Commercialisation of Microfinance in India: A Discussion on the Emperor's Apparel

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Abstract

The paper looks at the growth and commercialization of microfinance in India. It starts out be looking at how the commercial microfinance has evolved internationally by discussing two specific examples and then moves on to examine the specifics cases of four large microfinance institutions in India.

The basic argument of the paper is that most of the early microfinance in India happened through donor and philanthropic funds. These funds came in to not-for-profit organizations. However as the activities scaled up, it was imperative to move to a commercial format. The paper examines the growth imperatives and the transformation processes.

The paper then proceeds to look at the implications of the transformation process and its effect on the personal enrichment of the promoters of MFI as well as the governance implications. Basically it questions the moral and ethical fabric on which some to the large microfinance institutions are built. It ends by answering a set of questions that may emanate out of this discussion.

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Commercialisation of Microfinance in India[2]: A Discussion on the Emperor's Apparel[3]

Introduction

There has been a significant shift from the days when microfinance was being discussed as the next big innovation to address the poverty issues in India to being discussed in terms of the next big investment opportunity. The language of microfinance has undergone a fundamental change in the two decades of its evolution.

As some of the large microfinance institutions [MFIs] ready themselves to hit the capital market with their unbelievable valuations and the promise of deliverance, it might be important to reflect on the origins of these MFIs, examine the process of their transformation and discuss some basic structural issues that are plaguing the microfinance sector in general and large organizations in particular.

Unlike other developmental interventions of the past – be it joint forest management, natural resource management and marketing interventions that benefit the poor, microfinance caught the imagination of the NGO sector in a big way in the 1980s. While a large part of the 80s was spent in organizing groups, being focused on community owned and managed structures and integrating them with the banks, the impatience of the slowness of this process was showing. The global microcredit summit organized in Washington DC in 1997, widely attended by representatives of 137 countries and nearly 3,000 delegates was, in a way, a watershed event. This was an event that was used by Grameen Bank to showcase its work of the past two decades. Grameen and microfinance were clearly being acknowledged as an effective methodology to reach small loans to the poor. The high profile support from the then first lady Hilary Clinton and the Queen of Spain drew the attention of several interested parties.

[2] For the purpose of this paper, we restrict the definition of microfinance to "access to microcredit services being provided by for-profit entities on commercial terms". Thus we shall not be discussing a large community based self-help group model of microfinance, while putting on record the acknowledgement that such a model also has made significant contributions in providing access to financial services.

[3] All data quoted in this paper, pertaining to the big four NBFC MFIs have been sourced from the returns filed with the Registrar of Companies and have been downloaded from the Ministry of Company Affairs website. In case of SKS Microfinance, a large part of the data has been borrowed from the Draft Red Herring Prospectus filed with SEBI on March 26, 2010 in a run up to the proposed public issue. No data has been sourced from sources other than what is there in the public domain. However, interpretations drawn from the data are those of the author.

That was the time that many of the current large MFIs were setting shop in India. While BASIX was incorporated in 1996 and started off as the largest private sector MFI, SML, Spandana were following suit with SKS being a distance away. BASIX had a regional rural bank type of product portfolio – trying to address the needs of the poor as well as the non poor. Share was clearly sold on the Grameen model, Spandana was agnostic and even tried both the self-help group and the Grameen model before settling for the latter. SKS made a very slow start. The commonality in all these organizations was that [except for BASIX] they were all registered as public societies with grant money and came with a developmental orientation. Their original expanded names – Society for Helping and Awakening the Rural poor through Education and Swayam Krushi Sangham are indications of the orientation of these organizations. They were focused on poverty and looking at interventions that would benefit the poor. However, once these organizations discovered the magic of microfinance and started to grow, the issues were different.

Move from Not-for-profits to for-profits: The imperatives

When we look at the past two decades of microfinance, we find three distinct waves of action. The first wave was when people who were working in the development sector discovered the methodology of reaching micro-loans to the poor through a methodology that was mastered by Grameen Bank. The wave 2 came in when the first generation organizations reached scale and sought methods to morph into for-profit commercial organizations. The wave 3 is when mainstream commercial institutions like L&T finance, Equitas and the private equity players started looking at microfinance as an interesting business.

The basic methodology being used in commercial microfinance in India was innovated by Grameen Bank and later improvised by several players. This methodology involved the following elements:

1. Identify the potential customer. This was to be done by using a poverty index, thereby ensuring that the customers had a great deal of homogeneity
2. Organise them into groups so that they could address the issue of information asymmetry and lack of collaterals by transferring what could be an individual liability into a group liability and hold the group morally responsible for repayment – through a process of public oath[4].
3. Have standardized products, standardized operating systems and enforce discipline; ensure that the exceptions were dealt with severely.

[4] For a detailed discussion see Sriram M S [2005]: Information Asymmetry and Trust: A Framework for studying Microfinance in India, published in Vikalpa: Volume 30, No.4. October-December.

This methodology meant that there was a great template that could be applied almost anywhere irrespective of local cultural issues or peculiarities. The amount was small enough not to threaten the existing vested interests, small enough to ensure that the basic fabric of the local economy does not undergo a drastic change and at the same time was appropriate enough for people to go through the process of group meetings. The magic formula worked and was geographically scalable.

For the first time people in the developmental sector were discovering a methodology where they could keep in touch with a large number of poor clients, scale rapidly, and actually count the direct impact of their work[5]. The counting could easily be done by number of clients reached, the portfolio quality, amount loaned and the magic 100% recovery statistic. This was a magic formula discovered and by the time the Microfinance Institutions [MFI] spent three to four years in operations, they found that there were challenges in keeping pace with the growth opportunities. From 2002 onwards we found these MFIs talking a new language – the language of transformation.

Globally this poor client hitting the Wall street was being celebrated by the formation and listing of Bancosol in the early 1990s. However, that was not a methodology that the South Asian players took fancy to, because of the basic differences in the delivery mechanism. However by the time microfinance in India had reached the second wave – the wave of transformation, every model became relevant for examination, because the delivery and the growth was contextualized for this region, and we needed solutions for continuous access to funds to fuel the credit tread mill that was built.

In case of legal ownership and governance, Indian MFIs had to find their own solutions. It was not possible to follow the Grameen Bank pattern in terms of ownership, where the borrower members also have a stake in the capital of the bank. That was possible with Grameen because it was incorporated under a special act. In case of the Indian microfinance the first wave institutions did not find a legal framework under which they could involve the community in the ownership structure of a MFI.

We had in an earlier paper listed the imperatives for movement to a for-profit format for MFI and the challenges in "transformation" from not-for-profit to for-profit format [See, Sriram

[5] We are not using the word "measuring" impact here. Impact has a much wider connotation but here we are implying that it is easy to "count" and possibly "account" for some numbers.

and Upadhyayula, 2002][6]. These imperatives stemmed from size – that the MFIs were growing much bigger than they should in their original form of not-for-profit incorporation. This meant that it would be increasingly difficult for them to explain their form to the commercial world, while the developmental world would stop funding them after a stage, given that the operations were largely profitable. It was also increasingly difficult for them to maintain capital adequacy or attract commercial capital because profits could not be distributed in a not-for-profit format. Therefore there was a need for all these institutions to "transform" or move from a non-profit format to a for-profit format.

While the potential for looking at this business from bottom-of-the-pyramid paradigm existed even then, the idea was not proven and therefore people with commercial interests were not coming in. It was indeed difficult for BASIX which started as a commercial entity, but with little capital, to explain to the investors that this was a business in which commercial capital could come in. Therefore it was imperative that the initial players in first wave were the ones who had limited personal means to run the business. At the same time, the donor community saw potential in market based solutions for helping the poor to gain access to financial services. Thus it was a good combination of a market waiting to be tapped, with the funding coming from softer sources. Clearly a market failure was being addressed through this mechanism.

However, once the methodology was established, and tested over a few years, and the experiment was scaling up, it was indeed difficult for the donor community to continue to be engaged in what could be seen as a rank commercial activity. It was also around this time that some of the investors [including from the silicon valley – Vinod Khosla, Michael and Susan Dell, Pierre Omidiyar among them who took active interest in the global microfinance space] started looking for investments which not only gave them returns, but also an enhanced image – as people who ploughed their riches into socially responsible businesses.

The wave 1 institutions that had started in the not-for-profit paradigm were facing challenges of stepping up their operations from their existing framework to a for-profit framework. These challenges were not only at the conceptual level, but also at the operational level.

Logic of public-purpose institutions

[6] Sriram MS and Rajesh Upadhyayula: The Transformation of Microfinance in India: Experiences, Options and Future. Journal of Microfinance Vol 6, No.2.

Unlike the for-profits, the not-for-profit organizations operate under a paradigm that can be classified as “public purpose” organizations. The essential difference is not necessarily in their operating methodology – for instance there might be little difference in the operating methodology of Grameen Bank of Bangladesh and SKS Microfinance in India, but there is a significant difference in what these organizations are. The organizations classified as “public purpose” are structured in a manner that there would be no residual claims – structured as dividends in ‘for-profits’ – on current income. Similarly there is also no scope for residual claims on the liquidation proceeds. For instance if a not-for-profit trust or a society liquidates and there are resources left after paying off all the liabilities, this residue cannot go to the promoters or any other persons identified as promoters or managers of the trust/society, but in turn has to go to another public purpose organization that persues similar activities or in the absence of such an institution, to the state.

The spirit is that if the organization is working on the basis of donor money which is coming in for the larger social good such monies are coming in from the public at large – it could be taxpayer money or potential tax payer money [money that is exempt from taxes due the nature of donations to a cause]. It could even be money which philanthropists put into the public arena. These funds should be necessarily used for a larger public cause than for generating private profits or enrichment of individuals. Therefore such funds should remain in the public domain.

The microfinance activities in wave 1, were all started in such “public purpose” space with significant donor money that came in. When microfinance scaled up and became commercially attractive for the mainstream market to address the access to formal microcredit, there no longer was a need for these institutions to continue making a point. Ideally it should have been declared that their mission was accomplished and therefore they should have moved on to other problems that needed to be solved in the society. However, with the experience and success it was too attractive for the players to give up this agenda, and thus the need to prove it at scale and take the success across the country and elsewhere was great.

Challenges and issues of moving from public purpose to private profits

Thus, we can see that there was a natural push for microfinance organizations to move into the commercial space. Unfortunately for the operators of microfinance, the move into the commercial space was not going to be simple. The options available in the commercial space to carry out microfinance activities were three:

1. Move the operations to a non-banking finance company [NBFC]
2. Move the operations to a co-operative format
3. Set up a local area bank

Each of these options had their own barriers from the perspective of the wave 1 microfinance organizations. Setting up of a local area bank [which BASIX did after much scrutiny and delays in obtaining a licence] was a painful and arduous route. The Reserve Bank was careful and miserly in granting licences for banks, its area of operations were to be restricted to three contiguous districts and the capitalization required was Rs.5 crores, a significantly steep hurdle for the players operating at that time. The regulations also prescribed divestment of the equity stake in a specific time frame and diversification of ownership, with cap on voting rights irrespective of investments. All these did not make the prospect attractive for anybody to pursue.

While several initiatives took off on the co-operative format, the design of co-operatives dictate it to be user-member based and therefore posed a challenge of continuously raising capital from the members, a much more difficult, slow and arduous route.

This actually left the players with only one option of setting up of an NBFC. While BASIX had set up its operations in the for-profit space right from the beginning – through a complex structuring of softer loans obtained from patient investors like Ford Foundation and the Swiss Development Co-operation in a highly leveraged holding company and downstreamed as equity in an operating company, it was not possible for the others to replicate the model. Following a scam in the NBFC space in 1996-97, the Reserve Bank tightened the regulatory environment for NBFCs. The initial capital requirement for new NBFCs was set Rs.2 Crore and licence from RBI was made mandatory.

The wave 1 organisations that were operating under the not-for-profit format were ostensibly not in a position to bring in this capital through their personal resources to morph into wave 2 organisations. Most of the players at that time were from the developmental sector, who had discovered the magic of microfinance. There was a peculiar situation of having generated adequate business and profits within the non-profits, enough funds to promote an NBFC but a clear legal hurdle that these funds could not be invested in for-profit NBFCs because they were not public purpose organizations, but private profit generating organizations.

Internationally this was not much of a problem. In our discussion on BancoSol of Bolivia and Banco Compartamos of Mexico a little later, we shall discuss the specifics of the experiences in moving from non-profits to profits. In the Indian context the law – through the office of the charities commissioner – prohibited equity investments by not-for-profits. The logic followed the spirit of what public purpose organizations ought to do. The public purpose organizations were holding public funds in "trust" and such funds could not be invested in risky ventures irrespective of how proven the idea was, because the funds were infact meant for larger public good. Therefore the law provided that it is okay to park excess funds in approved safe securities [like government bonds, mutual funds and so on] so that they earn a return while they are waiting to be deployed, but not used as investments in commercial activities.

International Experiences in "Transformation"

While there are several examples internationally in organizations "transforming" from not-for-profit paradigm to commercial institutions [See Rhyne, 2001[7] for a detailed discussion] we will discuss two celebrated stories as an illustration here.

Bancosol

BancoSolodario [BancoSol] of Bolivia was the first celebrated experiment that moved from starting off as a donor based not-for-profit entity to a full-fledged bank that celebrated the listing of its instruments on Wall Street. Its background was in a not-for-profit institution called Prodem. The Bolivian law permitted Prodem to take an equity position in the new entity and thus it was possible for Prodem to transfer its existing portfolio to the newly created entity BancoSol in consideration of getting an equity position in the bank, while the new bank could also attract independent private parties to contribute to the equity. The route was clean where the not-for-profit took a direct equity position. Prodem continued to fund newer clients and transfer the stable clients to BancoSol. However over a period of time, there were tensions between Prodem and BancoSol on the orientation of the latter, with differences on excessive commercialization and Bancosol being accused of drifting away from small clients towards the larger ones. Over a period of time the ownership structure of Bancosol underwent a fundamental change with the original promoters fully moving out, Prodem reducing its stake in the bank and giving up its board seat. However there is no ready data available on "enrichment" of Prodem or any of the individual promoters. The

[7] Rhyne, Elisabeth [2001] Mainstreaming Microfinance: Connecticut: Kumarian Press

shareholdings were largely held with institutions with individuals having less than 2.5% shares. The controversy of Bancosol was largely around the mission drift and strategic focus, and not really about public resources going into private hands. Part of this might have been because Prodem – the original microfinance institution actually continued to serve the poorer clients and held on to its work and its mission. There was never a full transfer of the portfolio, but only a part and gradual transfer of the portfolio in return for stakes in the bank.

Banco Compartamos

The case of Banco Compartamos [BC] of Mexico was much more controversial. BC was established in 1990 as an NGO. It had funding from aid agencies in the form of direct grants and grant like soft loans to the extent of $4.3 million [Rosenberg, 2007]. It did not kick up a controversy when it moved its portfolio to a newly set up finance company in 2000. The finance company received a banking licence in 2006. However, when BC decided to make a public offering in the year 2007 it opened up considerable debate both on issues of where the original investments came from as well as the question of undue enrichment of people running the institution in comparison to the "poor clients" that had contributed to the overall profitability of the institutions. However the case of BC was much simpler for analysis. In the case of BC the operations initially started in an NGO in 1990 and moved the microfinance portfolio to a regulated finance company in 2000. The NGO itself became a shareholder in the finance company thus ensuring that the money that came in for charitable purposes – to the NGO continued to remain within the NGO and any appreciation of the initial contribution would eventually accrue to the NGO, thus keeping the profits in the public domain.

While this issue did not draw much debate, the issue that drew the attention of the academics and practitioners alike was the investments made at the time of transformation by the promoters, aid institutions and individual investors including the Directors and Managers of the NGO/company. Rosenberg[8] indicates that the original investment of $6 million had grown to a book value of around $126 million and these were in the public offering fetching a valuation of 12 times the book. The initial investors sold 30% of their holding in the public offering. Clearly this was a case of super-normal returns in less than a decade. What was most intriguing is that the 41% of the book value was represented by accumulated profits – something that could be directly attributable to the interest paid by the poor borrowers. To

[8] Rosenberg, Richard [2007]: CGAP Reflection on the Compartamos offering: A Case Study of Microfinance Interest Rates and Profits

BCs credit it was one of the most efficient institutions in the market segment for the poor and at 86% per annum interest it was one of the cheapest providers of finance compared to its peers. However, the interest rate was significantly higher than the credit unions and the community owned institutions.

The major debate around the public issue of BC was three-fold:

1. The first was about its own business practices – particularly on the interest rates being charged to the poor;
2. Use of USAID and other grant money in the investment in BC and the resultant enrichment of some of the promoters – particularly directors and managers and even the institutional investors like the IMF and Accion;
3. The appropriateness of offering for sale the shares of the existing share-holders while there was no expansion of the capital at the time of the initial public offering

Surprisingly the debate was led by no less than Professor Dale Adams of the Ohio University on the devfinance listserve. Dale Adams and the Ohio school have constantly advocated the financial sector approach to microfinance – questioning subsidies and asking the market to take over. The messiahs of the market were pausing and asking a question on whether this was okay.

The debate stems from the basic issue of using or leveraging funds meant for public purposes to generate private profits. The grants given by organizations like USAID, or other donor agencies are in usually done in the spirit of benefitting the common good through various mechanisms, and are not meant for individual enrichment. Therefore it was appropriate for somebody like Dale Adams to raise an issue on whether the aid money was indeed spread out in an equitable manner to benefit a larger community. The basic difference between BancoSol and BC was that while most of BancoSol's shares were held by institutions, in case of BC directors and managers had shares to the extent of 23.7%, and other private investors had a share of 8.5% of the total capital.

Rosenberg's[9] defence of the BC issue was strong. The original investors were putting on sale only 30% of their holding and with the proceeds of $450 million unlocked, this would help in pushing the proceeds largely into the hands of the public purpose institutions. This amount clearly would go back into further developmental work and furthering the cause of microfinance. The NGO Compartamos held 39.2% of the shares and even this return [at a compounded internal rate of return of 100% per annum] would have meant substantial amount at the disposal for carrying out charitable activities. However Rosenberg in his

[9] Rosenberg [2007] Op.cit.,

arguments does not discuss the enrichment of the managers and directors. In one sense the argument is that there was indeed a market for loans at such interest rates, the borrowers would have been worse off, has BC not existed and the profitability of the operations spurs more people to come into the business and competition is certainly good for the poor.

The Indian Situation

When we look at the four large MFIs in India, we find the issues raised in the BC case resonating. Not only these issues come back to the fore, there are much larger ethical issues that we will have to discuss, not only from the underlying theory of understanding public purpose and private profits, but also from the apparently legal mechanisms used by the large MFIs. Given that these institutions are going to be hitting the market sooner than later, there would be a heightened public scrutiny of their practices and we will have to examine their conduct in greater detail.

In the following sections we shall focus on issues pertaining to the nature and type of capital infusion into the industry and its implication on the governance standards and client relations. For the purposes of discussion we have chosen four of the largest MFIs in terms of gross loan portfolio in India.

Based on the MIX data, each of these four institutions serve more than 8,00,000 customers, have a loan portfolio of more than US$ 100 million and an asset size of more than US$ 170 million each by the year end 2009. These four MFIs chosen based on the MIX data are:

1. SKS Microfinance [SKS]
2. Spandana Spoorthy Financials Limited [Spandana],
3. Share Microfin Limited [SML]
4. Asmitha Microfin Limited

Of the four institutions listed above, three [exept Asmitha, which we shall discuss separately] have followed a similar path in terms of the original organizational structure, incorporation into a commercial format and the methodology of moving from a "charitable" construct to the "commercial construct." The issues arising out of such a movement and the path adopted by Spandana were discussed in detail in an earlier paper[10]. Unlike the international counterparts

[10] Sriram MS: Expanding Financial Services Access to the Poor: The Transformation of SPANDANA, IIMA Working Paper Series [2005-04-03]. Also published in Sujatha B (Ed): Financial Inclusion Concepts and Strategies. Hyderabad: ICFAI University Press, 2008.

of BancoSol and BC the legal framework in India did not permit the NGOs to take an equity position in for-profit finance companies.

The promoters of each of these institutions possibly did not have the resources to meet the initial capitalization requirements of Rs.2 Crore to set up a for-profit finance company at that time. While this is not explicit, the nature of initial capitalization and the later movement gives enough reason to believe that personal resources were indeed a problem. Given the legal framework of non-profit societies which were operating in the microfinance space, it was impossible to shift the portfolio without the new company providing consideration in cash. It was not possible for the newly formed company to acquire the portfolio of a public society in consideration of equity shares, which was the route that was adopted by the Latin American models.

This posed a significant challenge because residual claims on current income and on liquidation cannot be applied for such purposes, the promoters had to look at innovative mechanisms of utilizing the investments made in the non-profits in a meaningful manner. If we were to look at a legal [and not necessarily moral/ethical] mechanism to overcome this there could have been only two options:

1. Ensure that the residual claims are so low, by skimming resources above the line. This could be done by paying an exhorbitant salary to the promoter and enrich him or her to generate personal wealth in a legal manner to invest in the next wave of the business. It appears that this was not a route that these promoters preferred at that time, because all of the promoters genuinely came from a developmental background. A look at the composition of the boards of these non-profit organizations in the early days indicate that the membership of the boards consisted of people who were known development professionals and none from the commercial world. Therefore attributing a ‘conspiracy theory’ of wanting to skim resources above the line might be inappropriate. A perusal of the salary expenses of these not-for-profit entities does not seem to instill any doubt on such a possibility.
2. The second option for these entities was to look at ways of distributing the un-distributable – the residual claims themselves – the excess of income over expenditure as well as the grant funds held in the books of the not-for-profits.

When we look at each of the four firms listed above, at least three of them resorted to the second option of using the grant funding sought in the not-for-profit organization to capitalize the for-profit operations of NBFCs. This possibly was done with a fairly benign intention at that time – as it was seen as genuinely involving the community members who were also borrowers in the capital structure of the companies that were being promoted. Infact this was honourably called transformation and all these MFIs had no problems in sharing the details of the process with the world at large.

The documents of that time available in the public domain as well as the rating reports that were submitted by MCril – an international rating agency to a public institution SIDBI does mention the process of "transformation" from a non-profit entity to a for-profit NBFC. Infact SIDBI also launched a special product called "transformation loan" in order to help these organizations to have liquidity in the process of transformation to a for-profit entity.

In addition to SIDBI's offer of the transformation loan, when we look back, we find that a product innovation by ICICI Bank also was in no mean measure a contributory factor for the transformation of microfinance sector. ICICI Bank first launched the securitization product in 2003, wherein it would buy out the portfolio of the microfinance institutions in return for an agreement for collection of the loans [See Nair, Prasad and Sriram][11]. By offering this product, ICICI Bank helped microfinance institutions – particularly those operating in the not-for-profit format to scale up faster. This was because, everytime a portfolio was bought out, the MFI would get the ability to lend as well as borrow more and thus expand. ICICI Bank followed up this product with a partnership model which essentially converted the MFIs into agents of the Bank, lending on their behalf, but with a touch and feel of the MFI. By introducing these innovations ICICI lent to the MFIs the strength of its balance sheet, making capital adequacy an irrelevant number. This helped the MFIs to grow at a pace faster than they would have grown. These twin products also provided the MFIs the necessary liquidity when they decided to move the portfolio from the non-profit format to a new NBFC.

As we stated earlier, transformation was not in the strictest sense morphing one organization into the other. It was actually transferring all the operations from one form of organization to the other while winding down of the operations of the former. Thus, for every inflow in the new for-profit company, there had to be an equal and matching outflow in the not-for-profit company. Two of these experiments were documented in detail in separate papers [Pathak and Sriram 2004[12], Sriram 2005[13]]

Unlike Compartamos and Bancosol where the process involved a direct allotment of shares to the NGOs in return for a portfolio of assets, in these cases such direct dealings with the NGOs were not possible. Thus the NGOs would actually give a grant to their individual

[11] Nair, Tara; Prasad, Vishwanatha and Sriram MS [2005]: ICICI Bank, Chapter in Small Customers, Big Market: Commercial Banks in Microfinance. Edited by Harper, Malcolm and Arora, Sukhwinder. Warwickshire: ITDG Publicatons.
[12] Pathak, Akhileshwar and Sriram M S [2004]: Community at the Core: A Case Study of Sarvodaya Nano-Finance Limited. IIMA Working Paper Series. Ahmedabad: IIMA.
[13] Sriram [2005]: Op.Cit.,

borrowers – who in turn would then invest in the shares of the new for-profit NBFC. The grant to the individual borrowers could be justified in law as having provided financial support to the poor, who were loyal customers/borrowers of the microfinance operations. With the donor community, this could be justified as *integrating the poor in the exciting investment opportunity in their own financial institution which could operate on market principles*. Thus even public institutions like SIDBI – possibly in good faith – joined the game by providing transformation loans at fairly low rates of interest. These loans would provide the NGOs necessary liquidity to actually put the money in the hands of the borrowers, who in turn would invest in the NBFC, and the NBFC in turn would buy the portfolio of the NGO for cash and this cash would be used to repay the transformation loan.

In the following sections we shall deal with specific details of some companies to extend the argument of usage of public purpose funds to leverage personal wealth in a much sharper way, with the data available in public domain.

Share Microfin Limited

The first in the series to be incorporated as a company was Share Microfin Limited [SML]. The NBFC was actually incorporated way back in 1999. However, unlike the later entrants SML did not have the necessary knowledge and experience of aggregating the "donor" funds through bulk transactions. Thus SML went through a fairly long process of canvassing small amounts of funds from individuals to be invested into the company. While the details are not fully available in the public domain, a perusal of literature around that time indicate that Share-group operated four entities – SML the NBFC, the society where most of the microfinance activities were carried out and two mutually aided co-operative societies [MACS] - these MACS went by the name Share India MACS and Sneha MACS, both collecting savings from a set of people who were borrowers of SML. The co-operatives in turn actually lent to SML the NBFC [See, Sriram 2006][14]. While there were indications that the savings of the members of the MACS was in turn used to invest in the capitalization of SML, it is also said that a grant from C-Gap was actually used in for capitalizing the NBFC.

While both these remain unverified, it was clear that in the first year of operations, the company claimed that it had raised equity from around 4,000 individuals who belonged to the community and had a capitalization of Rs. 4 crores. For SML, the charade of being a

[14] Sriram [2006] Growing with the Poor: SHARE and Microcredit, Chapter in Flow of Credit to Smalland Marginal Farmers in India, Samar Datta and MS Sriram, Delhi: Oxford and IBH

company owned by the community continued for a while. For instance, in the annual returns of 2003-04 filed by SML with the Registrar of Companies [RoC], we still find that under the head directors and relatives there are only two shareholders, while the rest of the shareholders were listed separately. It is also evident from the returns that there were people from the development sector [Jayashree Vyas of SEWA Bank, JS Tomar of Cashpor Financial Services] and at least two women who represented the borrower community on the board of the NBFC.

However it appears that SML learnt fairly early that being a "community owned" company was problematic. To be most charitable, one could say that the organization found it difficult to handle such a large and monotonous share holding pattern – a large number of shareholders owning just 5000 shares each. As we come to the annual returns and the shareholders list of 2006, we find that while the equity had substantially increased to more than Rs.20 crore, the number of shareholders were shrinking. The list of shareholders filed by the company as of 2006 showed a little under 3,000 shareholders. We also find that by 2006, the individuals were gradually replaced by a substantial holding by mutual benefit trusts [MBTs] – a new special purpose vehicle discovered by the microfinance sector. These for-profit MBTs – the creation of an intelligent legal brain – were actually special purpose vehicles that would aggregate the borrower-members of the microfinance organizations as members. The grant money in the not-for-profit society would find place in the MBT and this MBT in turn would contribute to the share capital in the NBFC.

This had two advantages – the companies did not have to deal with large number of retail share holders on their books – but would be dealing with blocks of shareholders in the form of MBTs. Two, the trust deed would be drawn in a way that an employee of the for-profit entity would act as a representative of these trusts in participating in the general bodies of the companies – thereby retaining complete control over the so called 'community investment' in the NBFC. Thus, by the time we come to the middle of the decade, the charade of the community participation in the capital structure of the company is also shed.

In case of SML something dramatic happened. Not only was the charade shed, the issue looked much more brazen: The list of shareholders filed by SML as a part of the annual returns of 2006-07 showed a dramatic fall in the number of share holders. From a 44 page document that had around 3,000 shareholders in 2006 it dropped to a two page document with just 68 shareholders, while the overall share capital remained at the level of around Rs.22 crores. The shareholding of the main promoter who just had around 75,010 shares in

2006 went drastically up to 24.25 lakh shares. Those of his family members went up from around 13% to 57% in individual names and another 40% of the shareholding were held by an investment company, which in turn was substantially owned by the promoter. The same year saw the exit of all the representatives of the 'community' and 'development sector' from the board of SML. Thus the privatization of the community owned entity was thus well on its way. The transformation of microfinance as a vehicle for personal enrichment clearly was visible.

While we examine the above, it is also important to look closely at the investment company that held 40% of the equity in SML at that time - Jacinth Finvest Limited. This aspect is important because of the relation of this promoter and the investment company with another microfinance institution Asmitha Microfin Limited about which we shall discuss a little later.

Post 2007, we find that other investors like Legatum Ventures and Aavishkar Goodwell come in to purchase shares from the company at a substantial premium. The investment company Jacinth was slowly divesting from SML, it became a subsidiary of Legatum Ventures. The skimming of profits and personal wealth was almost complete, though the story continues and possibly will continue for a little while more. We shall revert to this after we examine the case of Asmitha Microfin which is a 'related' concern of SML in more ways than one.

Asmitha Microfin Limited

Asmitha Microfin Limited [Asmitha] was set up in February 2001. While we do not have access to the data of the earlier years, by 2003-04 Asmitha had an equity of Rs.2 Crores, invested by 5 shareholders. Unlike SML, Asmitha did not have a charade of a community participation in its equity. However it is important to remember that the promoters of Asmitha were the same people as the ones who promoted SML. While it appears that there was a Chinese wall maintained in ensuring that there were no inter-corporate transactions between SML and Asmitha, when we look at the persons owning the significant chunk of shares in both the entities, the parentage is clear.

While Asmitha looked like a nice family managed entity in the first few years – the equity moved from Rs.2 crores to about Rs.4.91 crores and remained with around 59 shareholders, largely with individuals from the extended family. In 2007-08 something peculiar happened. The number of shareholders suddenly moved up to around 324 shareholders. While the list of shareholders from the family and the investment firm Jacinth [which invested in SML as well] numbering 24 held a significant part of the shares, another 300 shareholders came in with a monotonous holding of 1000 shares each, amounting to an equity contribution of Rs.30 lakhs. Around 270 of these shareholders mysteriously disappear in the year 2008-09. Of the 30 only 14 of the shareholders common, with the other 16 suddenly transferring their shares to some others! The shares of the disappearing shareholders is transferred to two shareholders by the name Vijayam and Chintamani, who suddenly increase their joint holding from 12,000 shares to 2.82 Lakh shares. These transactions do not seem to follow any particular logic but seem to have a pattern.

Between SML and Asmitha there is a clear distinction. Asmitha was a fully profit making investment oriented firm. While there is no strong reason to believe that the public purpose funds that came into the SML system could have been diverted to Asmitha, the unusual movement of capital during the period in which Aavishkar Goodwell and Legatum invested in SML is somewhat uncanny.

When we look at both the companies together, we find that there are great similarities in the ownership pattern and how the family ties are fostered. What is more important is not about how the family acquired significant holding in SML Microfin through creeping mechanism, but how above-the-line skimming has happened systematically. The managerial remuneration of the managing director of SML was around Rs.2.29 crores [including sweat equity of Rs.88 lakhs, valued at a notional price of Rs.34.67 per share but against a nil payment]. In 2008-09 it shot up to Rs. 8.08 crores [including sweat equity of Rs.2.69 crores], by far not only the highest remuneration in the microfinance sector, but way above the remuneration obtained by the CEO of the largest private sector bank – ICICI Bank. The remuneration paid to the managing director was around 7% of the total personnel cost of SML in 2007-08 and shot up to 15% of the personnel cost of the company in 2008-09. Similarly in Asmitha microfin, the managing director – who is the wife of the MD of SML was to obtain a salary of Rs.34 lakhs in 2006-07, which was proposed to be hiked to around Rs.60 lakhs in 2007-08 and in 2008-09 she was actually paid a salary of Rs.1.58 crores [including incentives] and allotted a sweat equity of Rs.1.94 crores taking the total remuneration to above Rs.3.5 crores. In addition to this, their daughter, a wholetime director in the company was paid a remuneration of Rs.24 lakh. The remuneration of the managing director moved up from around 3.1%of the personnel costs to more than 11% of the personnel costs. During the same period, Asmitha had appointed a Joint Managing Director at a grand salary of Rs.45,000 per month. The disconnect between salaries of the family and the rest of the staff is there to be seen.

Overall it is clear that in both the organizations, the promoters were skimming the benefits. In case of SML, it is of significance to note that the general body passed a resolution of providing the MD a salary of Rs.80 lakhs per annum and 'such other incentives as the board deems fit' [and such incentives are actually in the order of several crores]. In both the cases the overall salary provided to the chief executives is significantly above the maximum managerial remuneration payable as per the Companies Act, for which they would have sought special permission. When we examine these aspects from any benchmarks, it is clear that there is a disproportionate payment to the promoters of the firm. It is interesting that this happens even while the boards of both the organizations have representatives of not only the international investors, but also Indian public financial institutions such as SIDBI. While the banks and financial institutions have a large exposure on both the institutions, it is evident that they have not participated in the equity of either of the firms. However, as lenders having board positions, it was not clear as to the stand that an institution like SIDBI might have taken in the overall governance of MFIs like SML.

Spandana Spoorthy Financials Limited

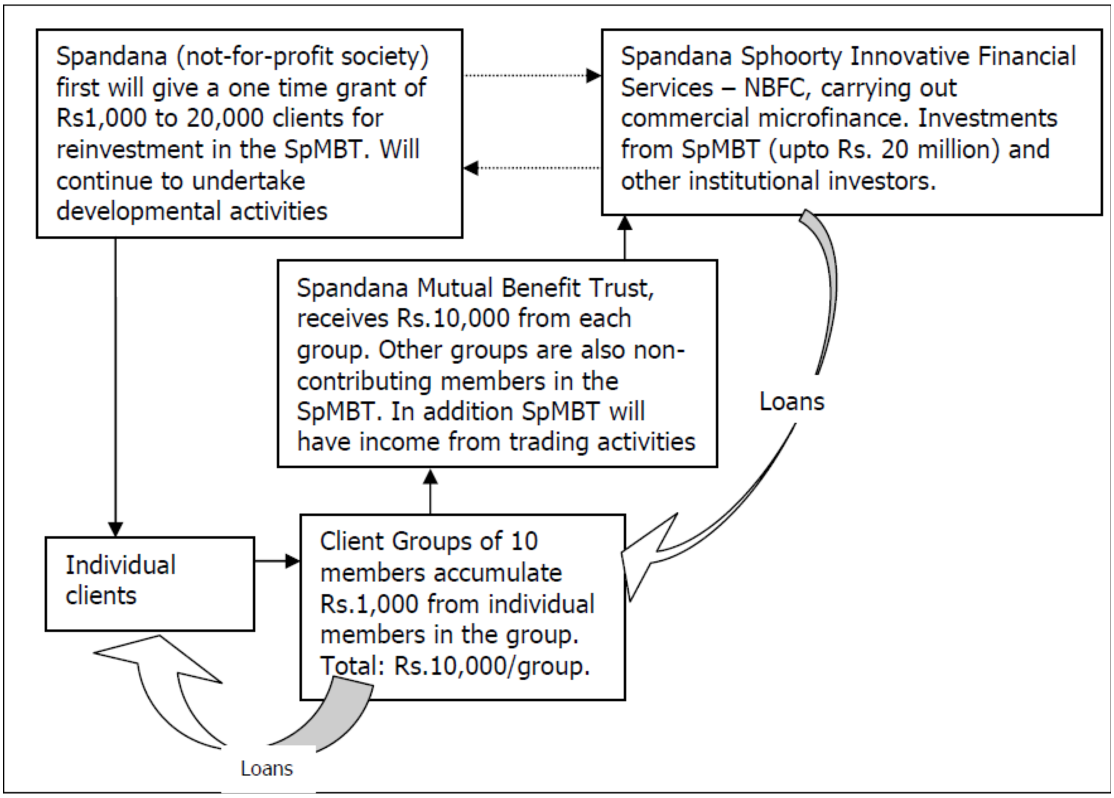
The for-profit entity Spandana Spoorthy Innovative Financial Services [Spandana] was incorporated after Asmitha. It was incorporated in March 2003. The process of investments carried out from the not-for-profit to the for-profit in case of Spandana was captured by us in an earlier paper[15]. We had represented this in a diagram as reproduced below. Unlike in case of SML where the funds were given to individuals and aggregated into multiple MBTs, in case of Spandana, the aggregation was into a single MBT. In Spandana the transition had to be managed in a fairly complex manner. The most important aspect was that Spandana was quite candid and transparent about its process of moving from an non-profit to a NBFC.

While Spandana used the MBT route to move the funds from the non-profit society to the NBFC, it did face problems pertaining to liquidity. Since all the resources in the non-profit were locked up in the loan portfolio, it did not have the liquidity to undertake the shift the funds through the MBT route. In order to overcome this problem, Spandana not only accessed a loan christened as 'Transformation Loan' from SIDBI but also resorted to an on-tap securitization scheme as well as the partnership scheme offered by ICICI Bank. The importance of the timing of ICICI Bank's securitization and partnership model cannot be undermined when we look at the evolution of the microfinance sector in India and at a stage when the largest microfinance organizations were trying to move into a for-profit format.

[15] Sriram M S [2005, 2008]: Op.Cit

The MBT shares were gradually wound down, with the promoter and her family picking up the shares of MBTs gradually over a period of 3 years. The annual returns filed in the early years indicate that these shares were picked up at par or at a nominal premium from the MBT. However the full details of how these shares – amounting to Rs.2 Crores were obtained is not completely clear.

Unlike SML, we do not find sweat equity or any other forms of non-cash allotment of shares to the promoters or their family members. While there has been a stake sale, this has largely been to expand the capital base of the company rather than to significantly dilute the shares of the promoters. For instance while the first generation investors – JM Financials and Lok Capital came at a smaller premium, and the convertible preference shares were converted at a premium of around Rs.155 per share, the later investors like Valiant were sold shares at a premium of over Rs.650 per share.



As of the last returns the promoter and family continued to hold around 59% of the stake in the company. The only intriguing part that is not clear is that how the promoter and her family continued increase their stake till 2008. The details of share allotments are not very clear from the data available. It is certain that these were not acquired through any form of stock options. The number of shareholders largely remained stable with minor movements.

When we look at how Spandana has managed the funds above the line, it is clear that there has been no blatant skimming of the profits. The managerial remuneration was Rs. 36 lakh in 2007, Rs.33 lakh in 2008 and went up to Rs.82 lakh in 2009. While in 2007 the remuneration was at 2.5% of the personnel expenses, in the years that followed, the managerial remuneration was at 1.4% of the total personnel expenses.

It also appears from the annual reports that the MBTs continue to exist as they are reported under the related party transactions. While in the earlier scheme of events, the promoter had planned to wind up the MBTs [See Sriram, 2005[16]] some funds continue to be held by the MBTs. However there are no details on how they are managed and to what purposes these funds are applied.

SKS Microfinance Limited

SKS is the most high profile microfinance institution in the country. It proudly states “Our purpose is to eradicate poverty. We do that by providing financial services to the poor and by using our channel to provide goods and services that the poor need.” Unlike the other companies discussed in this paper, the data for SKS is available in a consolidated format in the draft red herring prospectus filed for a potential public offering of shares.

The original shareholders of SKS were five mutual benefit trusts apart from a nominal holding by some individuals who were signatories to the memorandum. These MBTs held the initial share capital of Rs.2.05 crores. The offer document is candid in indicating that these MBTs received funds initially donated by the SKS Society [the non-profit entity in which the operations were carried out from 1997 to 2005]. The transition of SKS from a non-profit to for-profit format took a fairly long time when compared to SML and Spandana. Unlike SML and Spandana, there was little holding by the promoter Vikram Akula right from the beginning. However it is important to look at the details of the transactions that have happened after the company was incorporated.

Unlike the three organisations discussed above, SKS had an air of professionalism right from the beginning. Vikram Akula with his background in McKinsey and his awareness of the US markets had set in place some systems that would mimic the modern corporate. This included hiring high profile legal consultants as well as being audited by one of the big audit firms. Having a series of interns and generally being seen in the corporate world. In a way Vikram

[16] Sriram [2005] Op.Cit.,

Akula created a buzz around himself and his business, by putting a well oiled PR machinery to ensure that the firm was constantly in news.

While Spandana and SML were relatively low profile and could acquire the shares allotted to the MBT over a period of time and convert the shares into their personal holding, Vikram Akula was unable to do that. To be charitable to Akula, we could even assume for the moment that he was not interested in taking away the money that belonged to the community to divert it to have personal wealth. In that sense the case of SKS will be the closest to BC that we have discussed above.

However, it is important to note that while the grants that were meant for the community remained in the MBTs, Vikram Akula's holding did keep going up and down over a period that he was at the help of affairs of SKS. Unlike SML and Asmitha that discovered the power of a high salary for the CEO somewhat later in life, Akula did ensure that the salaries of SKS were the highest in the industry. There was a well designed stock option plan, which not only included him, but also the others in the hierarchy. He brought high profile directors to his board and was also able to reward them adequately.

Let us just examine how Akula rewarded himself and the other senior employees in SKS. The community funds came in to SKS in December 2003. However the company received the NBFC licence only in 2005. When we look at the accounts we find that commercial operations of SKS Microfinance for all practical purposes started in 2006. Between the time the company was set up and the time they got a licence, there were no personal finances of Akula locked up in the entity, but it was fully funded by donor money, and it was lying locked up in the NBFC for about two years. In 2005 when the NBFC licence came in, SKS microfinance had the advantage of a ready made portfolio to acquire without any preliminary costs. The portfolio of SKS society was transferred to SKS Microfinance and in 2006. By March 2006 SKS had a readymade portfolio outstanding of Rs. 78 crores – the cost of building this portfolio having been absorbed by the SKS society.

It was clear that SKS was growing fast and needed capital. However the first infusion of capital other than the MBTs happened around March of 2006 in three tranches. The MBTs invested more capital [the source of their funding is not clear from the documents available in public domain, but it is fair to assume that it came from sources with a philanthropic orientation], SIDBI and Ravi and Pratibha Reddy Foundation took substantial stakes. It is important to flag the point that SIDBI as well as Ravi and Pratibha Reddy foundation had also supported SKS Society, the NGO. We assume both these amounts are coming from developmental sources. In addition two other investors – Vinod Khosla and Unitus Equity Fund took a position in the company. It is possible that all the investors were still looking at this as an investment with a cause. All the investors were allotted shares at par. In this entire story we do not find the personal finances of Akula coming in [apart from a nominal amount of Rs.5,000 that is invested as a part of the subscription to the memorandum and even that is quickly sold within 8 months]. It is possible that he saw himself purely as a professional who was acting in trust – being a good intermediary between people who saw a developmental cause with a commercial approach. He was possibly being paid a professional salary for the work.

However, when we fast-forward to March 2007, we find that Akula gets an allotment of shares worth Rs.1.6 crore on par, on a day when other investors, including the investors of the first tranche Vinod Khosla pay Rs.49.77 per share. Assuming that the Akula has been getting a professional salary for carrying out his work in SKS and also given the fact that the original capital came in from developmental funds, this allotment looks somewhat peculiar. We also have to remember that this allotment is not even through the stock option scheme, from which he is going to get more money later. If we were to just monetise this amount Akula gets a one shot notional gain of Rs.6.5 crores, when we value it on par with the price paid by the other investors on the same day! However one does not need to wait long enough to find out whether he indeed encashed this amount. In 18 months from getting these shares allotted, Akula sells them out for a price of Rs.103.91 – a gain of 15 crores on an investment of Rs.1.6 crores. Microfinance is indeed a very lucrative business.

This is followed by a stock option allotted under the Employee Stock Option Plan of 2007 exercised in the month of December 2009 and promptly sold in February 2010 [in the run up to the filing of the draft prospectus]. The exercise of options was at a price of Rs.49.77 per share, while the sale to Treeline Asia Master Fund at a price of around Rs.636 per share indicating a neat profit of around Rs.55 crores in about three months. Currently as the company hits the market Akula, the main person credited to have been behind SKS holds nil equity, and some options that are to be exercised which he has subjected to a lock in. [Of course one does not know if Akula holds any stock indirectly through firms such as SKS Capital and Tejas Ventures, both entities putting a part of their holdings on offer].

The story of the senior employees – starting with the CEO Gurumani, is similar. Gurumani who had exercised his option to purchase 225,000 shares at a price of Rs.300 on March 23, 2010 already has an agreement with Treeline dated January 27th 2010 to sell his shares for a consideration for Rs. 14.32 crores – a neat profit of Rs. 7.5 crores. For a person who was appointed in December 2008, he was granted an one time bonus of Rs.1 crore in April 2008 and a salary of Rs.1.5 crore per annum, added with a performance bonus of another Rs.1.5 crore and stock options.

The senior employees – COO MR Rao, CFO Dilli Raj and other employees have all decided to cash out in the run up to the public issue, selling all their allotments under both the stock option and stock purchase plans at a significant premium. There is nothing legally wrong in the encashment process. However there is a larger question about the signalling of commitment on the eve of a public issue that we need to consider.

However there are two most important questions that the SKS issue leaves wide open. One is pertaining to the governance of MBT and the other pertaining to the governance of the company itself.

Unlike SML and Spandana the MBTs continue to hold a significant stake in the company. Not only do the MBTs hold shares, they also have been allotted shares twice in the last few years for which they have subscribed. Given that the MBTs have no business of their own and are shell organisations, one wonders how the share purchase of the MBTs were funded. Clearly if there is somebody backing the MBTs to not only invest at a premium and exercise the options, at a stage where the company does not need "developmental funds" for growth and can attract mainstream capital, there should be a larger interest operating. This larger interest could be that MBTs being institutions working for the benefit of the company should bolster their corpus so that they can work with renewed vigour to help the poor. Why would anybody grant more donations into an entity for a speculative business? The MBTs if they did not have resources to contribute to the options could have sold their options at that time and cashed in on those options and used the funds for the larger developmental purposes. It is clear that at the time MBTs were subscribing to the equity, the private investors were also making an investment at the same price of MBTs, and thus there was indeed a possibility of an investor coming in at that price.

Given that the MBTs own around 16% of the pre-issue capital at 1.04 crore shares, and assuming they would fetch a price of Rs.636 which was the last price paid by Treeline they are worth around Rs.650 crores. This is a large amount of corpus to be controlled. The question is, how would this amount – that came in as a small amount to kick start a development oriented MFI – be used or ring-fenced? If it were similar to SML or Spandana, this would possibly have been converted into promoter equity, but in case of SKS since that has not happened. Nevertheless, the magnitude of the money is staring at us.

Incidentally there have been changes in the governance of MBTs. *Each MBT had 5 turstees comprising of three employees and two beneficiary members from the regions. In November 2009, SKS Trust Advisors [formerly Utthan Trust Advisors] was designated the sole trustee of each SKS MBT*[17]. Currently there are only two persons, including Akula, in charge of this as members on the board of SKS Trust Advisors. The governance of this outfit is expected to be broadbased as per the prospectus. However, the fact that there were three high profile persons Gurcharan Das [the famous author of the book on modern 'Dharma' – The Difficulty of Being Good, and a host on a television show that asks questions on ethical and moral dilemma], Anu Aga of Thermax and Narayan Ramachandran of Morgan Stanley, on the board of this advisory till days before the prospectus was filed. Their sudden resignation in March in the run up to the filing of the prospectus raises some questions. Afterall these persons had joined to board of in the months of November, December of 2009 and January 2010. Gurcharan Das not only quit the board of the advisory trust but also quit the board of SKS in the run up to the public issue raises some questions. Akula who was never on the board of the Trust Advisory, has joined the advisory, indicating his intent in controlling the kitty that is available with the MBTs.

When we come to the governance of the company itself, while we find that there are fairly high profile personalities on the board two recent incidents worry an outsider or even a prospective investor. The company has an ESOP 2008 [ID] scheme. Though the name of an ESOP is a misnormer – it is a stock option plan for independent directors. The stated purpose of the plan is to attract and retain independent directors, and to remunerate them. While it is true that independent directors time needs to be compensated and also they need a cover for the risks of being on a board, the compensation has to be above board – either as a fixed sum, or as a commission from the profits that have been earned. Offering independent directors stock options and putting their incentives on par with the management of the company is actually taking their independence out. Why should an independent director be rewarded with options whose exercise depends on the performance of the company not on fundamentals, but on its behaviour on the stock market? Added to this, one of the independent director Tarun Khanna also has been allotted shares worth $50,000 on a preferential basis on August 18th

[17] Quoted from the draft red herring prospectus filed with SEBI on March 25th 2001.

2009 at a price of Rs.300 per share. The justification for this offer is that he would take more interest and show a greater involvement in the affairs of the company. Governance that is laced with conflict of interest of this nature – particularly a reward system that puts the independence at stake does not appear suitable from a company that has to boast of good governance. We have to remember that this company claims to be in the service of the poor and vulnerable and therefore it is all the more important that such a company does not appear greedy at all levels of operation.

Apart from the above a new and interesting development happened in January 2010. Catamaran Management Services [a fund set up by none other than NR Narayana Murthy of Infosys] have been preferentially allotted shares in SKS on January 19th 2010 at a price of Rs.300 per share, when around January 27th Treeline was willing to buy the shares of Gurumani at Rs.636 per share. Why would Murthy want a share in SKS? We can suppose that there is a spirit of nurturing entrepreneurship and promoting innovation – and possibly that is the reason why he set up Catamaran from his personal resources. SKS is neither innovative nor an untested idea. Catamaran has doubled the value of its holdings in less than a week and might even see a greater value unlock at the end of its lock in period. While doubling or tripling of the investment in a quick period could be a good enough reason for any investor, does the same hold good for Murthy who has carefully nurtured his image as an ethical, non-greedy, professional?

Of course it makes perfect sense for SKS to sell shares to him at Rs.300 [or even less for that matter], because that would be an investment they would be making in a brand ambassador for the public issue. They would be getting credibility – something that is most needed when one is doing a business with the poor at a price that is marginal. The agreement indicates that Mr.Narayana Murthy would be heading an advisory board. This arrangement is interesting because SKS gets the upside of the association with showing Murthy as heading the "advisory board', Murthy himself would not have the downside of the responsibility of a full board member – no liabilities or responsibilities of the director of a company. While from the perspective of SKS this arrangement is perfectly understandable, it is not clear from the perspective of Murthy as to why he would want to do it.

Discussion of the issues arising

Microfinance sector has emerged out of the development paradigm. Over a period of time microfinance sector has tasted success, because it was addressing a latent need for financial services for a certain market segment that was willing to go through the standardization of delivery of the MFIs and also the discipline. This ensured that there were sufficient rents to be sought – because of the inelasticity in interest rates at the client end. The market has been discovered and well catered to.

When we look at the above cases, and look at the data, it is quite easy to get carried away by an ill founded argument that the poor are being exploited with usurious interest rates. But our argument is not about interest rates. If there is market at these rates of interests and MFIs can deliver efficient services, they should do so and earn a good profit in order to carry out their business. Those who are ideologically opposed to the market based models should be free to examine the community based SHG models that could be persued.

We would go a step further and also argue that even if we for a moment assume that the interest rates are usurious, the MFIs still might have a place under the sun. The MFIs have been variously called white collared moneylenders in several forums. The reason why they should be welcome to operate, even if the interest rates charged is usurious is because of the fact that they belong to the organized sector. These organizations file their returns and are therefore open to scrutiny. The fact that SKS is going public is welcome from a singular point that it will now be accountable to a larger number of people and thus would hopefully show a more responsible behavior. If we assume that the MFIs are exploitative, then they could be brought to the table for counseling or brought to book by the regulator. Therefore a MFI – however usurious it is, should be desirable than a faceless moneylender where the terms of exchange never come out and can be discussed. The fact that we are able to write this paper today is in itself an indication of the positive aspects of such activities being in the organized space.

Our argument in this paper is basically about the ethical fabric on which the largest MFIs are being built. Each one of the promoters possibly came in with a developmental objective – that they indeed wanted to promote institutions that were with the community. The fact that each of them tried to have community share holding and give some parts of the profit back to the community is coming from their developmental background. No commercial outfit would have thought of such a structure. The fact that they had to move to the mainstream was also imperative due to the requirements of capital and the pace of growth. That might also be the reason for public institutions like SIDBI to pro-actively design products and be a part of this process. However, in the process of getting the mainstream into the poverty market, somewhere they seem to have lost the vision. Whether they were pushed into a corner because the private equity investors gave them offers that they could not resist or they thought that their job was done and they have a larger agenda in life is not known. However it is clear that the incidents in the history of these organizations do not make a very good reading.

Possible responses

This paper is bound to evoke some responses from the practitioners of microfinance. It might be a good idea to anticipate the usual responses from the practitioners and provide our stand.

Criticism 1: We have painted all microfinance through a common brush, but not everybody and every organization has these issues.
Response: Indeed this would largely be true. Therefore, these cases should be seen for what they are individually. This does not mean that the other organizations operating in the MF space have issues of mission drift or personal enrichment. These are specific organizations on which we collected data and analysed. The reason why these were analysed was that they were amongst the top microfinance institutions of the country and we had to examine them carefully.

Criticism 2: The paper is timed just before the public issue of the largest microfinance institution and if the issue gets affected, it affects the microfinance sector as a whole.
Response: A large part of what has been written in the paper has been well known and talked about privately. Given that some of these organizations would come in to seek funding from the public at large, it is important that these issues be discussed at this time.

Criticism 3: What is wrong with personal enrichment? Ultimately that is what all profit seeking enterprises would be doing. The celebrated Bottom of the Pyramid market is all about trying to make a business out of the poor.
Response: There is nothing wrong about personal enrichment and these questions would not have been asked, if for instance this was in investor owned firm from day one. The reason why this question becomes important is because of the source of the funding and where it came from. The questions that Dale Adams and others asked about Compartamos are exactly the ones that are being asked now. If we are dealing with funds from public sources, then it is important to ensure that we not only deal with it in a fair manner [and that does not mean that people should stay impoverished] and also appear to be seen to be fair. In each of these cases, neither the original investment belonged to the entrepreneur, not was the original idea theirs.

It is true that the bottom of the pyramid argument should apply for this business as well. Unfortunately unlike a FMCG company which looks at the bottom of the pyramid and tries to design products that would attract the poor, it is difficult for anybody to trace the profits of the company specifically to the poor clients. In any case, the people in the bottom of the pyramid market do not put their mission as eradicating poverty. The problem with microfinance is the traceability of its profits. Given that it is possible to trace these profits to exclusively the poor, the contrast becomes so much more stark. Therefore it is essential to be moderate on such a business. Infact it would be in the long term interest of these businessmen to take this into consideration because the backlash in case of undue enrichment from the poor is going to be much larger and harsher than in any other business.

Criticism 4 – Specific to SKS: What is wrong if the promoters and management exit in the run up to the IPO, afterall they are eligible to do that.
Response: Legally there would be nothing wrong, and that is the reason why they have indeed done so and reported it. However, why should any person exit if they see a long term potential in the business. If we look at all the large business houses, be it the Tatas, the Birlas and the Reliances – we constantly find that the promoters are usually there for the long haul and over a period of time even consolidate their holdings by buying back stock from the market. The innovators who work with ideas tend to cash out, because they are basically bored with the idea and would like to move on to the next big one. But in case of microfinance, neither seems to hold good, and it appears that the promoter-managers are keen to get as much out of the business as quickly as possible.

Whose loss is it anyway?

There have been talks that the microfinance market is overheated, and that there is a bubble in the making. If there is a crisis in the microfinance sector whom would it affect? If we look at this question carefully we realize that it will not affect the poor in a big way. Yes they would lose out on an assured source of lending from the formal sector, but that hopefully would be covered by newer and innovative institutions. The poor have already paid the price for the loans that they got. They would benefit if the loans come at a more moderate rates of interest, but if there is healthy competition even that will happen in the long run. Therefore this entire argument is not about the poor at all. However this argument is certainly about doing business with the poor and with the claim of eradicating poverty.

Thus the issue is about the potential investors and the valuations at which they would invest. Let us elaborate on this a little. Let us assume that these organizations continue to get the valuations that they are getting as of now. Are these valuations realistic? If they are, what are the assumptions under which they are realistic? This would at least mean that the institutions would continue to have earnings as per the historical trend, and would possibly even better it. This would mean that there is a tremendous potential for somebody investing at this level to make more money. How well founded is it in the banking industry. If it indeed is, then we would be indicating that the poverty market is perennial and managers would return the same types of returns over a period of time. If the valuations are reasonable then the industry will stabilize at this stage.

If we were to look at MFI sector as a whole, the SKS public issue might turn out to be watershed. If the valuations are way about realistic levels and go the dotcom way, then somewhere there would be a crash and the last person holding the shares would be left with a dud. We have to realize that all the original investors of these institutions have almost cashed out and therefore it is imperative that the current holders of equity – largely the private equity funds show restraint and steady the ship, in case it is rocking. If the valuations are below expectations and the issue devolves, then it might take some time for the other players in the industry to recover, re-consolidate and hit the market. In any case for an industry that has grown at a scorching pace, it is time to hit the pause button and look back a little bit before the next phase of growth.