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**Title of Work:** Commercialisation in the Microfinance industry: a failure of responsible management.

**Abstract**

This case study analysis explores commercialisation in the microfinance industry as a failure of responsible management. I begin with a discussion of two businesses which are understood to be examples of the commercial model of microfinance.  I then situate these examples within the wider debate and outline criticisms of commercialisation with reference to academic literature, empirical evidence and the arguments of industry leaders.  In doing so I highlight the social impact of commercialisation and the nature and of the response to it by key actors in the sector.  Through a consideration of the concepts of social business and creating shared value, I show that the commercialisation controversy in microfinance can be seen as a distillation of a wider discourse in which the role of business in poverty alleviation is contested.  As such, I argue that the application of for-profit commercial models to poverty alleviation initiatives serves to perpetuate the inequality inherent to capitalism and conclude that there exists an onus on governments and industry to legislate business interaction with the poor.

**Introduction**

The United Nations has published the 2030 Agenda for Sustainable Development in which microfinance is identified as playing a key role in ending poverty in all of its forms everywhere (United Nations 2015).  Typically defined as the provision of small loans to poor people who are excluded from accessing traditional finance, the industry was serving 211 million borrowers globally by the end of 2013, 114 million of whom were living on less than US$1.90 per day (Microcredit Summit Campaign 2015).  The industry therefore serves as a client group the most vulnerable people in the world.  Initially founded on the notion of microcredit for enterprise as a tool for economic empowerment and poverty alleviation (Yunus 2007), the positive impact of microfinance on the lives of the poor has recently been called into question (Banerjee, Karlan and Zinman 2015; Bateman and Chang 2012).  In particular, the introduction of for-profit business models and private equity investment to the sector has been criticised as enriching private investors at the expense of the poor (Ashta and Hudon 2012; NextBillion 2014b).  Issues of responsible management have come to the fore and industry wide debate has been characterised by a dichotomy of opinion as to whether commercial business models can prioritise and achieve social outcomes (Clinton Global Initiative 2010).

In order to explore these issues further I begin with a discussion of two businesses which are understood to be examples of the commercial model of microfinance.  I then situate these examples within the wider debate and outline criticisms of commercialisation with reference to academic literature, empirical evidence and the arguments of industry leaders.  In doing so I will highlight the social impact of commercialisation and the nature and of the response to it by key actors in the sector.  Through a consideration of the concepts of social business and creating shared value (CSV), I will show that the commercialisation controversy in microfinance can be seen as a distillation of a wider discourse in which the role of business in poverty alleviation is contested.  As such, I argue that the application of for-profit commercial models to poverty alleviation initiatives serves to perpetuate the inequality inherent to capitalism and that there exists an onus on governments and industry to exercise caution in this regard.

**The Controversy of Commercialisation in Microfinance**

The Initial Public Offerings (IPO) of Compartamos Banco and SKS Microfinance (SKS) serve to illustrate the controversy surrounding commercialisation in the microfinance industry.  Initially founded as a not-for-profit nongovernmental organisation in 1990 to deliver tiny loans to low income women in rural areas, Compartamos launched a for-profit regulated finance company in 2000 and gained authorisation to operate as a full service bank in 2006 (CGAP 2007).  By charging high interest rates of 86% per annum, Compartamos had been able to dramatically grow its outreach and become a highly profitable model with a return on equity of more than 50% per annum (Ashta and Hudon: 2012: 332). Compartamos had issued debt on the Mexican bond market in 2002 which saw private investors become shareholders for the first time. In the IPO of 2007, those private investors received an estimated $150 million (CGAP 2007).  Two years later, SKS became the first Indian MFI to go public through an IPO.  Initially established as an NGO in 1997, SKS became a non-banking finance company in 2005 and accessed private equity to pursue an aggressive growth strategy (CGAP 2010a).  By the time of the IPO in 2009, SKS had over 5 million borrowers and 72% of the company was owned by private equity investors (CGAP 2010a).  Hailed as a success, the SKS IPO was 13 times oversubscribed and share price rose by 42% after five weeks of trading.

The response of the sector was dichotomous.  On the one hand, senior executives of Compartamos and SKS celebrated success: private investors had helped them to dramatically scale their operations and achieve outreach to millions of borrowers (Clinton Global Initiative 2010; Knowledge Network 2009). On the other, founders of prominent microfinance institutions (MFIs) condemned the high profit generated for private investors, with Muhammad Yunus claiming that high interest rates were akin to the usury of moneylenders (NextBillion 2014a).   Likewise, Carmen Velasco argued that any surplus used to pay dividends to investors comes from the pockets of poor clients: “that surplus could represent an extra bread for a kid, clothing for a kid...they (MFIs) have to be aware that they are dealing with people that are extremely poor” (NextBillion 2014b).  Instead, Yunus and Velasco advocate the mobilisation of savings as a favourable and more ethical source of capital for MFIs (Clinton Global Initiative 2010; NextBillion 2014b).  Grameen Bank had introduced savings products to reduce its reliance on external financing and in the space of 2 years deposits accounted for three quarters of its loan portfolio (Armendariz and Morduch 2005). Building assets in the form of savings is crucial to exiting poverty, thus a further argument is that microcredit must be offered in conjunction with savings in order to help the poor escape chronic reliance on debt (Bhatt and Tang 2001; Microcredit Summit Campaign 2015; NextBillion 2014b).

The introduction of commercial models to the industry therefore raised questions about social performance and the ability of for-profit MFIs to balance social and financial goals.  A major concern was that the presence of private shareholders might lead to ‘mission conflicts’ within an organisation.  Ashta and Hudon (2012) have suggested that private investors will expect a financial return to be a priority for MFIs, and that this may influence decision making in favour of financial outcomes even if private shareholders are in the minority.  Further to this, Mori and Mersland (2014) have applied stakeholder theory to suggest that private investors on the board of an MFI may cause a conflict of interest.  As it is a shareholder's role to monitor the activities of management, private investors may advise against activities which would affect the MFIs ability to repay debts and make a profit (2014).  A second implication is the question of whether outreach can be considered an acceptable measure of social impact.  Ashta and Hudon (2012) suggest that it cannot, and there is evidence that access to credit does not have transformative effects on the lives of the poor per se (Banerjee, Karlan and Zinman 2015).  In fact, it is now widely acknowledged that the very poor require complex interventions and that multifaceted microfinance programmes are the best mechanism to deliver lasting progress (Banerjee et al. 2015; Microcredit Summit Campaign 2015).

A further criticism levied at for-profit models of microfinance is that a drive to cover costs through earned income can lead to subprime lending i.e. the distribution of loans irrespective of a borrower’s capacity to repay (Morris 2012).  The Bolivian overindebtedness crisis of 1999-2000 was attributed to competition and commercialisation (Rhyne 2001), and a highly penetrated market in the Indian province of Andhra Pradesh created stiff competition in client outreach and gave rise to multiple borrowing (Ghiyazuddin and Gupta 2012).  In the crisis of 2010, commentators argued that overlending combined with high interest rates and aggressive collection practices drove a large number of borrowers to suicide (Ghiyazuddin and Gupta 2012).  The ensuant media frenzy drew international attention to the crisis and SKS in particular, whose operations had been established in Andhra Pradesh in 1997 (CGAP 2010a) and had lent to 17 of the borrowers who had committed suicide (Burke 2011).  The company denied coercion and responsibility on the basis that the 17 borrowers also had loans from other MFIs (Atul Takle, cited in Burke 2011).

The response of the government of Andhra Pradesh was also to allocate blame for the crisis to MFIs.  The government issued the Microfinance Institutions Ordinance, 2010, in which they explicitly accuse private MFIs of usury and exploitation.  The Ordinance set requirements for all MFIs to apply for registration and made provisions to protect borrowers through regulating the industry and greater transparency.  The subsequent nationwide Micro Finance Institutions (Development and Regulation) Bill 2011-2012 expanded the requirement to register, in addition to setting a cap on interest rates and requiring MFIs to implement a code of conduct (PRS Legislative Research 2017).  The Indian government’s response is in some ways reflective of initiatives in the wider sector which aim to respond to growing commercialisation and a perceived need for increased consumer protection.  A microfinance leaders retreat in 2008 recognised the need to develop a code of ethics in microfinance, and the resultant Pocantico Declaration called for standards on consumer protection, social performance, pricing transparency and promotion of financial literacy (Smart Campaign 2014b).  In 2009 the Smart Campaign was launched as a global effort to unite industry leaders around client protection principles, followed by the launch of the Social Performance Taskforce to assess how an MFI aligns its systems to its mission (Smart Campaign 2014a; Social Performance Taskforce 2017).  It is also thought that the introduction of credit bureaus will contribute to a reduction in multiple borrowing through facilitating data sharing between MFIs (NextBillion 2010) and this has attracted considerable funding worldwide (International Finance Corporation 2012).

However, it has been suggested that even established credit reporting industries can be inaccurate and unreliable (Centre for Financial Inclusion 2010) and it is important to note that participation in both the Smart Campaign and the Social Performance Taskforce scheme are voluntary and rely on self-reporting.  The impetus to self-report can therefore be expected to vary between institutions and will rely upon managerial perceptions of the responsibility that their business has to clients.  In this way, issues of responsible management come to the fore.  It is clear from SKS’ statement in response to the Andhra Pradesh crisis that they did not see the overindebtedness of clients as their responsibility.  The government response is also telling.  They accept no responsibility for the crisis, laying blame at the door of MFIs whilst simultaneously constructing a new regulatory framework within which MFIs can operate.  It could be argued that this regulation was reactionary and that government neglected its duty of care to citizens by failing to implement controls sooner than they did.  That this was not the case implies a degree of trust in business and an understanding of microfinance as inherently beneficial for clients, regardless of the provider.  In order to understand this relationship more fully, it is useful to look at dominant conceptions of the role of business in poverty alleviation.

**The Role of Business in Poverty Alleviation**

In their defence of commercial models of microfinance, senior executives of SKS and Compartamos argued that mainstream investors would help their companies to grow and serve more clients than they would otherwise (Clinton Global Initiative 2010; Knowledge Network 2009).  Vikram Akula of SKS highlighted that savings mobilisation is not an option for Indian MFIs and that they had to find a way to bring capital into as many poor households as possible (Clinton Global Initiative 2010; Morris 2012).  Carlos Danel of Compartamos agreed that access to financial services is key for the development of the poor and that sources of investment are limited(Knowledge Network 2009). It is therefore necessary to involve private investors and the only way to do this is to provide a profit as they have a fiduciary responsibility to protect the assets that they hold to produce a return. This is in line with Friedman’s (1970) assertion that the only social responsibility of business is to increase its profits. The arguments of Akul and Danel reflect an understanding of the role business in poverty alleviation which diverges from the concept of social business as propounded by Muhammad Yunus as the pure definition of microfinance (Kickul et al. 2012).

In the concept of social business, a business exists for the collective benefit of others as a non-loss, non-dividend company (Kickul et al. 2012).  “The investor can recoup his investment capital, but beyond that no profit is to be taken out as dividends by the investors.  These profits remain with the company and are used to expand its outreach, to improve the quality of the product or service it provides, and to design methods to bring down the cost of the product or service” (2012: 455).  In their criticisms of commercialisation in the sector, both Yunus and Velasco state that they do not have a problem with profit per se, but argue that surplus should be reinvested in the business or be passed on to borrowers in the form of lower interest rates (NextBillion 2014a; NextBillion 2014b).  This idea is compelling as MFIs globally are improving their surplus (Perilleux et al. 2012).  As such, social business belongs to an entirely different logical structure to conventional business management, which focuses on the logic of personal profit.

A strikingly different understanding of the role of business in poverty alleviation is the concept of creating shared value (CSV).  According to Michael Porter, CSV is about applying the capitalist model to addressing the issues in society: “it is pure unadulterated capitalism, it is about making money” (World Economic Forum 2012).  For Porter, CSV is about doing business in a smart way.  There is money to be made by broadening the view of who can be considered a customer and opening up business to new ways of designing, developing and delivering products (World Economic Forum 2012).  In contrast to traditional corporate social responsibility which uses a philanthropic approach to ensure the redistribution of wealth, CSV instead aims to wealth for all parties (Porter and Kramer 2011). Companies can make money and also improve the lives of the poor by virtue of doing business with them (Porter and Kramer 2011).

It is possible to understand microfinance as having its roots in capitalist thinking, in that it is premised upon the notion that business loans will enable microentrepreneurs to increase their productivity and raise themselves out of poverty (Yunus 2007).  This embodies the neoliberalist principle of individual responsibility and indeed Yunus distinguishes social business as a new way to help the poor by allowing them to use their own initiative, rather than taking that initiative away through charity (Yunus 1999). Social business therefore has similarities to CSV as it is not purely about redistribution: it’s success also rests on increasing the total profit generated.  However if we apply the CSV approach to microfinance we see that lenders would necessarily be required to make a profit in order to justify their involvement, which resonates with the arguments of Akula and Danel.  Whereas Yunus’ social business concept sees private investment as acceptable on a non-dividend and non-loss basis, Akula and Danel see profit for private investors as an inevitable requirement to secure their involvement.  The commercial microfinance model that they advocate reflects the CSV way of doing business in that it operates within the existing rules of capitalism.  Social business, on the other hand, aims for an increase in wealth for only one party and as such seeks to redefine the rules of the game to create a more equitable relationship between investor and borrower.  CSV by this interpretation can be seen as a less socially valuable approach in that it does not seek to redress the imbalance of power relations inherent to capitalism.

A final concern related to the application of commercial models to microfinance is that it risks normalising the notion of the poor as consumers.  In their discussion of business in the role of ‘development agent’, Blowfield and Dolan (2014) note that in attempting to make markets work for the poor the very notions of poverty and development worthiness become constructed around what is material, instrumental and comprehensible to business.  People become customers rather than recipients, and the meaning of ‘pro-poor’ activities becomes defined by the normative biases of business (2014).  By this interpretation it is possible to see Akula and Danel’s focus on outreach as a measure of success as reflective of the emphasis on scale in traditional business.  This interpretation also resonates with Sandel’s contention that with some practices, “when market thinking and market values enter, they may change the meaning of those practices, and crowd out attitudes and norms worth caring about” (TED 2013).  Importantly, a key concern for Blowfield and Dolan is “private and non-private sector agents that not only fail to reflexively consider the consequences of this, but show no appetite for holding business to account for the outcomes” (2014: 35).  In the context of microfinance, where attempts at consumer protection and tighter industry regulation have been introduced more than three decades after the birth of the sector as reactionary measures to crises, I would argue that this may indeed be the case.  I conclude by agreeing with Boyle and Boguslaw (2007) that while greater corporate involvement in poverty alleviation is necessary, this should be done in greater conjunction with government and non-profit sector efforts.

**Conclusion**

I have argued that the commercialisation of microfinance was characterised by the application of capitalist business models to a field which was founded on the premise of microcredit for enterprise as a means to combat poverty.  Inadequate supervision and a lack of agreed measures of social performance combined to result in severe negative consequences for borrowers. As such, commercialisation in microfinance represents an industry wide failure of responsible management. More than this, it represents the failure of governments globally to adequately protect the most vulnerable people in their societies from commodification and exploitation.

I would contend that voluntary measures to regulate the industry are not sufficient and that there exists an onus on governments and industry leaders to establish more stringent consumer protection, such as mandatory engagement with credit bureaus. More controversially, governments might consider profit caps in an attempt to facilitate the redistribution of wealth globally. Finally, I advocate a shift away from any neoliberal perspective which holds people living in poverty to be individually responsible for improving their own fortunes. It is the responsibility of governments and industry to support individuals to exit poverty, and in fact we might consider stronger legal and financial consequences for those whose actions prove detrimental to this cause.

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**Appendix 1 - Details of original assignment brief.**

A Case Study analysis in which students explore an example of “responsible management” in their professional field or specialist discipline, and include examples of evidence which have informed the analysis.

Assignment format:

Investigation of an example of a failure of responsible management. Students analyse a corporate scandal or business controversy, examining its causes, its social and/or environmental impact, and the nature and adequacy of response to it on the part of the company involved or wider industry or sector.