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I. Introduction

The recent microfinance crisis in the southern Indian state of Andhra Pradesh caught the world's attention and caused many to wonder who was to blame. Sensationalized newspaper accounts of suicides among over-indebted clients of microfinance institutions (MFIs) brought to light the increasing debt stress across tens of thousands of clients, exacerbated by explosive growth of these MFIs in southern India.[1] In light of these events, India's Ministry of Finance released a draft of the Microfinance Institutions (Development and Regulation) Bill 2011 (MFI Bill) to address the oversight of MFIs and establish more control over this vastly growing sector of the Indian economy. This article will begin by addressing the beginnings of microfinance in India and then explain the crisis in Andhra Pradesh and its causes. Ultimately, the Microfinance Bill will be explained and analyzed to determine the effects it might have on Indian MFIs and the Indian people as a whole.

II. The Beginnings of Microfinance in India

Microfinance as we know it today can be defined as "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers, and insurance to poor and low-income households and, their micro enterprises."[2] Historically, unethical moneylenders with extremely high interest rates have been the poor's only access to capi-

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1. Elisabeth Rhyne, *On Microfinance: Who's to Blame for the Crisis in Andhra Pradesh?*, HUFFINGTON POST, Nov. 2, 2010, http://www.huffingtonpost.com/elisabeth-rhyne/on-microfinance-whos-to-b_b_777911.html.

2. Md. Waliul Baten, Vision of Micro Financing in Bangladesh: Success and Challenges 29 (Oct. 21, 2009) (unpublished Master's thesis, Copenhagen Business School), *available at* http://studenttheses.cbs.dk/bit stream/handle/10417/796/waliul_baten.pdf.

tal because of larger formal banking institutions' unwillingness to lend without some sort of collateral backing their loans. Thus, microfinance has sought to "bridge the gap between formal institutions and the poor by providing some intermediary mechanisms of transaction aggregation and rationalizing transaction costs."[3]

Microfinance is not necessarily a new idea. "In the mid 1800s, individualist anarchist Lysander Spooner wrote about the benefits of numerous small loans for entrepreneurial activities to the poor as a way to alleviate poverty."[4] However, it was not until the end of World War II with the Marshall Plan that the idea gained notoriety. Historian Timothy Guinnane began researching Freidrich Wilhelm Raiffeisen's village bank movement in Germany that reached two million rural farmers between 1864 and 1901.[5] Still, the first microfinance and community development bank, Shorebank, was not founded until 1974 in Chicago.[6]

While the true beginnings of microfinance are not traced to India, the popularity and model used today can be attributed to Dr. Muhammad Yunus' Grammen Bank in Bangladesh. Dr. Yunus explained his beginnings as follows:

It has been a long journey for us. It began in 1976 with lending of $27 to forty-two poor people in a village next to the university campus where I was teaching economics. I had no intention of making a wave. Nor was I planning to create a bank for the poor. I had a very modest goal. I was trying to free forty-two people from the clutches of moneylenders by giving them the money they owed to the moneylenders, in order to repay them and become free from exploitation.[7]

Gradually, Dr. Yunus' model of giving collateral-free tiny loans for income-generating activities of the poor caught on and he founded the formal Grameen Bank in 1983.[8] The idea spread like wildfire across India and the entire world. Today, the Grameen Bank has a portfolio of over $3 billion and 2.3 million members, dispersing an average of $170 to each member, which is sixty percent of Bangladesh's per capita GDP.[9] To make these loans, field representatives will form groups of five within the villages and will only continue to make loans to the group if all of the members repay the previous loan. Thus, because the ability to receive future loans and standing within the village creates a huge incentive to repay the loans, Grameen has a ninety-eight percent repayment rate.[10] In 2006, Dr. Yunus was given the Nobel Peace Prize in recognition of his accomplishment in reducing poverty throughout India.[11]

3. M.S. Sriram, *Information Asymmetry and Trust: A Framework for Studying Microfinance in India*, 30 VIKALPA 4, 78 (Dec. 2005).

4. Adnan Ali & M. Ashan Alam, Role and Performance of Microcredit 6 (Spring 2010) (unpublished Master's thesis, University West Trollhättan Sweden 2010), *available at* http://hv.diva-portal.org/smash/record.jsf?pid=diva2:323460.

5. Baten, *supra* note 2, at 30.

6. *Id.*

7. Muhammad Yunus, *Grameen Bank, Microcredit and Millennium Development Goals*, 39 ECON. & POL. WKLY. 36, 4077 (Sept. 4, 2004).

8. *Id.*

9. Susan Wolcott, *Microfinance in Colonial India* 2 (Binghamton Univ. Dept. of Econ., Working Paper No. 0809, 2008), *available at* http://www2.binghamton.edu/economics/research/working-papers/pdfs/wp08/WP0809.pdf.

10. *Id.*

11. ALEX COUNTS, SMALL LOANS, BIG DREAMS: HOW NOBEL PRIZE WINNER MUHAMMAD YUNUS AND MICROFINANCE ARE CHANGING THE WORLD 1 (2008).

The success of the Grameen Bank must be attributed partially to the principles on which they were founded. First, Grameen believes that poverty is not created by the poor but by the institutions and policies that surround them, and thus changes are needed.[12] Additionally, they believe that charity is not the answer to poverty and only perpetuates the situation and creates dependency.[13] The Grameen system is also built on the belief that there is no difference in the ability of a poor person and any other person; the poor merely do not get the opportunity to explore their potential.[14] While conventional banks start with the principle that the more you have the more you can get, Grameen's credit principle is the less a person has, the higher the priority he gets.[15] Additionally, a central assumption of the system is that while it may take a poor person longer to pay back the loan due to circumstances beyond his or her control, the poor person will always pay back.[16] Lastly, the Grameen system believes that lending to women brings greater benefits to the family than lending to men because they believe that women have greater long-term vision and are ready to bring about changes in their lives systematically.[17]

With over 1.1 billion people, India constitutes one-sixth of the world's total population and its GDP ranks as the ninth strongest economy in the world.[18] However, 27.5% of its population lives below its poverty level.[19] Thus, India is home to the largest population of poor in the world and consequently has become a natural candidate for experimenting with microfinance as a way to reduce poverty.[20] Studies of microcredit programs have proven that providing "easy and affordable access to credit and other financial services to poor families can have a host of positive impacts on their livelihoods."[21] Moving out of poverty, improved nutrition, better housing and sanitation, lower child mortality rates, and greater empowerment of women are just a few of the proven benefits of microfinance.[22] Indeed, while other factors have attributed to this statistic as well, India's poverty level has continually decreased from 44.5% in 1983 to 27.5% in 2010.[23]

III. The 2010 Microfinance Crisis in Andhra Pradesh

While microfinance began as a way to reduce poverty, it has recently become a multi-billion dollar industry that has stakeholders in the financial services industry, non-governmental organizations, and global politics.[24] Mexican MFI Banco Compartamos listed eq-

12. Yunus, *supra* note 7, at 4077-78.
13. *Id.*
14. *Id.*
15. *Id.*
16. *Id.*
17. *Id.*
18. World Bank Data on India, http://data.worldbank.org/country/india (last visited Jan. 4, 2012).
19. *Id.*
20. Rajesh Chakrabarti, *The Indian Microfinance Experience: Accomplishments and Challenges*, *in* INTEGRATING THE RURAL POOR IN MARKETS 137 (Bibek Debroy & Amir Ullah Khan eds., 2005).
21. Yunus, *supra* note 7, at 4077.
22. *Id.*
23. World Bank Data on India, http://data.worldbank.org/country/india (last visited Jan. 4, 2012).
24. Ashley Feasley, *SKS Microfinance and For-Profit MFIs: Unscrupulous Predators or Political Prey? Examining the Microfinance Credit Crunch in Andhra Pradesh and Assessing the Applicability of the UN Global Compact "Protect Respect Remedy" Framework* 2 (Cornell Law School Inter-University Graduate Student Conference Papers, Paper 49, 2011), *available at* http://scholarship.law.cornell.edu/lps_clacp/49/.

uity shares worth an estimated $1.6 billion in 2007 and became the first ever publically traded MFI.[25] Then in August of 2010, Hyderabad-based SKS Microfinance carried out the very successful first IPO by a MFI in India and was reportedly worth $358 million at listing.[26] Vikram Akula, founder of SKS Microfinance, stated that he wants to "end poverty through profitability."[27] Many believed the successful IPO of SKS Microfinance marked the beginning of for-profit MFIs leading the way to eradicating poverty in India while also making a very large profit.

While microfinance has seen huge success and growth within India and around the globe, it hit a major roadblock with the microfinance crisis of Andhra Pradesh in October 2010. The Indian state of Andhra Pradesh accounts for almost forty percent of all microfinance activity in India.[28] Andhra Pradesh is called by many "the capital of microfinance in India" and is by far home to the largest number of MFI giants, including SKS Microfinance and Spandana.[29] Events after the SKS Microfinance IPO intensified criticism of for-profit MFIs; some argued that in an effort to sustain profits, for-profit MFIs were making irresponsible investments and were abusing the very poor communities they were supposedly trying to help.[30] Numerous news agencies began running articles on the rise of farmers in Andhra Pradesh committing suicide due to an inability to pay back their high interest loans.[31] Somewhat similar to the U.S. subprime mortgage crisis of 2007-2008, some claimed the for-profit MFIs were extending loans to the poor at extremely high interest rates without regard for their ability to pay due to their pursuit of profits.[32] With news of the sensationalized stories of over seventy suicides, politicians began urging borrowers not to pay back what they owed, and thousands listened. Repayments on $2 billion worth of loans were halted, and less than ten percent of borrowers made payments.[33] Additionally, the Andhra Pradesh state government created "An Ordinance to Protect the Women Self Help Groups from Exploitation by the Micro Finance Institutions in the State of Andhra Pradesh and for the matters connected therewith or incidental therefore" (AP Ordinance) which soon became the law regulating lending practices of MFIs in Andhra Pradesh.[34]

In passing the AP Ordinance, the government identified the problem as a debt trap and over-borrowing by the poor from multiple, competing MFIs that was resulting in default or near-default situations that were only worsened by aggressive collection practices that helped to possibly lead to the suicides.[35] The AP Ordinance laid down a heavy hand and created many stipulations for MFIs in Andhra Pradesh. First, it requires MFIs to register

25. Renuka Sane & Susan Thomas, *A Policy Response to the Indian Micro-Finance Crisis* 8 (Indira Gandhi Inst. of Dev. Research, Mumbai, Working Paper No. 2011-007, 2011), *available at* http://www.igidr.ac.in/pdf/publication/WP-2011-007.pdf.

26. *Id.*

27. Rajesh Chakrabarti & Shamika Ravi, *At the Crossroads: Microfinance in India*, ICRA BULLETIN: MONEY & FINANCE 2 (May 2011).

28. *Id.* at 17.

29. *Id.* at 17.

30. Feasley, *supra* note 24, at 2.

31. Lydia Polgreen & Viksas Bajaj, *India Microcredit Faces Collapse from Defaults*, N.Y. TIMES, Nov. 17, 2010, *available at* http://www.nytimes.com/2010/11/18/world/asia/18micro.html.

32. *Id.*

33. *Id.*

34. Feasley, *supra* note 24, at 3.

35. Chakrabarti & Ravi, *supra* note 27, at 20.

their branches at a district level.[36] As a part of the registration, MFIs are asked to report the effective interest rates they charge, which were found to range between twenty-five and thirty-five percent.[37] Also, any MFI executive who applied or ordered coercive measures against borrowers or their families would be punishable by imprisonment for up to three years.[38] Importantly as well, MFIs were prohibited from charging interest in excess of the principal amount of the loan.

The AP Ordinance drew a great amount of criticism. One critic noted that the AP Ordinance's "largest drawback is that it only regulates the conduct and actions of MFIs and does not attempt to regulate the Self Help Groups, (SHGs) or any other type of microfinance organization operating in India."[39] The critic also noted that the SHGs play a large role in microcredit activities in India and were overlooked because they are promoted by the Indian government and national banking system and are in an intense competition with the MFIs for loan disbursements.[40] Another critic noted, "while there are nuances in whether the Government of Andhra Pradesh has the ability and the inclination to digest the administrative implications of the ordinance, it has once again shown its inability to target the errant microfinance institutions, and has instead come down heavily on the entire market."[41]

The Andhra Pradesh crisis and subsequent AP Ordinance have caused many to seek to understand the underlying causes of the crisis to better understand how to solve the microfinance problems. Many believe that the extremely fast growth of the microfinance sector is at the root of the issue.[42] The strong desire to grow rapidly led many MFIs to streamline their underwriting practices through reducing personal contact with clients and skipping essential background checks that in turn resulted in providing loans to clients who could not repay.[43] Additionally, the massive amounts of new staff MFIs employed were not trained properly and were given responsibilities beyond their capacities, sometimes resulting in unethical collection practices.[44] The extremely fast growth was fueled by many factors. First, MFI growth was exacerbated by the easy access to debt funds, specifically from banks.[45] From the strong competition between banks, to the high repayment rates to MFIs, public and commercial banks saw MFIs as great investments. Also, the lack of governance that surrounded the transition of many non-profit MFIs to for-profit MFIs helped to sustain the high growth rates.[46] With shareholders now influencing decisions, CEOs felt greater pressure to achieve higher margins and increased profits.

36. Oliver Schmidt, *The Evolution of India's Microfinance Market—Just a Crack in the Glass Ceiling?* 2-3 (Munich Personal RePec Archive, MPRA Paper No. 27142, Dec. 1, 2010), *available at* http://mpra.ub.uni-muenchen.de/27142/.

37. *Id.*

38. *Id.*

39. Feasley, *supra* note 24, at 3.

40. *Id.*

41. M.S. Sriram, *Microfinance: A FairyTale Turns into a Nightmare*, 45 ECON. & POL. WKLY. 1, 13 (Oct. 23, 2010).

42. Pete Sparreboom, *The Indian Microfinance Crisis 2010 – Lessons for China* 13 (Working Group on Inclusive Finance in China, China Papers on Inclusiveness No. 4, Apr. 2011), *available at* http://www.microfinancegateway.org/gm/document-1.9.52004/The%20Indian%20Microfinance%20Crisis.pdf.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.* at 14.

The national Indian government took note of the crisis and the Reserve Bank of India (RBI) established a committee headed by Y.H. Malegam (Malegam Committee) to review the issues and to recommend regulatory steps that would prevent the Andhra Pradesh crisis from recurring.[47] The first suggestion was to create a new institutional category called NBFC-MFIs that would have a net worth of at least fifteen rupees (Rs.) with a minimum of ninety percent of their assets being "qualified assets;"[48] specifically, the "qualified assets" or non-collateralized micro-loans to households with annual income below Rs. 50,000 and/or total indebtedness not exceeding Rs. 25,000. Additionally, repayment should be within a month or less. In regards to pricing and transparency, the Malegam Committee suggested the MBFC-MIFs observe a margin cap of ten to twenty percent and a pricing cap of twenty-four percent, and all MFIs should provide borrowers with standard loan agreements where prices are prominently displayed.[49] To reduce coercive methods of recovery, it was suggested that MFIs recover loans at the group level at a central place and not at the borrower's residence or workplace.[50] Additionally, several provisions discouraged over-lending and suggested making it the responsibility of the MFIs to ensure the borrower is not involved in more than one Joint Liability Group (JLG) until another governmental agency can take over those responsibilities.[51]

As with the AP Ordinance, the Malegam Committee recommendations have been met with praise and criticism. Some have noted that the committee rightly recognized the importance of MFIs and the need for more oversight by the RBI.[52] Additionally, they state that the recommendations recognize the need for better information and communication in order to ensure that borrowers are protected and are given transparent information.[53] Critics, however, recognize that those recommendations could likely have unintended consequences that would greatly hurt the MFI sector. They note "the creation of entry and operational barriers through higher net worth, capital adequacy, loan portfolio allocation requirements and interest caps is likely to trigger consolidation within the industry, with a possibility of some banks absorbing some of the MFIs, if facilitated by the RBI."[54] They also warn "application of interest rate caps, borrower household income caps and reduced loan limits will result in significant exclusion of households in remote areas and poor households whose incomes exceed the income caps but remain unbanked."[55]

IV. The Microfinance Institutions (Development and Regulation) Bill 2011

In response to the Malegam Committee recommendations, India's Ministry of Finance released a draft of the Microfinance Institutions (Development and Regulation) Bill 2011 (MFI Bill) in July of 2011 that will likely reach the Indian Parliament in their coming

47. Jaideep Singh Panwar, *Microfinance in India: Mission or Misery*, *in* ISSUES FOR RESPONSIBLE INVESTORS 5 (Lucy Carmody ed., 2011).
48. *Id.*
49. Sparreboom, *supra* note 42, at 15.
50. *Id.*
51. Chakrabarti & Ravi, *supra* note 27, at 22.
52. Sparreboom, *supra* note 42, at 16.
53. *Id.*
54. Panwar, *supra* note 47, at 6.
55. *Id.*

Winter Session.[56] The bill proposes a regulatory framework for the microfinance industry that hopes to protect consumers by making the RBI the sole regulator of the industry.[57] Micro-Credit Ratings International Limited (M-CRIL) noted that the bill "represents a major step forward in the government's engagement with the microfinance sector."[58]

The chief features of the bill are that every institution in microfinance should register with the regulator, transform into a company when they attain a significant size, be subject to a variety of prudential and operational guidelines that are introduced by the regulator, provide periodic information to the regulator and face penal action for violation of law or any rules framed.[59] As with any vast changes in the regulation of an extremely large and important sector, the bill has drawn both praise and criticism with its methods of protecting the Indian citizens and economy.

The largest change for the microfinance industry would be the delegation of all regulation powers to the RBI. The bill establishes the supremacy of the RBI as the key regulator in hopes of resolving all political and regulatory ambiguity.[60] The bill seems to dissuade state governments from trying to replicate the AP Ordinance and notes that microfinance will be seen as an extension of the banking sector.[61] Going even farther, the MFI Bill requires that every institution involved in microfinance must register with the RBI to help avoid any confusion that may arise due to multiplicity of regulation.[62] Srinivasan, a foremost scholar on Indian microfinance, argues that state involvement should not be completely taken away.[63] He notes:

> The State councils are a good way of involving the state governments. But the councils should be linked to the national council and given a role with content rather than just creating them. Without a significant role and participation in some manner in the activities of the national council, the state councils will become either defunct or deviant.[64]

Alternatively, investors view this aspect of the MFI Bill as a great change. Investors dislike ambiguity and the Andhra Pradesh crisis scared many investors.[65] By creating a sole regulator, ambiguity will be decreased and clarity of rules will be created, enticing many investors to return to the microfinance market.[66] Despite being the sole regulator, M-CRIL also notes that the RBI may, with the previous approval of the Government, delegate any of its powers with respect to any class of MFI to the National Bank for

56. *Draft Microfinance Bill Gives RBI Total Control and Puts Sector under Strict Watch*, ECON. TIMES, July 7, 2011, http://articles.economictimes.indiatimes.com/2011-07-07/news/29747758_1_mfis-coercive-recovery-finance-institutions.

57. *Id.*

58. *Comments on the Draft Microfinance Bill: A Major Step Forward for Financial Inclusion?*, MICRO CREDIT RATINGS INT'L LTD. 1 (July 7, 2011), http://www.m-cril.com/BackEnd/ModulesFiles/Publication/M-CRIL's-comments-on-the-draft-Microfinance-Bill-July-2011.pdf.

59. N. Srinivasan, *India's Microfinance Bill Answers Most Questions*, CGAP MICROFINANCE BLOG (July 24, 2011), http://microfinance.cgap.org/2011/07/24/india's-microfinance-bill-answers-most-questions.

60. Vineet Rai, *India's Microfinance Bill Offers a Mixed Bag to Investors*, CGAP MICROFINANCE BLOG (Aug. 4, 2011), http:/microfinance.cgap.org/2011/08/04/india's-microfinance-bill-offers-a-mixed-bag-to-investors.

61. *Id.*

62. *Id.*

63. *See* Srinivasan, *supra* note 59.

64. *Id.*

65. Rai, *supra* note 60.

66. *Id.*

Agriculture and Rural Development (NABARD).[67] This of course could create some ambiguity and dissuade investor activity.

The MFI Bill also proposes a margin cap in Section 25 that will supposedly prevent MFIs from profiteering from the poor.[68] This is welcomed by some and not by others. Srinivasan notes that this can be positive in that absolute interest rate caps are "anti-market and introduce rigidities."[69] However, he also notes that the MFI Bill also gives the RBI the power to impose an APR cap but believes that margin caps will be imposed across the sector and the APR cap will only be used in emergencies.[70] Another also argues that the margin cap could be a blessing in disguise by scaring away short-term, opportunistic investors from the MFI sector and making it easier for long-term investors to find good deals at reasonable prices.[71] While M-CRIL agrees that there should be a limit on loan amounts to define MFIs, they argue that the margin cap is "unnecessary micro-management of a business relationship."[72] Additionally, it can be argued that a margin cap will take away incentives for MFIs to rework their cost structures and use technology to bring down their costs once they have reached a certain benchmark.[73]

The MFI Bill also tries to protect clients through introducing obligations and establishing extensive monitoring and reporting requirements.[74] Specifically, the MFI Bill creates grievance procedures, mandatory enrollment to credit bureaus, and code of conduct enforcement through industry associations.[75] Requiring all MFIs, regardless of form, to register with the RBI will begin the process of simply gaining more knowledge of the MFI sector in India.[76] While some investors do understand the need to protect vulnerable clients, they also believe that systems for implementation and cost implications have not been taken into account.[77] Nevertheless M-CRIL sees these developments as "inevitable and necessary" in the current situation and "normal in any regulatory regime and beneficial to the sector as a whole."[78]

V. Conclusion

While the MFI Bill has drawn criticism and support from different groups throughout India, most everyone agrees that it provides a step in the correct direction in preventing another crisis from occurring like the one in Andhra Pradesh. While it began as a way to bring the poor from the depths of poverty, microfinance's success has also brought growing pains that have been detrimental to some of those it was trying to help. Through the MFI Bill, the government seems to be striving to protect those that microfinancing was

67. *Comments on the Draft Microfinance Bill*, *supra* note 58, at 1.
68. *See* Srinivasan, *supra* note 59.
69. *Id.*
70. *Id.*
71. Rai, *supra* note 60.
72. *Comments on the Draft Microfinance Bill*, *supra* note 58, at 2.
73. Rai, *supra* note 60.
74. *Id.*
75. *See* Srinivasan, *supra* note 59.
76. *Id.*
77. Rai, *supra* note 60.
78. *Comments on the Draft Microfinance Bill*, *supra* note 58, at 2.

intended to help in the beginning. The fate of the bill has yet to be determined within the Indian Parliament and only time will be able to determine the final specific steps that will be taken to protect India's poor.