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Microfinance and the challenge of financial inclusion for development

Jayati Ghosh*

This article provides a review of the recent literature on microfinance in developing countries and a critical assessment of its effectiveness. It examines the experience of India, which has one of the largest microfinance sectors in the world, and particularly the unfolding of the microfinance crisis in Andhra Pradesh. It concludes that microfinance cannot be seen as a silver bullet for development and that profit-oriented microfinance institutions are problematic. To fulfil even some of its progressive goals, it must be regulated and subsidised, and other strategies for viable financial inclusion of the poor and of small producers must be more actively pursued.

Key words: Microfinance, Financial development, Development, Poverty reduction, Financial crisis

JEL classifications: G21, O16

1. Introduction

Within a relatively short time, perhaps just a decade, microfinance has gone from being hero to zero in the development discourse: from being lauded as the silver bullet to solve the problems of development and poverty reduction, to being derided as the progenitor of financial instability and enhanced vulnerability among the poorest people who can ill afford to take this additional burden. Indeed, it is now even described as ‘a poster child of exploitation of the vulnerable’ (Priyadarshee and Ghalib, 2011). This is a far cry from the situation in the early 1990s, when microfinance—particularly in the form of microcredit—was the most popular fad of the international development industry (it has since been replaced by conditional cash transfers), emphasised by the World Bank as an almost universal panacea for poverty and receiving the lion’s share of untied aid money from international donors.

Modern microfinance could be said to have originated in Bangladesh, as Mohammad Yunus built upon earlier models of small-scale lending (the ‘Comilla model’) to create a network of lending that was eventually formalised in Grameen Bank in 1983. However, the not-for-profit orientation of the form of microfinance provision championed by

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Yunus and others, in which NGOs focused on development and poverty reduction were the dominant providers, was gradually phased out during the 1990s, to be replaced by a model that emphasised ‘full-cost recovery’ and thereby paved the way for a more market-oriented approach that would accommodate and even encourage for-profit microfinance. [Bateman \(2010\)](#) has described how international donors such as the World Bank and USAID pushed for such a shift, which was ostensibly about greater efficiency and spread of microfinance, but in effect had little to do with that. Rather, it essentially created a relatively small elite of microfinance providers who (much like lenders in the US ‘subprime’ credit market) entered into unsustainable patterns of lending that ensured short-term profitability but increased the vulnerability of the poor.

The middle of the previous decade showed the high watermark of international support for microfinance.¹ The United Nations (UN) declared 2005 to be the ‘International Year of Microcredit’. Mohammad Yunus received a Nobel Prize (for peace, not economics) in 2006. There was an explosion of not just interest but of actual microfinance institutions (MFIs) across the developing world and even in the developed world. The global surge in enthusiasm for this concept soon also extended to the active promotion of microfinance as a viable commercial activity to be engaged in for profit.

However, the mushrooming of MFIs of both non-profit and profit varieties was very quickly followed by crises in many of the same developing countries that were earlier seen as the most prominent sites of success, in the typical manner of most financial bubbles that burst. There were meltdowns of MFIs—and sometimes of the entire sector—in countries such as Bolivia, Morocco, Pakistan, Mexico, Nicaragua, India and, most recently, Bosnia. Since then, the naysayers (who were earlier a suppressed minority) have become more vocal and the critique has become more roundly developed. One careful review of all the empirical literature that had been drummed up in support of microfinance ([Duvendack *et al.*, 2011](#)) came to the conclusion that the widespread policy enthusiasm for microfinance in the global development community had no empirical basis; rather, it was built on ‘foundations of sand’. Indeed, the critique has also brought into focus the problematic methodology employed by some of the early more positive evaluations, particularly the problems of selection bias and unobservable characteristics. [Duvendack \(2010\)](#), while re-examining the actual data used in a highly positive evaluation by USAID of the microfinance programme of Self Employed Women’s Association (SEWA) in Gujarat, India, found that careful use of the data did not support many of the claims of success. He argued that

not only do these data and methods not provide support for the idea that microfinance is highly beneficial to the poor, rather than perhaps benefitting a slightly better off group, but it leaves open whether microfinance is of any real benefit at all, since much of the apparent difference between microfinance participants and controls is likely due to differences in their characteristics rather than the intervention *per se.* ([Duvendack, 2010](#), p. 44)

By now, even strong votaries of the microfinance model have come to accept that the structure is flawed and fragile. Simply put, across the world, ‘too many clients of too many MFIs have taken on too much debt’ ([Centre for the Study of Financial Innovation, 2012](#)) and the sector is displaying the problems that are widespread in

¹ Incidentally, this was despite some early warning signals about the lack of any real impact on poverty alleviation even in the most ‘successful’ country (Bangladesh) or in other countries, such as was noted by [Hulme \(2000\)](#).

other parts of the financial sector: wrong incentives, poor corporate governance and lax or inadequate risk management. Certainly, it has moved very far from the original motivations of poverty alleviation that drove the early manifestations of the model.

Bateman and Chang (2012, p. 13) go well beyond the now more common critiques of microfinance that suggest it does not do much for poverty reduction, to argue that ‘microfinance actually constitutes a powerful institutional and political barrier to sustainable economic and social development, and so also to poverty reduction’. They provide some trenchant arguments in support of this conclusion: the microfinance model ignores the crucial role of scale economies and thereby denies the importance of large investments for development.² It ignores the ‘fallacy of composition’ and adds to the saturation of local economies by microenterprises all trying to do the same or similar activities. Partly as a result of this, it helps to deindustrialise and infantilise the local economy. Microfinance fails to connect with the rest of the enterprise sector and so does not allow for synergies to develop in productive activities, without which innovation and productivity improvements do not occur. The model is pre-programmed to precipitate a subprime-style oversupply of credit. By emphasising individual access and achievement, it ignores the crucial importance of solidarity and local community ownership and control. Bateman and Chang therefore argue that the widespread adoption of this model and its international acceptability are not because of its inherently positive qualities, but rather related to the fact that it is a model for poverty alleviation that is politically acceptable to the neoliberal establishment.

2. How microfinance has worked

Microfinance is most fundamentally the provision of credit without collateral, usually in relatively small amounts and for short periods of time. The excitement around microfinance, and microcredit in particular, has generally been based on the perception that it allows formal financial institutions to enter into forms of lending that are otherwise dominated by informal arrangements, such as traditional moneylenders. The phenomenon of group lending, whereby borrowers are clubbed into small groups whose members typically receive sequential loans, has been seen as the fundamental innovation that allows MFIs to service clients without collateral, who would otherwise be excluded not only because of the risk of default in general but because of the difficulties and high transaction costs involved in sorting more and less reliable borrowers. This is achieved through peer monitoring (Stiglitz, 1990), since the members of the group now have a direct interest in ensuring that no individual member defaults. This reduces both *ex ante* moral hazard and adverse selection, since the borrowers, who are presumed to have greater knowledge of one another, will not choose to be in groups with potential defaulters.

What this effectively means is that all the costs and risks of the lending process are transferred from lenders to borrowers. It is notable, as Armendariz de Aghion and Morduch (2005, p. 108) point out, that ‘the group lending methodology does the trick even though (1) the bank remains as ignorant as ever about who is safe and who is risky, and (2) all customers are offered exactly the same contract. All of the action occurs through the joint responsibility condition combined with the sorting

² This point has also been made very effectively by Amsden (2012).

mechanism.’ Proponents argue that this process of voluntary self-selection among borrowers allows price discrimination whereby riskier groups pay higher rates, so that safer borrowers no longer have to bear the burden of riskier ones. This reduction of cross-subsidisation in turn implies some reduction in average interest rates.

The point that is typically less widely noted is that this particular route to financial inclusion imposes a heavy cost on borrowers, who are forced directly or indirectly to undertake the supervisory, monitoring and penalising activities that are usually seen as the responsibility of lenders. For one thing, all borrowers may not want (or have the time) to engage in these activities. It has been observed in the case of the Small-farmer Credit Program in Bolivia that it proved to be very hard to find volunteers willing to lead the groups (Ladman and Afcha, 1990). The process can also be destructive to social cohesion or aggravate existing forms of economic and social hierarchy and discrimination. The self-selection into groups tends to be based on existing patterns of economic and social stratification, with the poor or marginalised within a population getting disproportionately excluded from groups containing viable borrowers. Further, the sanctions imposed on potential or actual defaulters typically involve not just economic actions, but social discrimination and tension that can become unpleasant and oppressive for all concerned. Indeed, it has been noted that better-off borrowers tend to get more rapidly dissatisfied with the group lending contracts (Madejewicz, 2003), so that several more established MFIs (including Grameen Bank in Bangladesh and BancoSol in Bolivia) have been pushed to introduce individual lending contracts for more successful or better-off borrowers.

An issue that was noted relatively early during the ‘development-oriented Non Governmental Organisation (NGO) phase’ of microfinance delivery was the mismatch between MFI orientation and the actual needs of poor people. Where the focus was on microenterprise development (as was touted by many NGOs who wanted to develop this route to asset creation for poverty reduction), loans that were ostensibly given for that purpose haphazardly had to be used for other purposes because of the material exigencies of poor households. Hulme (2000, p. 27) pointed out that ‘Clients have to pretend that they want microenterprise loans (when they need to pay school fees, cope with a medical emergency, buy food, etc.) and do not have access to the types of microsavings services that they desire.’

As Philip Mader (2013, p.360) notes in an insightful review, “this industry consists of two types of actors – MFIs (microfinance institutions) and funders – whose interest is usually to lend or invest money at the highest possible rate of return. For the MFIs, the only sources of revenue are the clients who pay interest (and often deliberately-hidden fees, as Sinclair alleges) on their loans. Rather than engage in costly screening of clients, it is easier for MFIs to charge excessive interest rates to everyone, through which they can absorb any losses on bad loans. To this scheme Sinclair adds the typical practice of not writing off failing loans, indefinitely postponing default with replacement loans instead, plus a general incompetence among MFIs at making good choices. As a result of these things, high interest rates are most MFIs’ only possible survival strategy. The second set of actors, the investment funds, needs to find MFIs to invest in, which promise an assured return on their investment. To satisfy the fund’s own fees and its investors’ tastes, this return need not be particularly high, but funds (just like MFIs) find it costly and difficult to screen for the right partners to give money to. Their easiest and safest option, therefore, is to give it to the MFI with the highest returns, and preferably one in

which other funds have already invested (the herd-instinct), so that at least some money will certainly be left over for the fund and its investors at the end. The losers in this scheme, according to Sinclair, are the poor people who pay excessive interest rates – with all the imaginable effects, from business failure to over-indebtedness and worsened poverty – as well as the original investors and donors, who are duped.”³

A problem that has become evident in the various microfinance meltdowns in countries where microfinance had developed most rapidly is the tendency of competition between microfinance providers to generate patterns of multiple lending and borrowing. This was marked in some of the early ‘successes’, such as Bolivia (where the problems erupted when Chilean profit-oriented MFIs entered the market that was earlier dominated by BancoSol) and Bangladesh. The ‘overlapping’ of borrowers was found to exist even when the lenders had agreements not to approach the same clients, as was the case in Bangladesh in agreements between Grameen Bank, BRAC and Proshikha. [Matin and Chaudhury \(2001\)](#) found that by the end of the 1990s, there was more than one microlender operating in 95% of 80 villages and 15% of all borrowers took loans from more than one institution. In several of these cases, loans were taken to repay original lenders, in an unsustainable Ponzi process that dramatically reduced repayment rates across all lenders. The short lending frames of loans (often as little as one week for the initial repayment) accentuated this tendency.

Many recent empirical studies (including those cited in [Duvendack et al., 2011](#)) have found that there is no strong evidence of net income gains for borrowers through this process. Indeed, given the nature of the loans (small amounts given for short durations at very high interest rates), this is scarcely surprising. [Banerjee et al. \(2010\)](#) found, on the basis of a randomised controlled trial of households in Hyderabad, India, that existing business owners appeared to use microcredit to expand their businesses, while (poorer) households with low predicted propensity to start a business increased their spending on non-durable items, particularly food. The study found ‘no discernible effect on education, health, or women’s empowerment’. Often, those who showed some benefit were those who had higher and more secure incomes to start with, as [Snodgrass and Sebstad \(2002\)](#) showed for Zimbabwe. A study of north-east Thailand ([Coleman, 2006](#)) found that microfinance borrowers tended to be significantly wealthier than their non-participating neighbours. The wealthiest villagers were nearly twice as likely to become borrowers as their poorer neighbours and the wealthiest were also more likely to use their power to obtain much larger loans than others. A study in India ([Dewan and Somanathan, 2007](#)) similarly found that participation of the poorest households in microcredit is disproportionately low.

A study by Consultative Group to Assist the Poor (CGAP) ([Chen et al., 2010](#)) examined microfinance crises in four countries: Morocco, Pakistan, Nicaragua and Bosnia-Herzegovina. It found that while there were some differences in the credit approaches in different countries, all of them were similar in terms of low emphasis on savings as a service or as a means of mobilising resources—savings represented less than 10% of

³ There are obvious similarities not just with the US subprime crisis but indeed with many other financial crises in which deregulation has accentuated the (Minskian) tendency of financial markets to move towards more speculative and Ponzi types of lending activity.

outstanding loans in this sector, in contrast to the global average of 46%. Problems had emerged in all of these countries before 2007, but they were greatly accentuated by 2008–09, as microfinance borrowers were severely affected by the economic downturn, job losses and declining flow of remittances. But this was really an aggravating factor rather than a basic cause of the problems of microfinance in these countries. Rather, three factors were the most important and all of them reflect systemic features of the recent expansion of microfinance: extreme market competition and multiple borrowing; overstretched management systems and controls; and erosion of lending discipline.

Thus the leading MFIs did not spread their lending out, but rather tended to concentrate in certain geographical areas, thereby generating saturation and excess competition in the local market. Partly, this was because the microloans that were used by borrowers to engage in small productive activities resulted in too many competing producers for relatively limited markets for local goods and services. But in addition, multiple lending sources increased the likelihood that clients would borrow from more than one MFI, thereby reducing dependence on any single lender and increasing the probability of default. This geographical concentration is not just an accident: it is also because MFIs focus on the easiest targets by prioritising localities with higher population density and more economic activity.⁴ The rapid expansion of MFIs, which was once again driven by incentives at the heart of the system, created overstretching in a number of ways. Staff were employed without adequate training, monitoring became more difficult and the internal controls that could control fraud were relaxed. Competition also eroded the credit discipline of the MFIs themselves, as the incentives of middle managers downwards were increasingly oriented to maximising the number of loans and clients. The similarity with the behavioural tendencies and incentives of other financial institutions in relatively under-regulated financial markets is obvious.

Incidentally, the very context of increased competition among MFIs in these markets also reduces the incentives for and likelihood of information sharing about clients across MFIs, a feature that has been noted in a study of Ugandan microfinance (McIntosh *et al.*, 2005). This was found to lead to ‘a gradual deterioration in repayment performance and to a drop in savings, both of which are consistent with clients responding to rising competition by engaging in double-dipping’. An extension of this argument (McIntosh and Wydick, 2005) is that as competition results in reduced returns from more profitable borrowers, it leads to the exclusion of poor borrowers, thereby undermining the supposed focus of microfinance in serving the underserved poor. As competition in turn aggravates the asymmetric information problems associated with borrower overindebtedness, the most impatient borrowers seek multiple loans, thereby creating outcomes that are less favourable for all borrowers (and lenders).

Viada and Gaul (2011) point to the growing links between MFIs and the rest of the financial sector, which can in turn generate or accentuate some of the problems described above. They note that (when compared with the standard donor-driven situation) competition for funding sources for the MFIs themselves encouraged MFIs to push the limits of their underwriting and risk management processes. The business success of microfinance attracted new and relatively large sources of both local and international funding, including private equity funds and other financial investors. As

⁴ Incidentally, this also makes them less likely to extend finance to the really poor and marginalised.

a result, MFIs were encouraged to increase loan portfolios to meet ambitious outreach goals or shareholder demands for increasing revenue growth. This in turn meant new pressures on management, as the boards of profit-making MFIs desired the managers to increase or at least maintain their market share when facing increased competition. Such competitive pressures can easily foster aggressive loan origination policies and staff incentives based on loan volume. It is easy to see how this would contribute to declining portfolio quality and more rapid market saturation.

3. Microfinance in India: the roller coaster

Asia has been leading the global exposure to microfinance: it is estimated that in 2010, 75% of the world's microfinance borrowers (around 74 million borrowers) were based in Asia ([Microfinance Information Exchange, 2012](#)). Seven out of every 10 of such borrowers live in India (32 million) or Bangladesh (22 million). Furthermore, over the past decade India has become the most dynamic country for microfinance. While the number of borrowers in Bangladesh remained broadly stable in the 2000s, after an earlier period of growth in the 1990s, in India the number of borrowers increased 5-fold in just six years until 2010. In 2011, there was an estimated \$4.3 billion given out as loans to around 26.4 million borrowers in India, most of whom (nearly 90%) were concentrated in just two states: Andhra Pradesh and Tamil Nadu.

Microfinance in India, as elsewhere, originally began as part of a developmental and poverty-reduction project, led by NGOs who thought this would be an effective way of allowing the poor to lift themselves out of poverty by their own efforts. Many NGOs began the process of group lending based on self-help groups (SHGs) and the linkage with commercial banks (whereby banks were allowed to lend to groups with a proven track record of repayment) further enlarged its scope. SHGs and their federations became the intermediaries between individual clients (who were mostly women) and the commercial banking system through the SHG–Bank Linkage Programme (SBLP), described below.

The basic methodology being used in commercial microfinance in India was broadly along the lines innovated by Grameen Bank and later adapted by several players. This involved three steps: (i) identifying potential customers, typically on the basis of some measure of poverty, which also ensured significant homogeneity among customers; (ii) organising them into groups (SHGs) that effectively dealt with the problems of information asymmetry described earlier; and (iii) offering standardised products based on standardised operating systems, with strict enforcement of discipline that ensured that the exceptions were dealt with severely.

There were some differences from the Grameen model, particularly in the role of the SHGs. An SHG has 10–20 members and each member saves a certain amount every month; the SHG lends the collective savings on a monthly basis to its members sequentially on terms decided by the group. Further:

In addition to group-generated funds, the group may also borrow from outside, either from the commercial bank with which it maintains a group account or from the NGO sponsoring it, in order to supplement the group's loanable funds. As SHG members maintain their individual accounts with the SHG (and not with the sponsoring NGO), the SHG is the retailer in the Indian case and performs most of the transaction functions, unlike in Bangladesh, where the microfinance institution is the retailer. ([Kalpana, 2005](#), p. 5404)

The SBLP began in 1992 and has grown exponentially thereafter. National Bank for Agriculture and Rural Development (NABARD 2011) estimates that currently around 97 million households have access to regular savings through 7.46 million SHGs linked to different banks. About 4.78 million SHGs also have access to direct credit facilities from banks; around 82% of these are women-only SHGs.

The focus on women borrowers has been a major feature of microcredit provision in India as in Bangladesh and is frequently cited as one of the ongoing public strategies for women's economic empowerment. However, as pointed out by Kalpana (2008, p. 3) even this linkage has often reflected and accentuated traditional patterns of gender discrimination: 'When they seek access to bank credit, women's groups are in a dependent relationship, and are subject to, and tarnished by, the institutional imperatives, systemic corruption and political compulsions that shape the behaviour of rural development bureaucracies and banks.' Indeed, loan recovery pressures from banks have added to the push factors (such as household livelihood stress, medical costs, migration, etc.) that drive poor women out of microcredit programmes. Bank pressure also creates tensions within SHGs that undermine solidarity and social cohesion among women. It is common to deny SHG membership to women who have experienced or are likely to experience financial stress, which obviously particularly impacts upon women from more deprived and marginalised groups. It is often found that women from Scheduled Tribe or Scheduled Castes communities or other deprived groups are disproportionately excluded from SHG groups or forced to form SHGs of their own, which are viewed as inherently weaker. The very existence of MFIs has therefore sometimes been seen as another vehicle for reinforcing the multiple deprivations of vulnerable women (Nirantar, 2007).

Unlike Grameen Bank and similar institutions around the world that are funded primarily by deposits raised from their own borrowers and non-members, Indian MFIs are prohibited by law from collecting deposits. So Indian MFIs did not have a legal framework that would allow them to 'involve the community in the ownership structure of an MFI' (Sriram, 2010, p. 5). When 'developmental' or donor funds were not forthcoming, they could not access private investors because they could not distribute the profits made, which made it harder for them to access adequate capital for expansion. This led to the drive for 'transformation' of the industry: the move from a not-for-profit to a for-profit format. While the MFIs of the 1990s were all started with the explicit intention of broader public purpose, and therefore spearheaded by NGOs, in the 2000s several of them transformed into for-profit entities and new ones emerged that originated with a for-profit intention. By 2009, the 233 MFIs that reported to the umbrella organisation Sa-Dhan apparently served 22.6 million clients independently of SBLP, with nearly two-thirds of this outreach being accounted for by for-profit MFIs (Sa-Dhan, 2009, quoted in Copestake, 2010).

This process was actively assisted by the public sector bank SIDBI (Small Industries Development Bank of India). In addition, the former development bank ICICI Bank, which had itself transformed into a commercial bank that aggressively sought new profit-making opportunities, launched a securitisation product in 2003, wherein it would buy out the portfolio of the MFIs in return for an agreement for collection of the loans. Every time a portfolio was bought out, the MFI would get the ability to lend and borrow more and therefore expand.

At the time, this process was widely celebrated as a 'win-win situation', as private profit could be associated with financial inclusion, extending formal financial

institutions to the poor who were otherwise excluded. However, the problems with this for-profit model speedily emerged, as the excessively high interest rates and often unpleasant and undesirably coercive methods that were used to ensure repayment showed that these new 'modern' institutions were no different from the rapacious traditional moneylenders that were supposed to be displaced by the more supposedly acceptable norms of institutional finance. As it happens, most MFIs charge interest rates of anywhere between 30% and 60% per year, with added charges and commissions and penalties for delayed payment. The rates are therefore not dissimilar to the rates charged by traditional moneylenders and other informal lenders in rural India.

Sriram (2010) has also pointed to another aspect of this transformation that has more in common with the various other methods of the 'get rich quick' capitalism of the past decade in India. In a study that examines in detail the 'transformation' of four prominent MFIs in India (SKS Microfinance Ltd, Share Microfin Ltd, Asmitha and Spandana), he noted that in some cases this was also associated with the private enrichment of the promoters through various means. These included inflated salaries and stock options provided to the top management, who were usually the promoters.⁵ A more interesting legal innovation was the use of mutual benefit trusts (MBTs) that aggregated the member-borrowers of SHGs as members. The grant money received for the purposes of 'developmental' microcredit could then be placed in the MBT, which would in turn contribute to the newly created for-profit MFI. In the case of two of these companies (Share Microfin and Asmitha) the matter was compounded by cross-holding, since the promoters of the two companies were the same family.

The initial public offering of SKS Microfinance in 2010 was attended by a media blitz in which the Who's Who of the international private philanthropic community joined hands with other more explicitly profit-minded investors in singing the praises of this new model that supposedly combined private incentives with public purpose. Ironically, this was also the most apt representation of hubris before the collapse, as the for-profit microfinance model then suffered severe blows to both its prestige and its viability, from which it has yet to recover.

Figures 1, 2 and 3 are based on data provided by the Microfinance Information Exchange (www.themix.org) on MFIs in India. A sample of 26 reasonably large MFIs for which data are available from 2005 to 2011 have been taken. These include some of the more prominent NGO providers (such as Self Employed Women's Association SEWA Bank and Shri Kshetra Dharmasthala Rural development Project SKDRDP) as well as some not-for-profit companies, some of which 'transformed' into for-profit companies (such as Share Microfin Ltd, Spandana, BASIS and SKS Microfinance Ltd). The figures show clearly how the main indicators of MFI performance peaked in 2010 and thereafter have been declining. The gross loan per active borrower is the only indicator that shows some increase—but this is probably illusory, since many loans that should be written off because of low possibility of being repaid are still being kept on the books.

⁵ For example, the Managing Director of Share Microfin was paid more than Rs 80 million in 2008–09, 15% of the total personnel costs of the company. His wife, who was Managing Director of Asmitha (a largely family-held company that also held significant shares in Share Microfin), received remuneration of more than Rs 35 million in the same year. Their daughter received Rs 2.5 million as compensation from Asmitha, while the next level of professional management in Share Microfin was paid only around half a million rupees.

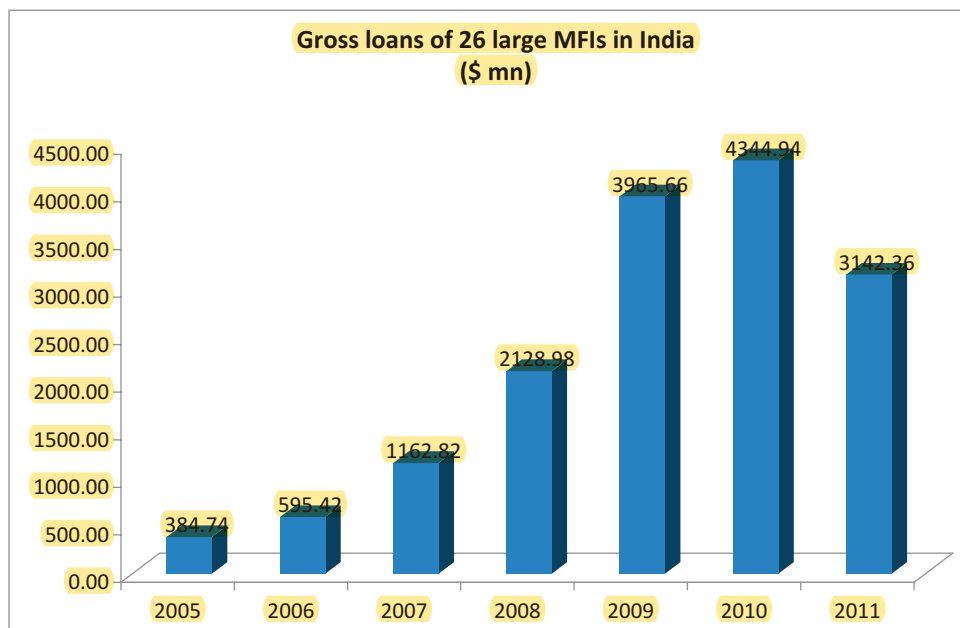


Fig. 1. Gross loans of 26 large MFIs in India (\$ million).

How did this decline occur? The answer must be sought in the recent pattern of growth of microfinance in India. The explosion of MFIs, particularly those that are profit driven, in India has been heavily concentrated in two states (Andhra Pradesh and Tamil Nadu), which by 2010 accounted for nearly 90% of all borrowers and value of loans of MFIs. In both of these states, private profit-making MFIs arrived precisely because they could leverage the existing SHG networks, which were largely built by NGOs in the first instance. The problems with the model, particularly the profit-driven version, were becoming sharply evident by the middle of the year 2010. By then, media reports were talking of more than 200 suicides related to the pressure of repayment of MFI loans. One news report (Kinetz, 2010) suggested that an internal study commissioned by SKS Microfinance Ltd (which was not subsequently made public) had found evidence of several suicides linked with loans made by the MFI.

The microfinance crisis in Andhra Pradesh provides almost a textbook example of what can go wrong in allowing the proliferation of relatively less-regulated MFIs in a boom that occurs under the benign gaze of the government. Arunachalam (2011) has pointed to a number of causes for this crisis, which are closely related to the very functioning of the sector in both for-profit and not-for-profit variants. In particular, the explosion of multiple lending and borrowing was a prime cause, and this was positively encouraged by MFI lenders. Poor households took on multiple loans from different sources, often only for the purpose of repaying one of the lenders, and this was fed by the combination of aggressive expansion in the number of clients and strict enforcement of payments.

Further, despite the claims about personal involvement and group solidarity being the basis of the lending process, Arunachalam notes the widespread use of agents. There are two main types of microfinance agents: local grassroots politicians, who use the loans to add to their political clout; and the heads of federations of borrower groups (or SHGs), who make an additional profit by controlling or appropriating the

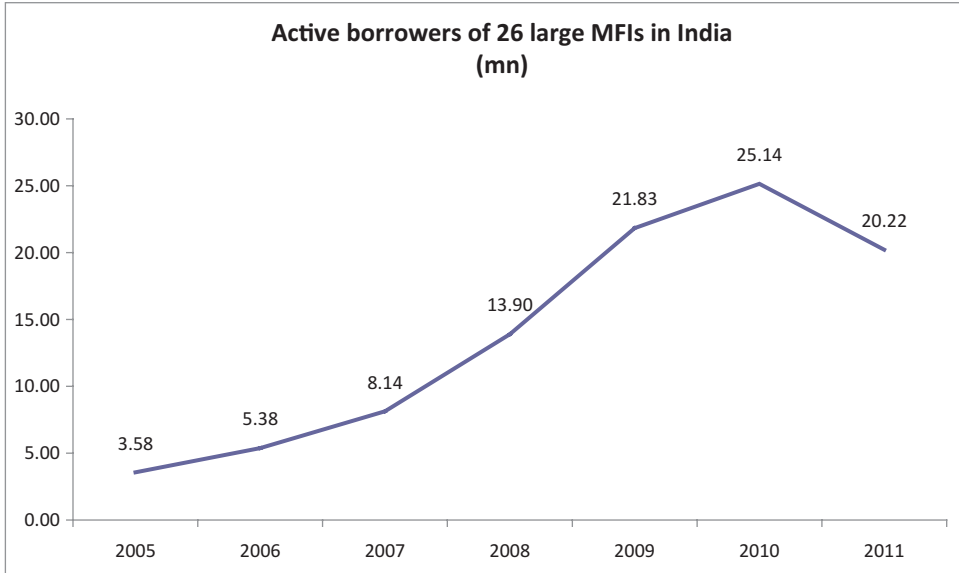


Fig. 2. Active borrowers of 26 large MFIs in India (million).

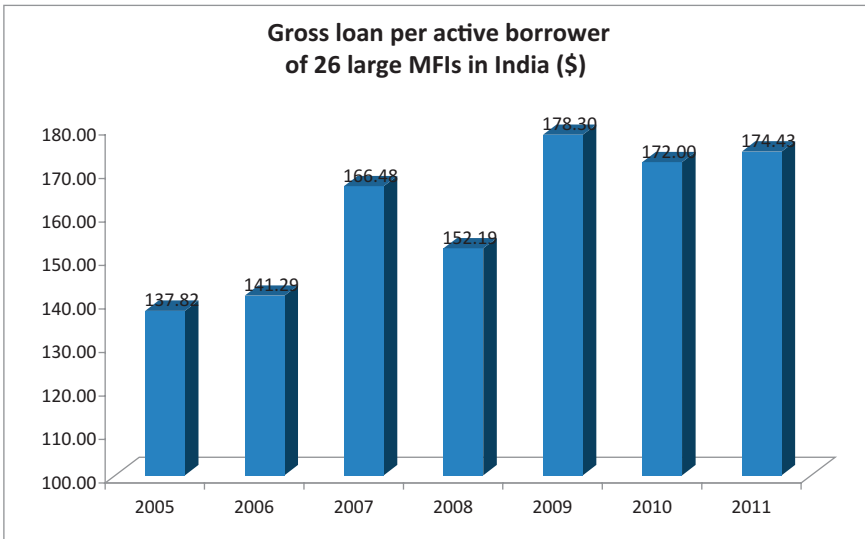


Fig. 3. Gross loan per active borrower of 26 large MFIs in India (\$).

flow of loans. Such agents also exercise tremendous power vis-à-vis not just the borrowers but also the MFIs themselves, as they ensure clients for the MFIs or cause them to lose clients and have their own means of (usually extraeconomic) coercion to ensure payments. These agents have become essential to the functioning of the system, as MFIs benefit from them and yet can claim that they are at arm's-length from any malpractices involved in loan recovery (Arunachalam 2011, p.312).

Priyadarshiee and Ghalib (2011) describe a process whereby the MFIs not only offered multiple loans to the same borrower household without following due diligence, but also collaborated with consumer goods companies to supply consumer goods such as televisions as part of their credit programmes. These purely consumption loans exacerbated the already worsening indebtedness of poor households and some of them started defaulting in repayment. Several MFIs then resorted to openly coercive methods for loan recovery. Extreme repayment pressure forced borrowers to approach moneylenders to borrow at exorbitant rates of interest simply to repay the MFIs. When the situation became impossible, and no fresh loans were accessible, some of these borrowers committed suicide and the issue attracted widespread media coverage.

The Andhra Pradesh state government blamed the MFIs for fuelling a frenzy of overindebtedness and then pressuring borrowers so relentlessly that some took their own lives. It immediately brought in regulations to control their activities, particularly measures to prevent the forcible recovery of loans from poor borrowers. The Andhra Pradesh Microfinance Institutions (Regulation of Money Lending) Ordinance, 2010 was implemented with effect from 15 October 2010. The ordinance mandated all MFIs to register themselves with the government authority while specifying the area of their operations, the rate of interest and their system of operation and recovery. The ordinance also specified stiff penalties for 'coercive action' by MFIs while recovering their loans. In addition, it prohibited them from extending multiple loans to the same borrower and limited the total interest charged to the extent of the principal amount.

This generated an acute crisis in the MFIs, which was then aggravated by a wave of defaults across the state; this has since made most of their functions financially unviable. The lack of confidence among borrowers that many MFIs will continue to exist has further reduced the incentive to repay, thus leading to a stalemate. A report in 2011 (*Economic Times*, 2011) quoted the high-flying Chairman of SKS Microfinance Ltd, Vikram Akula, as saying that the loan recovery rate in Andhra Pradesh had dropped to 10%; he resigned from that post shortly afterwards. In addition, this is perceived to have altered the behaviour of MFIs in other states, making them even less willing to lend to poor borrowers because of the higher transactions costs and risks involved. In other words, the perceived advantages of microfinance in terms of providing viable financial services to poor clients appear to disappear once they are regulated to prevent irresponsible lending and the coercive extortion of repayments!

Obviously, this particular financial crisis cannot be separated from the wider social and economic circumstances within which it played out. So it must be seen in the context of the severe impact on the agrarian economy resulting from the combination of trade liberalisation, cycles of repeated drought, increasing rural differentiation and 'a generalised crisis of social reproduction among land-poor farmers and landless labourers' (Taylor, 2011, p. 484). This context of economic uncertainty and growing distress created a ready clientele for the influx of microfinance, as households sought to maintain consumption and somehow deal with previously accumulated debt for productive or other purposes. But the very vulnerability that drove the expansion of microfinance in this area has been further accentuated by the crisis and the current uncertainty of the sector in this region.

A (presently) draft legislation has been placed in the Indian Parliament on the regulations of MFIs: the Microfinance Institutions (Development and Regulation) Bill, 2012. The legislation is supposed to deal with the regulatory issues and make it possible for MFIs of both non-profit and for-profit varieties to function again. The main concern, however, is that the regulation as it is currently drafted puts more emphasis on the 'promotion of the microfinance sector' than it does on the necessary regulation and the need

for developing mechanisms to ensure strict compliance with the regulations, which will limit phenomena such as overlending, multiple borrowing and coercive means of gaining repayment, especially through agents. More worryingly, the draft legislation implicitly seems to be driven by the belief that microfinance is an effective way to reduce poverty, a claim that is less and less valid on the basis of international and national experience.

4. Finance for small producers and poor consumers in developing countries

The preceding discussion highlights the many problems associated with treating microfinance as either a significant poverty alleviation strategy or even a means of incorporating otherwise excluded potential borrowers into the institutional finance system. It is evident that 'microfinance is a double-edged sword: it can either reduce the financial vulnerability of households or push them further into debt' (Guerin *et al.*, 2009). In any case, as is evident from the previous discussion, the processes and impacts of microfinance cannot be separated from the broader local and macroeconomic dynamics of livelihood and employment, consumption, investment and financial development in general.

Copestake (2010) has argued that

(a)n excessive focus on the potential of microfinance can simultaneously serve as populist modality for benevolent paternalism, convenient smokescreen for the messy finances of crony capitalism and fodder for an ideology of equality of opportunity over economic justice. By emphasizing the importance of *individual* access to financial services, a narrow definition of microfinance also risks contributing to the neglect of a wider development finance agenda that includes improving financial allocations to the *collective* services needed by poor people such as physical infrastructure, security, health and education services. (Copestake, 2010, p. 4)

It may well be argued that it is fine to reject microfinance as the means for either poverty reduction or economic diversification, but then how do policy makers address the problems of the exclusion of the poor from formal financial institutions? If formal finance is not forthcoming for the poor and those running microenterprises, they are left to the not-so-tender mercies of informal credit providers, who are likely to be as exploitative and bring in other forms of extraeconomic coercion to ensure repayment? In many countries, including India, the hold of traditional moneylenders is often closely linked with broader systems of exploitation that use interlinked markets of goods, labour and credit to oppress the poor. Access to alternative formal credit institutions is one of the means by which such links can be broken. In this context, how can the need for financial inclusion for egalitarian development be addressed?

The first point to note is that it is important not to reject microfinance in its entirety because of problems with some parts. For all its limitations and difficulties, as noted above, microfinance can still be a means of expanding credit access to those who are generally seen to be outside the coverage of formal financial institutions and who, in the absence of other proactive measures, would otherwise be forced to rely only on exploitative local moneylenders, pawnbrokers, etc. So it can provide a step in the movement towards universal financial inclusion, but only a relatively small step, of course. However, it is important to note that microfinance is *not* the only available alternative to exploitation by traditional moneylenders. Indeed, it is possible to argue that many alternative finance institutions, such as credit cooperatives, local development banks and community banks, were ignored and even undermined by the excessive emphasis placed on MFIs by both donors and governments. For example, the

poor in Brazil are less dependent upon moneylenders because they have greater access to community development banks and financial cooperatives set up by the community with active support from the state in the form of technical advice and even initial capitalisation from local and central governments as well as the Brazilian development bank (BNDES).

Microfinance, particularly in its not-for-profit developmental form, has on occasion been one means of greater mobilisation of women as savers and borrowers, in turn providing a step, once again a small step, towards their social and economic empowerment. So, while for-profit microfinance is inherently problematic and largely undesirable, the not-for-profit manifestation need not be abandoned completely. However, it should be recognised that even to fulfil these limited goals it needs to be strongly regulated, especially by banning profit-oriented provision and preventing the push towards multiple lending and loan pushing. In effect, it should be pushed towards the creation of savings and loans cooperatives, which can then be combined with other strategies of ensuring the viability of small producers, such as forming input and marketing cooperatives and providing access to technologies. The most successful Indian experience with ‘microfinance’ has actually been when it is effectively organised into a more cooperative structure that provides savings and loan functions as well as further cooperation for production and food security, such as in the Kudumbashree federation of SHGs in the state of Kerala (Mukherjee Reed, 2010).

Such provision of credit, if it is designed in a way that increases the access of the poor to regular institutional finance in a regulated manner, *must necessarily be subsidised*—and it is much better for this to be openly recognised and allowed for, rather than seeking to disguise this in ways that create additional problems. The subsidies given to such activities—as well as to ensure the access to finance of others who would otherwise be excluded from institutional finance, such as small producers—should be seen as a necessary cost associated with the social benefits of greater financial inclusion.

However, since even organised credit creation is clearly not a silver bullet to solve development problems, the measures to ensure formal financial inclusion need to be treated as one small element of a broader set of financial strategies for development, for example as elaborated in Epstein (2005) and Chandrasekhar (2010). In these financial strategies, one major focus should be on the expansion of normal institutional finance mechanisms into serving sectors and categories that are generally avoided by commercial banks because of their high risks and high transaction costs. Central banks can play (and, indeed, historically have played) an important role in this, not only through policies such as keeping real interest rates low and preventing or reducing destabilising capital flows, but also by influencing the allocation of credit in various ways.

As noted by a number of writers (Amsden, 2001, 2012; Chandrasekhar, 2010), the most urgent need for most developing countries is for the systematic and purposeful expansion of development finance, broadly defined. Development finance institutions are usually those tasked with financing economic sectors where the risks involved are beyond the acceptance limits of commercial banks, particularly for investment projects where scale matters. They are mainly engaged in providing long-term assistance and directed towards meeting the credit needs of riskier but socially and economically desirable objectives of state policy.⁶ Besides providing direct loans, these financial institutions also extend financial assistance by way of underwriting and direct subscription

⁶ Unfortunately, in several countries, such as India, these functions of development banks have been undermined by moves to transform development banks to universal banks, which then behave like commercial banks with similar profit orientation and lending patterns Reserve Bank of India (RBI, 2004).

and by issuing guarantees. As pointed out by [Chandrashkar \(2010\)](#), they lend not only for working capital purposes, but also to finance long-term investment, including in capital-intensive sectors. Because of this longer time horizon, they also tend to be more closely involved with investment and production decisions in various ways, as well as monitoring corporate governance and performance on behalf of all stakeholders.

The concerns that exist for development banks in general are particularly evident for sector-specific banks, such as agricultural banks, housing banks (particularly those that are oriented towards the provision of housing for poor and middle-class purchasers) as well as those oriented towards catering to small enterprises and community development banks. Similarly, it is important to actively promote cooperative banks (and then free these from political control) so that small producers in different categories can derive benefits of economies of scale and get access to loans. The group lending format is not always necessary in such contexts, as the successful experience of banking cooperatives in several European countries shows. Standard prudential norms can be counterproductive in preventing such institutions from exercising their required functions. Incentives generated by regulatory structures may operate to shift such institutions away from their primary focus and towards more explicitly profit-oriented motives or more risky activities. Regulators need to have different approaches (and different criteria) for monitoring and supervising different types of banks.

This altered policy orientation would change the manner in which microfinance is viewed. A common tendency in recent approaches to financial policy is to treat microfinance as a substitute for greater extension of institutional finance (i.e. formal finance for the rich or for companies and microfinance for the poor or for women). Yet, as evident from the preceding discussion, microfinance is *not* the same as financial inclusion ensuring access to institutional finance and, most significantly, does not allow for productive asset creation and viable economic activities to flourish. While the focus on group lending does allow for financial integration in the absence of collateral, the high interest rates, short gestation periods and (increasingly) coercive methods used to ensure repayment militate against its usefulness in poverty reduction and asset creation by the poor, even though it does typically play a role in consumption smoothing.

Proper financial inclusion into institutional finance will require some forms of subsidy as well as creative and flexible approaches on the part of the central bank and the regulatory regime, to ensure that different banks (commercial, cooperative, development, etc.) reach excluded groups such as Small and Medium Enterprises (SMEs), self-employed workers, peasants, women and those without land titles or other collateral. [Minsky *et al.* \(1993\)](#) noted that developing community banks for normally excluded communities and then creating a national network of them would allow for cross-subsidisation of activities and the development of synergies across institutions.

A secure savings function for the poor, which enables them to save for the future in a reliable asset, is also important and may require guarantees on deposits in community banks and savings banks, as well as other measures. It is unlikely that commercial banks will be willing to enter such activities without some pressure as the requirement of directed credit (as in specifying that a certain proportion of all lending should be allocated to certain priority sectors, including small borrowers). However, this stick needs to be accompanied by some carrots. In this context, the ideas proposed by [Pollin Robert \(2008\)](#), and others, for loan guarantees to cover the risks of small loans (50% or 75% of the value of the loan) and for subsidies to lenders to be explicitly designed to cover the excess transaction and monitoring costs of small loans, are important measures.

So, central banks that wish to ensure effective financial inclusion for more egalitarian and sustainable development need to encourage a diversity of institutions (public development banks, community banks and cooperative banks, in addition to standard commercial banks) through a combination of incentives and regulatory measures:

- Encourage the creation and expansion of development banks that are subject to different regulatory requirements from normal commercial banks.
- Ensure that sector-specific banks and client-specific financial institutions are operating under prudential norms and other regulations that are sensitive to the specific conditions under which they operate (e.g. agricultural banks and cooperative banks).
- Create and develop national networks of community development banks that are directed to financially underserved communities.
- Introduce policies to promote or ensure lending to certain priority sectors or other measures to direct some portion of total bank credit to small borrowers with defined conditions. This may require more than normative prescriptions to extend to actual enforcement through active monitoring of the lending practices of banks, as well as differential discount rates to certain priority borrowers (including small producers).
- Provide subsidies to cover the transaction costs of microlending where required, as well as loan guarantees.
- Consider portfolio ceilings and other measures to prevent overlending on 'low priority' activities, as well as variable reserve requirements.

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