

The trials and tribulations of microfinance: Putting the rumours to bed

The scandal in Andhra Pradesh (AP), India

In late 2010, following a wave of widely publicised suicides among borrowers of some of India's largest MFIs (SKS Microfinance, Spandana, and Share) sensational newspaper reports appeared in the press all over the world highlighting the plight of borrowers who were becoming over indebted, sometimes with many loans from different organisations and trapped in a debt spiral. The government of AP responded strongly, increasing regulation and advising microfinance borrowers to cease their loan repayments. The net effect has been to starve the loan providers of income, making them unable to provide further loans to borrowers and ironically forcing the poor back into the hands of local moneylenders.

What really happened in AP?

There is no one factor that can explain what happened in AP. However, we can definitely conclude that the rapidly increasing number of MFIs in India led to a 'perfect storm' of weak regulation and high capital influx, saturating the market with profit driven organisations looking to turn micro loans into major profits.

Public policy towards MFIs in India was weak. Although MFIs were able to turn from non-profits into commercial organisations, they were banned from taking deposits to prevent them from threatening the public sector banks (much favoured by the Indian Government). This prevented them from raising funds locally – in stark contrast to the Grameen Bank in neighbouring Bangladesh, where customers of the bank save large amounts of money and are a major contributor to Grameen's capital base. This lack of ability to take and subsequently on-lend customer's money led MFIs in AP to seek capital externally, from investors. Moreover, borrowers were denied the opportunity to save and reduce their vulnerability.

In addition, the governance makeup of Indian MFIs was problematic. In many countries, commercialised MFIs are made up of a mix of owners: the original NGOs, social investors and local shareholders (including borrowers). The NGOs keep the focus on poverty-reduction, while the

international social investors contribute a commercial orientation, also tempered by social mission.

In Indian microfinance, NGOs are prohibited from becoming shareholders. Instead, authorities accepted that client ownership would create grassroots accountability, but this actually created a governance void. SKS, for example, established a client trust that gave clients a monetary stake in the company but left the voting rights to the founder and managers. In India, several MFIs – including SKS – made Initial Public Offerings and floated their stock, creating large returns for their founders and managers and becoming accountable to shareholders.

At the same time, rules that limit foreign ownership and investment have made it hard for international social investors to participate in ownership and governance. The result: founder domination, a pattern that leads to a lack of checks on decisions by managers, and the entrance of pure commercial players like Sequoia Capital India with an over-emphasis on fast growth.

So AP had the twin problem of a rapid influx of capital from profit-focused investors, investing in an increasingly crowded, unregulated market. As competition increased, and as clients became more indebted, there were many reported cases of 'legal loan sharking': lenders lending at high rates of interest to already over-indebted clients. There were even cases of coercion and threats of violence being made against borrowers who were struggling to pay. This absolutely needed to be brought to light and it was therefore very important that it was reported in the media: however, it is just as clear that the entire industry should not be equated with the happenings in AP.

Bangladesh: Muhammad Yunus comes under fire

The scandal in AP, and the resulting wider criticism of microfinance created the backdrop for criticism of Muhammad Yunus. According to Transparency International, Bangladesh is one of the world's most corrupt nations, with systemic corruption at all levels of government and the judiciary. As 'banker to the poor', Yunus was much favoured by the government for many

years. However, in early 2007 he stated that he was going to set up his own political party based on good governance, which would work to establish public trust and be fully accountable. Later that year he abandoned his plans, however the mass of public support he received revealed his potential political power. It has been widely reported that the Bangladeshi Prime Minister Sheikh Hasina Wajed considered Yunus a major rival.

In November 2010, at the height of the Andhra Pradesh scandal, a documentary appeared on Norwegian T.V called 'Caught In Micro Debt'. The film was highly critical of Grameen and levelled three central arguments against Yunus and the bank:

1. Of diverting around \$100 million from the Norwegian Agency for Development Cooperation (NORAD) to another organisation called [Grameen Kalyan](#) in 1996. This allegation quickly spread through the Bangladeshi media. In fact, the Norwegian government had undertaken a serious case review of the allegations at the time and cleared Yunus and Grameen of any wrongdoing whatsoever. They issued a statement to that effect at the time and re-issued it after the release of the film.

2. Of charging borrowers interest rates of 30-200%. This rumour also circulated widely in the Bangladeshi press. Again, this was disproved by MicroFinance Transparency who employed an independent expert to investigate: they found that Grameen had the most (i.e. 100%) transparent interest rates of any MFI globally (which they stated was 'unprecedented') and that the highest interest rate they ever charged was 22.84%. The investigation also showed that Grameen actually has the lowest interest rates of any microcredit program in Bangladesh.

3. Of making empty promises to its borrowers and putting them in jeopardy with bad debt-recovery practices. After the documentary aired, Gayle Ferraro, an independent filmmaker who was already in Bangladesh, went to interview a woman featured in the documentary, who Heinemann claimed was the daughter of one of Yunus' original borrowers, and who claimed that her mother died in poverty. Ferraro discovered that the woman interviewed was not who the filmmaker claimed she was, and that the actual borrower from the documentary did not die in poverty, but was alive and able to tell her story about how she had benefitted from microcredit.

Yunus ousted, Grameen at risk

Despite these allegations being widely disproven, the Bangladesh government used them as justification to launch an investigation into Yunus and Grameen. After continuing to put pressure on him to leave the bank, he was finally forcibly removed from his position earlier this year. In Bangladesh, the heads of banks must retire at 60: Yunus was 70. He has twice appealed the decision and twice been defeated. The Bangladesh Government is now manoeuvring with little subtlety to take control of Grameen Bank.

The problem with microfinance

One of the major problems the sector has faced in recent years is its inability to definitively prove that MF causes a reduction in poverty. Whilst it is possible to show that microfinance clients have moved out of poverty – a report from the Microcredit Summit Campaign this year found that 10 million microcredit clients in Bangladesh moved out of poverty between 1990 and 2008 – it's very difficult to prove causality between the use of financial tools and moving out of poverty, ie that it was microfinance that caused them to move out of poverty. This leaves the door open for criticism: "MFIs push poor people towards unmanageable debt and that debt isn't even guaranteed to alleviate their poverty."

A lesson learned?

The crisis has been a wakeup call to a sector that was undergoing rapid expansion and had failed to balance the effect that heavy investment was having on its core philosophy. What the scandal made clear is that the industry needs to reassert its principles and its purpose. Of the flow of cash into MFIs like SKS, and the concept of profiteering from microfinance, Yunus stated: "Microcredit is not about exciting people to make money off the poor. That's what they're doing. That's the wrong message completely." We believe that much more needs to be done to demonstrate the positive impacts of microfinance through monitoring and evaluation, use these evaluations to drive improvements in the way microfinance serves poor people, and that we will need to support MFIs and governments including our own to be more rigorous about the claims they are making and how they communicate them.