November 15, 2010

Honourable Minister P. Mukherjee
Ministry of Finance, North Block
Central Secretariat
New Delhi - 110 001

Sub: An Urgent Appeal regarding the AP Ordinance on Microfinance

Dear Minister Mukherjee,

There is a crisis in microfinance in Andhra Pradesh, India. This crisis has been precipitated by a government Ordinance that effectively prohibits microfinance through onerous “License Raj” type restrictions. As such, it threatens to disrupt microfinance throughout India and undermine the strides toward financial inclusion the sector has made in the last two decades, which includes providing 30 million poor households a current loan portfolio of Rs. 30,000 crores ($6.7 billion). We need your help in bringing this to the attention of the central government officials and political leaders.

The bulk of the outreach from the microfinance sector has been done largely by microfinance institutions (MFIs) registered as non-bank finance companies (NBFC) regulated by the Reserve Bank of India (RBI) and largely not dependent on subsidies from the government. SKS Microfinance is the largest and currently reaches 7.8 million poor households with a loan portfolio of Rs 5,434 crores ($1.2 billion) and an average loan outstanding of 8,156 ($183). SKS is deemed by the RBI, India’s central bank, to be a systematically important NBFC and has disbursed a cumulative of Rs.19,841 ($4.4 billion), since it started operations.

The crisis started in early October. That’s when suicides started being attributed to MFIs. Specifically, there were 57 suicides among the state’s 6 million microfinance clients and their husbands in October. Populist politicians began clamoring for moratoriums, loan waivers, and imprisonment of MFI field staff. The Rural Development Minister of the state publicly asked people to “beat MFI agents with brooms and slippers.” The vernacular media started playing incendiary footage of suicides, with shots of MFI passbooks in the background. This culminated in the cabinet passing the AP Government's Ordinance to Protect the Women Self Help Groups on Friday, October $15^{th}$, 2010. The Ordinance rendered it illegal for MFIs to operate without registering and, since there were no rules for registration, the Ordinance effectively made it illegal for MFIs to operate. So from October $15^{th}$ through October $22^{nd}$ no MFI staff was allowed in the field throughout the state. The Ordinance was so severe that 29 SKS staff and 5 Spandana staff (the second largest MFI) were arrested for acts like simply making phone calls to village lending centre leaders to let them know that they would not be coming for microfinance activities. There was an even an arrest warrant on the Chair and MD of SKS and MD of Spandana.

On the question of suicide, in the case of SKS, 17 of the 57 suicides were SKS borrowers. Whenever such tragedies occur, it is a great loss for the family and SKS goes to meet them. In all the 17 cases, SKS is confident that our collection practices have not caused these suicides. For starters, none of the 17 were defaulters, so the question of putting any kind of pressure does not even arise. Second our methodology—rooted in the operating principles of the Nobel Prize-winning Grameen Bank—ensures that we have ethical lending practices. For example, SKS staff are not incentivized on loan size. This ensures that field staff do not give larger loans than what a borrower can manage; in fact, the group that guarantees the loan has to approve the loan size and, on average, they approve only 72% of the eligible loan amount, making our average loan outstanding of Rs. 8,156 ($183). Third, all of our loans are for productivity enhancing items or income generating activities and we conduct loan utilization checks; this ensures that borrowers generate income so that they can repay loans and retain surplus for themselves.

Also, we don't incentivize our staff on collections and all collection meetings happen in the center meeting only and not at households, so there is no incentive to or even scope for coercive collection. Finally, it should be noted that there is an average rate of suicides of .014% in the Indian population. [TIM, can you check this stat]. Since SKS serves 2.2 million clients, that means that the monthly average rate of suicide would be 25 members. So the 17 suicides in October are not beyond the statistical average suicide rate. Finally, we should note that SKS has been in existence for 13 years across 344 districts [ashish, please update] in the country and we have never had accusations of causing suicide. It is curious that in this month, we are being accused of having caused 17 suicides.

In our analysis, the real problem lies with the unregistered MFIs, not with groups like SKS, which is a registered NBFC regulated by the Reserve Bank of India. The unregistered MFIs, which have names like "Vessel under the Borewell," are basically loan sharks who have taken the garb of microfinance but who continue their age-old strong-arm collection practices and charge usurious rates of interest. We have asked the government to hold those rogue MFIs accountable instead of targeting regulated and law-abiding MFIs such as SKS Microfinance.

But the politicians and government simply lump all MFIs—good, bad, and fake—in one category and passed an Ordinance on October 15, 2010. SKS approached the High Court and on October 22, 2010 and the High Court passed an interim order that MFIs "shall be free to carry on their business" and it also put a stay on all arrests under the ordinance. But despite this, during the week of October 25 through October 29th, our staff have been physically prevented from entering villages because of interference by police, government officials, and local leaders. SKS staff have been able to physically enter only 41% of village centers, with the average falling from 48% on Monday to as low as 33% on Friday.

Worse yet, 61 one SKS staff were taken to jail by the police. Because the High Court had said that there can be no arrests under the Ordinance, more than half of the police detentions did not have any documentation, such as a First Information Report (FIR). Those arrests that were documented werefrom trumped up charges other than for provisions found in the Ordinance. In 5 cases, we were not even able to secure bail, and those staff are still in detention. In one case, the mother of a jailed SKS field staff died of a heart attack one day after his arrest. In brief, the state has taken extra-legal measures to sidestep the High Court order allowing us to continue to work and these measures affect our field staff, who are themselves from low-income, village communities—in many cases, they are sons and daughters of borrowers.

What is notable is that where SKS could enter villages and conduct centre meetings, the average repayment was 94%. So, despite the interference of the state and local leaders, our members repaid their loans, that too despite the fact that we stopped disbursing any new loans mid week. This is because members are aware that microfinance benefits them. In fact, an independent study commissioned by the Small Industries Development Bank of India showed that microfinance members increase income by 45% annually, after paying off the interest. Microfinance clients are also aware that, though the government has a subsidized 3% interest rate lending program, that program has not been effective. In fact, according to the World Bank's poor clients have to pay 42.3% in bribes to access funds from government schemes and it takes 89 weeks on average to receive the funds. The study was based on a NCAER survey of 6,000 households in AP and UP.

As for the accusation of usurious interest rates, borrowers in Andhra Pradesh are well aware that at SKS, we charge 26.7% along with a 2% up front loan cover insurance fee that goes to companies like the Life Insurance Corporation of India. (SKS has recently dropped to 24.55% interest rates and discontinued insurance on all new loans in Andhra Pradesh). When compared with the full transactions that poor clients have to pay (including interest, bribes mentioned in the World Bank study, bus fares for trips to the bank branch, lost wages, food, and other expenses), our members understand that SKS is one of the lowest cost forms of finance available.

As to why SKS charges 26.7% in AP (we have now reduced to 24.55%), the answer is that there is a high cost to delivering microfinance. Our cost of funds are 9% and delivery, taxes, write offs are a combined

13%, with a 5% margin—which is the return we try to provide to our shareholders. For comparison, Nobel Prize-winning Grameen Bank charges 20%. They can do so because they are allowed to take deposits by a special act of Parliament, which gives them a lower cost of funds than SKS. There is a lower operating costs in Bangladesh because it is more densely populated than India.

In any event, for the politicians and government officials, it did not matter whether poor clients of MFIs benefited, they went ahead with the Ordinance and then with extra-legal steps. As a result, SKS has withdrawn our 6,000 staff and we are not operating this week—the third week our operations have been disrupted. The will result in a disruption in cash flows—NBFCs depend on cash flows—from borrowers. If the sector is not able to restart operations, by next Monday, we may well have crossed a tipping point, after which there is no return. The credit culture built for 20 years will collapse.

This potential crisis of confidence is exacerbated by the fact that many banks have put all the credit limits for several MFIs across the country, including the sanctioned limits on hold and there is a credit choke which could translate into a huge liquidity crisis for the sector and put the 20 years of hard work in ensuring timely capital access to the rural poor in jeopardy, not to mention jeopardizing the banking sector's existing exposure of Rs.22,500 crores (about $5 billion).

As such, we plead with you to ensure the rule of law in the state of Andhra Pradesh as well as to examine how the Ordinance will lead to a destruction of the microfinance sector and the erosion of the strides made toward financial inclusion.

In closing, I have attached two WSJ articles and an op-ed from FT as well as some SKS Information.

Vikram Akula
Chairman
SKS Microfinance