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The Indian Microfinance Crisis

Noah Seelam/Agence France-Presse — Getty Images
A demonstration in Hyderabad, India, last October was aimed at microcredit companies, accusing them of high interest rates (New York Times, 5/01/2011).

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INTRODUCTION

"Everyone needs ways to manage money[1]". Realising this key need in developing countries like India, it is the provision of financial services to poor clients at the so-called bottom of the pyramid what forms the cornerstone of microfinance. Reaching out to the poor to enable them to "start new businesses, grow existing businesses, insure against shocks [...], and [guarantee] smooth consumption[2]" has since thirty years acquired a firm position in the toolkit of development policies all over the world. It is promoted by governments, NGOs, foundations and business enterprises in such diverse places as Mexico, Bangladesh, China, and India.

In India, microfinance institutions of all kinds have developed a dense network of different financial services and approaches to empower especially the rural population. The region of Andhra Pradesh has a special place in this development. It is here that the Indian microfinance sector has had its strongest base. And it is here that incidents occurred that have shattered the microfinance community recently.

Venkatalkshmi from Devarapalli, Visakha district in India, took out a microloan of Rs. 15000. When he could not deliver payment of interest, his 16 years old daughter was forced to prostitute herself for repayment. She was kept in a house under lock and committed suicide. Jayaramappa from Madaka Sira Mandal, Ananthapoor district, borrowed Rs 64000 from three microfinance institutions (MFIs). On October 3, 2010 he committed suicide because of MFIs debt collectors harassing his wife.[3]

These two cases are taken from a SERP report that followed an alleged wave of suicides in Andhra Pradesh (AP). According to the report, one can establish a direct link between these suicides and the practices of MFIs. These accusations - relayed by the local media - have prompted a severe reaction of the local government. A crisis of the microfinance sector has erupted.

On October 14, 2010, the government of AP promulgated an ordinance that "retroactively waived loans where a sum of twice the principal had been repaid, required that repayment collections occur at [only few and special] offices, and added onerous regulation that requires registration of microfinance institutions or MFIs with district authorities who may, at any time, cancel it[4]". This ordinance has allegedly caused large-scale defaults by borrowers. It has also caused a withdrawal of liquidity by banks and a severe loss in capital in the sector.

Not only, however, has the microfinance crisis in AP had negative effects on the microfinance industry in the region, it also attracted much negative publicity to microfinance in general and led even strong supporters of the concept to question its ability to alleviate poverty[5].

It is here that this paper starts off. To understand the background and effective consequences of the current crisis, a

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1 Gates Foundation (2011), *Financial Services for the Poor (Overview)*, accessible at www.gatesfoundation.org/financialservicesforthepoor/Pages/overview.aspx.

2 Cf. "Help Microfinance, don't kill it", *Indian Express*, 26/11/2010.

3 Cf. "Exclusive: 54 microfinance-related suicides in AP, says SERP Report", Microfinance Focus, 28/10/2010.

4 "Help Microfinance, don't kill it", *Indian Express*, 26/11/2010.

5 Cf. Kuts, Darya "Another look at the Indian microfinance crisis: Causes and Effects" 19/01/2011.

thorough analysis not only of the actual situation in India, but also of the general concept of microfinance is due. Is the crisis only a symptom of a greater flaw in the concept of microfinance? Has the trend to commercialisation corrupted what started off as a budding way to help the poor help themselves? Has a general malaise infested the Indian microfinance system, and will it spread to other parts of the world?

In order to try and comprehensively answer these questions, in part I, we will start off with an introduction into the concept of microfinance and microloans itself. For that purpose, we will briefly look at its historical development and the different phases it went through since its re-invention in the 1970s. By virtue of a distinct definition, we will set out the basis for further discussion of the concept throughout this paper. The concept of microfinance has been, and will be in the future, rethought and re-invented to fit different approaches and insights from sociology, psychology, economics and political sciences. In that sense, it is a contested and ambiguous term.

To get an idea of how his contestation is manifested within a both academic and practical debate on the merits and disadvantages of microfinance, we continue in part II with a discussion of what we identify as the two broad blocs of thought on the issue. Because the comparison mainly focuses on the heatedly disputed issue of commercialisation, we label the two sides non-profit and for-profit. Again, the sponginess of these terms underlines the high complexity of the current situation not only in the world-wide discourse on microfinance, but also within the microfinance community in India. While most of the arguments presented in the non-profit vs. for-profit debate claim general validity, we found the necessity to discuss the influence of different actors both from inside the microfinance sector and from the political landscape in India. In that respect, the emergence of the AP ordinance is discussed. The question then arises whether the crisis may be to large amounts the effect of a political turf war on different succession and power issues within the political parties.

On the basis of the considerations set forward in parts I and II, part III offers our own recommendations as how to evaluate the alleged Indian microfinance crisis and the general discussion behind it. Apart from several general concluding remarks that strive to guideline the reader and help clarify our stance on the situation, we offer six recommendations as how to simplify the chaotic discussion, and stabilise the fleeting microfinance environment in Andhra Pradesh and India. In that respect, we underline the need for a prudential and diligent approach to regulation, self-regulation and the extension of microfinance to entail more than just microcrediting.

The aim of this paper is to provide a comprehensive overview of a specific tool of poverty alleviation within the boundaries of a case study on the situation of microfinance in India. But when we accept that indeed, “everyone needs ways to manage money”, then this paper strives for more: it is a policy paper putting forward a concept of how to deal with microfinance.

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Part I
THE RISE AND FALL OF MICROFINANCE

In the last decades, microfinance and especially its public image have experienced several ups and downs. Considered to be the 'silver bullet' of poverty alleviation in the nineties and early 2000, microfinance has lost much of its appeal with recent scandals around Muhammad Yunus' Grameen Bank[6], political criticism in Bangladesh and India, and an ordinance by the Indian state of Andhra Pradesh effectively banning much of microfinance institutions' work.

Origins

The idea of microfinance reaches far back with some authors dating it back to the 16th century in Europe and even earlier in Asia[7]. What is commonly considered as microfinance today however, finds its origin in the 1970s, when mostly non-governmental organisations (NGOs), funded by donations from governments, aid agencies and multilateral organisations started microcredit programmes in Bangladesh, Indonesia and Brazil[8]. The principle of microcredit is to help the rural poor population to improve their conditions of living by providing it with small loans for money-generating activities, especially the founding or expansion of small businesses. The microcredit idea has been born out of necessity as the rural poor in general do not have access to the regular commercial banking channels. Their poverty and the resulting absence of collaterals make them "non-bankable"[9]. Moreover, most commercial banks do not have offices in the distant rural areas and generally cannot provide microloans as the costs for such small sums exceed the expected returns. Therefore, the only providers of financial services (besides friends and family) in rural areas are so-called moneylenders. These moneylenders usually charge very high interest rates for loans: in an analysis of 28 studies of informal money lending rates in 14 countries in Asia, Latin America and Africa, some moneylenders were found to charge rates as high as over 100% per months[10].

Microfinance thus started out with the provision of small credits and it was not until the mid-1990s that the term 'microcredit' began to be replaced by the term 'microfinance', which includes not only the provision of credit, but also other financial services such as saving accounts, insurance and money transfer[11]. Microfinance can thus be broadly defined as banking for the poor. A typical microfinance client, Morduch and Rutherford argue, are "men and women from poor households seeking a wide range of savings and loan

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6 Mr. Yunus was recently forced to step down from his position within the Grameen Bank because of alleged legal issues and an age limit for the post. In a TV documentary by the Norwegian journalist Tom Heinemann, Grameen Bank was moreover accused of having diverted money given by the Norwegian government for microfinance into an entirely different sector.

7 Cf. for instance Seibel, Hans Dieter (2005) "Does History Matter? The Old and the New World of Microfinance in Europe and Asia", Paper presented at *From Moneylenders to Microfinance Conference* Asia Research Institute, National University of Singapore 7-8. 10. 2005.

8 Cf. Grichting, Patricia (2007) *Microfinance, An Attractive Investment with Financial and Social Returns*, p. 9.

9 Cf. Bothra, Nidhi (2009) A *Face-off with micro finance – world over* p.6.

10 Cf. Robinson, Marguerite (2001) *The Microfinance Revolution: Sustainable finance for the poor,* The World Bank.

11 Cf. "The History of Microfinance", Global Envision, 14.10. 2006.

services to support a diverse set of consumption needs and investment opportunities"[12].

Today, organisations providing microfinance operate worldwide in all developing countries[13]. But, as Dunford underlined already in 2000, "there is a bewildering variety of types and combinations of clients, delivery systems, and institutional structures that shelter uneasily together under the big tent known as microfinance"[14].

Functioning

The institutions which provide micro-financial services usually focus their work on women. Experience has shown that women are better in handling money and repaying loans and that they are more concerned with the well-being of the family[15]. Microfinance has been heralded especially by western societies because "[i]n societies where women have to struggle against repressive social and economic conditions, microfinance has proven to be an important liberating force"[16]. While not all institutions, NGOs and banks involved in the microfinance business operate according to the exact same procedure, their functioning is similar to what Bothra describes:

> Commonly, an MFI does a comprehensive survey of the villages and then based on certain parameters chooses a village and offer their mission, methodology and the services to the villagers. Thereafter villagers [women] are asked to gather in a group of five to serve as guarantors for each other enforcing them to be loyal to each other. This is done so that in case a group member is not able to repay the loan, the others can help him/ her in making payments. In case if any member defaults in the loan the group is penalized and sometimes is also barred from taking a further loan. On the other hand making timely payments also attract incentives. This peer pressure always brings out the diligence in paying the loan and acts as collateral for the MFI[17].

Microfinance institutions thus imitate informal sector practices - like proximity to the client, character-based assessment and the forming of a group as pragmatic concepts of collateral. Simple lending practices are adopted and the weekly loan repayment helps to monitor and train the borrowers in financial discipline. While one of the declared goals of the pioneers of microfinance was to undermine the exploitation of the poor by the exorbitant interest rates 'loan sharks' usually demand[18], it has to be underlined that the interest rates for microcredits are not very low either[19]. This is usually explained by high transaction costs as Nancy Berry, president of the Women's World Banking Network underlines: "The biggest problem facing MFIs is the high transaction cost of making many minuscule loans, which drive up interest rates […] The administrative costs

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12 Morduch/Rutherford (2003) "Microfinance: analytical issues for India", p. 3.

13 Cf. Grichting, Patricia (2007) *Microfinance, An Attractive Investment with Financial and Social Returns* p. 9.

14 Dunford, Christopher (2000) "The holy grail of microfinance: 'helping the poor' and 'sustainable'?" in Harper, Malcolm (2003) *Evolution, Achievements and Challenges*, p. 150.

15 Cf. Grameen Bank Credit delivery system.

16 Mjøs, Ole Danbolt (2006) *Nobel Prize Award Ceremony Speech*, Oslo, 10.12.2006.

17 Bothra, Nidhi (2009) A *Face-off with micro finance – world over,* p. 1.

18 Cf. Yunus, Muhammad (2011) "Sacrificing Microcredit for Megaprofits", *New York Times,* 14.02.2011.

19 Interest rates for microcredits vary substantially by country and the institution providing the credit. The rates vary between approximately 20% to up to 60%.

are 10 cents to lend each dollar. High costs combined with inflation drive real interest rates above 25%"[20]. However, it has been established that if the microfinance system works successfully, the poor are able to pay these relatively high interest rates[21].

Boom

After a development phase during the 1970s and 80s, the idea of microfinance increasingly gained momentum. The worldwide impetus took off after the 1997 World Microcredit Summit in Washington D.C. which targeted at eradicating poverty of 100 million poorest families within 2005[22]. Microfinance was increasingly seen as a panacea for poverty eradication. The year 2005 was designated by the United Nations as the 'International Year of Microcredit' with the objective to "[a]ssess and promote the contribution of microfinance and microcredit to the Millennium Development Goals"; and to "[e]ncourage innovation and new partnerships by promoting and supporting strategic partnerships to build and expand the outreach and success of microcredit and microfinance"[23]. In 2006, Muhammad Yunus and his Grameen Bank (which operates in Bangladesh since the mid-70s) were awarded the Nobel Peace Prize. Today, microfinance institutions are present everywhere in the developing world. It is difficult to find exact numbers but millions of people have received microcredits and benefit from other financial services provided by hundreds of thousands of organisations.

Commercialisation

Increasingly, it is not only (or mainly) the wish to help the poor that makes organisations start operating in this business but the perception that high commercial gains can be realised[24].

The possibility of commercial gains has led to an increasing commercialisation of microfinance, a "paradigm shift"[25] in the last years which makes some even talk about a "microfinance revolution"[26]. Instead of relying on donors for providing the money to finance their operations, microfinance institutions (MFI) have increasingly become self-sufficient organisations. This means that these MFIs are able to guarantee the long-term sustainability of their operations since no subsidies by the states or private donors are needed. Additionally, the services can be provided on a much greater scale. As Christen and Drake point out: "In [commercialisation] lies the potential for truly exponential growth and ultimately,

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20 Nancy Berry quoted in "Microcredit Is Becoming Profitable, Which Means New Players and New Problems", 04. 05. 2005, Knowledge @ Warton.

21 Cf. "Helping to Improve Donor Effectiveness in Microfinance, Making Sense of Microcredit Interest Rates", *Donor Brief* No. 6, CGAP, September 2002/ January 2003.

22 Cf. Bagchi, Kanak Kanti (ed.) (2009) *Micro-Finance and Rural Development*, p. 11.

23 "Objectives of the International Year of Microcredit" at the International Year of Microcredit, Website www.yearofmicrocredit.org.

24 In this context, it should be noted that in general, loan repayment rates are very high in the microfinance business, reaching approx. 98% which is higher than the rates for most commercial credits in developed countries. Cf. for instance "Microcredit Lending", Foundation for Women, www.foundationforwomen.org/microcredit-lending.html, Grameen Bank claims that almost half of their branches maintain a 100% repayment record. Cf. www.grameen-info.org/index.php?option= com_content&task=view&id=26&Itemid=175.

25 Robinson, Marguerite (2001) *The Microfinance Revolution, Sustainable Finance for the Poor*, The World Bank/ Open Society Institute.

26 Ibidem.

vastly improved financial services to the poor"[27].

One of the best known advocates of this for-profit approach (as opposed to the non-profit approach of the pioneering organisations) is Vikram Akula, founder of *SKS Microfinance*. *SKS* made the news in summer 2010 when it became a stock corporation, making its initial public offering (IPO) on the Bombay Stock Exchange. In his autobiographical account "A Fistful of Rice: My Unexpected Quest to End Poverty Through Profitability", Akula makes the case for for-profit, arguing that making microfinance profitable is a "win-win" because the poor get access to financial services and the investors gain through their shares. Moreover, profitability enables operations at a much larger scale, thereby reaching more people, as the amount of money to be used is no longer restricted by the donors' generosity. As Dunford notes: "The Holy Grail of microfinance is a social enterprise that is helping the poor and is sustainable at the same time"[28]. Thus, by following the for-profit approach, MFIs could substantially increase access to financial services for the world's hundreds of millions of low-income households[29].

SKS' IPO was the most mediatised but not the first MFI going public. The Mexican microfinance institution *Compartamos Banco*[30] undertook a very successful IPO in 2008 and before it, the Bangladeshi *BRAC* as well as a small specialised MFI from Kenya had also gone public[31].

Criticism

While the "win-win" approach as put forward by Akula and other seems to be in the interest of everyone, there has been increased criticism concerning this commercial approach, as will be discussed below. The main critique, prominently brought forward by Muhammad Yunus, is that these institutions have become so radically commercial that all of the social and development considerations which have traditionally motivated work in the field of microfinance, seem to have lost their importance[32].

But not only has the commercialisation of microfinance attracted criticism. After years of heralding microfinance as the panacea for poverty, the principle of microfinance itself increasingly faces criticism[33]. Jonathan Morduch, Economics Professor at New York University for instance notes that there are very few

[27] Christen R.P./ Drake, D. (2002) "Commercialization The new reality of microfinance", in Drake, Rhyne (2002) *The Commercialization of Microfinance. Balancing Business and Development*, p. 4.

[28] Dunford, Christopher (2000) "The holy grail of microfinance: 'helping the poor' and 'sustainable'?" in Harper, Malcolm (2003) *Evolution, Achievements and Challenges*, p. 151.

[29] Cf. Ledgerwood, Joanna/ White, Victoria (ed.) (2006) *Transforming Microfinance Institutions, Providing Full Financial Services to the Poor*, xxv.

[30] Compartamos Banco is the biggest microfinance bank in Latin America. Its financial success set off a debate about the ethical implications of making money with the poor.

[31] Cf. Schmidt, Reinhard H. (2008) *Microfinance, Commercialisation and Ethics*, Working Paper Series Finance and Accounting, p.23.

[32] Cf. Ibidem p.3. Proponents of the commercial approach respond to that by pointing to the "double-bottom line" approach (see below, chapter on commercialisation).

[33] Cf. for instance Bateman, Milford (2010) *Why Doesn't Microfinance Work?*, Zed Books.

methodologically sound studies on the impact of microfinance on poverty[34].

The Case of India

In India, the business of microfinance plays a very important role. Home to millions of rural poor, the country has attracted a lot of NGOs as well as commercial organisations which provide microfinancial services in the last decades. A 2004 study identified India as the country having the highest percentage of poor being served by an alternative financial institutions; approximately 18% of the total national population[35]. "The pace at which the movement took off in India in the early nineties and the short span in which the microfinance system gained maturity in India is phenomenal"[36] notes Dhar. Andhra Pradesh (AP), a south-eastern, highly populated Indian state[37] has a unique leadership position within Indian microfinance[38]. It is estimated that AP has the highest penetration of microfinance in the country[39] with over 25 million borrowers and around Rs. 225 billion in microcredit[40]. While MFIs are present in almost every developing country, India's MFIs are considered to be amongst the most cost efficient in the world[41] and most Indian MFIs charge rates substantially lower than rates in many parts of the world. For instance, in Mexico and the Philippines, rates are often above 60% per annum while the Indian *SKS* charges below 30%[42]. Similarly, the cost per borrower in India is also one of the lowest[43].

However, it has to be underlined that while the scale of the microfinance sector in India is impressive, its scope is rather limited as most microfinance institutions in India see their main business still in the provision of microcredits[44]. The Reserve Bank of India accordingly focuses in its definition of microfinance on microcredit: : "the provision of thrift, credit and other financial services and products of very small amount to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards"[45].

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34 Cf. Ogden, Tim (2008) "Cutting Edge Research on Microfinance", *Philanthropy Action* 17.10. 2008. Cf. also
Roodman, David/ Morduch, Jonathan (2009) *The Impact of Microcredit on the Poor in Bangladesh: Revisiting the Evidence*, Working Paper Number 174, June 2009.

35 "Financial Institutions with a "Double Bottom Line": Implications for the future of microfinance", Occasional Paper, *CGAP*, July 2004.

36 Dhar, Samirenda Nath: "Sustaining the Microfinance Boom in India: Role MF Regulation and Education" in: Bagchi, Kanak Kanti (ed.) (2009) *Micro-Finance and Rural Development*, p. 12.

37 Andhra Pradesh has approximately 76 million inhabitants which makes it the fifth largest Indian state by population.

38 Cf. "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?", *Intellecap White Paper,* October 2010.

39 Ibidem.

40 Cf. "Help Microfinance don't kill it", *The Indian Express*, 26.11.2010. Rs 100 equal ca. 1,60 €.

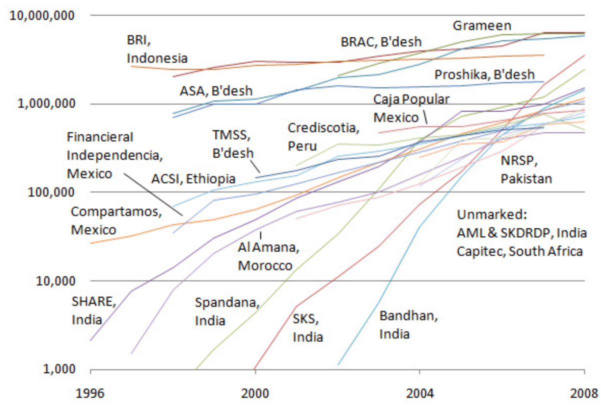
41 Cf. "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?", *Intellecap White Paper,* October 2010.

42 Cf. "Help Microfinance don't kill it", *The Indian Express*, 26.11.2010.

43 Cf. Bothra, Nidhi (2009) A *Face-off with micro finance – world over* p.7.

44 Rutherford, Stuart (2010) "Stuart Rutherford reacts to the Sa-Dhan National Microfinance Conference". March 23, 2010.

45 Reserve Bank of India, RBI Master Circular, 2008.



The 20 largest microfinance institutions of 2007, Number of borrowers[46]

Microfinance services in India are provided mainly by two different models, the government-supported SHG bank-linkage programmes and a growing amount of private MFIs. The SHG-linkage programme is organised since 1992 by the National Bank for Agriculture and Rural Development (NABARD)[47]. The functioning of the SHG programme is similar to the system explained above with the groups being slightly bigger as in the common MFI programmes (about 10- 20 women) and the loans and other financial services being provided to the group as opposed as to the individual within the group. Moreover, SHGs usually require savings to be made by all members and resources have to be handled for a while before any external loans are given out[48].

As most MFIs, the SHG-bank linkage model consists mainly of women's groups. SHGs play an important role in India's microfinance landscape; as of November 2010, there are 4.5 million SHGs receiving credit nationwide, with 58 million members[49]. 1.47 million SHGs, reaching 17.1 million clients operate within AP[50]. The competing model in India is the increasing number of private MFIs. Srinivasan estimates that by 2010, MFIs were expanding at an annual rate of 80 percent[51].

The Crisis of Microfinance: The Case of Andhra Pradesh

While Microfinance has been heralded for a long time as shown above, recently, it has increasingly faced criticism, especially in south-east Asia with Bangladesh and India being primarily in the focus. What caused this "crisis of microfinance"[52]?

The crisis erupted in early October 2010 in Andhra Pradesh when the government of AP promulgated the *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 thereto*. In this ordinance, the government claims that "[o]f late, many individuals and entities have come up styling themselves as Micro Finance Institutions and are giving loans to SHGs at very high or usurious rates of interest and are using inhuman coercive methods for recovery of the loans." According to the government, this has "resulted in suicides by many rural poor who have obtained loans from such

[46] Graphic from Roodman, Center for Global Development.
[47] Cf. Karmakar, KG (ed.) (2008) *Microfinance in India*, p. 59.
[48] Cf. Sing, Sukhbir (2008) "SHG-Bank Linkage Programme: Progress and Prospects", in Karmakar, K.G. (2008) *Microfinance in India*, p. 113, 114.

[49] "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance", *CGAP*, No. 67, November 2010, p. 1.
[50] Cf. Srinivasan, quoted in "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance", *CGAP*, No. 67, November 2010, p.2.
[51] Cf. Srinivasan, N. (2010) *Microfinance State of the Sector in India.*Access Development Services, Sage Publications.
[52] Cf. for instance "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?", *Intellecap White Paper,* October 2010.

individuals or entities". Thus, in order to "protect the poor from exploitation", MFIs are to be registered and regulated under the ordinance.

While it is not possible to prove or contradict the causation of the alleged suicides by exploitative lending or bullying practices by MFIs, AP's media and eventually national and international media picked up the story and MFIs were increasingly criticised. The issue of over-indebtedness on the other hand is founded in facts. In the last years, there has been a rapid proliferation of debt in AP and the average debt outstanding per household is Rs. 65,000 as compared to a national average of Rs. 7,700 of outstanding microfinance debt per poor household[53]. As MFIs in Andhra Pradesh were among the first to attract significant investment from private equity players, which is by many considered to be unethical and contemptible, it is not surprising that the crisis erupted in the Indian state[54]. But the AP government is not the only one making such indictments. Pranab Mukherjee, India's Finance Minister said that the rates charged by MFIs are "outrageous", and the central bank has appointed a commission to review all practices in the sector.[55] There thus is a risk that the Andhra Pradesh crisis could develop into a full blown Indian microfinance crisis.

While recent developments have attracted most attention, it is not the first time that MFIs have come under attack in India[56]. Wright and Sharma find three smaller crises leading to the 2010 big bang: already in 2006, the administrator in the Krishna district closed 50 agencies of the big MFI following allegations of unethical collections, illegal operational practices and exorbitant interest rates[57]. Clients were advised not to pay back their loans. The central bank intervened, the MFI accepted to reduce the interest rates and to exert self-regulation[58]. In 2009, a local MFI in Andhra Pradesh was unable to repay its own loans to other banks. There have been no internal controls or information systems to regulate the increasing number of MFIs. In 2009/2010, in the Kolar district, there has been a borrower strike organised by a religious organisation. In response to that, the local MFI have formed an umbrella organisation that represents the interests of the MFIs[59].

As a direct result of the crisis and the ordinance, loan collections in AP dropped dramatically[60]. Because of the crisis and the resulting media attention, MFIs operating in AP find it increasingly difficult to find financing and have to downscale their operations. This immediately affects their clients who rely on regular interaction with the MFIs.

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53 Cf. "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance", *CGAP*, No. 67, November 2010, p.3.

54 Ibidem p.2.

55 Cf. "The Crash of Microfinance, India's Poor Face Their Own Sub-Prime Crisis", Les Echos (English translation), 24.11.2010.

56 Cf. Wright, Graham A.N./ Sharma, Manoj K. (2010), "The Andhra Pradesh Crisis: Three Dress Rehearsals … and then the Full Drama", *MicroSaveIndia Focus Note 55*, December 2010.

57 Cf. "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance", *CGAP*, No. 67, November 2010, p.3.

58 Cf. "Crise de la microfinance en Inde", *Le Portail Microfinance*, January 2011.

59 Ibidem.

60 Cf. "Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance", *CGAP*, No. 67, November 2010, p.4.

Consequences on the long term are likely to be even more severe as the rating agency Crisil assigned negative ratings to 12 MFIs. It states that current events can "permanently damage the business model of MFI growth by damaging the quality of their claims, their profitability, and their ability to raise funds"[61]. Moreover, as on microfinance professional is quoted: "Years of education to inculcate the discipline of repayment are being shattered"[62].

The question therefore arises whether this local crisis does put into question the idea of microfinance in general. Has microfinance promised more than it could deliver? Is the commercial approach destroying the initial idea? Or is it only a local problem, due to Indian idiosyncrasies and exacerbated by politics?

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[61]"The Crash of Microfinance, India's Poor Face Their Own Sub-Prime Crisis", Les Echos (English translation), 24.11.2010.
[62] Ibidem.

Part II

THE DEBATE: NON-PROFIT AND FOR-PROFIT

The crisis of microfinance in India can be interpreted as an essentially normative debate that is "loaded" by an array of different sociological, psychological and economic arguments. In this debate, we can identify two broad normative blocs or categories in which these arguments can be arranged. For the purpose matter, we label these blocs the "non-profit" and the "pro-fit" or "for-profit" sides. It has to be understood, however, that this distinction is as artificial as it is applicable. When we agree with Duncan that there is indeed "a bewildering variety of types and combinations of clients, delivery systems, and institutional structures that shelter uneasily together under the big tent known as microfinance" (see above.), then we have to underline that this variety is mirrored in the ongoing debate. To label a certain category as "non-profit" or "for-profit" in this chapter signifies not a specific type of organisational or financial structure, or even any specific idea of how microfinance should be dealt with in detail. Instead, it signifies a certain mindset with several underlying arguments, the most of important of which are outlined here for both "blocs". Both for matters of chronological correctness and because in the recent debate, the non-profit "bloc" took the offensive role, we will start with these arguments.

Non-Profit Approaches

The non-profit argumentation can, very sketchily be summarised in one notion: if you want to make profit, you do not care about other things (either because the market dictates that behaviour, or because you are inherently bad). Thus, it criticises the for-profit approach for two distinct, though interconnected, reasons: 1) that the market approach in general is damaging to poverty alleviation and ongoing commercialisation without strict regulation has accentuated this flaw, 2.) that those adherent to the market approach are morally flawed, and want to profit at the expense of the poor. Two quotes may clarify these positions. Mohammad Yunus formulates: "Commercialisation has been a terrible wrong turn for microfinance, and it indicates a worrying "mission drift" in the motivation of those lending to the poor"[63], while Lenin Raghunvashi, prominent human rights activist, points out that "markets are essential, but they should be based on ethics and values. Those operating [private] micro-finance [institutions] have none"[64].

Commercialisation has led to increasing pressure on SHGs and non-profit MFIs from for-profit MFIs. Those have allegedly exploited the former, "reaping the fruits" of what has been built up in three decades of long-term educational and economic campaigns by today's most dense and successful system of self-help administration.

It is not surprising, therefore, that what can generally be understood as the non-profit side of the debate is largely recruited by those favouring "traditional" approaches to poverty alleviation, especially members of non-profit agencies and SHGs. The most

[63] Cf. Yunus, M. (2011), *Wrong turn for microcredit*, accessible at www.thedailystar.net/newDesign/news-details.php?nid=169263.

[64] Quoted according to Asia News (2010), *Microcredit driving people to suicide*, accessible at www.asianews.it/news-en/Micro-credit-driving-people-to-suicide-in-India-19794.html

furious agents of criticism, however, are found amongst regional and national politicians, that may want to express or mobilise fears and hopes within both the international development community and the local electorate[65]. Apart from voices that criticise the for-profit-approach from a moralist, often anti-capitalist stand more generally, others have outlined several core arguments in favour of non-profit approaches that are worth considering.

Scale and Lack of Social Mission

Because of what is called irresponsible concentration on scale and growth, and because of the lack of a clear definition of the social mission of poverty alleviation within the private companies, for-profit MFIs have allegedly tended to exploit their poor clients with their one-size-fits-it-all approach.

For-profit MFIs are said to have taken over many of the foremost self-help group members, especially because they did not set minimal investment requirements. This lack of individual assessment and the opening of the credit market to short-term consumption loans have enabled a vicious credit cycle. For-profit MFIs claim to assess the creditworthiness of their clients on the basis of fair and sustainable benchmarking systems[66]. But apparently, this situational approach conflicts with the idea of fast growth. Economies of scale, or so the arguments goes, can only be realised via the mass production and sales of similar products. In a for-profit business, cost efficiency and profits from economies of scale are naturally prioritised over any other goals, even within so-called "double-bottom line" enterprises. This effect is even greater if shares are traded freely after an IPO (as SKS has shown), because private investors prioritise profits, which, in a scale-dependent business such as microfinance, can be extended only through rapid growth. While current growth rates suggest that enterprises such as SKS, which has made its principles to granting of loans adequately transparent, can develop very positively, the tendency towards intense competition for growth and clients in the Indian "shark tank" of microfinance seems to predict a dangerous easing of loan policies[67].

This problem, the critics hold, is aggravated by the lack of clearly defined social standards in form of mission characters or visions for "double bottom-line" enterprises. While almost every for-profit microfinance institution has put forward lofty mission statements and commitments to poverty alleviation, rural development and other social, sometimes even environmental goals[68], the actual social bottom line often lacks behind the profit targets. This is effectively both a reason of and a trigger for the profit concentration of private actors in the field. Because following social goals can be costly, and can demand respect for situational circumstances, individual needs, higher risks and thoughtful handling of fields that need not necessarily

[65] For a more detailed overview of the SHG-MFI struggle and different political calculations, see chapter III.

[66] Cf. Brott, R. Murray, I. Rueda, I.& Torrico, A. (2006) *How Client Assessment Is Making A Difference*, accessible at www.microfinancegateway.org /p/site/m/template .rc/1.9.28603/.

[67] Cf. Ghosh, S. & Van Tassel, E. (2008). *Microfinance, Subsidies, and Dynamic Incentives*. Accessible at home.fau.edu/ sghosh/web/images/Jan31MFI.pdf

[68] Cf. the statement of CGAP at www.microfinancegateway.org; also Microfinancehub (2010), *Why Green Microfinance Matters to the Poor*, accessible at microfinancehub.com /2010/06/05/ why-green-microfinance-matters-to-the-poor/.

directly correspond with the primary entrepreneurial activity (e.g. health issues, education, infrastructure development, governance), it may be conflicting with private business. In case of doubt, the argument goes, private business will always opt for blurry visions and concrete benefits. And these blurry visions and missing target agreements have enabled managers and local salesmen to pursue profit recklessly[69].

Poverty Psychology

These effects have, in many cases, led to inconsiderate easing of loan policies, especially to unaudited credit approval processes in rural areas. It is commonly understood in microeconomic theory that poor clients tend to operate much stronger than non-poor clients under what is called "hyperbolic discounting" conditions when they "rationalise" about credits[70]. Hyperbolic discounting is usually shown to over-value current assets over future assets or returns, due to high uncertainty about risks. If there is an implicit risk that the future reward will not be available due to situational circumstances, for example because of, in the case of India, floods, droughts, illness, accidents, crime, insecure governance etc., and that this risk might even increase over time, then it can be rational to discount future benefits at much lower, even negative, rates, compared to time-consistent (linear) discounting models[71]. For the micro-crediting process for poor clients, this can mean that loans to poor clients are actually spent on present consumption instead of future-sustainable investment, if not closely monitored. This trend is aggravated by high money demand in India for situational developments, such as weddings, illness, or funerals, which as a symbol of social status, are very costly. Bateman (2010) estimates that around 80% of all microfinance services are used for consumptive credits[72]. Loans used for consumption, however, inherently signify a very low productivity of capital[73]. That means, the investment of the capital given by a bank or microfinance institution yields very little or no returns, and thus often leads directly to high probabilities of credit failure. Microfinance institutions therefore may have to deal with lowering repayment rates, which logically leads them to compensate the inherent risk with higher interest rates for loans on the one hand, and a tendency toward stricter measures, even bullying practices, to increase the payback rate on the other[74]. Because the poor clients have spent the loan given to them on non-productive consumption, they take on new loans to pay back the old ones. The new loans, however, have higher interest rates. This vicious cycle leads to an amassment of "bad", non-productive credits with the poor, and ironically, especially with women[75]. They are caught in the credit trap which has allegedly led many of them to suicide. "The suicides cast a dark shadow on the fledging microfinance sector" says Sudhirendar Sharma, former World Bank analyst and now director of the Delhi-based Ecological

[69] Cf. Dharker, A. (2010), *MFIs are making profits at the expense of the poorest people*, accessible at microfinanceafrica.net/microfinance-around-the-world/mfis-are-making-profits-at-the-expense-of-the-poorest-people/.

[70] Cf. Bateman, M (2010). *Why doesn't Microfinance work*?, Zed Books; Ch. 4.

[71] Cf. Dasgupta, P. & Maskin, E. (2004), *Uncertainty and Hyperbolic Discounting*, p.1; accessible at economics.ucr.edu/seminars/winter05/ets/EricMaskin.pdf.

[72] Ibidem, p.53; also Prahalad, C.K. & Hammond, A. (2002), *Serving the World's Poor, Profitably*, Harvard Business Review R0209A/(9, 2002), p. 5

[73] Ibidem, p.51.

[74] Ibidem.

[75] Ibidem, p. 63.

Foundation[76]. One strong argument against this has been put forward by Vikram Akula, who holds that while short-term profit maximisation may incentivise such a "trapping" behaviour, it is in the long-term interest of private financial institutions of any kind to guarantee high repayment rates, even if this goes along with high costs of customer assessment[77]. Others then see the suicides as a symptom of rapid economic transformation in which poor farmers were not able to adjust rather than wrongdoing from the MFIs[78]. This transformation, however, could well be worsened by microcrediting. Bateman argues that microfinance can cause market distortions that destroy productive capacities of those receiving and, paradoxically, also of those not receiving the loans[79]. If a farmer takes on a loan to buy dairy cattle, the increase in milk production may reduce the market price for milk, and worsen the situation of both the loan taker and other, non-borrowing farmers.

Missing Regulation

The apparent market failures in the microfinance sector result to a high degree from missing regulation, especially from the unclear status of MFIs as Non-banking Financial Institutions (NBFC) that are as of yet not under the same direct control of the central bank (Reserve Bank of India, RBI) or state supervision in the form of direct ownership as most of the regular banking institutions in India. Microfinance institutions, especially if they are allowed to access deposits and offer savings accounts, have a specific obligation not only to their clients, as has any banking institution, but to society in general, because they deal with clients at the "bottom of the pyramid". These clients are often badly educated, especially in financial issues, therefore easier to defraud, run a higher risk of substantial crises that endanger their entire existence, are more sensitive to external shocks, and generally highly vulnerable[80]. If even normal banks are heavily regulated to protect their clients from harm, why would institutions that deal to a far greater degree with a much more vulnerable clientele be except from supervision?

Rethinking Microfinance I

The arguments on productivity and missing regulation in mind, Bateman (2010) quotes the so-called "Dichter microcredit paradox": "The poorest can do little productive with credit, and the ones who can do the most with it are those who don't really need microcredit, but need larger amounts and longer credit terms"[81]. This has led many experts to denote that to tackle poverty alleviation by microcredits is the wrong starting point. It only benefits the entrepreneurial poor, which comprise only a small percentage and live mostly in urban areas in a prospering economic surrounding. To fight rural poverty in India, microfinance

[76] Quoted according to knowledge.allianz.com/microfinance/microcredit/?309/microfinance-debt-trap-credit-crisis

[77] Cf. Vikram Akula (2002: *A Fistful of Rice*, Harvard Business School Publishing, p.153.

[78] Quote from Suvarna Ghandam, according to knowledge.allianz.com/microfinance/microcredit/?309/microfinance-debt-trap-credit-crisis.

[79] Cf. Bateman, M. (2010), p. 35.

[80] Cf. Banerjee, A. & Duflo, E. (2004), *Poor Economics: A Radical Rethinking of the Way to Fight Global Poverty*, Public Affairs; Prahalad, C.K. & Hammond, A. (2002), p. 5.

[81] Quoted according to Bateman (2010), *Book Launch Presentation* for "Why doesn't Microfinance Work?", accessible at www.odi.org.uk/events/documents/2447-presentation-m-bateman.pdf.

needs to be taken at its title. Microcredits are often not suitable for minimum efficient scale farms[82]. The concentration on microcredits needs to be broadened to finally encompass services such as saving accounts, insurance, and transfer payments. Indeed, access to full-fledged financial services, and especially to deposits, is crucial and can help to break the "hyperbolic discounting" cycle outlined above. Savings can well be seen as a form of indirect insurance, while actual insurance enables released capital to be reinvested. As of 2011, data suggests that only 5% of the poorest (1$ income per day) and around 35% of poor clients (up to 4$ per day) have a savings account[83]. Transfer payments can, especially if family members move from rural areas to find work in urban areas, make up large percentages of total income for family members that have remained in their rural hometowns. Furthermore, allowing MFIs to mobilise deposits would mean they fall under the formal regulatory authority of the RBI, which would facilitate and fasten attempts to necessary supervision. In that way, microfinance needs to be reviewed, and streamlined to actually help the poor.

For-Profit Approaches

"For-profit is a win-win situation. Both those who are in need and those who invest can benefit from it. [...] Only for-profit MFIs can get the capital required to serve all the poor who need loans."[84] The for-profit arguments are generated out of two broader streams of thought, which are tightly connected. We find 1) microeconomic arguments, and 2) business-management arguments, which are either related to business in general or to the specific advantages of public enterprises (that is, MFIs that can be traded in shares).

They have been advanced by those in favour of market solutions in general, by economic theoreticians as well as practitioners of microfinance, both private investors, MFI CEOs and activists from NGOs alike, and national and international institutions that have expertise in the field (such as the Asian Development Bank).

The for-profit arguments are largely ordered in the same way as the non-profit argumentation above, because many of them directly address concerns from the latter.

The Competition Cycle

A straightforward microeconomic concept can be simplified by the use of the "competition cycle". In a competitive surrounding with different private actors, every actor competes with every other actor in the same sector for marginal profits. These profits can be reached only by the production and selling of goods to customers on the one hand, and cost savings on the other hand. This implies two different forms of consequences. Firstly, it underlines the need for cost-efficient operations and efficient organizational structures. Secondly, it furthers the need for customer orientation; that means, loan efficiency (indicating to give loans to those who actually need them, and an assessment of credit-worthiness) and flexibility to match what clients want (indicating flexibility and need for pricing strategies other than maximum exploitation of single customers). If we assume that poor clients in need of credits are mainly interested in flexible situational solutions with low interest rates, we can assume that the private MFIs will

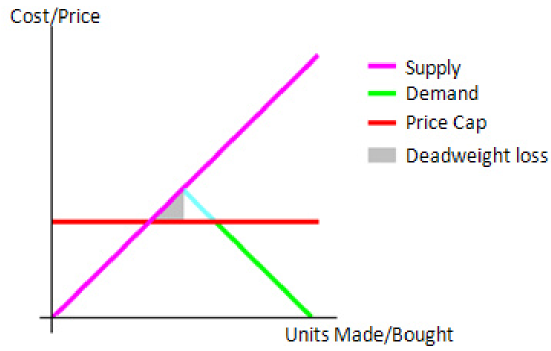
[82] Ibidem.
[83] Data available at www.pooreconomics.com/data/668
[84] Akula, V. (2002), p.140.

compete for such baskets of goods (credit services), that they can attract a sustainable profit-yielding maximum of customers. Due to poor clients having a higher probability to default and less or no collateral, interest rates for microcredits will remain higher than usual bank interest rates, but will over time converge down to a sustainable equilibrium interest rate[85]which is considerably lower compared to moneylenders[86].

Addressing Intervention

Interventions into the competition cycle, even with benevolent motive, can lead to market-disturbing outcomes. This has been proven comprehensively for excessive government subsidies[87].

One specifically interesting form of regulatory intervention in the case of MFIs has been interest rate ceilings. Economically speaking, an interest rate ceiling is a price cap for credits. This, at least theoretically, results in a deadweight loss, or a loss of resource allocation efficiency, for the national economy. This burden has to be paid for by the producers, in this case: the Microfinance Institutions.



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The Asian Development Bank names a couple of international examples, in most of which the ceiling is prescribed in a specific anti-usury law or detailed by government policies, rarely also by imposition from the central bank. The ADB states: "Interest rate restrictions impede the development of sustainable microfinance, and it would be appropriate for central banks to remove any such restrictions within their control. Even where such restrictions do not result from central bank actions, central banks may be able to lend their prestige and influence to efforts directed at their removal"[89]. After all, if the microfinance sector is supposed to flourish, there need to be a relative freedom of operation. It is indeed the "lack of regulation [that] may help to explain why the microfinance sector has developed much further in Bangladesh than in other countries"[90]. Ceilings on interest rates limit the ability of MFIs to provide permanent

[85] Note here that this directly contradicts the "poverty cycle" theory of the non-profit argumentation, so that we find there is a micro-economic foundation both for rising and for sinking interest rates respectively, which underscores the inherent normativity of the debate (see above).

[86] Cf. Vikram A. (2002, p.152; see also knowledge.allianz.com/microfinance/microcredit/?309/microfinance-debt-trap-credit-crisis.

[87] Cf. Ghosh, S. & Van Tassel, E. (2006), p.20.

[88] Graph from avromandina.net/ avrom/ 2008/11 /how-a-minimum-wage-can-create-jobs/. Please note that while price caps and interest ceilings cannot be discussed comprehensively here, any good microeconomic textbook may help. We find strong economic arguments that price caps can be a good thing in general, and in the Microfinance Sector in particular.

[89] Asian Development Bank (2010) *The Role of Central Banks in Microfinance in Asia and the Pacific: Regulation of Non-Bank Micro-Finance Institutions (ch.6)* , accessible at www.adb.org/Documents/Books/Central_Banks_Microfinance/Overview/chap_06.pdf

[90] Ibidem.

access to an increasing segment of the excluded households[91]. We find governments that inappropriately and extensively intervene in microfinance to address the perceived market failure of "too high interest rates" through channelling microcredit to target groups that are considered to have been underserved or not served by existing financial institutions. "With subsidized interest rates and poor loan collection rates, these interventions undermine sustainable development of microfinance. As a result, [India and many other countries in Asia] are crowded with poorly performing government microfinance programs that distort the market and discourage private sector institutions from entering the industry". That is not to say, however, that no regulation is required at all, because apparently, some MFIs are not operating on a sound basis, especially with respect to accounting and legal repayment collection.

Addressing Regulation and the Central Bank

Whilst it is acknowledged that a "greater emphasis on financial monitoring and reporting"[92] might be due, there is a strong argument against entrusting the regulative duties to a central body, especially to the central bank of India (RBI). The legal framework for regulation and supervision of any financial institution rests essentially on two arguments: 1) the need to protect depositors from loss of their savings, and 2) the need to maintain confidence in, and stability of, the financial system[93]. Since no MFI is big enough to threaten the Indian financial system as a whole, and since in India, only very few MFIs are as of yet allowed to take deposits and mobilize savings, this suggests that MFIs cannot be regulated by the RBI. Additionally, we find three supporting arguments: First, it is questionable if the RBI has the resources needed to regulate a large number of MFIs in addition to its core functions. Second, even if this was possible, "nominal imposition of […] regulation would not necessarily result in better performance by MFIs"[94]. Third, even if nominal regulation was put in place, uninformed and unspecific supervision by the already existing supervision authority could likely stifle the microfinance sector. Out of the notion that imposing central bank regulation and supervision on all MFIs would be both impractical and inefficient, the Asian Development Bank suggests that "credit-only MFIs should generally be free of prudential regulation and supervision […] It does not appear practical to regulate the full range of nonbank MFIs; however, any institution accepting deposits from the public should be regulated and supervised"[95]. While this argumentation essentially denies the RBI the possibility to regulate MFIs, and while penal and economic law govern sanctions bullying practices and competition distortion behaviour between rivals, central regulation and supervision could be possible under special law and independent regulatory authorities, as exist in other Asian countries (namely Nepal and Bangladesh)[96].

[91] Cf. Asian Development Bank (2011) *Microfinance Development Strategy: Microfinance in the Asian and Pacific Region*, p.7, accessible at www.adb.org/Documents/Policies/Microfinance/microfinance0304.asp.

[92] Cf. Asian Development Bank (2010).

[93] Ibidem.

[94] Ibidem.

[95] Ibidem.

[96] Ibidem.

Professionalism

If, however, competition is not unduly stifled, a turn within the microfinance sector towards customer orientation and empowerment may be perceived. The poor are not mere beneficiaries anymore, who need to be carried out of their misery by enlightened patrons. They instead become valuable customers. This change of perspective brings into the fore elements such as customer services, customer care, attractive individual problem solutions, and long-term professionalism in dealing with poor clients. This is to ensure that in a competitive market environment, growth is possible and current customers can be retained. As outlined above, it is clear that "MFIs that do not meet basic operational standards are not likely to reach large numbers of poor clients on a sustainable basis"[97]. And it is clear that, faced with a large number of potential credit grantors to freely choose from, customers would choose that one enterprise that serves best their interests; that is, that firstly offers low interest rates; and secondly efficient operations, simple and effective repayment collection, and attractive customer services. If we assume that interest rates from different MFIs will converge to a minimum rate over time as implied by the competition cycle, the latter elements become more and more important. The poor client will not be patronised, but wooed. Thus, the MFI networks advise their members to adhere to principles of respect, fairness, and sincerity. "Responsible clients with good credit scores are given special treatment", while "adequate redress mechanisms allow customer complaints to be handled promptly and transparently […] Client needs and domestic/business problems have been identified and acted upon"[98]. Many MFIs therefore start to focus on client retention, cross selling practices and diversifying revenues. In the end, the MFI that offers the most attractive product range will most likely retain the most customers to guarantee sustainable success[99].

Sustainability

It is indeed the element of sustainability that distinguishes private MFIs from non-profit MFIs and SHGs. Both NGO-based MFIs and SHGs are dependent on continuous funding from national and international private and state donors. Oftentimes, new non-profit microfinance projects are budgeted around 25000 to 250000$, which enables them to serve a considerable, yet compared to the entire poor population, negligibly small number of people in a very limited territory, often one or two villages. Once the money is spent, no additional financial services can be offered; and due to repayment hold-ups and administrative costs, the entire project requires new funding approximately every two years[100]. As long as microfinance is an internationally accepted tool for poverty alleviation, and especially in the "boom period" after Yunus' Nobel Prize, funding for microfinance projects has not been an

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97 Ibidem.

98 Cf. Microfinancehub (2010). *Principles for Microfinance Institutions*, accessible at microfinancehub.com/2010/12/04/customer-service-checklistprinciples-for-microfinance-institutions/

99 A good overview on ideas of customer relations can be found in Buttle, F. (2009) *Customer relationship management: concepts and technologies*. Oxford: Elsevier, p. 32.

100 Cf. Lightfoot, N. (2011), *Microfinance Funding to Shrink Globally in 2010*, accessible at www.cmlnortheast.org/microfinance-development/microfinance-funding-to-shrink-2-3-billion-globally-in-2010.html.

issue. However, the donation scenery can be volatile, and the willingness to contribute to poverty alleviation in far away rural areas in India may decline; especially so if specific events (e.g. economic downturn, natural catastrophes, wars), other topics (climate change, fighting malaria), or other forms of poverty alleviation (autarkic communities in Africa, production cooperatives) come to the fore or gain momentum. According to The Economist, aid flow is already beginning to diminish because of the more pressing challenges that donor governments have at home such as narrowing fiscal deficits and ageing populations[101]. In that respect, for-profit MFIs have a considerable advantage: as long as they are able to generate profit, investors will be willing to fund growth. In plain terms: there are much more people that want to make profit themselves, than want to do good to others. But is the goal that counts, not the means or motives behind its achievement. Lightfoot notes: "Fortunately, the funding crisis has arrived at a moment when many MFIs are proving themselves capable of operating as for profit, independent businesses. The MFIs which continue to depend on donor aid and don't have the legal status or institutional capacity to transition to commercial funding will be the most severely exposed"[102]. Access to commercial funding can be guaranteed in two ways: either by private investors and capital markets, or by mobilising deposits.

Capital Market Funding and Governance

For-profit MFIs can offer investment opportunities to private investors, either through informal placement of shares by negotiation (non-listed) or by going public at stock markets (initial public offering, IPO). Both ways have been undergone by a considerable number of MFIs all over the world[103]. "As with any business going public, the IPOs [...] have allowed [MFIs] to tap into the mainstream investor community and take advantage of myriad new opportunities"[104]. Firstly, acceptance of private equity investors provides flexible capital at low capital costs. Secondly, it increases liquidity for investors by creating opportunities for investors to *exit,* which is "a critical step in attracting private capital"[105].Unlike loans, equity capital requires no direct payback, but interest in the form of accrued dividends, which are negotiable and rather flexible in amount and time[106]. "Additionally, equity capital can be leveraged to enable [MFIs] to borrow more money from banks which is then lent out to poor clients […] The net benefit to poor clients is more loan money at lower interest rates"[107]. Dependency on private investors (especially through disclosure requirements) incentivises MFIs to operate transparently and reduces their susceptibility to mismanagement and fraud. In the same way, a transparent and well governed MFI receives better credit ranking by banks and rating agencies, which again lowers their costs of capital. This advantage can - and will under competitive pressure - be passed on to the poor clients[108]. "Given their profitability, strong management and social

[101] Ibidem.
[102] Ibidem.

[103] Cf. Lieberman et al. (2008). *Microfinance and Capital Markets: The Initial Listing/Public Offering of Four Leading Institutions*, accessible at www.cmef.com /Document.Doc?id=575
[104] Ibidem, p.3.
[105] Ibidem.
[106] Cf. Richards, D. (2006), *For-profit microfinance*, accessible at www.defeatpoverty.com/2006/05/for-profit-microfinance.html
[107] Ibidem.
[108] Ibidem.

missions, it is not surprising that [MFIs] were able to successfully list their stock, and [many of them] have shown remarkable growth since going public"[109] both with regard to share prices and overall organizational growth.

Rethinking Microfinance II

While capital markets can themselves be subject to mood cycles, irrationality and the boom and bust cycle, and thus by some are considered not more helpful than donor dependency, the possibility to mobilise deposits could overcome these difficulties. CGAP notes: "Savings can be an attractive funding source in terms of cost, stability and reduced dependence on external borrowing"[110].

Not only that savings serve a strong customer preference, they also add to higher repayment rate probability, lower costs of capital, and can be an important tool for for-profit MFIs. "Poor savers turn tiny amounts of money into lump sums to help smooth consumption and mitigate the effects of economic shocks […] In many developing countries, poor people are willing to pay to save" says Kate McKee, CGAP senior advisor[111]. Additionally, saving accounts are seen as an important starting point to customer retention and cross-selling possibilities. Evelyn Stark, CGAP microfinance specialist, explains: "In some cases, a simple deposit account is the gateway product that leads this low-income customer, over time, to other, more profitable products, like loans and money transfers. And the more services a client gets from a financial institution, the more likely that client is to stay for the long term"[112]. Thus, saving accounts do not only contribute to the social mission of double-bottom line enterprises, but can also in themselves be important for profit generation. Microfinance then need to be rethought, and MFIs allowed to mobilise deposits from their clients. Up till now, less than 10 percent of the 2.5 billion people in the world who live on less than $2 (U.S.) per day have access to formal financial tools. "They pawn jewellery, sell a goat, or borrow from a moneylender—often to pay for basic needs such as seeds, school books, or a trip to the doctor"[113]. Enabling these clients to obtain traditional saving accounts would make them less dependent on informal, often dubious ways of financial transactions. For-profit MFIs can help to achieve this at a much faster and more sustainable rate, even if short-term costs for this enterprise may be high. CGAP found that "both small and large institutions can offer savings services, even to small savers, and still be profitable overall […] In some institutions, small accounts were not profitable per se but were cross-subsidized with larger accounts […] The use of efficient delivery models and broad outreach can decrease the negative impact of the greater expense associated with small balance savings accounts"[114]. In that case, the double-bottom-line approach can prove its actual truthfulness, and side by side with non-profit organisations work towards fulfilling poor clients' needs sustainably, and ensuring that financial services reach the poorest.

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[109] Cf. Lieberman (2008), p.3.

[110] CGAP Report (2011). *Savings for Poor People: Good for Clients, Good for Business?* Accessible at www.cgap.org/p/site/c/template.rc/1.26.2209/

[111] Quoted according to CGAP Report (2011).

[112] Ibidem.

[113] Cf. The Gates Foundation (2011).

[114] Cf. CGAP Report (2010).

Part III

THE POLITICAL SITUATION: A TURF WAR?

The Indian state of Andhra Pradesh (AP) where the microfinance crisis erupted in 2010 represents the highest number of microfinance borrowers in India. It is also the base for the biggest for-profit MFIs. As mentioned in the first part of this paper, several abuses and practices of the MFIs were denounced by the media and local politicians. Loans were made too easily and interest rates were opaque, leading some borrowers to a situation of excessive debt. Collection practices were often aggressive. MFIs were accused of being responsible for the suicides of desperate borrowers.

In this tense context, the state promulgated the Andhra Pradesh Microfinance Institutions ordinance on October 14, 2011. Officially the law was motivated by a desire to protect the poor and defend them "from getting stuck in a debt."[115] Nevertheless, this ordinance and the reaction of the local government seem extremely severe. The ordinance "was intended to check MFI excesses, but it has ended up checking all MFI activity."[116] It "requires MFIs to take government approval before granting a loan, bans weekly collection of dues, and stops lenders from collecting instalment from a borrower's house. Basically, it makes it almost impossible for MFIs to do business."[117] According to David Roodman, this ordinance even "contains provisions that would be unconstitutional in many countries; and it could bankrupt several lenders."[118] The ordinance has also triggered non-official and sub-legal actions against MFIs, which could put some of these institutions in a desperate financial situation. For instance, "word went out to local officials to block all MFI employees from entering villages"[119] and prevent them from collecting repayments.

Not only seems the ordinance extremely severe with MFIs, it was also passed like an 'ambush'. The minister for rural development briefed the central government and the high command of the Congress Party in order to secure their support. Then, the first special state cabinet meeting in history was called on October 14 with only one agenda item, the ordinance, which was approved within an hour. Since the legislature was not in session, the bill went directly to the state's Governor for interim approval on October 15. The whole process was very quick and did not give MFIs the opportunity to intervene or defend themselves against the various accusations.

Considering the measures contained in the ordinance and its procedure of ratification, one might wonder whether this ordinance and the reaction of the government is only intended to protect the poor as it claims to. Is there some concealed state interest or political calculation behind it? Does the government have a hidden agenda which has nothing to do with the performance of the MFIs? How much of the microfinance crisis is politics?

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115 "Microfinance: Leave well alone", *The Economist*, November 2010 Print Edition.

116 "That Sinking Feeling", *The Economic Times New Delhi*, 13/01/2011.

117 Ibidem.

118 Cf. Roodman, David (2010a) "When Indian Elephants Fight", *Center for Global Development*

119 Ibidem.

SHG vs. MFIs

To answer these questions, we will first have a closer look at the two rival programmes in India providing credit access to the poor: the first implemented and government funded Self Help Group initiatives and microfinance programmes (from NGOs and MFIs)[120]. With the development and success of MFIs in India and especially in AP, tensions have grown between SHG programmes and MFIs. The former accuse the latter of taking advantage and reap the fruits of the work realised by SHG programmes. Before the development of MFIs in AP, there were already a large number of SHG. When MFIs arrived in AP, they "could just poach the SHG members, who were already screened for creditworthiness, organized into groups, and accustomed to credit"[121]. B. Rajsekhar, the CEO of the Society for the Elimination of Rural Poverty (SERP) in charge of the implementation of the World Bank financed *Velugu* programme that provides financial and other services to SHG in Andhra Pradesh, explains the resentment toward MFIs: "It's like SERP have cooked the food; it's ready; MFIs can just come serve themselves and start eating."[122] In addition, tensions between the public SHG programmes and the private microfinance programmes were fuelled by better repayment rates for MFIs than SHG. Indeed, because SHG "are communal rather than corporate, they tend to be more lenient than microcreditors. When cornered, women with multiple loans default on self-help group loans first."[123]

[120] Cf. part I of this paper.
[121] Roodman, David (2010a).
[122] Ibidem.
[123] Roodman, David (2010b) "Understanding India's Microcredit Crisis", *Center for Global Development.*

The state of AP is involved in the SHG programmes. For example, the SERP, whose interests were threatened by MFIs, is formally non-governmental but funded by the state government while its governing board is chaired by AP's Chief Minister. More generally, the government has funded and supported SHG programmes. Therefore, the government appears to be an unfair referee because it is at the same time a player in the game. The content of the ordinance confirms this suspicion of conflict of interests and reveals a certain bias. According to N. Srinivasan, author of the 2010 Indian Microfinance State of the Sector Report, "the ordinance imposes other burdens on MFIs without equivalent demands on SHGs. MFIs, for example, must obtain permission from the district government to lend to SHG members but not vice versa."[124] For David Roodman, "the ordinance comes off as assuming that MFIs are devils (companies that act out of pure greed rather than a mix of that with the pursuit of growth and genuine commitment to the poor) and assuming that SHGs and district officials to whom MFIs must now pay obeisance are angels."[125]

Furthermore, the reaction of village leaders in AP may also be related to a conflict of interests. Since the ordinance was passed, some village leaders have forbidden the MFI employees from entering the villages to collect the payments. Some of the village leaders happen to also be moneylenders and have seen their business deeply impacted by the development of MFIs. In this context, it is unclear to what extent the ordinance and the political reactions actually correspond to a sincere desire to protect the poor villagers or rather

[124] Roodman, David (2010a).
[125] Ibidem.

to an attempt to oust a dangerous competitor, the MFIs.

Political Calculations

In addition to the conflict of interests related to the government funded SHG programmes, the Indian microfinance crisis may also be the product of political calculations to destabilise the powerful Gandhi family who is said to have connections with the famous MFI SKS founded by Vikram Akula. As Vikram Akula recounts in his book "A Fistful of Rice", Rahul Gandhi visited SKS in 2005 and was photographed next to Akula. In addition, Sonia Gandhi, Rahul's mother and the Congress party president, was also photographed presenting Akula with an award for Social Entrepreneur of the Year at the 2006 World Economic Forum's India Economic Summit (picture below[126]).

To understand the motivations behind these political calculations, it is useful to go back to September 2009, when the Chief Minister of Andhra Pradesh, Y.S.R. Reddy, died in a helicopter crash. Sonia Gandhi decided not to support the candidacy of Reddy's son Jagan, who believed he deserved to inherit his father's position. Instead, she gave her and the Congress party's support to the current Chief Minister Konijeti Rosaiah. According to Amy Kazmin, this decision has damaged the relationship between Reddy and the Gandhi family and "the theory goes that Reddy is out to do anything he can to embarrass the Congress party's high command, including its golden boy, Rahul."[127] Although Jagan Reddy has kept a low profile in the press on microfinance, he owns some of the newspapers and TV channels which have whipped up public and political backlash. Therefore, some microfinance executives argue that "the outcry against the microfinance sector is being deliberately fanned by Jagan Reddy."[128]

At the same time, N. Chandrababu Naidu, head of the opposition TDP party, who was a former Chief Minister and swept out of power in 2004 by the Congress party candidate Y.S.R. Reddy, has also expressed strong opposition to MFIs and has advised borrowers not to repay MFIs until rates are cut to 3 %. Some argue that his opposition is a political calculation to win back poor people's vote "on the if-you-can't-beat-them-join-them theory"[129].

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126 Schwab Foundation (2011), accessible at www.schwabfound.org/en/Communities/SchwabFoundation/index.htm.

127 Kazmin, Amy "India's microfinance crisis: the Rahul Gandhi factor", blog Financial Times, 01/11/2010.

128 Ibidem.

129 Roodman, David (2010) "Indian Dispatch #2", *Center for Global Development.*

Part IV

RECOMMENDATIONS

In this part, we advance three concluding remarks, which aim to answer our initial question on whether the Andhra Pradesh crisis will put into question the fundamentals of microfinance and its value as a global poverty reduction tool. Then a set of recommendations is presented on what needs to be done to lead the microfinance industry in India out of its current deadlock.

First, microfinance should not be abandoned as an instrument for poverty reduction. Despite recorded abuses and some valid criticism, microfinance has proven to be a useful tool for poverty alleviation as it has helped millions of the world's poor to access basic financial services and to improve their livelihood over the past thirty years.

Second, the so-called "double bottom line" - making profits and serve a social cause - is possible. We do not see the commercialisation of the microfinance sector as a "terribly bad turn", as Mr. Yunus claimed.[130] On the contrary, we are convinced that private MFIs, which raise their funds in the global capital markets, are very valuable and necessary players, especially because of three points previously mentioned: their ability for large-scale operations reaching millions at "the bottom of the pyramid" (BoP)[131]; their financial sustainability and their professionalism. There should be a combination of state-supported SHG programmes, NGO-based and profit-oriented MFIs possible in the future microfinance industry.

Third, we favour a market solution as state-supported SHG programmes have proven less efficient than private MFIs and were additionally often subject to corruption. We are convinced that doing business with the poor and treat them as customers rather than beneficiaries is a very sustainable way to help them out of poverty.

However, in the light of the recent crisis of microfinance in India, the MFI sector needs to be better regulated, and quickly reformed because of the rapid expansion of the MFI sector in India in recent years, both in number of institutions and in scale of their operations. Regulations are moreover needed to prevent excessive short-term profit strategies, and to defend the poor who do not have the means to defend themselves.

We have identified six recommendations on how to learn from the mistakes of the past and find a way forward.

1. Need of Regulations of the Microfinance Industry

In contrast to India's formal banking sector, which is strongly regulated by the *Reserve Bank of India (RBI*) and is mainly state-owned, there have been until this spring no clear regulations binding MFIs, since this sector was not seen as a risk for the financial system. Regulations are needed not to protect primarily the financial system, but the poor population from the excessive practices of some ruthless MFIs.

Restrictive governmental legislations to regulate the microfinance industry, such as

130 Cf. Yunus, Muhammad (2011), "Sacrificing Microcredit for Megaprofits", *New York Times*, 14.01.2011.

131 Cf. Prahalad C.K. (2009) *The Fortune at the Bottom of the Pyramid: Eradication Poverty through Profits,* Prentice Hall International.

the Andhra Pradesh ordinance should be avoided. The crackdown led to a situation where many MFI still have serious trouble obtaining funding six month later, as investors and development agencies seem to have lost confidence in the microfinance sector. The widespread fear that the ordinance would destroy the sector, or at least seriously damage it, seems to have come true. However, shutting down the whole microfinance industry does not help the poor.

Furthermore, the Indian MFI industry should be regulated on the national level, not on the (federal) state level. As the main regulator of the banking sector, the *RBI* set up an expert committee, the *Malegam panel*. In January 2011, it presented a set of policy recommendations on how to reanimate the Indian private MFI industry while protecting the borrowers[132]. A new nation-wide legislation aiming at regulating the Indian microfinance industry was planned to be adopted by April, but has not been endorsed so far. The legislation will create a new non-banking financial company category called NBFC-MFI, which will fall under the new regulation framework. Also it will most probably introduce an interest rate cap at 24%, limit loans to maximum $550, and restrict a borrower to two loans.[133] Until now a proper analysis of this new regulation framework cannot be made at this early stage. Even if parts of the legislation have been criticised (we are for example opposed to an interest rate cap), it goes in the right direction. Regulations will define the general conditions in which MFIs are allowed to operate and will prevent abuses. The AP ordinance will then become unnecessary.

2. Moderated Regulations by an Independent Microfinance Regulatory Authority

Since the Indian government is directly involved in the microfinance business through its support of the SHG programmes, its role as regulator of this very sector is dubious. As previously mentioned, many observers see in the AP ordinance an eruption of the long-lasting competition between the government and private MFIs.[134] Thus, moderated regulations should be carried out by an independent microfinance regulatory authority – for example under the auspices of the *RBI*. In Bangladesh, the microfinance NGOs have been monitored and supervised by such an institution since 2006. There are plans to expand to for-profit MFIs as well. [135]

The aim of more "prudential regulations" should prevent excessively high interest rates, protect borrowers from abusive collection practices and ensure transparency in lending and the formation of interest rates. However, the regulations should be designed to specifically target the wrongdoers. With its current regulation framework, the AP government punishes the whole microfinance sector in Andhra Pradesh, making no difference between microfinance NGOs and private MFIs.

However, regulations should not impose interest rates ceilings, as it has been suggested by Mr. Yunus to prevent predatory lending in Bangladesh. So far,

132 *Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector,* Reserve Bank of India, 19 Jan 2011.

133 Ibidem.

134 Cf. "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?", *Intellecap White Paper,* October 2010.

135 For more information, cf. www.mra.gov.bd

there is no interest rates cap in place in India, but as already mentioned, the Malegam Panel suggested a cap of 24%. According to the *Consultative Group to Assist the Poor* (CGAP), an independent policy and research centre dedicated to advancing financial access for the world's poor, "evidence from many countries suggests that enforcement of unrealistically low interest-rate caps can make sustainable micro-lending impossible."[136] MFIs need to charge considerably higher interest rates than normal banks, because of higher administrative costs. But there are MFIs which do have too high interest rates, because of inefficiencies in their financial operations.

Therefore, policies that promote competition have to be encouraged. For example an obligation for transparent loan cost disclosure coupled with consumer education would -according to the CGAP-permit customers to "price shop."[137] This would then result in the exclusion of the most inefficient MFIs from the market and finally bringing down the rates offered by the most efficient MFIs. Competition policies should also include incentives and rewards for MFIs to charge reasonable rates or to introduce innovative and more flexible repayment mechanisms.

3. Self-Regulation of India's Microfinance Sector

Self-regulation of the sector is crucial. Unfortunately, this approach was not successful in the past. Through honest self-regulation measures, overly severe government regulations could have been prevented – and this has to be a lesson for the future. The most important role lies with the Indian self-regulatory MFI associations, most importantly the *Microfinance Institution Network (MFIN)*, which represents 46 percent of the legally approved MFIs in India. According to the organization, "they account for over 80 percent of all microcredit activity in the country."[138]

These associations should improve the development of their Codes of Conduct and visible ethical practices, such as open commitment to more transparency, controlling over-indebtedness and prevent coercive collection practices. If the Indian microfinance sector wants to regain the public's trust and their lost reputation, they need to demonstrate immediately that these standards really serve as guidelines for their work. *Intellecap,* a social business consultancy, suggests that industry-administered reasonable monitoring and enforcement mechanisms should be developed in order to sanction MFIs that do not comply.[139]

It is important to inform the public about the benefits of microfinance. With regard to the recent crisis, it has to be outlined that the media and the politicians exaggerated much of the scandal. This could be done through educational campaigns on the "forgotten values" of microfinance, restating the benefits of microfinance, and explaining the necessity for MFIs to charge higher interest rates than normal banks, as well as the need for capital from private investors. This is important both for the for-profit and non-profit organisations – to re-attract hesitating investors and to raise necessary funds.

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[136] Cf. CGAP-homepage: *What Is the Role of Regulation and Supervision in Microfinance*?: accessible at www.cgap.org

[137] Ibidem.

[138] For more information, cf. www.mfinindia.org.

[139] "Indian Microfinance Crisis of 2010: Turf War or a Battle of Intentions?", *Intellecap White Paper,* October 2010.

The microfinance industry does not only need to be regulated, but also needs innovative institutional reforms. Self-regulation of the microfinance industry should be combined with such institutional reforms. The next recommendations focus on two such ideas: A credit Bureau (building up), and a third party certification mechanism to label "good" MFIs.

4. Establishing Credit Bureaus by MFI Associations

A credit bureau allows MFIs to track borrowers' overall indebtedness and credit histories. If the information is shared in a transparent way between the different MFIs, the risk of over-indebtedness could be significantly reduced. It would then be possible for the MFIs to distinguish between low-risk and high-risk borrowers by comparing their loan and repayment histories. "Good" low-risk borrowers with strong repayment records would benefit from lower interest rates. The tasks for the credit bureau would be: first to identify all the borrowers; then gather all their information and stock it into a digital database; which then can be accessed by the bureau's members in order to share the information.

In India, self-regulatory MFI associations such as *MFIN* have been working on building up credit bureaus in recent years. According to the association, a fully functional credit bureau for the microfinance industry is expected to be operational by April 2011.[140]

There are mainly two important challenges for the establishment of such credit bureaus: First, as experience from other countries demonstrates, it is best to attribute each borrower's credit history to its identity number, in order to identify the borrowers. However, most poor people do still not have a unique identity number in India – the government should push this process.[141] And second, MFIs will have to overcome fears of sharing competitive customers and entrust the data control to an independent institution. Competition among Indian MFIs is severe, even if they participate in the same associations; there are frictions to be expected.

5. Third-Party Certification Mechanism

A particularly straightforward idea has been proposed by Alex Counts, CEO of the *Grameen Foundation*. He advances the idea of an objective third party certification for the MFI sector.[142] An independent overseeing body would, together with the MFIs, establish credible certification criteria for their actions and achievements. The result would be very similar to a fair trade label for MFIs which claim to be double-bottom line organizations. Thus, investors could acquire objective information on whether a specific MFI is actively and effectively working to alleviate poverty; borrowers would know if a specific MFI was truly committed to its social mission or only to short-term profits; and governments could weigh off better if further regulations were necessary. In order to acquire certification, four criteria are suggested:

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140 Cf. Microfinance India (2011) *Report Statement*, accessible at www.mfinindia.org.

141 Cf. "Leave well alone - Capping microfinance interest rates will hurt the poor. There are better ways to regulate the industry", *The Economist,* Nov 18th 2010.

142 Cf. Counts, Alex, „Reimagining Microfinance", *Stanford Social Innovation Review,* 2008, pp. 46 – 52.

Social performance. Clear Indicators have to be established to measure the poverty-reduction impact of the MFIs, such as the Grameen Bank's "Progress-out-of-Poverty Index".[143] Also, MFIs should release data on the percentage of the rural poor below the poverty line among their clients in order to get the certificate.

Private benefits. Excessive salaries and bonuses of some MFI CEOs damage the reputation of the whole sector. We suggest self-limitation. MFIs receiving the certification would have to demonstrate that the salaries of staff and CEO are not excessive.

Consumer protection. To be certified, MFIs would have to implement measures to protect consumers, such as public disclosure of interest rates and fees. Also, they would not be allowed to operate unethical debt collection practices.

Profit reinvestment. When MFIs generate profits, they should have an obligation to reinvest some portion of these profits into the social cause. Doing this would, according to Mr. Counts, "help make sure that profits mainly benefit clients directly through lower interest rates and indirectly through product development".[144]

6. Rethinking Microfinance: Savings are Crucial

Even if a comprehensive definition of microfinance services for the poor – savings, credit, insurances and money transfer - is widely acknowledged[145], and there is a broad at least theoretical agreement that the poor need all four elements, most microfinance institutions in India provide only microcredits to poor borrowers. Microcredit is helpful for the more entrepreneurial poor in economically dynamic centres, mostly cities. However, most poor households need to start with savings and insurance services first, before they can even think of taking a microcredit. All people need access to secure saving services. Milford Batman, and many other microfinance experts advise the urgent need to "refocus on the promotion of local micro-savings, rather than microcredit, as the first step in the local accumulation of capital."[146]

However, access to formal saving accounts in India for poor people is still very limited and has to be expanded. According to *CGAP*, "poor people save mostly in informal insecure ways. Most poor people lack access to safe, formal deposit services. Formal Banks are often too far away, or the time and procedures needed to complete transactions are too difficult. Institutions may also impose minimum transaction sizes and/or require depositors to retain a minimum balance, both of which can exclude the poor. Low-income savers tend to care most about accessibility and security of their savings." [147]

MFIs are seen to be better equipped and positioned than formal banks to meet the needs of the poor. However, up to date MFIs do not have the legal authority to mobilize deposits in India. According to an analysis in *The Economist,* the government should allow this, since it would make the microfinance sector less dependent on

143 For more information: progressoutofpoverty.org
144 Cf. Counts, Alex (2008).
145 Cf. Rutherford, Stuart (2009) *The Poor and Their Money,* Practical Action Publishing, UK, 2009.
146 Cf. Bateman, Milford, "Microfinance as a development and poverty reduction policy: is it everything it's cracked up to be?" Background Note, *Overseas Development Institute,* March 2011.
147 CGAP-homepage: Poor people and Savings, www.cgap.org

capital markets or international donors for funding.[148] In Bangladesh, the Grameen Bank requires all borrowers to have a saving account at the bank as a precondition for getting microloans. This would not forestall the necessity of central bank supervision, as was outlined above, and instead leave open the way to formal legal procedures regarding other MFI regulation.

More and more institutions aim to apply the comprehensive understanding of microfinance when working with the poor worldwide - for example the *Bill Gates Foundation* or *BASIX*, an Indian MFI.[149] But especially in India, much more has to be done to go beyond microcredits and focus again on the other crucial pillars of microfinance, insurances and savings and money transfers.

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[148] "Overcharging, Micro lending is under attack, unfairly", *The Economist,* November 2010, Print edition.

[149] For more information, cf. www.gatesfoundation.org; www.basixindia.com.

CONCLUSION

What has been called by many a fundamental crisis of the microfinance sector has been the starting point and topic of this paper. Preposterous interest rates for credits, bullying practices by those institutions that set out to help the poor, suicides all over India - what has happened to the secret star of poverty alleviation?

In this paper, we start to discuss the concepts of microfinance against the background of its historical development. What is microfinance, and where does it come from? The first chapter answers these questions conclusively. We offer a thorough discussion of the often blurry and intensely debated means of poverty alleviation, from its roots in the European renaissance to the current understanding of microfinance that evolved in the 1970s. The idea of microfinance as a way to give the poorest at the so-called "bottom of the pyramid" access to much-needed financial services to save, insure, and prosper economically is not only morally attractive, but has been perceived by many as a milestone to self-help poverty alleviation. Its cornerstones of empowerment, entrepreneurial spirit and an acknowledgement of the inherent importance of a huge percentage of the world population both socially, economically and politically have attracted supporters, donors and entrepreneurs all over the world. It comes with this acknowledgement that the poor need not be patronised, or led into a better future by benevolent foreigners: they are able to escape poverty themselves, if they are given the opportunity. In that sense, a deeply moral character of microfinance is revealed: to ensure fair and equal chance to a secure life in dignity. How could this idea degrade in such a way that poor peasants are bullied, that they are trapped in a vicious cycle of indebtedness?

This question already implies a tendency to hold the general concept of microfinance, and especially the ongoing commercialisation of the sector, responsible for developments whose connection to this concept is at best remote. We saw the need to critically examine the two sides in what has evolved into a highly emotional debate. Has the crisis in India uncovered general problems of the microfinance concept? Or are there mere deviations and misdeeds by individuals that account for the problems?

In putting a special focus on the debate between non-profit and for-profit opponents, we tried to answer specifically if the entrepreneurial pillar of microfinance and its tendency to commercialise can be held responsible for the current problems, if it is indeed "a terribly bad turn[150]". For this purpose, we tried to comprehensively outline the two lines of argumentation that are co-noted with different economic and sociological ideas and theories. We found that while both groups have made valid claims, the non-profit side of the debate seems to lack strong evidence that the idea of commercialisation is generally flawed. Instead, it seems that a combination of certain sector externalities and individual misdeeds has corrupted the image of microfinance. This conclusion led us to discuss the political elements and interests that play into the debate. The so-called AP ordinance, which is practically a ban on private microfinance activity in one of the most important regions for the sector, has been seen as the most important expression of the crisis. But its emergence is dubious at

[150] Cf. Yunus, Muhammad (2011), "Sacrificing Microcredit for Megaprofits", *New York Times*, 14.01.2011.

best. It has been set forward both legally disputable and rests on an unsound argumentation, which has led critics to analyse the particular political situation in India. We found that the debate on microfinance is not only heavily entrenched with moral and economical arguments, but also with specific political interests of different actors in modern India. This underlines that the crisis and its expression in the AP ordinance might not be an end-point of alleged inherent flaws in the concept or the development of for-profit institutions, but indeed a development that was consciously exploited by different actors on both sides.

Out of this critical analysis, we set forth to find ways in which the complex current situation could be unwound. It has led us to believe that microfinance should not be abandoned as an instrument for poverty reduction. While we acknowledge that part of the general criticism of chaotic commercialisation may well be sound, especially that some institutions have apparently developed an alarming tendency towards controversial practices of loan granting and collection, we do think that microfinance has proven its value. In the last thirty years, millions of poor in the world have been granted access to basic financial services and thus were able to improve their livelihood. How then to combine this general acceptance of the concept of microfinance, and its inherent and assumedly promising turn to commercialisation, with unjustifiable practices on the ground? How to guarantee that the idea of the double-bottom line, a combination of social goals and profitability, is more than empty talk? How to ensure that for-profit institutions, both theoretically and practically important elements for the microfinance sector in India, due to their scale, sustainability and professionalism, do not degenerate into exploiting their poor clients? How to make them co-exist harmonically with state-supported SHG and NGO-based projects?

For that purpose, we recommend six crucial steps to a sustainable solution for the microfinance sector in India. These steps include thorough governmental and self-imposed regulation of a so far chaotically growing sector. Commercialisation must not be abandoned; for-profit institutions must not be consciously driven out of the market for reasons that are neither economically sound nor desirable for the poor. In that sense, we favour a market solution. We are convinced that doing business with the poor and treat them as customers rather than beneficiaries is a very sustainable way to help them out of poverty. But it requires MFIs to go beyond microcredits and focus on the other crucial pillars of micro-finance: insurances and savings and money transfers. In that sense, microfinance needs to be rethought to include comprehensive financial services to those that cannot be reached by traditional banks.

This paper aimed at simplifying what has proven to be a highly complex debate on microfinance, which has entailed both specific regional elements of rural India, and general questions of indeed global importance. The future of microfinance not only in India, but its entire role in the spectrum of development policies seems to suddenly depend on only a few, nevertheless tragic, suicides in rural Andhra Pradesh. What will happen on the ground in India remains for the people and their governments to decide. Implementing our recommendations, however, could help to ease tensions and find the way back to what we see as the most important goal:

"Everyone needs ways to manage money, especially the poor[151]". Meeting these needs sustainably, and ensuring that financial services reach the poorest may very well lead into a better future.

[151] Cf. Gates Foundation (2011).

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