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The crisis of microfinance

Once hailed as a solution to poverty, microfinance lenders are criticised for profiting from exploitative usury.

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Mohammed Yunus, founder of the Grameen Bank, has been criticised by Hasina Wajed, the Bangladeshi president, for 'sucking the blood of the poor' through his micro credit operation [GALLO/GETTY]

The recent ouster of the Nobel Prize-winning Bangladeshi economist Mohammed Yunus as Managing Director of the Grameen Bank, which blazed a trail for microfinance in developing countries, has thrown a spotlight on the crisis engulfing a business that was once seen as a harbinger of hope for millions.

Yunus's tussle with the government of Bangladesh, which had tried to retire him on grounds of age (he is 70) before firing him from his own board, is entangled in his country's complicated politics.

But Bangladeshi President Hasina Wajed's remark that Yunus had "spent years sucking the blood of the poor" echoes similar charges being made in neighboring India against companies and banks that sought to emulate Grameen.

Last November, Andhra Pradesh, one of India's most populous states, cracked down heavily on private microfinance institutions (PMFIs), banning many of their activities and telling borrowers they did not need to repay their loans.

State authorities said they were prompted to take decisive action by a spate of suicides by borrowers who were unable to pay their debts. Roughly 80 clients were reported to have taken their own lives last year – an alarming figure, though tiny relative to the 26.7 million active borrowers from PMFIs in India.

'Usurious' loans

Andhra Pradesh officials charged that PMFIs, which had lent around 80 billion rupees (\$2bn) in the state, levy "usurious" interest rates (24-30 per cent per year) to sustain their promoters' extravagant salaries and profits. In addition, too many borrowers had taken multiple loans from different sources and were unable to repay them. Aggressive agents were marketing the loans with no heed to borrowers' capacity to repay.

It was alleged, too, that coercion was being used to exact repayment, leaving victims with no way out but to end their own lives.

One institution that received unwelcome attention was SKS Microfinance, once a poster child for the PMFIs, which

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had done so well and grown so large that its initial public offering last year was oversubscribed 13-fold and raised \$350m.

The salaries paid to its top executives – as a reward, essentially, for lending successfully to the poorest of the poor – were excoriated by leaders across India's political spectrum. SKS' Chairman, Vikram Akula, reportedly made \$13m by selling some of his shares last year. Is it moral, critics asked, to profit so much from providing services that alleviate poverty?

But the counter-argument is that professionally-run private microcredit is better than no credit at all – the situation most of the poor confront. State banks are supposed to lend generously to India's rural poor, but their operations are mired in inefficiency and corruption. Loans often require bribes, and the banks' procedures are bewildering to the unlettered.

Traditional moneylenders are the only alternative, and they extort far more than 30 per cent a year – often at the point of a knife, or worse.

Profit vs charity

The problems with microcredit raise a larger question: should the poor be served by modern financial institutions that raise their funds in capital markets, or must they rely exclusively on non-profit sources of support? The late Indian management guru CK Prahalad suggested in his bestselling book *The Fortune at the Bottom of the Pyramid* that businesses could make healthy profits by serving the poor – and so satisfy their shareholders while promoting social development.

Selling five-rupee sachets of shampoo to poor consumers is considered clever marketing, but lending 5,000 rupees to a starving peasant at high interest rates is viewed as exploitative. Both activities, after all, are financed by investors looking for returns on their capital and motivated more by profit than compassion.

But one is clearly less socially acceptable than the other. A high salary earned by a cosmetics or soft-drink manufacturer attracts no attention; one paid to the CEO of a company that thrives on lending to the poor appears unseemly, if not immoral.

Yet PMFIs had succeeded by meeting a genuine need. Only 50 of India's roughly 1,000 microfinance institutions are private (as opposed to NGOs), but the top four PMFIs account for 80 per cent of the market. Many of them doubled their revenues in the 2009-2010 fiscal year, reaching more than 100 million borrowers, whereas rural co-operatives, which also make small loans, grew by 3 per cent, to 45 million borrowers. State banks are farther behind.

PMFIs are lending in a market vitiated by a populist political culture. Whereas microcredit institutions' business model depends on a very high repayment rate (often exceeding 98 per cent), government-run banks and state-supported co-operatives tend eventually to write off their loans when elections come around, with state and national governments waiving poor farmers' debts for political reasons. Private institutions obviously cannot afford to do that.

There are other complications. The village moneylender, though often a shark, at least belongs to the community and knows his clients. A PMFI, as a faceless institution, relies on good faith and peer pressure to recover its money.

The moneylender is happy to lend for any purpose, including non-productive expenditures like weddings and dowries, whereas a PMFI, if it is to succeed, can finance only income-generating, economically sustainable activities. But PMFIs seeking to attract private-equity capital emphasized growth over sustainability, lent indiscriminately to people who couldn't pay them back – and attracted public opprobrium in the process.

Indian regulators are sorting out the tangle of issues that have plunged India's microfinance industry into crisis. Ironically, none of these problems seems to have befallen Bangladesh's Grameen Bank, which survives largely on donor grants and sustainable repayments. Yunus's ouster, it is suggested, has much more to do with his having once expressed political ambitions. But association with a suddenly tarnished industry cannot have helped.

Shashi Tharoor, a former Indian Minister of State for External Affairs and UN Under-Secretary General, is a member of India's parliament and the author of several books, most recently *Nehru: the Invention of India* (in German).

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