*Draft, comments welcome*

Bankers to the poor, bother to the state—Political Risks in Microfinance\*

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Abstract

In this paper, we survey the various episodes of political interference in microfinance. The paper highlights the common sequences of such intervention and its aftermath as well as the reasoning behind the interferences. We suggest that the Bangladesh case is different, as it did not fit the pattern of intervention in other countries. We discuss the steps MFIs need to take to reduce political risks. We suggest that the Bangladesh case is different, as it did not fit the pattern of interventions in other countries. Our main finding is that rapid commercialization that entailed profiteering instead of profit maximization resulted in the political backlash causing enormous damage to the whole sector.

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1. Introduction

“ Although microfinance is, on the surface, about loans and business and interest rates, my time in India had convinced me that at its core it’s really about *power* (italics added). Success in microfinance wasn’t measured only in numbers. It is measured in the *changing power dynamics*. It was about changing historical and cultural norms, shifting *centuries old power structure* in a way that would help the traditionally downtrodden. So a political science doctorate seemed a more natural fit for what I was trying to accomplish than, say, economics,” claimed Vikram Akula, the founder of the Microfinance Institution (MFI) SKS in his autobiographical book *A Fistful of Rice*. This was an ironic observation. It showed immense naiveté--the claim of changing the old power structure through microfinance. What Akula did not realize was the old power structure would react not because microfinance is helping the downtrodden but a successful microfinance industry will be a threat to the existing structure and to the status quo. And react they did!

Akula and his company paid a steep price for miscalculating the political risk. Soon after his company going public in 2010, the Andhra Pradesh (AP) government passed an Ordinance that almost shut down microfinance in the state. Now the business of SKS is nearly dead in AP, its share price has plunged from a peak of 1490 Rupees during the halcyon days and is hovering near 100 Rupees. Akula unceremoniously left the company he founded, and SKS is venturing into non-finance type of business to stop the losses. Some would argue that even though Akula was pushed out of the company he founded, he left the company as a millionaire. The political interference by the state government has affected other MFIs that have large exposure in AP and the flow of funds to the sector came to a screeching halt. Next door in Bangladesh, the government pushed out Professor Muhammad Yunus who founded the Grameen Bank on the plea that he is too old—70 years—to run a bank. One commentator summarized the episode by suggesting, “The State is reasserting itself.”[[1]](#footnote-1)

The political interference and the resulting consequences surprised everyone. The consensus was that large-scale default by borrowers is the biggest threat to microfinance. Since microfinance is provision of small loans without collateral, everyone thought the risk of borrowers colluding not to repay on a large scale and the lack of legal framework that would enable the MFIs to collect repayments will be the existential threat to the sector. The flagship report on risks in the sector, *Microfinance Banana Skins*, ranked political interference as a low level risk. Only the last two reports published after the crises in India and Bangladesh, political interference received some prominence. It received the overall fifth ranking in the 2011 and 2012 report, a jump of five positions compared to the ranking in 2009. Even then the responses varied: Asians put political interference top overall, Latin Americans at No.3, Africans and Central and Easter Europeans ranked it lower at No. 22 (CSFI, 2011). Recent episodes suggest that the biggest threat for the industry is the capricious politicians and the domestic politics of the country.

The interference by politician, elected or unelected, however, is not unexpected. The microfinance movement began its journey as NGOs in Bangladesh and in Latin America in the 70s. It was part of the civil society. By definition, civil society is “an intermediate associational realm between the state and family populated by organizations which are separate from the state, enjoy autonomy from the state and are formed voluntarily by members of society” (White 1994). Naturally, the politicians are suspicious of civil society actors especially when they accumulate economic and political powers without being accountable. Many worry that NGOs have become a shadow state and are undermining the state by providing essential services that are the domain of the state. Others argue that NGO’s narrow focus on delivery of credit and other services in lieu of social mobilization and collective action strategies has undermined governance. In democracies characterized by highly competitive political parties, interest rates and repayment terms of credit provided to large numbers of poor is an easy target of populist policies as they form the largest voter base.

 Many of the MFIs in the crisis countries began as NGOs to meet the needs of the poor. Later many of them converted into for-profit companies. As for-profit companies, they attracted commercial sources of funding from the banks and equity investors, in many cases, from outside the country. Some of them have gone public, enriching the original founders that began the institutions as non-profit. Turning non-profit institutions of the poor into for-profit enterprises as means of enriching a few has also drawn the ire of the other members of the civil society and opportunistic politicians. The reported high salaries of upper management of the MFIs in some countries and cashing in millions in stock options by the founders of original non-profit MFIs have also turned the public against these institutions. The rush to commercialization and move away from the preserve of socially motivated, not really hard-headed investors to real banking and the attempts to turn microfinance into a new asset class was the last straw for some politicians. Irrespective of the nature of intervention, politically motivated interference creates unprecedented risk in the operation of MFIs and for the whole industry.

In this paper, we will survey the various episodes of political interference in microfinance. We will highlight the common sequences of such intervention and its aftermath. We explore the Bangladesh case a bit more in detail because it did not fit the pattern of intervention in other countries. In Bangladesh, only Grameen Bank was targeted whereas in other countries the whole sector was affected by political interference. We will discuss the steps MFIs need to take to reduce political risks. Finally, we will conclude the paper with suggestions.

2. Episodes of Political Interference in Microfinance

The nature and timing of political interference is related to the size and effectiveness of the microfinance sector. When the sector is in the incipient stage, it does not draw that much attention from the politicians. However, when the sector become large enough to compete with the formal sector and becomes profitable, the political risk is heightened.

Political interference can come in different forms. The most visible and direct form of political interference is when the governments respond by promulgating laws that caps the interest rates that MFIs can charge their borrowers in reaction to real and imagined claims of over indebtedness and exploitation through high interest rates. In many cases this is preceded by the call by politicians to clients not to repay their loans because the interest rate on these loans are usurious (CSFI, 2011). The tendency of fast-growing MFIs in some markets to lend to borrowers who already have loans from their competitors and cannot service additional debt are the alleged causes of the over indebtedness. In some cases, even though the government does not put interest rate caps in place, through its regulatory powers and jawboning, it puts pressure on the MFIs to lower the interest rate and or related fees.

Political risk can manifest in an indirect way as well. The government can set up their own microfinance institutions and offer loans at lower, and most often highly subsidized, interest rates. This sends the signal that the poor cannot be lent money at high interest rates and institutions that charge such rate are not serving the needs of the poor (Marulanda et al., 2010). Subsidized credit is used as a form of clientelism and patronage. The coexistence of such institutions puts pressure on the MFIs to lower their own interest rates or risk an interest rate cap.

Another form of state intervention is the offering of public guarantees for MFIs (Marulanda et al., 2010). Political interference can also take the form of product limitations and directed lending to “priority sectors” (CSFI, 2011). Loan forgiveness by government usually after a natural disaster is also an indirect form of political interference.

In some cases the government was instrumental in setting up microfinance institutions. The government set up two flagships MFIs, Grameen Bank in Bangladesh and BRI in Indonesia. There is always a tension between prudent regulation and politically motivated interference. The government has an obligation to regulate financial institutions and ensure the safety of the savings especially of the poor. The problem arises when an over zealous regulator masquerades political interferences as prudent regulation.

Bolivia 1999-2003[[2]](#footnote-2)

During the late 90s consumer credit entered the microfinance scene. These companies adopted a methodology that worked in Chile for salaried workers: use credit scoring to approve loans, break down loan approval and collection into steps, and create an assembly line of loan disbursement. Using the streamlined process and a large work force, these companies expanded rapidly. However, unlike Chile, Bolivia did not have a sizeable salaried employee pool. To continue to expand at a higher pace and achieve large volume, these companies started offering loans to the clients of MFIs. Like the credit card companies, consumer lenders were aware that many clients would pay late. They incorporated this into the price of the loan and in addition charged fines for late payments that became an additional revenue source for them. In contrast, the microlenders used immediate personal follow up of missed payments. The increased competition from consumer loan companies impacted MFIs in two ways: tolerance of delinquency and over-lending.

The poaching of clients and staff by the consumer credit company also impacted the business of microlenders. Instead of doing the hard work of identifying good clients through due diligence and adapting the lending methodology, they simply lured away good clients of microlenders by giving them larger loans. Because of their size and limited exposure to lower end of the clientele, these companies could afford to offer microcredit at loss. The upshot of the aggressive entry by these entities and the use of irresponsible techniques was that the default shot up both for the consumer and microlender creating the crisis of *sobreendeudamiento* (over indebtedness). Many borrowers had several loan at a time and could not maintain the repayment and ended up defaulting. Worse yet, some of them were using one loan to pay off another.

Around that time financial crisis and currency devaluation in Brazil created economic downturn in Bolivia and other South American countries. The Bolivian society was facing social unrest, with mass protests about the price of essential products such as water and electricity. The resulting recession affected the microentrepreneurs adversely. The staffers of MFIs had to spend more time chasing borrowers who were in default caused by unsustainable debt burden and a reduced demand for their product and businesses. These caused a backlash against consumer and microfinance lenders and paved the way for union organizers to create debtors’ association and demand for full debt forgiveness. The associations organized violent demonstration against MFIs and other financial institutions. They accused these institutions of using abusive and humiliating practices against the borrowers. The newly created association of microlenders, Asofin, was unable to stop the demonstration through the courts. The largest of the borrowers associations took over the office of the Superintendency of Banks and held more than 100 people as hostage. They carried dynamite and demanded forgiveness for debt incurred through micro and consumer lenders. Ultimately, a dialogue was held between the Superintendency of Banks, Asofin and the debtor associations and the microlenders agreed to debt relief on a case-by-case basis.

The debtors association faced its own crisis when it turned out that some of the associations were actually running a pyramid scheme, collecting debt payments from the borrowers and using them to make new loans and some others mishandled membership dues. Some of the leaders of the association were put in jail for their alleged crimes. However, after a few months the association was back in the scene. They petitioned to the President of Bolivia with renewed, albeit less harsh demands: extended grace periods, longer loan terms, and annual interest rates of 2 percent. However, many borrowers left the association and resolved the problem through dialogue with their respective institutions. Rhyne (2001) concluded the description of the episode with an ominous warning, “The Microfinance industry will have to live with the debtor associations, or at least the attitude they represent, for the foreseeable future” (P. 147).

There was another episode of protest in 2003 when a violent mob ransacked the offices of BansoSol. Rhyne (2011) describe the events thusly:

The protests were partly about microfinance, but they were also about bigger political issues. For one thing, the microfinance industry had recently participated in a rush to lend (provoked by the entry of consumer lenders into their market) that resulted in widespread over-indebtedness among clients. This fueled a protest movement centered on debt and directed against microlenders. By 2003 another motive had emerged: BancoSol was sometimes called “Goni’s Bank” because President Sánchez de Lozada, known as Goni, was among the original founders of Prodem and owned a small share of BancoSol. BancoSol was a surrogate for Goni. The looting reflected the broader social disorder across economic sectors that led to Goni’s fall and ultimately to the ascent of Evo Morales as Bolivia’s first Aymara president (P.2).

Pakistan 2008-2009

 In October of 2008, clients of the MFI Kashf Foundation in the central part of the Punjab province sought the help of local politicians in having their debt waived. The whole episode started when a female borrower who worked for a local politician received his support for relaxation of the terms of loan repayment. This prompted other borrowers to approach the same politician to support write-off their loans to Kashf. The politician gladly lent his support to gain cheap popularity. This triggered rumor of mass writes offs of loans by Kashf.

The rumor began as a story of the death of the Head of Kashf and that just before her death she waived all loans of the borrower. The rumor spread rapidly through the social network of the borrowers aided by mobile telephone (Chen, Rasmussen, and Reille, 2010). The borrowers, however, wanted a proof of loan write off before they stopped repayment. This allowed crooks to sell fake documents: copies of newspaper articles announcing the death of Kashf’s President and loan write –off, stay orders from local lawyers supporting withholding repayment of loan, and copies of letters written by local politicians encouraging borrowers not to repay (Burki, 2010). Some collected money from borrowers in return for the promise of access to influential politicians’ support of write off (Burki, 2010). Things got worse and in some cases the borrowers physically attacked the field workers. What began as a localized crisis in one area rapidly spread to the whole Punjab province and affected repayment rates of few other MFIs as well.

Nicaragua (2008-2010)

 The problem in Nicaragua started with the arrests of six people with overdue loans in the Municipality of Jalapa in June of 2008 as a result of the legal action of the MFI ProCredit. The family of the debtors blockaded the Panamerican Highway for 11 days protesting against the practices of the MFIs charging usurious rates. The movement known as “No Pago” or “I won’t pay” gained momentum with the explicit endorsement of President Ortega. Ortega stated, “You have done well protesting against the usurers, but rather than protesting on the roads, protest in front of the offices of the usurers and plant yourself outside their offices. Stand firm, we support you” (Cole and Kempner, 2011a). The movement had 10,000 members and in October 2008, it submitted the Moratorium Act to the Nicaraguan legislature that called for a three-year freeze on debts and a 16% cap on interest rates. In February of 2010, the legislature approved the Act that required the MFIs to renegotiate all loans to delinquent borrowers past due since June 30, 2010. The uncertainly and the increased riskiness of operation prompted a number of MFIs to close operations in the northern municipalities. The biggest casualty was the liquidation of BANEX, one of the largest MFIs in the country.

India (2006-2010)

Even though the passing of Ordinance by the AP government caused the current crisis in Indian Microfinance, there were earlier episodes of political interferences. In 2006, the District Collector of Krishna District-- administrator of the whole District--shut down the offices of leading MFIs in the area and asked the borrowers not to repay the loans. He alleged the MFIs were charging usurious interest rates and using coercive collection methods. The Reserve Bank of India intervened and stopped the offices from being closed for prolonged period. In return, the MFIs promised to reduce the interest rate and comply with a voluntary code of conduct. However, once the crisis died down, some MFIs raised the interest rate and the code of conduct was not fully implemented and in some cases was largely ignored (Wright and Sharma, 2010).

In 2009, the Anjuman Committee, a local Muslim organization issued a ‘fatwa’ against the MFIs in the town Kolar in state of Karnataka that banned all interactions between the MFIs and their Muslim majority clients. The ban followed the attempted suicide of a prominent member of the Muslim community in Kolar on 30 January 2009 (AKMi, 2010). The delinquency crisis spread amongst Muslim clients and vested interests in nearby town took advantage of the religious ban to organized repayment strikes. Wright and Sharma (2010) termed these episodes as dress rehearsals for the ultimate drama that unfolded full scale in Andhra Pradesh in 2010.

 In August and September of 2010 numbers[[3]](#footnote-3) of borrowers of MFIs had committed suicides due to debt burden allegedly caused by loans from these institutions. In early October, the debt driven death of Prabhakar, a fruit seller in Southern Andhra Pradesh, triggered a protests and attacks on several MFI offices (Mader, 2010). Supposedly in response to the reported suicides, on October 14, the AP government proposed an Ordinance that was passed into law within two months. As we will point out later, the AP government had other reasons to go after the MFIs. The Ordinance required the MFIs to register with the district authority and to collect repayments once a month at the Panchayat (Village Government) office. The MFIs were forbidden to issue new loans without the prior approval of the authority. The law, however, did not put a cap on interest rate. The Ordinance, even before becoming the law, effectively shut down the microfinance sector in Andhra Pradesh. Around the same time, the Reserve Bank of India appointed a Board Sub-Committee under the leadership of Mr. Malegam, a long time board member of the Bank to examine the crisis in Andhra and in India. Based on the recommendations of the Malegam Committee, the Government introduced legislation to the Parliament. The Microfinance Institutions (Development and Regulation) Bill 2012 is waiting for the approval of the parliamentary standing committee before being introduced to the full Parliament.

Bangladesh

The Bangladesh case is different from other crises surveyed so far. The current political interference directly affected only one institution, Grameen Bank, instead of the whole sector, though of course many other microfinance and civil society institutions took note of these developments. The removal of Professor Yunus is only the most recent episode of political interference in microfinance in Bangladesh. In 2004, the government arrested Qazi Faruque Ahmed, the founder of the NGO Proshika, and his deputy for alleged charge of misusing donor funds. The government was led by a coalition of Bangladesh Nationalist Party (BNP) and Jamaat—e—Islami, an Islamist political party. Proshika had one of largest microfinance programs in the country. In 2002, the government initiated an audit of Proshika’s finance and halted disbursement of $50 million of donor money. Even though the government denied any political motive behind the arrests, the consensus was that it was pay back for the alleged support for the opposition party, the Awami League, during the 2001 general election (Waldman, 2004). Qazi Faruque was the President of Association of Development Organization in Bangladesh (ADAB), an umbrella organization of NGOs. Other NGOs alleged that he was representing the political interest of Awami League (Karim, 2011).

Professor Yunus faced opposition from leftist politicians, religious leaders, journalist and the intelligentsia before. While a succession of Finance Minsters in the country tried to sabotage the operation of the bank in certain ways, overall the posture of the government to Grameen Bank until 2010 can fairly be termed “benign neglect” despite occasional public comments that were not supportive or helpful. The finance minister of the previous government used to derisively call Grameen Bank a *fakirnir bank* (bank for the beggars) and questioned whether Professor Yunus deserves the Nobel Prize. “What did microcredit do regarding life expectancy, women literacy and reserve of foreign exchange?” asked the Finance Minster in a public meeting (The Daily Star, 2006). Professor Yunus and the bank were able to withstand these charges because the rest of the government supported the mission of the bank. Hulme and Moore (2006) noted

With specific reference to the Grameen Bank, it has to be observed that it has been skillfully managed since inception so that it is both embedded in Bangladeshi society and able to leverage changes in that society. Professor Yunus has been able to use and build on his personal status, as a member of Bangladeshi elite with a PhD from the USA, to steer Grameen Bank around potential obstacles in the country’s political economy. While the country was under authoritarian rule, Yunus negotiated Grameen Bank’s progression to be a statutory organisation. This gave Grameen Bank the freedom to escape having to lend as part of a patronage system, to set its own interest rates and to be officially regulated in ways that did not constrain the institution. Subsequently, Grameen Bank has been able to avoid challenges from the country’s various democratic governments -- BNP, Awami and Coalition -- by careful management. This involves closely following politics, managing a set of elite relationships and a public image so that Grameen Bank is prominent but non-controversial and creating an image of being nonpolitical.

The latest trouble for Grameen and Professor Yunus started when a Norwegian television network aired a documentary titled “Caught in Micro Debt” in November 2010. The documentary was highly critical of various Grameen practices and was later discredited, but the government used press attention immediately following its airing to change its posture towards the Bank to one of open hostility. One of the more incendiary claims was that Grameen Bank improperly transferred Norwegian government aid meant for its own use to its sister organization Grameen Kalyan. The local media owned by supporters of the ruling party hyped up the charges and the allegations snowballed into a full frontal attack to get rid of Professor Yunus led by the Prime Minster of the country, Shiekh Hasina Wajed. The Prime Minister claimed, “"Micro-lenders make the people of this country their guinea pig. They are sucking blood from the poor in the name of poverty alleviation” (Financial Express, 2010). The 77-year-old Finance Minster alleged that Professor Yunus, who was 70 years old at the time, is too old to run the bank.

To put pressure on Professor Yunus, in January 2011, the government appointed Muzzammel Huq, a former subordinate of Yunus who had been forced out in a management shake-up many years earlier, as Chairman of the Board of Grameen Bank. On the same month, the government set-up a five member review committee to examine various legal and financial aspects of the bank such as its relationship with other sister organizations and how its interest rate compare with the rates of other MFIs in the country. The review was backed by a special audit of the bank by Bangladesh Bank, the central bank of the country. During this time, there were a number of frivolous lawsuits against Professor Yunus and Grameen Bank at various courts all over the country.

In early March of 2011, the Bangladesh Bank backed by the Finance Ministry informed in a letter that Prof Yunus holding of the post of managing director is in violation of its rules and asked the Board to take appropriate action against him. The Government handpicked Chairman fired Professor Yunus for noncompliance. Professor Yunus and the nine independent board members began a legal process to declare the letter and the action by the Chairman as invalid. In late March the High Court ruled against Professor Yunus and he appealed to the Supreme Court. In May, Professor Yunus lost his final appeal in the Supreme Court. On May 12, 2011 Professor Yunus resigned from his post as managing director of the bank after a leader of the employee association who supported him was abducted and tortured.

3. Unfolding of political interference

 In the previous section, we surveyed the various episodes of political interference in microfinance. Even though the timing and the countries are different, most of the incidents of political interference follow a common sequence.

1. In most cases, the political interference followed extraordinary growth fueled by the availability of cheap source of funds. In Pakistan and Nicaragua, the gross loan portfolio of the microfinance sector grew with a compound annual growth rate of 67 and 33 percent respectively during 2004-2008 (Chen et al. 2010). The source of such funds varied across countries. In India, the leading MFIs grew between 93 to 152 percent during 2007-2010 (Sinha, 2011). The Bolivian microfinance sector also grew rapidly because of the entry of consumer loan companies even though these were not really microfinance institutions.
2. These extraordinary growths were funded by commercial sources instead of funds from the donors. In Bangladesh, however, most of the growth was financed by savings and retained earnings, by Apex organization PKSF, and loans from local commercial banks. In Bolivia and Nicaragua, the funds came from foreign investment. One industry observer noted, “At the IDB’s annual FOROMIC conference in El Salvador in 2007, I knew there was a bubble as I watched investment funds competing to get face time with a number of Nicaraguan MFIs…I wondered why it made sense to lend to so many small MFIs in one country with 5 million people, 600,000 informal sector workers and 300,000 credit clients” (Magnoni, 2010). In India, the commercial banks provided funds to MFIs to scale up because this way they could increase the extent to which they meet the requirement to lend to the “priority sector.” SKS in India grew rapidly by virtue of the equity stake by a host of international and Indian investors. In Pakistan, the MFIs received funding from a national apex fund (Pakistan Poverty Alleviation Fund), a guarantee scheme developed by the Central Bank and DFID, the and domestic commercial banks (Chen et al. 2010)
3. The extra funding allowed the MFIs to reach more borrowers quickly, which was the stated reason for switching to the commercial sources instead of depending on the donors and charity. In Bolivia, Nicaragua, and India (SKS), the MFIs grew to maximize returns for the private equity investors. MFIs that did not receive equity investment also grew in the hope that their larger market share will entice outside investor. The attitude can be summarized by the comment of an MFI manager in the FOROMIC conference mentioned earlier, “Now I have access to credit, so why should I merge with someone else. I should focus on growing and increasing the value of my MFI, when I am big, I will be able to negotiate better terms if I get bought out” (Magnoini, 2010). In Bolivia, the MFIs were rushed to excessive lending to compete with consumer lenders (Rhyne, 2011).
4. The chase of rapid growth rate created perverse incentives for the MFIs. They focused more on increasing the number of borrowers and the size of the portfolio instead of the quality of relationship with borrowers. In their zeal to grow and be profitable, some MFIs disbursed credit without an adequate evaluation of the borrowers’ repayment capacity. Instead of competing by giving better price and service, MFIs poached clients from their competitors. The intense competition allowed the borrowers to take credit from multiple sources and in many cases it added to the debt burden for the borrowers. In India, “By the time the race for growth became the norm around 2007, MFI loan officers had abandoned all concern for group processes and single source lending; the situation was reached where, in the extreme, an MFI loan officer waited outside a group meeting organized by another MFI in order to offer the same group another loan or to collect from the same group” (Sinha, 2011, p.9). In Bolivia, staff of Pro Mujer would find their delinquent clients standing in the queues of other microlenders (Rhyne, 2001). In Pakistan, MFIs followed others into local markets to lend to the same borrower groups to free ride on the works of the early entrants (Chen et at. 2010). In Nicaragua, ““Microentrepreneurs were being offered Mother’s Day loans, Christmas loans, loans for beginning of school, housing loans, home improvement loans, educational loans, motorcycle loans” (Magnoni, 2010).
5. To achieve disbursement targets, MFIs instituted compensation package that encouraged loan officers to disburse loan to borrowers who already have loans or seek new borrowers that does not have the capacity to repay. In contrast to the founding principle of choosing a client to help them get out of poverty, staffers in commercial MFIs treated them as part of “sales quota.” In Bolivia, to achieve the growth target, MFIs introduced a salary system for loan office that would pay a minimum salary plus a commission based on number of loan processed (Fiedler et al., 2002). In Pakistan, MFIs depended on commission agents to find new clients. The commission agents are generally a group leader or a local activist who in exchange for a commission would get a loan for a borrower. The MFIs depended on these agents to get them new clients to grow rapidly and in the process the staffers delegated client selection to these agents who did not follow the proper procedure to select clients. In some cases, the group leaders employed as commission agents used the group members as a proxy to collect bigger loan for themselves. These asymmetric relationships also changed the dynamics of client selection, loan disbursement of the MFIs; the staffers were dependent on these agents for client selection and collection of repayments (Burki, 2009). In India, the loan officers of MFIs appointed agents to form groups and disburse credits to meet the sales target and receive bonuses. In some case, MFIs employed agents who were not full time employee to reduce costs. (Srinivasan, 2009). SKS ran a massive sale drive known as “Incentive Galore” prior filing for IPO backed by a generous incentive system for loan officers. The staff won prizes such as televisions, refrigerators, gold coins, washing machine, and DVDs for meeting the sales quota. These prizes were extremely generous and in many cases were close to 10 times their average monthly salary (Kinetz, 2012).
6. The rapid expansion of credit without due diligence led, predictably, to over-indebtedness of borrowers in some regions of certain countries. When borrowers failed to repay the loans, some loans officers felt pressure to start using coercion and repression to collect repayments, sometimes to preserve their salary and bonuses and to meet the quota. They started increasingly going to the borrowers’ houses to collect the loans instead of in public meeting – which many had done before in cases of default but now, with more clients missing payments, it became a more frequent occurrence. The SKS employees had “verbally harassed over-indebted borrower, forced them to pawn valuable items, incite other borrowers to humiliate them and orchestrated sit-ins outside their homes to publicly shame them” (Kinetz, 2012). In India, such techniques are alleged to have caused the suicide of the borrowers and the Associated Press report implicated SKS employees to at least seven of the deaths (Kinetz, 2012). In Nicaragua, the problem started as a result of MFI ProCredit’s legal action against six defaulters. In Bolivia, over-indebtedness peaked just as its economy faced a recession
7. In two of the cases, in India and Nicaragua, the political interference was partially motivated by the attempts to promote government run microfinance program. In India, the government run microfinance program followed the Self Help Group (SHG) model. The groups are mainly organized by the NGO and they act as a liaison between the banks and the groups. The banks give loans to the group consisting of 10-20 members. The group distributes the loans to its members and is responsible for repaying the bank loan, sometimes directly to the bank, sometimes through the NGOs that promotes the groups. The State of Andhra Pradesh was among the first to adopt the SHG model and scale it up to provide financial services to the poor. Its program is run by Society for Eradication of Rural Poverty and its microfinance business. The now famous AP Microfinance Ordinance excluded the SHG from its purview and openly declared in the Preamble of the Ordinance that its goal is to protect “the interests of SHGS, by regulating the money lending transactions by the money lending MFIs” (Government of Andhra Pradesh, 2010). Field level research and analysis of aggregate data suggest that SHG lending has contributed more to the over-indebtedness of the borrowers (Johnson and Meka, 2010 and M -CRIL, 2011). In Nicaragua, the opponents of the *No Pago* movement suspect that its real objective is to undermine MFIs so that poor farmers get credit through Alba-Caruna, a government sponsored credit union. (Pachio, 2009).

As mentioned earlier, the political interference in Bangladesh does not resemble the sequence of other cases where the political interference came about as a result of alleged repression of indebted borrowers who were duped into taking multiple loans by loan officers trying to meet the sales quota and MFIs trying to grow big to look attractive to potential suitors and investors. Bangladesh has one of the highest penetrations of microfinance in the world. But unlike other cases, the expansion was not fuelled by commercial funds. There are allegations of multiple borrowings and even harassment of borrowers (Karim, 2011). These incidences, however, have not gotten out of hand to allow politicians to meddle. The political interference in Bangladesh was directed at Professor Yunus and Grameen Bank, instead of the whole industry as in other countries. The only case that comes close to Bangladesh is the government’s hostility towards BancoSol because a political opponent, a former President founded it (Rhyne, 2011).

There were number of theories as to why the government and especially the Prime Minister took such an action. The consensus explanation is that the Prime Minister considers Professor Yunus to be a political threat. The controversial Norwegian documentary alleging illegal transfer of donor money allowed the Prime Minister and the ruling party to coalesce long simmering criticisms of Grameen Bank and Professor Yunus by a section of the country’s intelligentsia, bureaucrats, and the vernacular press, to get rid of a potential rival once and for all. A commentator has labeled the episode as “a confederacy of dunces”: Jonathan Swift noted that the sign of a true genius is that all the dunces are in confederacy against him (Sobhan, 2011). All indications are that Professor Yunus’s declaration to form a political party in 2007 was the cardinal sin. The following news report from BBC (Lawson, 2011) captures the essence of the issue.

It would be no exaggeration to say that in 2007 Prof Yunus was revered in Bangladesh for winning the Nobel prize. He had, up until then, mostly stayed clear of politics, apart from occasionally joining aid agencies and non-governmental organisations to call for better governance in his home country.

In January of that year he was reportedly approached by the military to head a caretaker government, with a view to becoming the new prime minister, and so bring an end to what it saw as a damaging cycle of poorly-performing governments either led by the Bangladesh Nationalist Party or the Awami League.

He later recommended the former head of the Bangladeshi central bank Fakhruddin Ahmed for the job.

Soon afterwards Prof Yunus decided to form his own political party - in a move which even his most ardent supporters have described as a huge miscalculation.

His critics denounced him. He soon realised for himself it was a bad idea when the small support base he had for his party evaporated within hours. The move into politics was rapidly aborted, but it came too late to pacify some of his enemies.

Prime Minister Sheikh Hasina has never forgiven him. The announcement came just as the military began a crackdown on political parties, arresting dozens of top leaders on charges of corruption. Sheikh Hasina herself would be put under arrest a few months later.

She saw Prof Yunus's move as a behind-the-scenes and shabby deal to remove her from politics. It was a charge he denied - arguing that he could not abandon his country in what looked like its hour of need.

Other theories suggest that his “other sins included his accepting a Nobel peace prize that Sheikh Hasina felt should have been hers, failing to commiserate after an assassination attempt on her in 2004, and being ungrateful for the help she gave Grameen. In brief Mr. Yunus was resented for his high international profile, which threatened to eclipse the sacred memory of Sheikh Hasina’s father, Sheikh Mujibur Rahman, who led Bangladesh to independence” (The Economist a, 2011). Professsor Yunus wanted to meet the Prime Minster to resolve any misunderstanding, but did not get an appointment .The WikiLeak cables corroborates the reasons for pushing out Professor Yunus mentioned above (The Daily Star, 2011).

4. The aftermath of political interference

 We have described the sequence of events that led to the crisis and the unfolding of the crisis and how it spread. The aftermath of the crisis also followed sequences that were similar across countries.

1. In all cases, the defaults shoot up after the crisis. In cases of organized protests, clients stop paying the MFIs was part of the strategy of the organizers to force the regulators and MFIs to forgive loans and reduce debt burden of the borrowers. In case of direct political interference as in Andhra Pradesh, the Ordinance changed the repayment schedule—monthly instead of weekly—and collection points—in the meetings of village council instead of in group meetings. This made is impossible for the MFIs to collect repayments. Moreover, the borrowers interpreted the unspoken message of the Ordinance was that MFIs would not be allowed to operate and hence there was no need to repay (M-CRIL, 2011). In some cases the borrowers stopped repayment because of the increased debt burden.

In most cases, the default was intentional. Once there was an organized collective default, it became contagious. Even borrowers, who could repay, did not want to repay because the other were not repaying a phenomenon known as “borrowers runs” (Bond and Rai, 2008).

Burki (2009) outlines how the “borrowers run” unfolded in Pakistan:

It needs to be noted here that the delinquency crisis did not hit the affected MFP (Micro Finance Program; added for clarification) because the clients were disgruntled by MFP-X (X is actually Kashf Foundation). In fact both delinquent and repaying borrowers were unanimous in their view that MFP-X offered them the easier service in terms of quickest disbursement of loan, larger loan size, and multiple loan products. Furthermore, nowhere did any borrower mention high interest rates as justification for inability to repay: instead even the delinquent borrowers admitted that microfinance provided them an option other than money lenders for accessing loans that their family and friends cannot provide. The key reason given by most delinquent borrowers for not repaying was that “no one else was repaying” (Burki, P.9).

The group lending model used by MFIs also increased the defaults. Since the whole group is liable for each other’s loans, group members in good standing did not have any incentive to pay as they were branded as defaulters along with other members in the group. Besides, MFI lending rules did not permit loan officers to consider their cases individually (AKMi, 2010). In Nicaragua, the draft usury law encouraged borrowers to delay payment unit the enactment of the law (Cole et al. 2011). In Bolivia, even clients who were not member of the debtor associations stopped repayment in the hope of benefiting from the probable success of debtors associations with the exception of NGOs (Fiedler et al. 2002). This “borrowers run” was contagious. Even though the organized delinquency was directed at one or few MFIs and began in one part of the country, it quickly affected other MFIs in the area as well the rest of the country.

However, Marcon and Mosley (2006) and Dunford (2013) point out that NGOs ProMujer and CRECER did not face a borrowers run in the face of crisis. Marconi and Mosley (2006) attribute this exception to the rule to a number of factors: smaller average loan size that prevented the clients from putting pressure for loan forgiveness; the mostly female clientele that is synonymous with high repayment rate; the use of ‘village banking’ methodology that offers emergency loans funded internally via a surcharge on interest rates paid by all members and the use of these loans to manage debt; and the use of an integrated model that bundled credit with training, health services, education on legal and political rights. All these factors created an environment of intense loyalty to the institution so much so that even in the face of crisis, the clients repaid loans from these institutions first (Marconi and Mosley, 2006) and did not join the revolt (Dunford, 2013).

In Nicaragua, the delinquency affected all major NGOs. In India, the default spread to the adjacent states and because MFIs had to divert capital from these states to shore up AP portfolio, the value of the loan portfolio decreased as well (Legatum Ventures, 2012).

b) In every instance the number of borrowers served either declined or the rate of growth slowed considerably. In Bolivia, from 1998 to 2001, the number of clients decreased by 18 percent. The decline was in response to reduction in demand for loans as well as reduction in disbursement by the MFIs in response to the crisis. (Fiedler et al. 2002). The total number of clients for BancoSol and Prodem decreased from 129,000 to 113,000 in 1999, a decrease of 10 percent of clients (Rhyne 2001). In Nicaragua, the number of clients’ served decreased from 324,000 before the crisis to 225,000 in January 2011 (Center for Financial Inclusion Blog a, 2011). In Nicaragua, the microcredit market contracted by half between 2008-2010. BANEX, the largest MFI in Nicaragua went bankrupt and ProCredit, the second largest MFIs in the country lost almost 75 percent of its clients by the end of 2010 (Magnoni, 2011). In India, MFIs lost 1.8 million clients in Andhra Pradesh between March and December of 2011 (Legatum Ventures, 2012). In Pakistan, total number of clients fell from 2 million to 1.8 million during 2008-2010 (Zafar, 2012).

c) Facing large scale defaults, MFIs were forced to reschedule loans. MFIs usually resist rescheduling because it undermines the repayment culture developed over a long period through hard work. In Bolivia, the Superintendency granted a one-time amnesty on rescheduling for several months. Under the standard procedure, MFIs had to set aside 20 percent of the value of the rescheduled loans as a bad debt reserve. Under the amnesty, MFIs did not have to make provisions for the rescheduled loans. BancoSol and Caja Los Andes rescheduled $6 million and $1 million in 1999 (Rhyne, 2001). In Nicaragua, the leaders of the “No Pago” lobbied the National Assembly to pass a Moratorium Law. The law would have forced the MFIs to renegotiate loans to the borrowers on easier terms. In India, Micro-finance Institutions Network (MFIN), an organization representing non-banking financial companies (NBFCs) offered a one-time settlement to reduce the repayment burden of the borrowers in AP in return for allowing the MFIs to issue fresh loans in the state. The package included loan restructuring, interest rate reduction, and interest free extension of loan term to 48 months. The AP government did not respond to the proposal that would have cost the MFIs over R 1,600 crore Rupees ($355 million) (Mahalakshmi, 2012).

d) The declining quality of loans forced the MFIs to write off loans. In Bolivia, an index of portfolio covered by provisions increased from 30 percent in 1998 to over 160 for the year 2000. For consumer credit companies, loan loss provision reached 70% for 2000 (Fiedler et al. 2002). The Nicaraguan MFIs had to write off a significant part of their portfolios that dropped from $420 million in 2008 to $170 at the beginning of the year 2011 (Center for Financial Inclusion Blog, January 24, 2011). MFIs in India have increased the loan write-offs. Everyone expects that 70-90 percent of loan portfolios in AP that will amount to 19 to 24 percent of the entire sector’s portfolio will be eventually written off (Legatum Ventures, 2012). The Reserve Bank of India wants MFIs to make 100 percent provisions on overdue loans for 180 days or over by April 1, 2013. The MFIs have expressed their inability to meet even this extended deadline and the RBI declined their request. Instead, the RBI imposed the condition that for the MFIs to recast their loan second time, their banks will have to provide 15% of the loan amount as provision.

e) After the crisis, MFIs faced liquidity problems. Some of it was caused by the need to write off loans and the increased defaults. The major reason for the liquidity crisis is the drying up of additional funds for on-lending. In India, the major source of credit was the commercial banks. Spooked by the crisis, the banks reduced lending to MFIs. The MFIs had to obtain scarce funds under stringent conditions: shorter terms and higher interest rates. On average, the banks are now offering loans for 24 months with interest rate as high as 15 percent compared to 37 months and interest rate of 12.4% prior to the AP Ordinance. The total amount lent to the sector in 2012 was $835 million, less than a third of lending in 2011(Legatum Ventures, 2012). The drying up of lending by banks affected MFIs operations in other states. In Nicaragua, MFIs needed to recapitalize their institutions. BANEX, the largest MFI in the country needed an injection of $3 million into the bank that was updated to 4.5 million because of higher than expected default rate (Cole et al. a 2011). Even the proposed injection of new capital was not enough. The Bank Supervisor liquidated BANEX on August 2010, making it the first and largest bankruptcies in the microfinance industry (Cole et al. 2011 b). A Belgium based investment fund, Incofin, did not renew its investment of $5 million into the country (Center for Financial Inclusion Blog, March 23,2010).

f) The MFIs in crisis countries had to restructure their operations to survive. As part of the weeding out process, MFIs in Bolivia and Nicaragua closed branches in areas facing large-scale defaults. In India, eight MFIs with large exposure in AP, under the direction of the Reserve Bank have completed Corporate Debt Restructuring (CDR). As part of the restructuring, the creditors banks agreed to turn the loan into equity and the institutions had to inject fresh funds. Over 60 percent of the creditors by number and over 75 percent of lenders by value have to approve a restructuring package (Chakraborty, 2012).

 One of the India’s oldest MFIs, BASIX, was on the verge of collapse despite slashing staff almost by half (Unnikrishnan, 2012b). However, recently it has signed a CDR worth 677 crore rupees ($124 million) with 19 lenders led by the Small Industries Development Bank of India (Sidbi). Under the deal, banks will convert 500 crore ($91 million) or more than 75% of loan to equity. BASIX has to bring in 25 core rupees ($4.5 million) in equity, and the remaining 152 crore rupees loan will have to be repaid in seven years. The CDR requires BASIX to make operating profit in fiscal year 2012-13 and to do that it has to recover at least 100 crore rupees ($27.77 million) of overdue loans and raise extra revenue from its other business ventures such as insurance and IT kiosks. Trident, Share, Asmitha, Spandana and Future Finacial Services are the others MFIs that had their loan recast through CDR (Unnikrishnan, 2012b). SKS did not participate in loan restructuring. Instead, it raised funds through a combination of term loans, sale of securitized loans and qualified institutional placement and preferential allotment of shares (Chakraborty, 2014)

g) Unsurprisingly, the increased defaults, loan loss provisions, lack of funds for making new loans, reduced the profitability of MFIs. In Bolivia, the return on assets (ROA)—a measure of how profitable a company’s assets is in generating income--- dipped after the crisis for all institutions: regulated and unregulated MFIs, credit unions, and consumer credit companies. The ROA for consumer credit companies turned negative (Fiedler et al. 2002). The return on equity (ROE), another measure of a company’s profitability, also decreased in the aftermath of the crisis. The industry leader, BancoSol’s ROE decreased from 29 percent in 1998 to 9 percent in 1999, while Fassil’s decreased from 12 percent to 1 percent during the same time period (Rhyne, 2001). In India, the weighted average return on assets declined to 1.9 percent in 2011 compared to 4.4 percent in 2010. Similarly, the return to equity fell to 9.5 percent from 26 percent in 2010 (Shyamsukha, 2011).

h). In every episode, the crisis accompanied the governments proposing tougher regulations of MFIs. A common response has been the proposals to cap the interest rate. In Nicaragua, the “No Pago” movement was able to get the National Assembly to institute an interest cap of 16 percent. MFIs were able to persuade the President not to sign the bill into law. Similarly, in Bolivia, through dialogue and lobbying with the government, MFIs were able to avoid interest rate cap. The industry has promised to work toward cutting the interest rate by half to a single digit (Rhyne, 2010)

In India, the Reserve Bank of India announced an interest cap of 26 percent on microloan up to 50,000 rupees ($1,124). This is two-percentage point higher than the recommendation of Malegam Committee. The regulation further set the margin cap—the difference between the amount charged to the borrower and the cost of funds to the MFI—at 12 percent.[[4]](#footnote-4) An analysis by MIX suggests that Indian MFIs are well within the suggested interest rate cap with the margin cap exceeding the limit set by RBI occasionally (Samarapally and Gaul, 2011). Some worry that the interest cap will be harmful for small MFIs as their cost of operation is higher, and will result in the exclusion of clients in remote areas. In Bangladesh, the government’s Microcredit Regulatory Authority capped the interest rate at 27 percent in November 2010, before the government’s intervention in Grameen Bank.

 In Bolivia, the Superintendency required the MFIs to ask for tangible collateral against the loans. A new law established a registry of movable goods that the clients can use as a collateral against the loans (Rhyne, 2001). In Bangladesh, the commission set up to review the operation of Grameen Bank and its sister organization conceded that its interest rate is the lowest among all MFIs in Bangladesh even though the initial salvo against the bank is that it is “sucking the blood of the poor” by charging usurious interest rate.

The political interference in Bangladesh and in India is of recent vintage. In other words, the dust has not settled. In Bangladesh, the government has yet to form a search committee to replace Professor Yunus. After the release of the controversial Norwegian documentary that alleged that Grameen Bank illegally transferred donor money to create Grameen Kalayn, a sister organization, the government formed a 10 member review committee on January 10, 2011 to investigate the allegation. In addition, the review committee examined the relationship between the bank and its sister organizations, its interest rate policy and how it is regulated. Despite being successful in removing Professor Yunus, the government is still running a campaign to malign him. In October of 2011, without any evidence the Prime Minister accused Professor Yunus of lobbying the World Bank not to fund the bridge over river Padma. Now the government wants to control firms in Grameen network worth an estimated $1.6 billion (The Economist b, 2012). During her visit to Bangladesh in May 2012, US Secretary of State Hilary Clinton publicly expressed her support for Professor Yunus and asked the government to ensure the independence of Grameen Bank. The government responded by setting up another Commission to review the entire operation of Grameen Bank and its network of companies. The Commission has the option to even review the ownership structure of the bank. Many believe that this is the government way of grabbing the ownership of the bank and highly profitable and valuable venture Grameen Telecom (The Economist b, 2012). The government has already amended the Grameen Bank Ordinance to allow the government-appointed Chairman to hire and fire the Managing Director regardless of the will of the Board of Directors.

In 1986, government ownership was set at 25% with the remaining owned by the borrower. Such structure gave the government 3 seats in the board. The government, however, did not inject any new money since 1986, whereas the borrowers contributed more equity through share purchases. As a result, they now own 97% of the paid-up capital of the bank, and the government the remaining 3%. So, any review of the ownership structure of the bank should lead to reduce seats for the government on the board. Instead, the commission is likely to explore how to increase government’s share as well as how the board members are selected, and provide recommendation on the qualification requirements to be a board member.

The interim report of the Commission suggested that the election rules for board membership in the bank is *ultra vires* or not in line with the Ordinance, and it recommended that the elected board members should quit immediately. The Commission recommended that the government should choose the board members with certain academic qualification and rank (Byron and Rahman, 2013). Further, the commission recommends that the government become majority shareholder of the bank and that the bank should be broken up into 19 zonal banks. The final report of the commission has not been published yet. In the meantime, the government has passed Grameen Bank Act 2013 to replace Grameen Bank Ordinance 1983. The new law effectively nationalized the bank: it will increase government’s power in running the bank. The new law raises the government’s stake in the bank to 25 percent and empowers it to appoint three directors on its 12-member board including the Chairman and make rules for running any aspect of the bank. The law also allows the Board to hold meeting with only three members. In other the government appointed Chairman, Board members and the Managing Director can bypass the rest of the Board that represent the shareholder-owner of the bank.

In India, the Micro Finance Institutions (Development and Regulation) Bill, 2012 is currently waiting the approval of the Indian Parliament makes the Reserve Bank of India the regulator of the microfinance sector. The MFIs will have to register with RBI and the central bank will be able to set the interest rate and margin, the kinds of recovery methods to be used, the processing fees, and the tenure and ceiling of the loan. The Bill proposes setting up microfinance development council at Central and State level. These councils consisting of representatives from government institutions and independent members and will advise the central and state government on formulating policies for the sector. The state council will monitor over-indebtedness of the borrowers and report on unfair recovery methods used by the MFIs. Further, the Bill entrusted the RBI to create a microfinance development fund for funding the MFIs. The fund will be partly funded by the central government.

According to the Bill, MFIs registered with RBI will not be treated as moneylenders. This provision, if it becomes law, will keep the MFIs out of the purview of AP Act, 2010. The AP government and the central rural development minister are opposed to the Bill in its current form. If and when the Bill becomes a law, it will make the operations of the MFIs transparent and add clarity that might make the sector stronger in the future.

In Bangladesh, the political interference has only affected Grameen Bank and has not spilled over to the rest of the industry in any significant way yet. The worry that Grameen Bank’s savers would withdraw savings in a large scale from the bank if government succeeded in removing Professor Yunus did not materialize. The default rate has increased somewhat compared to the historical average likely as a result of the destabilizing impact of the government’s campaign. However, it is too early to conclude how much the operation of the bank will be affected. As mentioned before, the government has yet to form a search committee to replace Professor Yunus as Managing Director. If the government increased its ownership in the bank by fiat, replaced the board members elected by the members, and increased its share of board membership, hired an MD without a close tie to the bank and the sector in the future, the borrowers might vote with their feet and take their business elsewhere. If it happens, it will likely be a slow process because many borrowers are locked in with contractual savings and have long term loans such as education loan and housing from the bank. Unless these contracts expire, the borrowers would be unable to leave the bank.

In Nicaragua, the industry appears to have survived the crisis. The government and the MFIs were able to resist the pressure of the “No Pago” movement. The leaders of the protest movement have allowed their members to renegotiate their loans with the MFIs individually. The President has agreed to take over $25 million owed to 67 financial institutions including MFIs. The debtors have agreed to repay the amount over a 10-year period to the state (Center for Financial Inclusion Blog, 2011).

Bolivia faced the crisis more than a decade ago and the industry has learned to live “among the populist.” They did this in three main ways (Rhyne, 2011): improving their ability to judge repayment capacity by revising lending methods and upgrading the credit bureau, develop new products to satisfy the diverse financial needs of the clients, and getting better organized to speak with a common voice to policy makers. The “populists” have also adjusted. They have realized that MFIs serves the very people the government represent. The government is still pushing the MFIs to pay the savers more and lower the lending rates. Even though the interest rates in Bolivia is below 18 percent, lowest in Latin America, the Morales government is pushing for single digits. The bank regulators are tougher on the MFIs, but believe that they are better than the banks (Rhyne, 2011).

5. Postscript to the crises

It would not be far-fetched to blame too rapid commercialization resulting in noticeable violations of societal norms for the unhelpful attention from the opportunistic politicians. The argument in favor of commercialization was that “Half the World is Unbanked”[[5]](#footnote-5) and the methods used by Grameen Bank and others: grants, subsidized donor money, borrowing from the commercial banks is passé. The old method of slow and cautious scaling up of financial services does not have a sense of urgency and to provide these services to the unbanked of the world, MFIs has to invite “smart money” and need to be rescued “from the ghetto of high-minded, donor supported initiatives.” There were claims that private investor could fund $30 billion per year instead of current funding of $4 billion and in the process serve over one billion rather than 133 million through commercialization (Cull et al. 2009). The supporters of commercialization conceded that these organizations may charge higher interest rate to entice outside money, but in return, they would make financial services available to millions who would have been without these services had it not for the infusion of funds by private investors. Further, they argued that by scaling up, for-profit organizations will be able to reduce costs and pass on the savings as lower interest rate to the borrowers.

Vikram Akula (2011) narrates a touching story of a woman who came from quite a distance and wanted him to start a microfinance program in her village. He told her that he couldn’t start a program because he does not have enough money to start a new program in her village. Exasperated, the women asked, “Am I not poor too?” Do I not deserve a chance to get my family out of poverty?” Akula says that that particular incident changed his life. He narrates,

I believed that if I could, microfinance could expand to serve tens of millions-even hundreds of millions—more people than it was serving…I hit on a simple but powerful ides: why not make the practice of microfinance operate more like a business...If a microfinance institution could be run as a profitable enterprise, it could attract investment from private investors—those who expected a return. Since private investors are a virtually unlimited pool—after all, everybody wants a return on their investments—there would be no limit on the amount of funding available. And inviting private investors would have another benefit: once we had the equity provided by their investments, commercial banks would be willing to lend us even more money, giving us a vastly bigger pool of capital. The only catch was that interest rates would have to be fair for borrowers but high enough to not only cover costs but provide investors a healthy return (P.52-53).

 Unfortunately, as we have described adequately, this is not how the story ended. Instead of providing microfinance to millions, the number of borrowers served has decreased in India, Bolivia, and Nicaragua due to political interference bought about by commercialized microfinance. The crises even affected the global figure. According to Microcredit Summit Campaign Report 2013, the total number of clients served decreased from 205 million in 2010 to 195 million in 2011. The corresponding figures for the poorest clients dropped from 138 million to 125 million for the same period (Reed, 2013). Instead of increased access to financial services, the borrowers are left with increased debt burdens. In India some had to pay the ultimate price for this version of microfinance with their lives (Kinetz, 2012). In an ironic twist, many of the borrowers are going back to the moneylenders for financial services even though the founding mission of microfinance was to save the poor from the clutches of moneylenders.

Akula paid a personal price for his vision. Even though the SKS IPO made him a wealthy man, he was pushed out of SKS, the company he founded to realize his vision.[[6]](#footnote-6) A recent attempt to put him back in the Board of SKS failed. To survive, SKS moved its headquarters to Mumbai out of Andhra, changed its business model by becoming a multiproduct rural service company selling gold backed loans and insurance (Bandyopadhyay, 2013). Instead of serving the woman in purple sari mentioned in the story above, SKS is now serving women who wear *Banarasi* Saris[[7]](#footnote-7) and gold jewelry.

BancoSol, the flag bearer of commercialized microfinance in Bolivia introduced housing loans and other kinds of loan aimed at better off and raised the ceiling on individual loans from $30,000 to $100,000. The original founder of BancoSol, Pancho Otero, had a more honorable exit before the crisis. He left BancoSol to make room for a smart money manager. Whenever private equity investors took a seat in the board, they crowded out the founders and social investors and their only objective was for the institution to grow so that they can make their quick return and exit. The flagship MFI in Nicargua, BANEX, went bankrupt. Before the bankruptcy, the local shareholders fought with international shareholders on how to recapitalize the bank to meet the capital adequacy ratio and avoid bankruptcy. Just before the declaration of bankruptcy, the shareholders pushed out, Gabriel Solorzano, who founded BANEX as an NGO in 1996 and built it into the largest MFI in Nicaragua (Cole et al. 2011a and 2011 b).

Even though the move to rapid commercialization of microfinance was well intentioned, the evidence so far is that the unintended consequences of such move are reducing the access to finance for the poor and making the industry vulnerable to capricious regulation and unhelpful political action. We are not suggesting that MFIs should not be profit. Unfortunately in their zeal to commercialize rapidly, they are more interested in profiteering instead of content with merely making profit. Commercialization has enriched some of the managers and directors of the small number of MFIs that went public. The fact that outside equity investors and even some founders enriched themselves via commercialization of MFIs is not a big surprise. However, in some markets such as India, the media and the general public found enriching oneself on the back of the poor by charging them above market rates troubling. This created an opportunity for politicians to intervene in the name of saving the poor.

The supporters’ of commercialization might retort by saying that it is not the fault of commercialization per se; it is how commercialization was implemented. The congenital problem with rapid commercialization is that it is more interested in “valuation” instead of “value creation,” concerned with the growth of the institutions instead of the “growth of the livelihood and economic status of the clients”, and turn the double bottom line institutions—sustainable institutions supplying credit to the poor—into a single bottom line institutions concentrating on making profit only. For commercialization to be feasible, scaling up of microfinance is not enough; the institutions has to give larger loans to existing customers. Morduch et at. (2009) points out “This is where the action is”(P. 183). And larger loan is often synonymous with better off customers; not the ideal intended clients of the microfinance industry if it intends to combat poverty directly rather than indirectly through “trickle down” approaches.

We have already seen what happens when MFIs give larger loans to existing customer without considering repayment capacity. Alok Prasad, the CEO of MFIN, uses an apt metaphor to describe the dangers of commercial microfinance: he says it is like “going 200 kilometers per hour in a Ferrari down Indian country roads.” You might get the adrenaline rush and air in the hair, but most likely you will endanger passengers, pedestrians and other cars on the road as you try to drive around the hairpin turns (McKee and Prashad, 2011). In their survey of the clash between profit-driven and social business model of microfinance, Morduch et al. (2009) conclude, “We do not find that the typical commercial banks replicate the outreach of the typical nonprofits, and the data thus suggest strong reservations about embracing commercialization as the single way for the future” (P. 172).

Morduch et al. (2009) point out that there is limited evidence that scaling up lowers costs. The celebrated claim of passing on cost savings to borrowers in the form of lower interest rates via scaling up has happened rarely. In Bolivia, MFIs lowered the interest rate. Keen observers of Bolivian microfinance industry attribute this decline to a combination of increased competition and an strategic move by the industry to ward off onerous interest rate cap that might result in the future. Some of the Indian MFIs lowered the interest rate in AP after the government passed the Ordinance in response to political pressure.

The above analysis is not to absolve the politicians for their role in creating the crises. The politicians and a section of elites have a paternalistic attitude about credit for the poor. They believe that the poor cannot be trusted to use credit properly and credit is something that only the rich and educated can handle; blogger and economist Alex Tabarrok label this as credit snobbery (The Economist, 2007). The politicians feel that as the legitimate guardian of the poor, it is their responsibility to protect them from the lure of credit and indebtedness or decide the manner in which it is actually delivered to them. Their preferred mode of credit delivery is through subsidized government run programs that they can control or to offer them handouts. So, whenever they feel threatened that private creditors might undermine their role as the custodian of the poor, they react in various manners documented in the paper. In the Punjab province of Pakistan, a local politician termed all microfinance practitioners as *kafir* (infidels) and promoter of capitalism (Zafar, 2012)

Private equity investors especially the ones from outside the country were partly responsible for the crises. Their investments, even though well intentioned, allowed the MFIs to grow rapidly at the cost of pushing debt on unsuspecting borrowers. The equity investors only looked at the prospect of profitability as measured by the volume of the portfolio and number of borrowers in deciding where to invest. They did not realize that the huge scale was achieved by dubious means such as hiring external agents and giving incentives to field staff to meet sales quota.

The MFIs themselves were responsible to draw the wrath of the politicians. In Indian case, there were enough signs of trouble as captured by the title of a note by MicroSave India: “Three Dress Rehearsals … and then the Full Drama.” In every episode discussed, there were allegations that MFIs charge high interest rate[[8]](#footnote-8) -- which is ironic since in India, Bolivia and Bangladesh, the microfinance interest rates are amongst the lowest in the world and have been for some time. The typical response of MFIs are that because of the nature of the business—providing small loans to large number of people—the higher interest rate represents the cost of doing business in a challenging terrain. The politicians respond by suggesting that high interest is the means used by MFIs to exploit (sucking the blood) the poor and enrich themselves. There is not a single study by any MFIs that explain in an open and transparent way the break down of the cost of doing business. In other words, MFIs have not been able to convince the politicians and the general public as to why their interest rate is higher than the rate charged by the commercial banks.

There is also allegation that MFIs use hidden charges, when included, will make their effective interest rate higher than the reported rate. Since their salary depended on loan collection, loan officers of MFIs used coercive techniques and treated the clients with disrespect. This allowed the borrowers to seek the help of local politicians.

There are allegations of MFIs using coercive techniques to collect timely repayment. The network of MFIs needs to develop a code of conduct for their members and impose penalties for the ones who violate such norms. In Krishna District in AP in 2006, in response to the shutting down of their operation by the District Collector, the MFIs promised to reduce interest rates and introduced a code of conduct. Once the crisis subsided, the MFIs did not follow through with their promise (Wright and Sharma, 2010). The MFIs found out how expensive this move was to their bottom line during the full-blown crisis in 2010.

Conclusion

In this paper we examined the sequence, causes and consequences of political interference in microfinance in several countries. It is unquestionable that there are millions of people that need access to finance. The important question is what is the best way to provide finance to the unbanked without harming them and leaving them in debt and tattered lives. The challenge moving forward is how to combine commercialization with responsible finance and make commercially funded microfinance “politics proof” and “client friendly”. One suggestion that has been floated is to cap the return on assets (ROA) of for-profit MFIs. Another has been to establish a “Seal of Excellence” that defines standards for MFI pursuing a true double- bottom line agenda.

 The way the episodes of political interference in microfinance unfolded and their consequences suggest lessons for everyone involved on how to prevent and reduce the political risks. Political risks are hard to anticipate and manage as they depend on the personal choice of politicians, the ruling party, or the regulators who may respond to jawboning by the politicians. And many of the interference are not rational.

The networks of MFIs should sign up with MicroFinance Transparency (MFT), an international NGO that provides estimates of the actual interest rate paid by the borrowers of MFIs. MFIs that provide data and allow MFT to report the results achieve its Seal of Transparency. MFIN India has signed a partnership with MFT to address microloan pricing transparency in India. Under the partnership, MFT will collect and publish comparable data on interest rates and fees charged to microfinance clients in India. The networks of MFIs should engage in dialogues with policymakers, regulators, and journalists, and show them how the industry sets the interest rate and the charges. They should organize immersion trips for the key opinion makers to visit their place of work and watch them how they work.

The Smart Campaign has announced the client protection principles and many MFIs are endorsing the principles and most recently, a certification program was launched to enable MFIs to prove they are in compliance. The campaign’s goal is to ensure that the clients are treated fairly and implement safeguards such as prevention of over-indebtedness to protect them. However, it is too early to tell how effective the Smart Campaign will be. Because the MFIs don’t have the ownership of campaign and is a top down initiative, they may not comply with the benchmarks. Many MFIs may sign up to ensure funding from the donor and fudge the data on compliance.

 The crises hold important lessons for businesses that supply products and services on a large scale to the poor because the State also provides similar services. MFIs have to accept the fact that the State is a key actor in such businesses because of the overlap of responsibility. Granted, one would expect the State to behave responsibility and stick to the principle of “do no harm” in its policy towards the sector. The crises pointed out that MFIs did not attempt to secure buy-in from the State and to allay their fears.

 The crises revealed a systemic weakness of the MFIs: their inability to manage the public opinion that turned sour so quickly. The biggest failure was their inability to rally support from silent majority of the clients in the face of public and political backlash. An industry that was enjoying good will and public recognition after the awarding of Nobel Peace Prize suddenly became a pariah overnight. The decades long good press was overturned by the publicity generated by the report of ill treatment of clients and use of coercive techniques that allegedly caused them to commit suicide. There was a perfect storm of bad press. Just before the explosion of crises in Nicaragua, India and Bangladesh, several working papers were published that questioned the impact of microfinance. Even though the authors of these studies did not have a hand in writing the headlines and were more nuanced in their conclusions, major newspapers around the world quoted out of context negative findings from these studies and the researchers did little to correct the resulting wrong impressions. So, when the crises erupted, the press had a field day. In addition to aggressive reporting of the crises, the media in these countries supplemented their reporting of the crises along with the negative finding from the celebrated “scientific studies.” These and other headlines about the investors in SKS IPO making millions and suicides of borrowers in AP, an erroneous Norwegian documentary about microfinance became the dragon slayer for MFIs in AP and for Grameen in Bangladesh.

The Bangladesh case has to be interpreted with a wider lens. By getting rid of a Nobel Laureate, despite veiled threat from the US government and multilateral institutions, the Prime Minister and the ruling party is sending warning signal to any and all potential opponents from the well organized NGO sector of the consequences of acting against the interest of the ruling party. The ruling party has already changed the constitution to get rid of the requirement of a neutral caretaker government to run the elections and diluted the provisions of the anti-corruption act. The political interference in the affairs of Grameen Bank is part of a broader strategy of staying in power in the future by destroying any semblance of opposition in the country. Unlike the other cases, we may be seeing the trailer of a horror movie in Bangladesh whose ending will be hard to predict.

 These episodes provide a lesson for the microfinance industry: get ahead of the headlines, invest resources in responding to criticisms, and engage the critics in a constructive way. Big MFIs must maintain a vigilant public relations office. In addition to spreading uplifting stories publicizing the positive benefit, the staffers have to be prepared to deal with bad stories. Instead of doing it alone, MFIs, through their associations should have a common response to public criticisms as done by the American Bankers Associations. In evaluating the role of Indian MFIs in drawing the ire of politicians, Rozas (2011) points out that the Indian MFIs by allowing themselves to be defined entirely by their critics had committed the cardinal sin of political gamesmanship. His suggested remedy is applicable for large MFIs all over the world.

 Large MFIs should be on first-name basis with journalists in every major

Publication, whether on a local or national level. They should be known and seen regularly by senior politicians of all major parties. They should have their eyes trained on the political landscape to see obstacles ahead, and have ears pressed to the ground to pick up stirrings of discontent below. Most importantly, they should heed the warnings that they pick up.

 The microfinance industry has avoided the issue of debt forgiveness so far. It is clear why they don’t want to destroy the repayment culture built by painstaking work over the years to be undone by the example of loan forgiveness. The industry has to revisit the issue to prevent future episodes of political interference. The fear is that once MFIs forgive debt, it will be impossible to maintain the repayment culture that is essential to the survival of the industry. The industry is being too cautious. The original group lending model that is the basis for disbursement of loan did not include the issue of shocks or risk that individual borrower might face. Given the group liability, a shock faced by a borrower and his or her inability to repay become the business of the whole group. And this creates tension among the group members as other become liable for the his/her debt. However, the MFIs could come up with creative means to institute a policy of debt forgiveness. One MFIs in Chile used the community to decide whose loan should be forgiven after the devastating earthquake in the country. The advantage of using the community to decide the qualified borrowers for debt forgiveness is that it reduces the issue of moral hazard; they are able to identify the borrower that deserves the break.

In addition to profitability, the prospective private investors must examine fundamentals such as strict corporate governance, nature of operations, strong management, prior to their investment in MFIs. In this new brave world of microfinance, investors must have ongoing monitoring process to verify numbers presented by the management. They must develop local presence to monitor their investments and be prepared to accept the risk that their investment may fail ((Cole and Kempner, 2011b).

Alok Prashad, CEO of MFIN summarized investor action on six fronts (McKee and Prasad, 2011):

* As foreign investors, you must be “engaged owners, not just sleeping partners.” The industry needs active governance, especially around the decisions that affect client welfare.
* Do your due diligence. You can’t just fly into India on Monday, review the CEO’s projections, meet some senior staff and fly home on Thursday. You need to ask hard questions and counsel the promoters. Seventy percent this year and 150% the next? No sector can sustain or manage this kind of growth.
* Insist on compliance with the industry code of conduct. It’s not enough for the network to say “come on, guys, let’s do the responsible thing.” Bank loan covenants should address this, and other investors have influence too.
* Get regular feedback from the networks. Is your MFI partner a member in good standing of MFIN? Maybe you should urge the networks to do annual certification.
* Really integrate social performance indicators into your investment decision-making processes.

There are lessons for the government and the politicians too. The state has to realize that even though its reach is vast, it cannot deliver financial services to the poor effectively. As the case in AP revealed, unjustified intervention has unintended consequences of destroying an industry that provide services that is valued by the poor. At the end of the day, the government’s intransigency will lead to its carrying the bag for the failure of the MFIs. The government in Nicaragua learned that lesson. As mentioned earlier, the government has agreed to take over $25 million debt owed to 67 financial institutions including MFIs as a consequence of the crisis. The Nicaraguan National Assembly approved into law the promotion and regulation of its microfinance industry in June 2011. The law is expected to clarify and resolve issues that are necessary for a vibrant microfinance industry in Nicaragua: the definition of microfinance, free negotiation of interest rate instead of a cap preferred by the political parties, guarantee of customer rights, and which legal action MFIs can take against defaulting borrowers (WCCN, 2011)

However, the governments in other crisis countries are still creating problems. In India, the Microfinance Bill currently under consideration by the Parliament has cleared out some of the ambiguity and is likely to inject new lease of life for MFIs, especially the one in AP that are on life support. However, the AP government opposed the Bill being considered in the Parliament that empowered the Reserve Bank to regulate the MFIs. The AP government still feels that it has the right to regulate the MFIs and that has prompted the Reserve Bank to file an affidavit with AP High Court (Sulukmar, 2012). The AP government has continued to subsidize loan to Self Help Groups, lending at an unrealistic rate of 3 percent. Further, it has not accepted the responsibility for destroying the sector and forcing the poor to return to the moneylender to borrow at high rates. (India Knowledge@Wharton, 2012). Many worry that the current Parliament will not be able to pass the Bill and it will be up to the new Parliament and a new government to pass in bill—a delay of 18 months or so. The Bangladesh Government effectively nationalized Grameen Bank by amending the original charter passing the new Grameen Bank Act, 2013.

 We began the paper with the story of Akula’s epiphany to use commercial sources to scale up microfinance to serve 3 billion people who live below $2 a day. We want to end the paper by suggesting that commercialization, instead of increasing the number of people served, has for the first time contributed to a decline in the total number of clients globally (Reed, 2013). Even though the politicians intervened and acted capriciously, the ultimate responsibility for creating the crises lies on the shoulders of the industry, foreign investment vehicles, equity investors, founders and most importantly MFIs and their staff. It is clear that microfinance is now and will be a political issue and the industry has to learn to live with the “populist.”

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1. Quote by Lamia Karim in Nolan (2011). Karim is the author of a highly critical book on microfinance and its discontents in Bangladesh (Karim, 2011) [↑](#footnote-ref-1)
2. This section borrows extensively from Rhyne (2001). [↑](#footnote-ref-2)
3. The actual number of suicides is unclear. The press report range between 19—57. (Mader 2010). Associated Press reports 200 deaths (Kinetz, 2012) [↑](#footnote-ref-3)
4. The margin cap set by RBI is within the range proposed by Muhammad Yunus (2011). Analysis by MIX shows that most of the MFIs exceed the upper end of cap of 15 percent suggested by Yunus in Latin America and Africa and even in Asia (Gonzalez, 2011). Cull et al. (2009) show that even non-governmental finance organization charge more than the upper limit. [↑](#footnote-ref-4)
5. Title of a report funded by McKinsey (Chaia et al. 2009). [↑](#footnote-ref-5)
6. In a keynote speech in the 13th Social Enterprise Conference at Harvard, Akula admitted that in his zeal to scale up the SKS model, he did not take time to anticipate the potential downside of using public market for fund raising. More importantly, he acknowledged that Professor Yunus was right in criticizing him for taking the commercial route to scale up microfinance (Microfinance Focus) [↑](#footnote-ref-6)
7. Banarasi Saris are among the finest saris in India and are quite expensive. http://en.wikipedia.org/wiki/Banarasi\_saris [↑](#footnote-ref-7)
8. MFT has certified Grameen Bank’s interest rate and found that the effective interest rate on loans from Grameen is close to the reported rate and when one takes into account the charges and fees related to the loans the effective interest rate is slightly higher than the reported rate. For example, the effective interest rate on basic loan that constitute close to 97 percent of the portfolio of the bank is 22.9 percent compared to the reported rate of 20 percent (mftransparency.org, 2011). All Grameen’s loan products received a perfect score for the MFT transparency index: The index “compares the nominal interest rate communicated to the client to the APR of the loan” (mftransparency.org, 2011). Roodman (2010) calculated Grameen’s effective interest rate in the range of 23.33 percent to 24.28 percent. The critical Norwegian Documentary that was used by the government to get rid of Professor Yunus claimed that Grameen charges 30 percent interest rate. The government appointed review committee found that Grameen’s interest rate is the lowest charged among the MFIs in Bangladesh. All these, however, did not deter the critiques to charge that Grameen charge high interest rate. [↑](#footnote-ref-8)