THE POLITICS OF THE MICROFINANCE CRISIS IN ANDHRA PRADESH, INDIA

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INTRODUCTION: THE MEDIA WAR

In December 2010, reporters around the world declared that Andhra Pradesh, the fifth largest state in India, was facing an unprecedented suicide epidemic. The alleged cause of the spike in suicides was malpractice on the parts of microfinance institutions (MFI). The media rapidly became saturated with stories of individuals whose excessive debt burdens were composed of multiple MFI loans, and whose deaths were prompted by the coercive practices of MFI employees. The accusations were explicit, as the New York Times, BBC News, and Bloomberg ran articles entitled *"India Microcredit Faces Collapse from Defaults,"* [1] *"India's Micro-finance Suicide Epidemic,"* [2] and *"Suicides in India Revealing How Men Made a Mess of Microcredit."* [3] By December 2010, the Society for Elimination of Rural Poverty (SERP), a governmental agency, reported at least 70 MFI-related suicides.[4] Hence, the financial service, which had once been hailed as the *silver bullet* against poverty, became the target of public and governmental outrage. Faith in microfinance deteriorated around the world as the deaths unfolded.

Yet the causes behind the MFI crash, measured by the high default rates that rendered these institutions unsustainable, remain unclear. Following the suicides, the government of Andhra Pradesh passed the Micro Finance Institutions Ordinance in October 2010, which substantially limited the growth and operation of MFIs in the state. According to Reddy Subrahmanyam, the rural development

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official who drafted the law, MFIs' sole focus on making "hyperprofits off the poor" justified such regulations.[5] Subrahmanyam claimed that MFIs awarded loans to "rural people without checking whether they had the capacity to repay," and thereby caused their own demise.[6]

However, as argued in this paper, the incompatibility of MFIs with the political system in Andhra Pradesh was the true driving force behind the crash. The portrayal of the crisis as entirely the fault of the MFIs prompted skepticism among microfinance scholars and practitioners regarding the role and culpability of the government itself. Elizabeth Rhyne, the Managing Director of the Center for Financial Inclusion, argues that the passage of the Andhra Pradesh Micro Finance Institutions Ordinance (2010) was based on the state government's ulterior political motives. She suggests that the government capitalized on the increasing dissatisfaction with MFIs to suppress private competition with the government's self-help group (SHG) programs. Therefore, the ordinance, not the farmer suicides, signaled the beginning of the MFI crash, as it impeded the operation of MFIs and increased banks' reluctance to provide liquidity.[7]

The polarized media war between those who blame the MFIs and those who find fault with the government has raised several questions. Firstly, is for-profit microfinance, a model prevalent in rural Andhra Pradesh, inherently at odds with social development? Secondly, was the Andhra Pradesh Micro Finance Ordinance (2010) necessary? Finally, what are the impact and implications of the crisis on microfinance and development policies in Andhra Pradesh and around the world?

This paper aims to answer these questions through a discussion of the economic and political aspects of microfinance expansion in Andhra Pradesh. Superficially, the crash appears to be a manifestation of the controversy regarding best practices in poverty alleviation strategies. However, the story actually centers on the competition among various actors to gain political power through the installation of development programs. The intense conflict between political parties and their struggle to gain votes through clientelism contributed to a politically tense environment. By providing a service that overlapped with those extended by the government, private MFIs interfered with political parties' strategies to establish power and thus served as the perfect scapegoats to further each player's ulterior agenda. Therefore, while financial motives may have encouraged MFI growth and misconduct, the threat that these organizations posed to Andhra Pradesh's political system is the primary factor that precipitated the crisis.

This article supports the thesis through a critique of the government's fundamental arguments against profit-seeking MFIs. The first section provides the historical background surrounding government regulation, particular in regard to development projects and the banking system. The paper then focuses on the relationship between the World Bank and the central government of India, and the effects of political competition on welfare and development programs in Andhra Pradesh. The final sections discuss the competition between the government and private actors, and analyze the factors that differentiate MFI outcomes in Karnataka and Andhra Pradesh. These comparative analyses reveal that the difference between the microfinance markets in Andhra Pradesh and those in other states and countries was not due to the MFIs' operations but rather the political context in which these MFIs functioned.

THE GOVERNMENT'S JUSTIFICATION OF THE ORDINANCE

The primary purpose of microfinance in India is to provide a means through which impoverished families who are generally excluded from financial systems may access credit. Prior to the introduction of microfinance institutions (MFIs) in India in the 1980s, the poor predominantly relied on informal commercial lenders, as formal banks were unwilling to provide credit to those who were insolvent or could provide no collateral.[8] These moneylenders were easily accessible and unregulated, and were thus able to charge exorbitant interest rates.[9] MFIs provided a seemingly preferable form of credit. Microcredit, as originally conceptualized by Muhammad Yunus, consists of small loans that primarily "support income-generating businesses aimed at lifting the poor out of poverty."[10] Most MFIs in India grant loans to individuals, though some encourage clients to form joint-liability groups (JLGs). The latter scheme allows members to guarantee each other's loans.[11] The microfinance industry, composed of both government-sponsored and private institutions, aimed to meet the poor's unfulfilled demand for financial services and rapidly burgeoned, reaching a year-over-year growth rate of 7 to 8 percent from 2005 onwards.[12]

The microfinance which emerged in Andhra Pradesh significantly differed from that proposed by Muhammad Yunus. According to Yunus, MFIs should charge the minimum interest rates required to sustain functionality.[13] Unlike Yunus' model, however, some Indian MFIs such as SKS Microfinance Limited sought profits. SKS was first founded in 1996 as a non-profit NGO. The organization rapidly grew with the financial support of Yunus's Grameen Bank and ICICI, one of the largest banks in India. In an attempt to increase the growth rate of his MFI, Vikram Akula transformed SKS into a for-profit Non-banking Financial Company (NBFC), which enabled him to access to new and larger sources of funding through the banking sector.[14] As a result, the institution's branches, staff, and money disbursed increased more than ten-fold from 2007 to 2010.[15] Thus, SKS received innumerable accolades and was ranked the number one MFI in India and the number two MFI in the world, according to MixMarket.[16] SKS is merely one of many for-profit MFIs headquartered in Andhra Pradesh.

What incited controversy among development experts was the extent to which MFIs in Andhra Pradesh appeared to prioritize profits. In an attempt to further accelerate growth, SKS launched an initial public offering and raised over $350 million only four months before the crisis.[17] This action garnered criticism from Akula's former supporter and financier, Muhammad Yunus, who argued that this transformation would pressure the MFI to prioritize the interests of shareholders over the interests of clients. In catering to profit-seeking investors, SKS would, Yunus feared, support the prospect of "making money out of poor people."[18]

Indeed, both government officials and microfinance executives, including BASIX chairman Vijay Mahajan, agree that MFIs' sole focus on this "quest to grow" compromised ethical standards and thereby contributed to the crisis.[19] Profit-driven expansion of services pushed MFIs into overlapping geographical regions. Due to the absence of a unified microfinance regulatory authority, complete data on the extent of this overlap are unavailable. Regardless, the Institute for Financial Management and Research (IFMR) has managed to construct a map of microfinance penetration in India based on limited data. According to IFMR, Andhra Pradesh has the highest MFI/SHG penetration of all of the states in India.[20] Additionally, Sa-Dhan, an association of over 200 Community Development Finance Institutions (CDFIs), has generated a *Microfinance Map of India* based on the data reported by its members.[21] Although the data are gross underestimates of MFIs' true reach, as many do not regularly submit and monitor their finances, these maps provide important insights. For one, compared to other states in India, the MFI market in Andhra Pradesh is relatively saturated.

Based on this broad conclusion and the anecdotes relayed through the media, the government publicly concluded that the geographic concentration of MFIs led to intense competition and inappropriate practices within the sector. According to Reddy Subrahmanyam, Principal Secretary of the Department of Rural Development in the

Andhra Pradesh Government, MFIs engaged in "irresponsible lending leading to multiple loans without due diligence, unproductive loans for consumption and consumer durables, lack of transparency in operations, usurious interest rates, and coercive recovery practices."[22] Prabhu Ghate, author of *Microfinance in India: State of the Sector Report* (2007), further asserts that in order to attract clients, many MFIs relaxed previously stringent deadlines and fines.[23] Taylor (2011) provides further descriptions of misconduct and asserts that MFIs additionally obscured the high interest rates that they would ultimately charge on the loan repayments.[24] This prioritization of profits over social development appears to be supported by the finances of the MFIs—such institutions as SKS, BASIX, and Spandana charged interest rates as high as 30 per cent on loans, while they borrowed funds from banks at interest rates as low as 11 per cent.[25]

Due to the large number of MFIs, clients began to simultaneously take loans from multiple institutions, and often used one loan to repay another.[26] Cases such as these were widely documented in the media, as households that engaged in such practices became saddled with insurmountable debts. MFIs essentially partook in subprime lending, as they primarily lent to marginal farmers who already faced extreme financial pressures. The clients were generally agrarian families who were susceptible to the financial stresses of irregular weather patterns and poorly developed infrastructure.[27] This aggressive growth created a bubble in the microfinance industry that, according to the foresight of Ashish Lakhanpal, Managing Director of Kismet Capital LLC, and Monica Brand, Principal Director at Accion International, was bound to burst.[28]

The government's accusations against profit-seeking MFIs imply that for-profit microfinance is inherently doomed to fail. As asserted by Reddy Subrahmanyam, the MFIs' focus on profits pushed them to award loans to "rural people without checking whether they had the capacity to repay," and thereby caused their own demise.[29] These statements suggest that such profit driven microfinance is unsustainable and inconsistent with the ultimate goal of poverty alleviation. If the government's argument were true, it would imply that similar MFI crises should be observed in for-profit dominated microfinance markets outside of India.

Yet a closer analysis of the ordinance reveals that the government's actions do not resemble the legal frameworks established in any other microfinance-rich region. The legislation unmistakably favors banks over MFIs, as it states "No MFI shall extend a further loan to a SHG or its members, where the SHG has an outstanding loan from a Bank unless the MFI obtains the prior approval in writing in such manner as may be prescribed from the Registering Authority after making an application seeking such approval".[30] The MFI Ordinance (2010) also contains stipulations that are overly punitive and seemingly arbitrary. For example, the legislation broadly defines coercive actions as:

> (a) obstructing or using violence to, insulting or intimidating the borrower or his family members, or
> (b) persistently following the borrower or his family from place to place or interfering with any property owned or used by him or depriving him of, or hindering him in, the use of any such property
> (c) frequenting the house or other place where such other person resides or works, or carries on business, or happens to be, or
> (d) doing any act calculated to **annoy or intimidate** such person or the members of his family, or
> (e) moving or acting in a manner which **causes or is calculated to cause alarm or danger to the person** or property of such other person
> (f) seeking to remove forcibly any document from the borrower that entitles the borrower to a benefit under any Government programme.

Complaints that fall within any of the categories above warrant prosecution of the MFI and such punishment often led to revocation of registration.[31] Given the potential consequences of such complaints, points (d) and (e) above appear exceedingly biased toward the client, as any minor annoyance may legally justify court proceedings. The severity of the state government's view of and actions toward the microfinance industry contrasts the cultivation and treatment of for-profit microfinance in other countries such as Bolivia in which the sector remained healthy.

INDIA'S STATE-LED DEVELOPMENT AND ITS EFFECTS ON MFI EVOLUTION

The power dynamic between these different actors in the years immediately following India's independence provides the context for the government's regulation of the financial sector. Given that the Indian government's ability to drive industrial growth has long pivoted on its "power to define and *pursue* its goals."[32] India's government has made frequent use of the banking sector to implement the country's broader development strategies.[33] Such was the case when the he government nationalized private banks in 1969 and 1980. Although some private banks were permitted to exist, the rules governing their operations were stringent. Moreover, the state mandated that all public and private banks expand into rural regions, which were generally excluded from financial systems.[34] The government further demanded that all banks allocate at least 40 per cent of their net credit to priority sectors, such as agriculture and other such underdeveloped sectors.[35]

The government attempted to further improve financial inclusion through the establishment of banks specified for this purpose. In 1976, for example, the Indian government established a system of regional rural banks (RRBs) with the intention of extending credit to the poor.[36] Furthermore, in 1981, the government created NABARD, a development bank intended to "provide and regulate credit and other facilities for the promotion and development of agriculture, small scale industries, cottage and village industries, handicrafts and other rural crafts and other allied economic activities in rural areas with a view to promoting integrated rural development and securing prosperity of rural areas and for matters connected therewith or incidental thereto".[37] According to Sa-Dhan, an association of MFIs, these attempts to meet the financial needs of the poor were insufficient. The main inefficiency of these government backed programs, particularly the Indian Rural Development Programme (IRDP), was the allocation of large subsidies to each participating family. The spending of these subsidies, essentially deemed loans handouts, were not closely monitored or supervised by the government and allowed for the misuse of the money received.[38] Hence, such programs proved unsustainable, as they perpetuated dependence on the government, resulted in high bank losses, and resultantly came to be widely regarded as temporary rather than long-term initiatives.[39]

It was precisely these conditions that prompted the introduction of MFIs in India. The demand for a secure and monitored credit scheme for the poor remained high in spite of the government's attempts to address this neglected population while the priority sector lending (PSL) requirement pressured banks to find and extend loans to partnering service-providing organizations. As such, MFIs were convenient channels through which the PSL stipulation could be fulfilled.[40] Thus, even such development banks as NABARD and Small Industries Development Bank of India (SIDBI) began lending to and encouraging the growth of MFIs as a way to reach larger segments of the poor population.[41] The government's initial financial support of MFIs is consistent with its early provision of subsidies and grants to capitalists for the sake of accelerated development.

The increasing diversification of MFI structures enabled each institution to occupy a different legal classification. Although initially, MFIs were viewed solely as non-governmental development agencies and were registered as either societies and organizations "for the promotion of literature, science or the fine arts or the diffusion of useful knowledge/political education or for charitable purposes," public or private trusts with defined members, or Section 25 companies defined as "limited company[ies] for promoting commerce, art, science, religion, charity or any other useful object.[42, 43, 44, 45, 46, 47, 48, 49] These classifications soon changed as the size of MFIs increased. With the growth of the MFIs, many legally transitioned from non-governmental organizations (NGOs) to non-banking financial companies (NBFCs), in order to access bank credit, as in the case of SKS (Taylor, 2011). According to the Reserve Bank of India (RBI) Act (1934), an NBFC is a "company…, which has as its principal business the receiving of deposits, under any scheme or arrangement in any other manner, or lending in any manner".[50] These companies are regulated by the nationalized RBI.[51]

The evolution of MFIs in this manner allowed them to commercialize and make the transition from non-profit to profit-seeking organizations though for many MFIs this transition remained incomplete. The RBI requirements for NBFC-MFIs can be difficult to fulfill including, in one example, required minimum net owned funds of Rs. 50 million or roughly $1,000,000.[52, 53] for an MFI to attain NBFC status.[54, 55] Previously, in 1999, this particular requirement was less taxing though still unattainable for many MFIs, as the minimum net owned funds amounted to Rs. 20 million, or approximately $400,000.[56] The MFIs' inability to raise such funds may be partially attributed to RBI's additional limitation that MFIs cannot accept deposits. The government's strict rules, which are rooted in its long-standing desire to control development and maintain power, have thereby pushed MFIs to seek profits as a means to ensure sustainability.

In this fashion, he government's interference with

MFI growth may have contributed to the Andhra Pradesh crisis. Even those MFIs registered as NBFCs cannot offer savings mechanisms, as the RBI explicitly defines an NBFC-MFI as a "non-deposit taking NBFC".[57] These limitations reveal that Yunus's denunciation of for-profit MFIs in India should be redirected toward the government. Yunus argues that the primary alternative to the for-profit structure is the acceptance of deposits. He contends that savings programs for the poor are currently unavailable, are in high demand, and may provide the capital required for the proper functioning of financial institutions.[58] Yet MFIs in India, through no fault of their own, are legally prohibited from restructuring their programs in this manner. Due to the restrictions imposed by the government, even NBFCs that gain access to bank credit may be forced to resort to high interest rates in order to sustain function. The Indian government's regulations stand in stark contrast to the microfinance industry in Latin America, as many for-profit MFIs in such countries as Bolivia and Mexico are authorized to not only provide loans but also savings mechanisms.[59]

The state's attempts to regulate the industry through the Andhra Pradesh MFI Ordinance (2010) are consistent with the nation's interference with all development programs. It seems that India's history of heavy regulation not only encouraged profit-seeking behavior, but also established precedence for the government of Andhra Pradesh to enact a heavily biased and harsh mandate.

WELFARE POLITICS IN ANDHRA PRADESH

Although the government's history of strictly regulating development explains why the microfinance market in India was vulnerable to crisis, it does not wholly elucidate why the crash specifically and so catastrophically occurred in Andhra Pradesh. Indeed, he severity of the restrictions on MFIs and the government's apparent favoritism of MFI clients may only be fully explained by the competition among national and state level political interests.

In 1982, the Telugu Desam Party (TDP) emerged in Andhra Pradesh politics with the primary purpose of challenging the Congress Party. The Congress Party's constituency in each state of India differed depending on the local divisions. For example, "in Tamil Nadu conflict divided Brahmin and non-Brahmin, while in Rajasthan it was Rajput versus Jat, and in Andhra Pradesh the Kamma against the.Reddy]," though the *Reddy* and *Kamma* castes comprised only 6.5 and 4.8 percent of the state's population respectively.[60], [61] The Congress Party in Andhra Pradesh was largely composed of *Reddys* and relied on the support of the *backward* castes, a diverse group of communities. Members of the latter cohort ranged from small farmers to washer men to landless laborers.[62] The TDP was founded on the basis of caste rivalries and economic discontents against the Congress Party's supporters. The *Kammas*, who had largely improved their economic status through assorted entrepreneurial activities and commercial activities, were eager to challenge the political legacy of the *Reddys* and increase their own power.[63] Therefore, they supported N. T. Rama Rao (NTR), the *Kamma* film star who founded TDP.

The politics of Andhra Pradesh, like the national politics, were largely governed by the concerns associated with the fragmented-multiclass state. NTR's support base was heterogeneous, as he attempted not only to appeal to *Kammas*, who occupied a range of economic classes, but also the rural poor, women, and the "backward" castes.[64]65which had traditionally served as the base of Congress Party's traditional supporters. These factions were unified predominantly by dissatisfaction with the perceived corruption and inefficient practices of the Congress as well as their admiration of NTR's apparent dynamism. Due to the diversity of the constituents, NTR's promises ranged from economically and politically reforming the corrupt government to demanding increased state autonomy and implementing welfare programs to provide basic living needs for the poor.[66] The TDP thus became a party caught somewhere in between development-oriented and populist policies.

The TDP entered a second distinct stage under the leadership of NTR's son-in-law Chandrababu Naidu. Naidu ousted NTR from the party in 1995 after his father-in-law's command of the party proved too autocratic. He, too, drew support from a diverse base (Suri, 2004). Hence, Naidu's rhetoric was carefully calculated to appeal to "the world outside AP, the urban middle classes, his own Members of the Legislative Assembly (MLAs), his rural party workers and the electorate".[67]

However, the TDP's actual policies substantially differed from those proposed in its campaign platforms, due to the heterogeneity of its political constituency. Naidu was widely viewed as pragmatic relative to NTR, particularly in his apparent prioritization of development over populism. Specifically, he emphasized the need for fiscal austerity and a resistance towards implementing welfare programs the entire spectrum of proposed, citing the increasing need to balance the state's budget as the top priority. He thereby gained the support of the higher socioeconomic classes who grew increasingly dissatisfied with NTR's populist policies.[68] Yet socioeconomically and ethnically divided societies provide an environment conducive to clientelism (Medina & Stokes, 2002). According to Bardhan and Mookherjee (2011), "clientelism refers to strategic transfers made by political parties and governments to poor and disadvantaged groups as a means of securing their votes, in an effort to consolidate political power".[69] Indeed, in order to maintain support among all socioeconomic classes, Naidu tempered his promises of true development with new welfare policies such as "India's largest public housing program, a widespread consumption subsidy on rice, cut-rate power provision, and even free clothing".[70]

The dichotomy between development and welfare populism in Naidu's policies may therefore be viewed in two lights. Naidu may have either genuinely planned his development strategy to gradually phase out the government's history of handouts and/or may have intentionally engaged in clientelism. Much of the rationale for clientelism arises from the large agrarian population. Aside from the socioeconomic and caste based divisions, factionalism also exists between urban and rural populations. It is also important to note that Naidu was often hailed as a leader of technology, in part because he supported the booming Information Technology sector. While this earned him praise, it also raised alarm among rural populations, who feared he focused too heavily on urban development.[71] This rural discontent certainly concerned the TDP, as 67 per cent of the state's population (and voters) resides in rural regions of the state.[72] With this in mind, Naidu was forced to consider the desires of the agrarian cohort. It is no coincidence, therefore, that the announcement and implementation of welfare programs coincided with election seasons.[73]

While these rural communities' distress was seemingly caused by apolitical factors, farmers often blamed the government's inadequate attention for their woes. Although Andhra Pradesh is a drought-prone state, the large population of farmers relies on rainwater for profitable crop yields. This dependence on natural processes increases the agrarian populace's vulnerability to extreme financial stress. As Cole, Healy, and Werker (2010) find, voters in India hold the incumbent party responsible for weather crises such as droughts.[74] The severity of this negative response declines as the party's relief expenditures increase *only* in the season preceding the election.[75] The effects of financial stress on the rural population's vote explains the increase in promises of welfare schemes prior to elections, and the trend that voters in Andhra Pradesh "express allegiance along party lines due both to an ideological commitment to parties *and* to the political biases in benefit allocations".[76] In 2004, for example, the coincidence of a drought and a resultant exponential increase in farmer suicides with local elections harmed the TDP, as it resulted in a significant farmer vote against the party.[77, 78] The distress and blame apportioned by farmers thus promoted clientelism as political parties attempted to buy their favor.

Despite his clientelist tactics, Naidu earned his state the reputation as the poster child for economic and political reform during his reign as President of TDP and Chief Minister of Andhra Pradesh from 1995-2004. This is largely due to his focus on heavily publicizing his efforts to develop the state.[79] The Chief Minister's evident resolve and enthusiasm for reform, particularly with regards to technology, market-led processes, and the transition from welfare to true development, apparently impressed the Bank.[80] Thus, Andhra Pradesh gained worldwide recognition.

The TDP's gradual transition away from populist policies at the encouragement of the World Bank left a power void that was quickly filled by the Congress Party. According to Medina & Stokes (2002), clientelism is based on one party's political monopoly over a particular good that may "reduce the risk entailed in variations in income from private sources".[81]Even while welfare programs initially proposed and implemented by the TDP are consistent with this definition as the TDP drifted away from populism and emphasized development policies it gradually released its grip on political monopoly and even unintentionally facilitated the rise of the Indian Congress Party. Against the wishes of the Bank, the ruling Congress Party insisted that free power be supplied to farmers following the drought in 2006.[82] Hence, this political party earned itself distinction as the party of the poor, with a political its clientelism that was largely mistaken for pro-poor policies.[83] The local political parties' quest for increased political power necessitated the installment of welfare programs alongside development initiatives and created a politically tense environment on which national and international spotlight focused.

SELF-HELP GROUPS

One of the primary development projects funded by the World Bank is the Self-Help Group (SHG) model, an alternative to microfinance. The governance of SHGs is separated into multiple tiers.[84] The SHG itself is generally composed of 10-15 "women whose primary purpose is to save and then to take loans, initially from their own funds but eventually from a bank".[85] The group as a whole must repay the loan.[86] The emphasis of the SHG model is group savings. This contrasts the standard microfinance institution (MFI) model of individual or join-liability loans.[87]

The dominance of SHGs over other models of microfinance was in part facilitated by the SHG-Bank Linkage Programme, organized by the National Bank for Agriculture and Rural Development (NABARD) in 1992.[88] After witnessing the success of early SHGs, NABARD began to offer loans to SHGs of a maximum of four times the group's savings.[89] Today, several models of the SHG-Bank Linkage exist. The main benefit of the SHG-Bank Linkage is to reduce the risk associated with lending to the poor. Information regarding credit and repayment scores is unavailable for the target cohort. This lack of data may be mitigated through SHGs, as peers select and pressure members of the group to engage in responsible practices and follow repayment schedules.[90] The SHG-Bank Linkage minimizes the transaction costs incurred by SHGs or small NGOs as well, as these organizations often do not have sufficient capital to absorb losses.[91]

Yet the rapid proliferation of the SHG model cannot be attributed to purely economic factors. Rather, the primary driver of its growth was the government's adoption of the movement. By March 2002, ten years after the initiation of the program, the government funded over 50 per cent of 460,000 SHGs.[92] As Chakrabarti and Ravi (2011) suggest, the SHG has become the preferred mode of MFI delivery due to its favored status, not merely because it was the first model introduced in the state.[93] Major developments in the government's support for SHGs occurred under the Naidu administration, in large part due to the TDP's need to retain the support of rural cohorts. In the mid-1990s, the government supported the program for the Development of Women and Children in Rural Areas (DWCRA), which largely focused on the establishment of SHGs.[94] In 2000, Velugu, funded by a $111 million grant from the World Bank, was launched to supplement existing SHG efforts.[95] The Velugu program not only functions to provide loans to SHGs, but also assists these groups in the formation of cooperatives which may effectively negotiate prices of any goods produced. Additionally, the SHGs are used as conduits through which advice on investments and savings as well as other developmental objectives such as education and child marriage is disseminated.[96] Velugu was later incorporated with District Rural Development Agencies (DRDA) to form Indira Kranthi Patham (IKP), a unified and more comprehensive agency targeting rural poverty.[97] These projects channeled resources specifically toward the rural constituency.

Given the symbiotic relationship between the World Bank and the government of Andhra Pradesh, the state's apparent prioritization of SHGs over other development or poverty alleviation policies and models is understandable. The government's priority remained to uphold its status as the poster child of reform and poverty alleviation, and maintain the support of rural voters.

COMPETITION AND REGULATION IN ANDHRA PRADESH

While the previous sections provide the context for the microfinance crisis, they do not answer why the MFI crisis specifically occurred in Andhra Pradesh over any other Indian state. The laws and regulations delineated operated at the national level, and thus created an environment that encouraged the growth of for-profit microfinance throughout the country. However, the true origins of the crash lie in the unique events and policies in Andhra Pradesh that forced MFIs and other financial institutions to become increasingly interdependent and profit-seeking.

The Krishna Crisis of 2005-2006

In 2005-2006, Andhra Pradesh witnessed a microfinance crisis similar in structure but smaller in scale to the crash of 2010. The Krishna Crisis, named because of its occurrence in the Krishna District of Andhra Pradesh, allegedly precipitated from MFI misconduct. MFIs, including BASIX and SHARE that were also implicated in the crisis in 2010, purportedly engaged unaggressive expansion and loan recovery methods such as the use of intimidating and abusive language. According to local reports, these practices resulted in the suicides of 10 MFI clients who had defaulted. Additionally, MFIs were accused of charging "usurious interest rates," further indebting the poor.[98] Therefore, the government shut down fifty MFI branches, apparently in an attempt to end these exploitative practices.[99] These actions resemble the government's effective shutdown of the industry in 2010.

During the Krishna Crisis, the state government's condemnation of MFIs masked the political dimension of their actions. The MFIs' inability to accept deposits inextricably linked the institutions with commercial banks for the sake of ensuring sufficient liquidity. In order to balance the interest rates charged on these bank loans, MFIs were forced to charge their clients high interest rates. Lower interest rates would have rendered these institutions unsustainable.[100] Although MFIs attempted to compromise with the government by formulating a Code of Conduct through the Sa-Dhan association and proposed lowering interest rates past sustainable levels, the state still pursued drastic action in raiding and temporarily terminating the branches in the region.[101] The government's actions, therefore, suggest ulterior motives.

The state government's dissolution of the microfinance branches lies primarily in the competition between state-funded SHGs and private MFIs. According to a survey conducted in Guntur, a district along the coast of Andhra Pradesh, 67 per cent of all Velugu and MFI members were clients of both institutions.[102] As Ghate reports, "government representatives [claimed] that the MFIs were 'eating into the SHG movement'".[103] A survey of Spandana clients showed that MFIs' competitive edge derived from SHG members' dissatisfaction with the relatively long loan waiting periods and small loan sizes offered through Velugu.[104] Thus, MFIs posed a realistic challenge to the uptake of SHGs.

Given the rampant national and international promotion of Velugu, the government apparently found the competition posed by MFIs unacceptable. This hostility may be attributed to the threat MFIs posed to the ruling party's political power. SHGs may be viewed as a "risk-free activity…that helps voters to diversify their risk in an uncertain economic environment….and] reduces fluctuations in private income".[105] In this framework, the government may have used SHGs as clientelist goods. This conceptualization of SHGs relies on the state's monopoly over the good. According to Medina & Stokes (2002), "the patron's control over such an activity allows him to offer voters exclusive-dealing contracts".[106] The introduction of microfinance challenged this political monopoly, as MFIs offered similar and competitive services and thereby reduced the state's full control of SHGs and its ability to use these programs as a means to gain power.

The impact of the Krishna Crisis on the growth and function of MFIs was limited. In response to the demand for regulation, the Micro Financial Sector (Development and Regulation) Bill was introduced into Parliament in 2007. This bill called for the formation of a Micro Finance Development Council to advise NABARD, the chosen regulator for all MFIs, on financial policy. Furthermore, the bill proposed a Micro Finance Development and Equity Fund to facilitate further development of microfinance. The proposed legislation spurred controversy and was opposed by feminists and agrarian activists. They complained that the bill allowed the government to evade its responsibility of increasing financial inclusion through a fundamental restructuring of the system by encouraging private MFI function and growth.[107] Others charged that commercial banks and accountability structures, among other necessities, were not adequately discussed in the bill. These critics ultimately prevented the passage of the legislation. Hence, the only weakly positive outcome of the crisis was Sa-Dhan's Code of Conduct, a voluntary set of regulations that members of the association promised to adhere to. This code did not legally increase accountability.

REGULATION AS A MEANS TO SUPPRESS COMPETITION

The dynamics between the MFIs and state government during the Krishna Crisis mirror those observed in the state-wide crisis in 2010. MFIs became increasingly involved as intermediaries in the SHG-Bank Linkage. Furthermore, the rapid expansion of MFIs into regions already saturated with state-funded SHGs associated with Velugu enabled clients to take multiple loans from different institutions.[108] According to M-CRIL, a microfinance rating organization, "in 2007, state-backed self-help groups…sometimes at subsidized interest rates, added 8.5 million clients, while microfinance groups added 3.2 million. Two years later, self-help groups added just 6.7 million clients, while microfinance groups added 8.5 million".[109] The success of MFIs at the cost of SHGs once again threatened Andhra Pradesh's status as the "unquestioned leader in the sector".[110] In fact, according to a study conducted by World Bank researchers, "marginal farmers exhibited a slightly higher preference for SHG loans than small and large farmers but they ended up borrowing the least from this source (less than 10 percent of households)," indicating that for the most part, MFIs were more popular than SHGs.[111]

The state government thus acted to inflict damage upon the microfinance industry in order to reduce such competition. The government passed the Andhra Pradesh Micro Finance Ordinance, which essentially terminated a substantial proportion of microfinance activity,,, mandated that all existing loans in violation of the terms of the ordinance must be refunded to the clients and included provisions which substantially retarded growth, such as the need for prior approval before the provision of loans to SHG members.[112] The ordinance did not require any changes to the SHG programs, showing clear bias. The state recently enacted additional regulations for NBFC-MFIs, including strict limitations on the size of the institution's loans to Rs. 50,000 or approximately $1,000. Loans greater than Rs. 15,000 or $300 are required to have a tenure of at least two years.[113] Due to the saturation of SHGs throughout the state and large client base, MFIs were forced to give up a substantial number of clients who also partook in SHGs. Thus, these MFIs faced enormous losses. For example, the Gross Loan Portfolio (GLP) of Spandana decreased by more than 30 per cent in the year following the crash. The GLP of SKS Microfinance Limited decreased by 75 per cent during the same period.[114] The state was able to use its power to punish the MFIs and thereby diminish their competitiveness in the market.

These losses were likely exacerbated by the actions of the opposition party, the TDP. Specifically, Naidu blasted the government for not having instituted a regulatory authority to control the exploitative practices of MFIs, and insinuated that the government was permitting the MFIs to enjoy free reign.[115] He also demanded that the government fulfill its promise to help women gain access to loans directly from banks at an interest rate of only three per cent, and called for the elimination of the SHG-MFI-Bank linkage. As

TDP struggled to rebuild its support base, Chandrababu Naidu urged MFI clients not to repay their loans. On the one hand, the TDP founded the Velugu project and likely had a vested interest in its success. On the other, Naidu manipulated the complaints against MFIs to criticize the government and praise his own party. Naidu juxtaposed such criticisms with an image of a pro-poor TDP. At a public meeting, for example, he stated "If MFI agents harass you for repayment, tie them up in a room and call the TDP workers for support".[116]

The two parties' rhetoric reveals that both aimed to promote their respective political standings under the guise of welfare. As suggested by Taylor (2011), "the [Congress Party's] actions were an attempt to use MFIs as a scapegoat for rural distress, not least because the expansive growth of MFIs was seen as a competitor to the state's SHG programme".[117] The government likely wished to eliminate any factors that would have tainted Andhra Pradesh's aggressively promoted and glorified image as the pioneer of development. The TDP similarly seemed to blame any trends that indicated slowed development or agrarian disillusionment on the Congress Party and MFIs, and portray itself as the true party of the economically disadvantaged and rural classes.

Yet rural distress has long existed in Andhra Pradesh, and does, in fact, indicate certain governmental failures. Hundreds of farmer suicides have been reported over the twenty years preceding the crisis in Andhra Pradesh. One of the first recorded spikes in such deaths occurred in 1987, when cotton farmers committed suicide due to crop losses and resultant financial burdens.[118] Since then, farmer suicides have become a widespread problem in Andhra Pradesh. This history of farmer suicides suggests that the government's neglect to focus on true development efforts may be at least partially at fault. Instead of providing handouts, the government could have theoretically protected farmers against price volatility or restructured and improved the financial services available to this population.

It is likely that the government feared the implications of the highly publicized rural distress. This fear may have stemmed from the suicide epidemic that began in 1997 in Telangana. The Bharatiya Janata Party (BJP), in opposition to Naidu's TDP, accused the government of failing to "provide extension services, to supervise quality control of seeds, fertilizers, pesticides and other inputs" due to the TDP's emphasis on reforms over welfare.[119] The BJP also suggested that the government's response to the suicide epidemic was insufficient.[120] The resultant negative publicity may have not only cost the TDP votes, but also weakened its image as a proponent of development.

Thus, MFIs served as a convenient scapegoat to divert the blame for farmer suicides away from the government. As stated earlier, the Society for Elimination of Rural Poverty (SERP) reported at least 54 "microfinance-related" deaths by October 2010. However, nowhere on its website does it define the term "microfinance-related." The SERP's full report, which includes descriptions of these deaths, was published online by Microfinance Focus, a microfinance news agency. Among these descriptions was one of a woman who "committed suicide by consuming pesticide. She is a SHG Member" who held both SHG and MFI loans.[121] The report also includes such brief statements as "Rs 57000 was given as loan and committed suicide".[122] This description, similar to many others recorded, does not even attempt to establish causation. SERP also described farmers who allegedly committed suicide due to harassment by MFI officers.[123] Yet the causes of death were often reported by family members of the deceased individual, and thus may have been shaped by the government's rhetoric of microfinance criminality. Therefore, the government's conclusion that the misconduct of MFIs was to blame for the spike in farmer suicides seems specious.

The government's actions were consistent with the Congress Party's previous efforts to gain the political support of the rural population. The state's history of providing unsustainable handouts to the poor condoned these politicians' harsh and rash statements and actions without raising questions. After the 2004 election in which the TDP was defeated, the Congress Party instituted the welfare schemes it had promised in its campaigns. One of these promises was a declared "moratorium…on the recovery of farm debts".[124] This essentially converted loans into grants. Similarly, during the crisis in 2006, the government convinced borrowers that MFIs were criminal and encouraged them to not repay their MFI loans. Rather, the government would absorb the loans and lower their interest rates.[125] The state government supported SHGs through *pavala vaddi*, a performance-based subsidy of up to 75 per cent of the interest that the linked banks charged on their loans. The cumulative cost of this program from 2006-7 was approximately $15 million.[126] The initiative seems unsustainable, as the government essentially provides nearly interest free loans by paying for the banks' transaction costs. This well-established trend in state-sponsored programs permitted politicians to implore clients to refuse repayment and thereby transform MFI loans into handouts during the MFI crisis of 2010, despite the fact that the funds were derived from private entities rather than the government.

The political structure of India's banking system also exacerbated the crisis. The financial link between MFIs and banks begs the question of why the banks did not speak against the government's clearly biased actions. The MFIs' losses resulting from the legislation and defaults encouraged by politicians would have certainly resulted in bank losses. However, approximately 83 per cent of all banking in India is controlled by the government or nationalized banks. Even those banks that are not nationalized must comply with the state's strict regulations.[127] The tight relationship between the banks and the government likely rendered protest against the new legislation politically risky. Had the banks challenged the government's actions, the government could have easily retaliated and imposed further restrictions on bank operations. Therefore, the unique image of Andhra Pradesh as the archetype of development, the government's history of interference with the private sector and the extreme political competition between parties created a political environment hostile to MFIs.

CONTAINMENT OF CONTAGION: MICROFINANCE IN KARNATAKA

This discussion of the evolution of MFIs and subsequent crisis in Andhra Pradesh suggests that political factors were involved in the failure of microfinance in the state. However, whether politics was the driving force behind the crash may be further informed by the comparative analysis of microfinance in Andhra Pradesh as opposed to its neighboring state, Karnataka. After the crisis in October 2010, questions emerged of about whether defaults would rise and the crash would spread throughout the states surrounding Andhra Pradesh. As posited by Shankar and Asher (2010), "the interdependencies between group members in microfinance can lead to a different kind of contagion effect. Widespread defaults can occur either if some members start consistently defaulting or if there are rumours of MFI failures".[128] In other words, reports of MFI failures in Andhra Pradesh may have encouraged defaults in adjacent regions. Yet no evidence of an MFI crisis in Karnataka following that in Andhra Pradesh has been reported. This section aims to elucidate the differences between MFI operations in the two states.

The demographic, economic, and environmental descriptors of the neighboring states of Karnataka and Andhra Pradesh are comparable. While the total population of Karnataka is roughly 60 million, that of Andhra Pradesh is roughly 70 million. The rural populations of both states are over sixty percent. The literacy rates of Karnataka and Andhra Pradesh are approximately 76 percent and 68 per cent, respectively.[129] [130] Both states experience similar climates and are drought and flood prone.[131] Moreover, the estimated MFI penetration in both states is similar, at approximately 5.3 percent in Karnataka and 7.0 percent in Andhra Pradesh.[132] The aggregate growth rates of MFIs and SHGs over the period 2007-2010 were also comparable, at 129.1 percent and 126.5 percent for Karnataka and Andhra Pradesh, respectively.[133]

Despite these similarities, the political systems of both states significantly differ. In Andhra Pradesh, politics are relatively volatile, characterized by the struggle between the Telugu Desam Party (TDP) and its primary opponent, the Congress Party, to win control of the government. The constituencies of these two parties are largely divided based on caste and socioeconomic status. In contrast, one party – the Congress Party, has generally dominated Karnataka's state government. This political party relies on the joint support of both the dominant and weaker castes and ethnic groups.[134] As a result, the governance of Karnataka appears far more unified, stable, and rational than that of Andhra Pradesh. Even when the opposition parties, the Janata Party and the Janata Dal, won control of the state government for short periods of time their constituents and ideologies did not dramatically deviate from those of the Congress Party.[135]

Given the economic similarities between Karnataka and Andhra Pradesh and the higher continuity of government in Karnataka, the World Bank's decision to focus on and publicize the development of Andhra Pradesh seems counterintuitive. The Bank's preference for Andhra Pradesh seems primarily based on its own political agenda. This objective stems from the Bank's inability to establish a strong foothold in Indian politics. Unlike other recipient countries, India retained a high level of autonomy from the World Bank with regards to policy design.136 The only manner in which the World Bank could push its agenda of liberalization and market efficiency was through state-based initiatives. Unlike in Andhra Pradesh, where the TDP allied with the parties dominating the central government, the dominant Congress Party in Karnataka provided fewer opportunities for the Bank to increase its influence throughout the nation.[137] Winning favor with Karnataka would not help the World Bank build a stronger presence in India. Moreover, Naidu's dynamic personality and eager dialogue with the World Bank stood in stark contrast to J. H. Patel, Karnataka's Chief Minister from 1996-1999, who appeared more hesitant to deal with the external agent. Hence, the Bank committed substantially higher funds to Andhra Pradesh than it did to its neighboring state.[138]

Thus, Karnataka was able to focus on independently designed reforms. The World Bank had a relatively lower stake in its relationship with Karnataka and did not condone populist schemes as it had in Andhra Pradesh. Therefore, while the Bank inadvertently supported the legacy of welfare politics in Andhra Pradesh, it applied harsher standards of development toward Karnataka encouraged more legitimate economic reforms. Finally, because the policies pursued in Karnataka were not as widely publicized as those in Andhra Pradesh, the World Bank allowed the state to retain more autonomy in the ultimate design and implementation of reforms.[139] The Bank's comparatively low and discreet presence in Karnataka meant that the state's government remained unfettered by any significant international image.

Additionally, Karnataka may be conceptualized as a cohesive multiclass state.[140] Although the government's political power derives from support across socioeconomic classes and castes, the convergence of their political interests allows social cohesion. Because of this relative unity, the Congress Party in Karnataka, unlike the parties in Andhra Pradesh, does not experience pressure to deploy welfare programs as a means to win votes. The Congress Party already enjoys general political monopoly and has no need to engage in competition with MFIs. In contrast, Andhra Pradesh is a fragmented multi-party state and as a result has a complex relationship with the private sector that is "sometimes cooperative but just as often conflictual."[141]

Accordingly, the relationship between MFIs and the government of Karnataka appears cordial, in contrast to the situation in Andhra Pradesh. This accordance does not suggest that the microfinance sector in Karnataka has always been highly regarded. According to Samit Ghosh, founder of the MFI Ujjivan Financial Services, the key factor that facilitated the success of MFIs in Karnataka was their ability to "[learn] from the setbacks in Ramanagaram and Kolar districts in 2009," where credit bubbles burst.[142] This is exhibited through the studies voluntarily conducted by the Association of Karnataka Microfinance Institutions (AKMI) immediately after the mini-crises.[143] One of the primary objectives of AKMI is to represent its members and engage in policy discussions with the government. As such, the association has repeatedly cooperated with the state government and organized meetings regarding the best practices in loan provision.[144]

This collaboration may be partly attributed to the fact that the SHG movement in Karnataka was not as strong as the government-funded scheme in Andhra Pradesh. While the combined MFI and SHG penetration in Andhra Pradesh appears to exceed that of Karnataka, a large number of districts in Karnataka exhibit a higher MFI penetration than the districts of Andhra Pradesh.[145] This pattern suggests that although the combined MFI and SHG growth rates are more or less equivalent across both states, Karnataka's market was dominated by an expansion of MFIs while that of Andhra Pradesh was dominated by an expansion of SHGs. Over the period 2007-2010, the estimated MFI growth rate in Karnataka (approximately 61 per cent) significantly exceeded that of Andhra Pradesh (roughly 45 percent).[146] The government's emphasis on SHG growth in Andhra Pradesh is therefore apparent.

The cooperative relationship between MFIs and the state appears opposite to the competition that precipitated the crisis in Andhra Pradesh. According to Palekar (2007), "the state leadership [of Karnataka] has always desired to resolve disputes through peaceful means rather than through the path of confrontation."[147] Indeed, the government did not pursue any drastic action following the local microcredit bubbles that formed in southern Karnataka, and instead permitted the MFIs to investigate the crises themselves. This contrasts the government of Andhra Pradesh's response to the Krishna Crisis in 2005-2006. Perhaps as a result of the cooperation between the government and MFIs in Karnataka, after the local crises, AKMI drafted a Code of Conduct to which the members actually adhered.[148] Therefore, in Karnataka, although MFIs faced similar growth challenges to those experienced in Andhra Pradesh, microfinance was compatible with the political system of the state.

In contrast, the hostility between the government and MFIs in Andhra Pradesh may have contributed to the MFIs' lack of adherence to the Sa-Dhan Code of Conduct, similarly written after the Krishna Crisis. The MFIs were not only competing with each other, but also with the government's SHGs. Thus, no true change in the practices of MFIs occurred after the crash. The fact that the state of Andhra Pradesh did not step in to restructure the rural financial systems suggests that the economic arguments and accusations against these institutions were not truly as salient as the political objectives of the government. The similarities between the Krishna Crisis of 2006 and the state-wide crises in 2010 imply that the latter could have been avoided through increased regulation. It seems, however, that the government of Andhra Pradesh was more preoccupied with completely shutting down microfinance than cooperatively addressing the economic challenges the industry faced. Therefore, in Andhra Pradesh, microfinance was incompatible with the political system of the state.

CONCLUSION: IMPLICATIONS AND THE WAY FORWARD

The microfinance crisis in Andhra Pradesh was a pivotal moment in the history of development assistance and poverty alleviation strategies. The apparent misconduct of for-profit microfinance institutions (MFIs) raised fundamental questions regarding the possibility of mission drift away from the original social motives to profit-driven growth. However, as shown through this paper, the events leading up to and following the crisis cannot be isolated as purely economic or exogenous processes. The main characteristic of Andhra Pradesh's microfinance market that distinguished it from those around the world and triggered the crash was the political system in which it was embedded. Specifically, various political actors competed for control of development policies in attempt to augment their own power and influence within the state, nation, and world.

The manifestation of the power struggle in the microfinance industry may be traced to the classification of India and Andhra Pradesh as fragmented multi-class states.[149] In such a developing state, political parties at the national and state level must design sufficiently broad agendas and policies to elicit political support across the country's innumerable ethnic and socioeconomic factions. This requirement has resulted in dualistic policies, whereby political leaders simultaneously establish populist programs and development or reform initiatives.[150]

The poverty and divisions prevalent throughout India increased the vulnerability of its political structure to clientelism.[151] In Andhra Pradesh, state-sponsored welfare schemes and self-help groups (SHGs) may be conceptualized as clientelist programs that political parties have constructed to gain the rural vote. Yet the success of clientelism depends on the patron's monopoly over the good provisioned.[152] The intense competition between political parties in Andhra Pradesh is evidence of this conceptualization, as the

Congress Party and Telugu Desam Party have actively attempted to undermine their rivals' ownership of welfare programs. The introduction of microfinance to this volatile environment threatened the political power of the ruling parties, as the patrons no longer retained monopoly over the clientelist goods, which were, in this case, financial services offered to the poor.

The resultant competition between MFIs and the government challenged not only the political actors' influence at the state-level, but also their international clout. The World Bank's targeted elevation of Andhra Pradesh as the poster child of reform and development increased the importance placed on the state government's reputation. That MFIs were able to undermine the operations of the government fueled the animosity between private MFIs and the state government. Thus, the state interfered in a manner consistent with its history of state-led development and heavy regulations, and pursued harsh actions that essentially shut down the industry.

The dynamics of the political system in Andhra Pradesh thus cumulatively presented not only a unique environment that precipitated the microfinance crisis, but also the conditions necessary to ultimately design an appropriate regulatory mechanism. Following the crash, the international reputation of Andhra Pradesh rapidly deteriorated as scholars questioned the aptness of the state government's actions toward MFIs. If the government wishes to maintain its political clout, it will likely pursue actions that reinforce the culpability of the MFIs and its own image as an apolitical regulator. Thus, it is likely that the government will adhere to the advice of the international community and construct regulatory mechanisms that, to a certain extent, increase the transparency of MFI operations, improve their integration with the financial sector, and display a certain level of forgiveness. Indeed, the Microfinance Institutions (Development and Regulation) Bill was introduced at the national level in March 2012. If passed, this bill will override the Andhra Pradesh Microfinance Ordinance of 2010, establish the Reserve Bank of India as the centralized regulator of MFI operations, and financially rescue some of the MFIs, including SKS, which suffered after the Andhra Pradesh crisis.[153] [154] Because the national government is not hindered by the political undercurrents in Andhra Pradesh, it is likely that this bill will, in some form, be signed into law.

Therefore, while the microfinance crisis in Andhra Pradesh certainly alarmed the international community, the fact that the events were primarily triggered by political rather than economic factors does not support the blanket denunciation of for-profit MFIs.

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