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SKS and the Crisis of Corporate-led Microfinance in India

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> "You see the extreme poverty we have in our country and you go back to the extreme wealth you have in an American suburb and I would do this consistently, every school holiday, summer after summer and that's a very jarring experience." An undergraduate at Tufts University in Boston, Akula says he chose to major in philosophy. But Akula remembered what Karl Marx had said: "Philosophers have only interpreted the world…the point is to change it." So, Akula started SKS in 1997…
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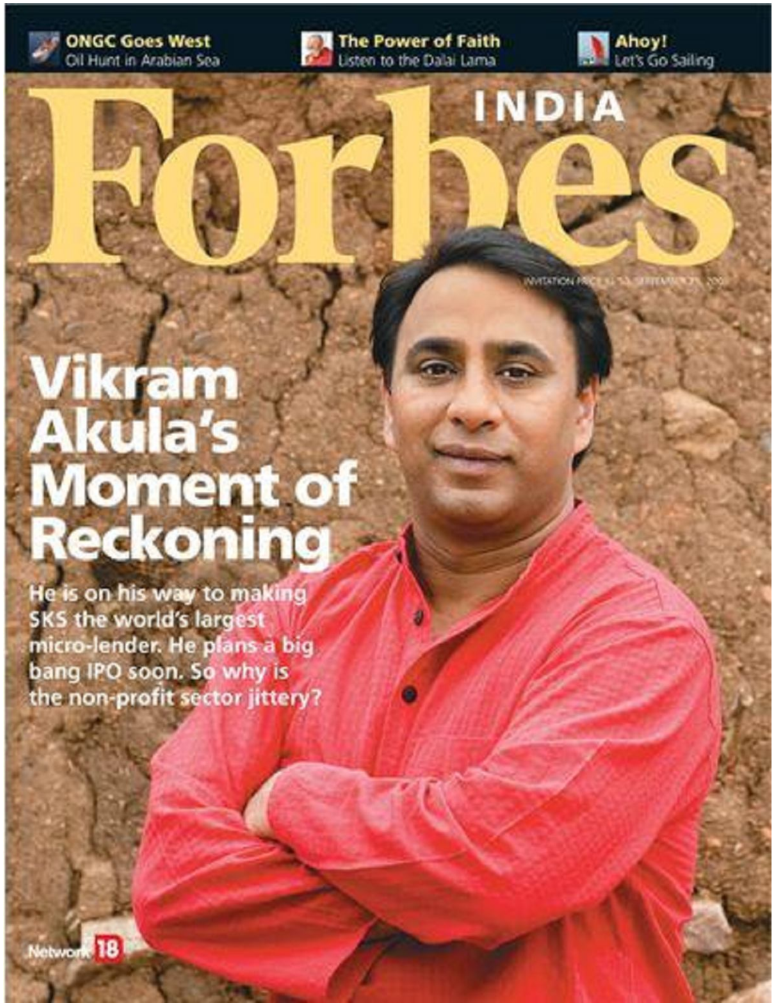
> From "The Tight Rope Walker [2]", *Forbes India*, January 2010



[1]

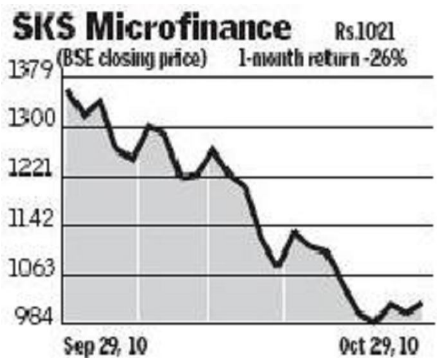
In September 2009, the *Forbes India* Magazine carried a rather interesting cover story titled "At the Crossroads". On the cover was Vikram Akula, founder of *SKS Microfinance* and the poster boy of social entrepreneurship in India. Here was the guy who had shown the world that poverty alleviation is not a sphere where the state has to spend money; instead, it was a sphere where you could actually make money. Here was that guy who was the "first to show that private capital could be harnessed to nurture sustainable livelihoods in villages." Here was that guy who tried to "bridge the gap between profits and compassion". Here was the guy who was, in 2006, in the *Time* magazine's list of the world's 100 most influential people.

The *Forbes India* cover was inspired by the one great leap that Akula was planning for his company. Till 2009, SKS had already mobilised a $ 153 million as equity capital. In the same year, CRISIL had rated SKS as the top Microfinance Institution (MFI) in India. And in 2010, Akula was looking at the "big bang"; SKS was floating an Initial Public Offer (IPO), the first for any MFI in India. He did the listing in style; at an 11 per cent premium. SKS raised a whopping Rs 1653 crore from the market at Rs 985 per share; the share was 13-times over-subscribed. Indrajit Gupta, the Editor of *Forbes India* commented (in an accompanying note titled "Creative Capitalism [3]"):

> "So what if a handful of investors make a little bit of money while millions escape the clutches of rapacious moneylenders?...To my mind, Akula now has the chance to show the world that it is possible to strike the middle ground between rabid capitalism and a pure development approach. So can he pull it off?"

But the real "big bang" was yet to come; the Akula bubble burst! A few weeks into the IPO, the SKS share prices fell as if in a slide; in the third week of October 2010, the price of SKS shares fell even below the issue price of Rs 985 during intra-day trade, before inching up by the end of the day. The party was over. The mood in the market was clear: lay off. On the 17th of October, JPMorgan tagged the SKS stock with an "underweight" mark, which is an advice for clients to sell the stock. Answering a question on SKS stocks from *ET-Now* [4], one leading stock advisor's answer was:

> …it is really important to understand where the entire thing is going there and lot of question marks being raised on whether the microfinance model being followed by these companies itself is a good idea or not and given all of this I would weight it out, I would not really want to get into the stock [SKS] right now… I would give a clear avoid on this counter for now.



SKS

The burst was actually something waiting to happen, for some time. The microfinance sector, particularly in Andhra Pradesh, was mired in controversies for a while. In early-2006, the Andhra Pradesh government had closed down about 50 branches of MFIs, following allegations of charging usurious interest rates and illegal harassment of borrowers. *The Hindu* reported [5] the then Chief Minister of the State – Y.S. Rajasekhara Reddy – to have remarked that “MFIs were turning out to be worse than moneylenders by charging interest rates in excess of 20 per cent”. In 2006, there were reports that about 10 borrowers of MFIs had committed suicide in Krishna district. The suicide stories began to pile up after 2006. In 2010 itself, there were about 30 to 60 reported suicides (as per different estimates [6]) of MFI-borrowers; of the 30 suicides, 17 were of those who had at least one loan from SKS.

To add to the suicide-saga, there was mud in the house too. A few weeks into the big bang Rs 1653 crore mobilisation, two top guns in SKS crossed. Suresh Gurumani, who was CEO of SKS and helped it cruise through the IPO, developed serious differences with Akula. In a rather dubious board room manoeuvre, Gurumani was sacked by Akula in October 2010. For the “market”, this was a signal that all was not well. The SKS share prices began to fall. With the recent ordinance of the Andhra Pradesh government, which seeks to regulate MFIs, the market appears to have lost all “trust” in SKS.

Some observers of microfinance have made it look as if the “market” has managed to locate the board room misdemeanours in SKS as indicating “loss of transparency”. This proposed “virtue” of the market should have no place in understanding the present crisis of microfinance in India; the point is that the present crisis is an inevitable outcome of the larger policy framework in which microfinance has been conducted in India. Here, I wish to argue out two points. First, the edifice on which microfinance has been built in India is the policy of financial liberalisation, and this has had adverse socio-economic consequences on borrowers. Secondly, the recent turn of microfinance (and the government’s encouragement of it) into the equity market for capital infusion is marked by huge risks. These risks are not borne by either the government or the investors; it is borne by the poor borrowers in various forms. The experience of SKS is an indicator of the pitfalls of the private equity-route in microfinance.

Microcredit: The arrival of the celebrity poverty alleviato

Over the last decade or more, microcredit has attained some sort of a celebrity status in the dominant development discourse. For instance, the year 2005 was observed as the *International Year of Microcredit*, of which Aishwarya Rai was an official spokesperson. It is claimed that microcredit has transformed the lives of the poor across the world through its innovative methods of small-loan provision. The argument here is that microcredit would raise the incomes of the poor so much as to raise them above the income-poverty line. At the *International Microcredit Summit*, sponsored by the World Bank in 1997, Mohammad Yunus had declared that the “summit [was] about creating a process that will send poverty to the museum...”

The problem, however, is that careful studies by scholars have not supported this argument. There is not yet one respected study in social sciences that has claimed, conclusively and confidently, that microcredit provision has reduced income-poverty in any significant way. Most studies that do claim so are based on methodologies that are questionable. Princeton economist Jonathan Morduch wrote in the *Journal of Economic Literature* that "while strong claims are made for the ability of micro-finance to reduce poverty, only a handful of studies use sizable samples and appropriate frameworks to answer the question." As a result, "even the most fundamental claims remain unsubstantiated." At best, studies have shown that microcredit serves as a weak survival strategy for the poor. It is baffling that a concept has not received adequate scientific backing, but yet has received so much attention, praise and finally, a Nobel Prize.

How is it then that the concept has endeared itself to a wide range of international organisations and governments? The most important reason is that NGO-led microcredit provision fits in well with the principles of financial liberalisation. A major objective of financial liberalization is the retreat of public institutions from provision of credit to the poor. In this view, microcredit institutions are seen as the alternative when public banks withdraw from the rural areas.

Microcredit and financial liberalisation

A good example of the adherence of microcredit institutions to the principles of financial liberalisation is the policy on the interest rates. An important objective of the earlier policy of "social and development banking" in developing countries like India was to augment the supply of credit to rural poor, and to do so at an affordable cost. It was recognized that a high rate of interest can shut out poor borrowers from the credit market. In India, under the policy of social and development banking, administered, and differential, interest rates were introduced into the formal system of credit.

Proponents of financial liberalisation sharply criticised the policy of administering interest rates. The argument put forward was that administering interest rates led to "financial repression", which undermined the profitability of operations of the banking system. Hence, the argument went, banks should be given a free hand to charge rates of interest as determined by the market forces of demand and supply. In some sense, interest rate deregulation has been the cornerstone of financial liberalisation in developing countries.

Mohammad Yunus' world view is remarkably similar. In his book *Banker to the Poor - Micro-lending and the Battle against World Poverty* (Pacific Affairs, New York, 1999), his basic argument was that Grameen Bank can be effective only in a capitalist and free market-driven economy. He said,

> "I do believe in the power of the global free market economy and using capitalist tools. I believe in the power of free market and the power of capital in the market place".

He further argued,

> "I believe in the central thesis of capitalism: the economic system must be competitive...[and] profit maximising."

In India, one of the major objectives of banking sector reform was to eliminate subsidies on interest rates. A NABARD booklet in 1997 asserted that the argument that "rural poor...need credit on concessionary rate of interest and soft terms" is a "myth." Similarly, the Reserve Bank of India's Cell on microcredit has noted, quite outrageously, that "freedom from poverty is not for free. The poor are willing and capable to pay the cost." The RBI's Monetary and Credit Policy for 1999-2000 fully deregulated interest rates on microcredit by banks and NGOs.

The available evidence show that deregulating the rates of interest has led to a significant rise in the costs of credit for poor borrowers. Final rates of interest on microcredit are in the range of 24 to 36 per cent per annum. This is almost two to three times higher than what banks used to charge for loans under the IRDP. Interestingly, the average annual interest on a home loan or a car loan is about 10-11 per cent. Large administrative costs of delivering microcredit, a feature noted across countries, is the primary reason for the high interest rates. These administrative costs have resulted in the practice of charging margins by various participant-links in the credit chain. This margin is charged by each participant primarily towards covering the transaction costs – costs of information, negotiation, monitoring and enforcement of the credit contract – incurred in the delivery of microcredit. In the end, the burden of large margins is simply transferred to the poor borrowers in the form of high interest rates.

It is often argued that in spite of the higher rates of interest charged, microcredit can raise the incomes of the poor significantly. However, this argument stands on very weak grounds. Under certain simple assumptions, it follows that the rural micro-enterprise that the borrower initiates with the small loan should have a rate of return of at least 24 to 36 per cent to break even. For a medium-sized industry, a rate of return (before interest payment) of about 24 per cent is generally considered to be respectable. For smaller industries, the rate of return would be lower. A rate of return of 24 to 36 per cent for a small rural enterprise is thus a highly unrealistic target, given the low organic composition of capital.

Usurious interests and debt cycles: Evidence from the field

In Bangladesh, the practise of high interest rates on microcredit has had many distressing consequences on the repayment behaviour of borrowers. Aminur Rahman pointed out in a study in Tangail district that most of the timely repayments were not made out of incomes flowing from assets gained from Grameen Bank loans, but through further borrowing from private moneylenders. This meant that the borrowers began a new Grameen loan "with a deficit on the capital", which led to the creation of "debt cycles" for the borrowers. In another study in Madhupur Thana in northern Bangladesh, Saurabh Sinha and Imran Matin noted that "most of the informal loans repaid with Grameen loans were taken to repay earlier Grameen loans."

The evidence from Andhra Pradesh has been no different. While systematic studies on debt cycles of borrowers and malpractices of MFIs in the State are yet to be done, news reports on each suicide are instructive. Here is the story in *Indian Express* [7] of Karri Ammaji, 48 years old, of Katheru village in Rajahmundry rural mandal:

> She had borrowed Rs 2 lakh from *four micro finance companies (MFIs)* at 10 per cent interest, and had stood surety for a loan of Rs 2 lakh taken by her relatives…She had been under enormous pressure to cough up repayment instalments, and was due to pay one of Rs 4,000 on Monday…Of the total amount she had borrowed, she had only repaid a meagre amount. Her co-members in the SHG mounted pressure on her to pay up…In the grip of panic, she reportedly jumped into a well near her house. Wife of a labourer, she is survived by four daughters (emphasis added).

Similarly, *Times of India* [8] reported the case of Talari Balanarsu from Annaram village in Machareddy mandal:

> Talari Balanarsu, 28, hanged himself in his house…in the afternoon. A Gulf returnee, Balanarsu took Rs 20,000 from a private MFI. "His debts mounted as he had taken *a loan of Rs 1 lakh from relatives, local villagers and private moneylenders for various needs*," a villager said (emphasis added).

From Rajahmundry, the same *Indian Express* [7] report noted that:

> Collection agents are widely reported to use abusive language against defaulting borrowers. MFIs tend to appoint agents locally to make collections…Some have been reported to ask women to take up prostitution to be able to pay their instalments…This is in

> contrast to what they say when they come to your doorstep to offer loans. They promise that there will be no harassment.

A *Times of India* [8] report from Guntur district noted that:

> In Guntur, a farm labourer, Borugadda Sudha, 27, tried to end her life by jumping into a well but she was rescued by villagers. Sudha took Rs 15,000 from an MFI to make both ends meet after her husband Ganapathi Rao, a casual labourer at a foundry, died six months ago. She has a two-month-old baby.
>
> Following non-payment of loan instalments, two women representatives reached her house and allegedly abused and threatened her. They detained her and released her only after her relatives assured them of loan repayment. The police who picked up the representatives did not register a case.

A *Times of India* [9] report from Visakhapatnam district noted that:

> Agents of a micro-finance company allegedly abducted a 10-year-old girl to “punish” her mother for failing to repay their weekly loan instalment at Narsipatnam in Andhra Pradesh’s Visakhapatnam district.
>
> Daralamma, a daily wage labourer, filed a police complaint on Tuesday, saying the agents abducted her daughter, Durga Anushka, on Saturday last when she was away in Anakapally for medical treatment. “My sister said the agents accompanied by three self-help group women came to our home and took away my daughter. They had threatened her that they would release Anushka only after I clear the dues,” Daralamma said.

And finally, *Times of India* [10] reported a “government study”, conducted by Sujata Sharma, project director of District Rural Development Authority (DRDA) of Warangal:

> …a government study has found that some MFI agents themselves are encouraging the debtors to commit suicide so that their loans are repaid. This happens because the borrowers are covered by insurance… According to sources, the MFIs draw up an insurance cover for the borrower at the time of loan disbursement. In the eventuality of suicide, they recover the amount under the Loan Protection Fund (LPF) by which 10 per cent of the loan amount is deposited with the RBI which repays the remaining loan amount due from the defaulter.

In sum, the policy of interest rate deregulation, as applied to microcredit, has led to a steep rise in the interest rates on loans to the poor. Combined with illegal collection practices of the lenders, particularly in Andhra Pradesh, microcredit has turned into a new extractive space for modern finance.

The Gordian knot: The turn to equity of MFIs

There is a difference that needs emphasis here. Through out, I have been referring to microcredit and microfinance as if they are the same. Not really. While microcredit refers to small loans without collateral, microfinance typically refers to microcredit, savings, insurance, money transfers, and other financial products targeted at poor and low-income people. Over a period, most microcredit agencies tried to transform themselves into microfinance agencies.

With the expansion in activities following the rise in microcredit as well as microfinance activities, the portfolios of MFIs grew sharply. The MFIs took over the task of identifying and encouraging "Joint Lending Groups" (JLGs) that needed loans and other financial services. The typical progression of an MFI, then, was as follows: begin as a *not-for-profit* unit using grants and mature gradually into a *for-profit* Non-Banking Financial Company (NBFC). The NBFCs needed new infusion of funds and suddenly, microfinance became an attractive destination for "investors". For a while, the innovation of new debt instruments has been a major focus of discussions in financial board rooms. In particular, focus has been on the interest of venture capitalists in microfinance.

This was the beginning of the era of equity capital [11] in microfinance that began in the early-2000s. The case of SKS is illustrative. In 2003, SKS brought in Mutual Benefit Trusts (MBT) as investors; in 2005, SKS registered as an NBFC; in 2006, SKS went through an equity infusion of $ 1.6 million and MBT put in another $ 1 million; in 2008, SKS raised another $ 37 million and the investing company Sequoia earned a stake of 27 per cent in SKS; in 2010, N. R. Narayana Moorthy's venture capital firm *Catamaran* invested Rs 28 crore in SKS and earned a 1.5 per cent stake. Shloka Nath reported for Forbes India [11] that "in 6 months time, the mark-to-market profit of Catamaran is about Rs. 64.24 crore." According to another report [12], "the returns on equity in MFIs increased from 5.1 per cent in 2008 to 18.3 per cent in 2009."

While the SKS' story of equity infusion is striking in its growth, a large number of MFIs in India also went through such phases of capital infusion. For instance [12], Spandana has recently negotiated $ 60 million in equity from Teamlease of Singapore. Reports say that both Spandana and SHARE Microfinance were planning an IPO when the SKS came crashing. According to an observer [12]:

> …by July 2010, more than 200 billion USD is pumped into MFI industry. Once they enter, they drive the industry according to their own interests. Currently Spandana negotiated for $ 60 million equity from Teamlease of Singapore. The World Bank and its MFI arm, IFC are active in lending to the corporate MFIs in India. The IFC even announced microfinance initiative for Asia in collaboration with *Kreditanstalt fur Wideraufbau* to lend to MFIs in India. The DFID is coming up with a new poverty initiative strategy focusing on states where MFI penetration is less. Thus, the entry of international finance capital and the profit oriented MFIs in lieu of SHGs which thrive on bank linkages, vitiated the market resulting in suicides by the borrowers, who fail to repay in time and withstand the pressure from the MFIs. This is what is happening in Andhra Pradesh and what happened in some other

states in recent years.

The equity route, and later the IPO route, had a rather straightforward problem. Investors were not angels, and their only attraction to invest in MFIs was the relatively high rate of yields. And how were these high yields sustained? Simply, by raising interest rates (and here we go back to the point made in the earlier section). In other words, higher interest rates sustained higher yields of MFIs, which in turn led to higher investments. Put differently, if yields were relatively low to attract investments, MFIs can have a quick way out: raise interest rates and thus raise yields. See the following careful response in CNBC-TV18 [13] from Saikiran Pulavarthi of *Indiabulls*, described as an "analyst who tracks this sector closely":

> **Q:** What about the yields, from what you are hearing about the mandatory registration and probably more regulation from the district level authorities, is it possible that yields may also come down?
>
> **A:** The industry even if you watched it closely earlier also they were suggesting that *once the operational efficiencies kick in, they will definitely pass it on to the customers [as reduced interest rates: RR] in terms of reducing the yields as a whole* but yes, I would not correlate with the regulation as a whole in terms of the interest rates coming down but yes, definitely *once the industry starts getting the more of operational efficiency, definitely you will see falling yields* (emphasis and parenthesis added).

MFIs have no escape from this dilemma when they adopt the equity or IPO route to infuse capital. They become slaves of the highly volatile system of financial flows in the market. The consistent pressure to keep yields higher would force them to keep interest rates higher. Or else, they would be starved of funds. However seen, the burden of this Gordian knot is borne by the poor borrower.

But then, do we really believe that finance capital would behave differently?

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