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Microfinance: Small loan, big snag

By Amy Kazmin

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With $52,000 raised from family, friends and others of Indian origin, Vikram Akula, a graduate student from Schenectady, New York, arrived in south India in 1998 to establish a microfinance programme.

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Like many small rural development projects, he set up his Swayam Krishi Sangham, or "farmers' self-help group", as a charitable trust. In eight years, it built a base of around 200,000 rural borrowers, mainly women, who received small loans to start enterprises that might help lift their families out of poverty.

But Mr Akula's ambition was to ramp up that number at a faster pace than a charity could typically manage. In 2006, he turned SKS into a for-profit company, backed by investment from Vinod Khosla, founder of **Sun Microsystems**, as well as the Silicon Valley-based Sequoia Capital and others in the US west coast technology industry. All were confident both in microfinance's transformative power and its commercial potential.

Since then, SKS Microfinance has expanded its client base to around 7.5m rural and urban women, who borrow an average of $165 each. In August, **SKS raised $358m in an initial public offering** that valued it at $1.5bn. Within weeks, the shares had risen by half – providing affirmation for Mr Akula and his backers of microfinance's ability to deliver "double bottom line returns", allowing investors to "do well by doing good".

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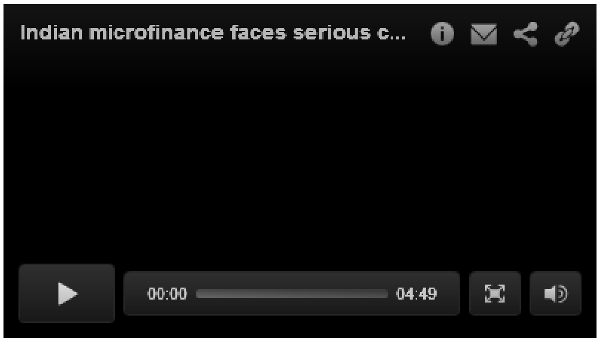

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Yet today, Mr Akula is on the defensive. **SKS stock** is 27 per cent below the offer price, amid a backlash by Indian authorities, who accuse microfinanciers of seeking "hyper-profits" from the poor through over-lending and "coercive" collection tactics. Collections have plunged below 20 per cent in **Andhra Pradesh state, where officials intervened** after more than 50 **suicides by borrowers**, mostly women.

Pranab Mukherjee, the country's finance minister, has chided Indian microlenders – who together have around $6.7bn in outstanding loans to 30m borrowers – for their high interest rates, which range from 27 per cent to more than 30 per cent, and has promised **tougher regulation**.

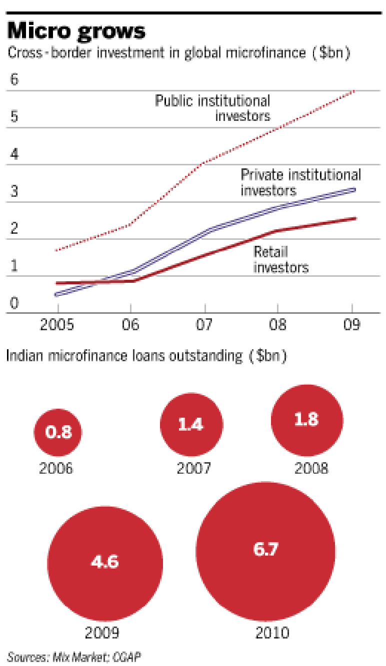
Public opinion has soured, too. At last month's World Economic Forum in New Delhi, Mr Akula, clad in his trademark orange cotton kurta, was asked whether Indian microlenders were "too greedy". Though a moderator tried to deflect the question, Mr Akula – who sold SKS shares worth $13m before the IPO – insisted there was no trade-off between helping the poor and earning handsome profits. "You can continually decrease your price to your customer but at the same time increase shareholder value," he maintained.

Afterwards, the forum's burly foreign security guards hustled Mr Akula away from a media throng. But the questions raised by India's microfinance crisis – just how far doing well and doing good go hand in hand – will not disappear so easily.

Once the slow-growing realm of development professionals funded mainly by western aid, microfinance has been transformed since Bangladesh's **Muhammad Yunus**, founder of Grameen Bank, won the 2006 Nobel peace prize for his idea of giving small loans to businesses run by poor rural women, whom he saw as more dedicated to their families' welfare than men.

Touted as a magic bullet that could in Mr Yunus's words "put poverty in the museum", microfinance has turned into a global business that links international finance with some of the world's poorest communities.

Amid the destructive excesses laid bare by the global financial crisis, microfinance acquired even greater lustre as a sober, socially responsible asset class: most microborrowers, in general self-employed women less affected by the global market turmoil, kept up their repayment rates of 95-98 per cent.



Yet India's experience is now threatening future capital flows to them, by challenging the pillars of microfinance investment: that it is both safe and beneficial to the poor.

Already in the past two years, Morocco, Bosnia, Nicaragua, and Pakistan have all been hit by microloan repayment crises. The Consultative Group to Assist the Poor, a World Bank-linked group seeking to improve financial access for the disadvantaged, blames the upheavals on lending that devoted inadequate attention to borrowers' ability to repay. In Nicaragua and Pakistan, the problems were compounded when political and religious leaders – like Andhra Pradesh politicians now – urged non-repayment.

"To scale microfinance to its true potential – making it available to as many poor people as exist in the world – it has to be sustainable, but there is an element of responsibility," says Jennifer Meehan, of the Grameen Foundation, which promotes Mr Yunus's ideals. "Certain parts of the industry have lost sight of its purpose. Microfinance is a means to an end: the end being reduction of poverty." But among India's biggest microlenders, she sees a focus "on growth of the institution rather than transformation of the client".

As **microfinance evolved** from niche activity to trendy asset class, investors ranging from Sequoia in venture capital to pension funds such as TIAA-Cref of the US and the Dutch PGGM poured money in. So did sovereign wealth funds including Abu Dhabi's **Aabar Investments** and individuals such as Pierre Omidyar, chairman of **Ebay**. Global banks offer microfinance investments to private clients, while websites allow person-to-person microlending. By the end of 2009, global microfinance had around $12bn in cross-border investment, up from $4bn three years ago, according to CGAP.

Coupled with a rising tide of direct bank lending to microfinance institutions, these funds have fuelled a surge in microcredit portfolios, integrating poor women into the global financial system as never before. According to the Microfinance Information Exchange, a data provider, more than 95m microborrowers together have around $65bn in credit – with an average loan of $520 apiece – from some 1,800 lenders, up from $24bn in 2006. Yet stories of indebted Indian women hounded into suicide by aggressive collection agents – and the government crackdown that followed – hardly fit the industry's typical promotional images of beaming women next to their grocery stands, tea stalls or livestock.

Although SKS accepts that some of the suicides involved its borrowers, it and other Indian microlenders deny responsibility, blaming "rogue elements" – traditional moneylenders operating under the guise of modern microfinance who also lent them money. But the regulatory backlash has highlighted the political risks of pushing credit to poorly educated borrowers of uncertain financial literacy and repayment capacity, while microfinance executives and shareholders reap millions in salaries and profits.

"India is so big and dynamic, and international eyes are on it so much, so it will have an impact on investors," says Elisabeth Rhyne, of the Washington-based Centre for Financial Inclusion, a proponent of commercial microlending. "It changes the image of microfinance. Everybody wants to make sure if they are putting their money into microfinance institutions, they can trust their clients are not being harmed."

Commercial, for-profit microfinance was supposed to be the answer to the question of how to scale up access to funds by people otherwise reliant on usurious traditional moneylenders. Nowhere did that seem more relevant than India, where 42 per cent of the country's 1.2bn people lack access to formal banking services.

The entrepreneur who led the rapid roll out of credit was Mr Akula, who argued that the process of granting loans to the poor should be as efficient as serving up a meal from McDonald's or a Starbucks coffee. He claims fealty to the Grameen methodology – a system of group lending, where women borrow together and take responsibility for each others' repayment obligations if any is unable to meet their instalment. In essence, group members – neighbours who know each better than any outsider ever could – serve as credit committees by their willingness to take liability for each others' loans.

At Grameen, group formation and pre-loan training is a painstaking process. But SKS streamlined it to around four hours, helping it to expand its loan book rapidly. In the year to March, profits doubled to $38m on revenues of $212m. "The more profitable you are, the more households you can reach, and that's what we try to pursue," Mr Akula told a recent forum in New York.

But SKS was not the only enthusiastic lender to the poor. Other Indian microfinanciers have also grown fast, encouraged by investors and bankers, hoping to follow SKS's path to market. According to Rajiv Lall, co-founder of Lok Capital, a fund that invests in social business, "together, they became committed to the myth this sector is capable delivering hyper-growth for the indefinite future".

Suddenly, women who had had limited access to credit were spoilt for choice. Many borrowed from multiple lenders. Microfinance "developed its lending methodologies at a time when it was tiny – nobody had to worry about overlending", says Ms Rhyne. "It's like a car with no brakes."

Over the past year, Indian policymakers had repeatedly expressed concern about microloans' high interest rates. Though the industry defended these rates as necessary to cover the cost of reaching customers, unease grew amid reports of executives being paid more than those who ran India's biggest commercial banks. The sector's return on assets was also well above those of banks. After the SKS IPO and reports of borrowers' suicides, the official mood hardened.

"The Silicon Valley guys or financial investors seeking high growth, high profitability couldn't see the political writing on the wall," says Vijay Mahajan, president of India's Microfinance Institutions Network, which represents 44 for-profit companies. "They thought they are doing it for a good cause [and that they would] be able to carry public opinion with them. But everybody in this world, even at a bus stop, has an opinion of what is a fair interest rate. This is the one price in the entire economy that everybody has a view on."

Today, as Indian microlenders trying to stabilise their business and brace themselves for new regulations, the global microfinance sector is drawing lessons from the crisis. Some argue that events in India demonstrate the need to adopt consumer protection principles, including complaints mechanisms. Others say lenders must do more to measure not just their financial performance but their social impact.

"Investors must have more realistic expectations," says Lok Capital's Mr Lall. "The company does not exist to serve their interests. The company exists to serve clients, and they make money because they do that well."

Lessons for commercial banks keen to tap into a growing middle class

Dressed in a smart suit, Lynne Patterson looks like a banker and has the energy of one. But as the co-founder of the 20-year-old, non-profit organisation Pro Mujer, or "pro-woman", the former US schoolteacher certainly does not talk like one, writes John Paul Rathbone.

Although her conversation is peppered with loan default statistics and the "need for scale" to drive down lending costs, Ms Patterson cherishes the belief that financial services are only one part of what microfinance organisations (MFIs) such as hers should offer clients.

"Mostly, we have been advised to stick to finance and forget about health, empowerment, business and financial literacy training," she says. "But I think our day has come."

Many would disagree with such an approach, arguing that "financial inclusion" is goal enough. But then the ecology of the Latin American microfinance industry is diverse. Throughout the region, more than 700 institutions service 10.5m borrowers with a total loan portfolio that the Inter-American Development Bank estimates grew 12 per cent in 2009 to about $12.5bn.

Mexico's **Compartamos** is one of the biggest. It began as a small non-government organisation in 1990 and now has 1.7m clients and a listing on the Mexican stock exchange. Interest rates are high, as with all MFIs, but clients seem to prefer Compartamos' terms to the 100 per cent-plus annualised rates offered by local loan sharks. "Going down that route is to sell your soul to the devil," says María Ester Hernández, who has a 6,000 peso ($478) Compartamos loan. "It's affordable and I always know where I am with repayments."

Other MFIs have made a similar transition from quasi-charity to more commercially driven operation – such as Edyficar, founded by Care, a charity, and bought last year by Credicorp, Peru's biggest financial group. "Lately, we've seen a lot of Brazilians coming to Peru to try and poach our expertise," says Alvaro Correa, Credicorp's chief financial officer.

That is not surprising. Peru is a recognised leader in microfinance; and, in a continent where banks have traditionally been reluctant to lend and credit penetration is low, commercial banks are seeking to learn from microfinanciers to lend to the region's emerging middle class. In Brazil, for example, Spain's Banco Santander is opening branches in *favelas* to tap into a credit and consumption boom.

Still, if a competitive market is starting to deliver credit to people who have never had access to it, that also places a greater emphasis on the sector's social role. According to Luis Alberto Moreno, head of the IADB, speaking at a recent regional forum on the industry: "In this new stage – and this is one of the lessons from the recent crisis – there will be growing concern over client welfare."

David W | December 9 9:51am | Permalink Report

Great article though I think it misses what, for me, is the critical point. MFIs attempting to make profits sufficient for satisfactory shareholder return is, in my view, at odds with their success.

The purpose of MFIs is to generate a financially-included, financially-literate audience who have credit history, ready to enter the banking network for real. Right now, it seems that there is too big a jump for them from successful repayment of micro loans to entering the commerical banking system at-large.

As a soluition MFIs are trying to move up into the commerical space, growing with their customers. This I think is a mistake. They need to stay heavily focused on social benefit whilst sacrificing profit to do so or they face having to handle the inherent conflict of geneoristy and the helping hand with the severity of collections.

In my mind it is the banking sector that needs to expand downwards into "micro banking" which is at fault, not micro finance.

RiskyMark | December 2 11:28pm | Permalink Report

A clear example of a reputation risk for high profile people and institutions. Also before the clampdown a negative risk value: little upside - big downside. With historical average probability higher on the downside that on the upside.

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tom.sanderson | December 2 3:54pm | Permalink Report

Good article. The industry is maturing. Many players, many models, many motives - and as you say - everyone has an opinion. My own view is that we need greater transparency so that consumers, investors and donors know what they each expect, including the risks and the unintended consequences. There are a number of initiatives in this line: MFtransparency.org and the SMART campaign are examples. I believe strongly that client training is vital, and NGO- rather than commercial-models are likely to provide more (and more suitable) training to MF clients. Remember, such clients are much more vulnerable and fragile than your average banking customer.
Tom Sanderson
UK Director
Five Talents charity

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shanker menon | December 2 11:40am | Permalink Report

There was a swagger about this microlenders just some time ago..what with investors queing up to invest and the lazy Bankers eager to lend so that the targets set for subsidised lending are met by the draw down on such lines of credit. The only wolves left out in the cold huffing and puffing were the traditional moneylenders...no suicides on their account....they know how to lean on and how much to...its not a one off transaction for them...its life long bondage that they aspire to keep their customers in. Is there a ghastly lesson to learn there...only the poor can tell..and its the one voice you cannot discern in the recent cacophony.

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cliveparry | December 2 9:28am | Permalink Report

Micro-financing - Loan sharking..... both small loans to poor people. The difference is the price and the motivation..... and the micro-finance industry must never forget that!!
