There was also fear that other states may follow suit and put such opaque regulations in place, disrupting the operations of the MFIs in the other states. The regulatory interventions of 2011 and 2012 have helped the microfinance sector to weather the crisis, and evolve into a better-regulated sector with more transparency, reporting structures, and client protection (CARE Ratings 2014).

One of the key lessons that may be drawn from the Indian experience with microfinance is the necessity of enabling a regulatory framework to ensure that the growth of the sector is accompanied by transparency, reporting norms, and client protection. With no specific microfinance regulation from the RBI, the sector was practically unregulated, which also meant it was open to regulation from virtually any agency. Avoiding such situations would go far in avoiding a crisis similar to the case of Andhra Pradesh.

Second, microfinance needs to be viewed through a wider lens that goes beyond microredit alone, since the poor need a whole range of financial services like credit, savings, insurance, money transfers, and pensions.

Third, the establishment of credit bureaus is critical to ensuring information sharing, but requires investments in technology by lenders. Lenders in India fear that this may be difficult to manage especially for smaller MFIs. There may be a need for government intervention to ensure that smaller MFIs also report to credit bureaus.

Fourth, it is essential for MFIs to train their staff and monitor them effectively. One of the key problems of the fast growing NBFC-MFIs was that the only parameters to which the managements and boards seemed to pay attention to were the growth and health of the loan portfolio, and the reduction of operating costs. The field staff quickly learned to respond to being monitored and incentivised but ignored all the rest, including going to remote villages, searching for the really poor clients, handholding and training client groups before giving them the powers to approve each other's loans, ensuring client education, and providing adequate disclosure about interest rates and other terms.

Technology will and should play a key role in moving the microfinance movement forward, regardless of the speed with which it is resisted or accepted by policymakers. To achieve effective financial inclusion in India, both the players in the microfinance sector and the government need to complement each other's efforts in different ways. The microfinance sector could develop a wider array of financial services for the poor as well as look at other models in place globally such as Bolivia, Indonesia, and Brazil. The government needs to provide a facilitating environment to ensure that there is a stable flow of funds for microcredit transactions through regulatory uniformity and reducing policy uncertainty.

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