One Size Fits Some:  
The Case against the Unregulated Growth of Microcredit

A Thesis  
Submitted to the Faculty of the  
Graduate School of Arts and Sciences  
of Georgetown University  
in partial fulfillment of the requirements for the  
degree of  
Master of Arts  
In Development Management and Policy

By

Adam Robert Vaught, B.A.

Washington, DC  
July 4, 2012
The growth of microfinance over the past two decades has been nothing short of astounding. Fueled by a mixture of good intentions and the potential to earn profit the industry quickly became the development world’s new silver bullet to end poverty as many microfinance institutions (MFIs) enjoyed annual growth rates that surpassed 100%. However a series of crises towards the end of the last decade have shaken the foundation of the industry and left many looking for a new way forward. This thesis argues that these crises were the result of credit-first policies which strapped borrowers with insurmountable debt resulting in widespread default. An analysis of the growth of India’s SKS Microfinance and Bangladesh’s Grameen Bank will be used as evidence to support the prioritizing of savings products before credit as a way to protect borrowers from over indebtedness and to protect MFIs from themselves. The thesis finishes by looking at regulations enacted by the government of Ecuador in 2007 as a means to coerce MFIs into a savings based model which sacrifices short term rapid growth for the long term stable variety.
Table of Contents

INTRODUCTION ............................................................................................................................................ 1

ALL MICROFINANCE IS NOT CREATED EQUAL: ARGUMENTS AGAINST MICROCREDIT ................................. 2

CHAPTER 1: THE INDIAN MICROFINANCE CRISIS ........................................................................................ 4

WARANGAL, INDIA - DECEMBER, 2010 ...................................................................................................... 5

BUILDUP TO A CRISIS .................................................................................................................................. 6

THE PRIORITY SECTOR .................................................................................................................................. 7

MERCURIAL GROWTH .................................................................................................................................. 11

THE BUBBLE BURSTS ................................................................................................................................... 12

WHAT WENT WRONG? ............................................................................................................................... 15

CHAPTER 2: GRAMEEN BANK AND THE EVOLUTION OF MODERN MICROFINANCE ................................. 19

JOBRA VILLAGE, BANGLADESH – 1976 ......................................................................................................... 20

THE INDUSTRY’S MODEL ............................................................................................................................. 21

A LESSON TO BE LEARNED ........................................................................................................................... 22

FROM MICROCREDIT TO MICROFINANCE: GRAMEEN GENERALIZED SYSTEM ........................................... 25

DIFFERENCES BETWEEN GRAMEEN AND SKS ............................................................................................. 28

CHAPTER 3: ECUADOR AND THE REGULATION OF STABLE GROWTH ..................................................... 30

LA ESTACADA, ECUADOR – 2010 ................................................................................................................ 31

ECUADOR’S MICROFINANCE LANDSCAPE IN 2007 ................................................................................... 31

A PREEMPTIVE STRIKE – LEY DE REGULACION DEL COSTO MAXIMO DEL CREDITO .............................. 34

POST REFORM OPERATIONAL CHANGES: FROM AN SKS MODEL TO GRAMEEN II ..................................... 37

CONCLUSION ................................................................................................................................................. 40

Sources ........................................................................................................................................................ 44

APPENDICES .................................................................................................................................................. 47

APPENDIX 1: CLIENT AND FUNDING NUMBERS FOR THE TEN LARGEST INDIAN MFIs (2010) ............... 47

APPENDIX 2: GROWTH OF GRAMEEN BANK LOAN AND SAVINGS PORTFOLIOS, 1983 - 2009 ............ 47
LIST OF FIGURES

Figure 1: Number of Clients: SBLP and MFIs from 2006 - 2009 (in millions) ........................................ 8
Figure 2: Government Regulations and their Effects .......................................................................... 10
Figure 3: SIDBI Growth 2002 - 2010 ................................................................................................. 12
Figure 4: Value of SKS stock between Aug 2010 and Feb 2011 .......................................................... 14
Figure 5: MFI Sources of Funding (%) ................................................................................................. 17
Figure 6: Baseline statistics: Countries that suffered microfinance crises from 2008 - 2010 .......... 18
Figure 7: Growth of Grameen Bank 1983 - 1998 .............................................................................. 23
Figure 8: Growth of Grameen Bank 1993 - 2009 .............................................................................. 28
Figure 9: Number of New Clients, Percent Increase 2005 - 2007 ....................................................... 33
Figure 10: MFI Interest Rates in by Loan Size (2010) .......................................................................... 36
Figure 11: Ecuadorian MFIs - Percent increase in new clients (2005 – 2010) ................................. 38
TERMINOLOGY

Although microcredit by definition refers to the offering of small loans, a single service under the umbrella of microfinance, the rapid growth of microcredit has led to the two terms often being used interchangeably. Throughout this thesis I will stick to the literal definitions of the words whenever possible; using microfinance to refer to all financial services and microcredit to refer simply to the offering of loans. I will however occasionally reference or quote sources that use the term microfinance when microcredit should be used.
MODELS FOR FUNDING MFIs

The following three chapters will reveal three separate methods by which MFIs microcredit activities are funded. Although exploring these methods in great detail is outside the scope of this thesis, a basic understanding of their differences is important.

In the case of India, MFIs offered clients loans predominantly through funds acquired by borrowing from commercial funds that Deustche Bank defined as having a predetermined financial target rate of return where social benefits play a secondary role (Diekmann, 2007). This is the means by which the majority of the world largest MFIs have been funded.

The model used by Grameen Bank in Bangladesh prior to 1998 provides the second example where funds are raised through microfinance development funds that act as non-profit entities or cooperatives and primarily target the development of MFIs by granting favorable financial conditions without necessarily seeking a financial return (Diekmann, 2007). These favorable conditions would allow for an eventual shift in Grameen’s operational practices to a third model, similar to the one found in Ecuador today, in which funds for loans are largely drawn from client’s savings accounts.
**POPULATION AND ECONOMIC INDICATORS**

*Baseline statistics for the countries discussed in this thesis:*

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>Bangladesh</th>
<th>Ecuador</th>
</tr>
</thead>
<tbody>
<tr>
<td>Population</td>
<td>1,189,172,906</td>
<td>158,570,535</td>
<td>15,007,343</td>
</tr>
<tr>
<td>Urbanization</td>
<td>30%</td>
<td>28%</td>
<td>67%</td>
</tr>
<tr>
<td>GDP - per capita</td>
<td>$3,700</td>
<td>$1,700</td>
<td>$8,300</td>
</tr>
<tr>
<td>Below Poverty Line</td>
<td>25%</td>
<td>32%</td>
<td>33%</td>
</tr>
<tr>
<td>Agricultural Labor Force</td>
<td>52%</td>
<td>45%</td>
<td>8%</td>
</tr>
</tbody>
</table>

*Source: CIA World Factbook*
INTRODUCTION

On October 13th, 2006, Muhammad Yunus was awarded the Nobel Prize in Economics for his pioneering role in the fight to assist the world’s poor in gaining access to financial services; an industry known as microfinance. Virtually unknown ten years earlier, Yunus first captured a wider audience with his publication of the book, “Banker to the Poor” in 2003. The years that followed would see microfinance ride a wave of positive publicity as further publications and countless articles in mainstream media sources aided in making it a household name.

Books such as “The Economics of Microfinance” (Armendáriz & Morduch, 2007) and “Microfinance: The Way of Grassroots Finance” (Gabriel, 2009) used theoretical arguments to explain why the poor needed access to loans, while the New York Times and countless other newspapers published articles replete with anecdotes praising microcredit for helping seamstresses in India (Bennett, 2006), farmers in Bolivia (Gleeson, 2006) or fishermen in Uganda (Narang, 2006). Adding additional fuel to the publicity fire, the growth of peer to peer lending websites such as Kiva allowed individuals from all corners of the globe to join the microcredit revolution by “investing” as little as $25 to help in the development of small businesses around the globe. But while the theory behind microfinance seemed sound, the anecdotes undeniably uplifting, and the positive feeling brought on by a Kiva donation unmistakable, the outpouring of praise lacked empirical substantiation supporting that microcredit, at the macro level, was actually doing what it espoused—reducing poverty. As it turns out, this evidence was lacking because it did not exist.
According to Economist David Roodman, although earlier studies on microcredit exist, it was not until May of 2009 when the Poverty Action Lab published “Measuring the Impact of Microfinance in Hyderabad, India” that we had the first rigorous analysis of microcredit’s impact. The result of this study provided little ammunition to those touting the industry’s effectiveness in terms of poverty reduction with the authors concluding that households that accessed loans saw no impact on total household spending, likelihood to own a business, overall health, or expenditures on education.

Less than a month later Yale Economist Dean Karlan released a similar study concluding that, “No evidence that increased access to credit improves subjective well-being, as many microcredit advocates claim; rather, we find some evidence of a small decline in subjective well-being”.

Along similar lines, 2011 saw the publication of two more studies, one by the British Department for International Development (DFID) and another by the non-profit Grantmakers without Borders both of which came to the same conclusion; there is no evidence to prove that the average impact of microcredit is positive.

While it would be foolish to suggest that microcredit has no place in the fight against poverty, it would be equally as misguided to suggest that everyone in the world would benefit from borrowing money. Nevertheless, the credit-driven growth of the microfinance industry over the past ten years provides numerous examples of MFIs that operate with their primary indications of success measured by the number of loans issued. This thesis presents evidence in support of the argument that the unregulated growth of microcredit can be harmful not only to

---

1 Surveys taken in Bangladesh in the 1990s have been the subject of ongoing debate between microcredit scholars. Pitt and Khandker both argue that these surveys show clear improvements in the lives of borrowers while Roodman and Morduch argue the surveys indicate no impact.
borrowers but to the MFIs themselves. It argues that savings accounts, not microcredit, should be prioritized by MFIs both for the well being of their clients as well as their own stable long term growth, and that it is the responsibility of each country’s government to create an environment, through laws and regulations, that allows for MFIs to succeed while still protecting their citizens.

I will analyze recent developments in the microfinance industries of India, Bangladesh and Ecuador through the lens of the three characteristics identified by the Consultative Group to Assist the Poor\(^2\) (CGAP) found to be common factors in a string of recent microfinance crises:

1) Industry fueled by abundant funding

2) Deterioration of credit quality and multiple loans

3) Growth led by credit services rather than savings

Where the CGAP study goes as far as identifying the causes of these repayment crises, this thesis will take the next step in identifying government regulation and the promotion of savings accounts as a possible solution.

To support this argument, this work begins by analyzing the crisis that struck India in 2010, which crippled the country’s microfinance industry. Focusing on what was India’s largest MFI, SKS Microfinance, I demonstrate how a system driven by outside funding and lacking regulation led to the rapid growth of the microfinance industry, overindebtedness and eventually the suicide of eighty-five borrowers.

The second chapter turns to the origins of modern microfinance and Grameen Bank in Bangladesh. I will argue that the unmonitored proliferation of microcredit nearly brought down

\(^2\) As described on their website, CGAP is an independent policy and research center dedicated to advancing financial access for the world’s poor. It is supported by over 30 development agencies and private foundations who share a common mission to alleviate poverty. Housed at the World Bank, CGAP provides market intelligence, promotes standards, develops innovative solutions and offers advisory services to governments, financial service providers, donors, and investors.
the microfinance giant in 1998 and that only after a shift to an operational model that prioritized savings was the MFI able to secure sustainable long term growth.

The third and final chapter looks at regulations implemented in Ecuador in 2007 that, thus far, have benefitted borrowers and resulted in the contraction of microcredit focused MFIs and a renewed emphasis on savings accounts for the country’s rural population. Evidence shows that these regulations altered the growth trajectories of the country’s two major MFI groups resulting in a situation that, if continued, should benefit both the MFIs and the Ecuadorian citizens and provide a model for other governments to emulate.

The evidence in favor of a savings-driven model for MFIs provided in chapters one and two along with the example set by the regulations in Ecuador in chapter three are meant to illuminate a path forward for a microfinance industry that is still yet to find its direction.

**CHAPTER 1: THE INDIAN MICROFINANCE CRISIS**

At the most basic level, the key to ending extreme poverty is to enable the poorest of the poor to get their foot on the ladder of development. The ladder of development hovers overhead, and the poorest of the poor are stuck beneath it. They lack the minimum amount of capital necessary to get a foothold, and therefore need a boost up to the first rung (Sachs, 2005).

In his quote, economist Jeffrey Sachs makes an idealist, market fundamentalist argument for the role that microfinance can play in the lives of the world’s poor. The idea that those living in poverty simply needed access to loans in order to improve their economic standing has been widely accepted and promoted in recent years. The first chapter of this thesis focuses on the growth of microfinance in India and how Sachs’ idea became corrupted due a lack of government intervention and the unregulated growth of microcredit in the world’s second largest market.
WARANGAL, INDIA - DECEMBER, 2010

From 2006 to 2009 Andhra Pradesh served as a symbol for the immense potential of microcredit. The unrelenting growth rates of MFIs in the south Indian state led most observes to assume that entrepreneurship would soon lead to a decrease in the state’s disproportionately high levels of poverty. Sadly the reality did not match these assumptions and in the worst cases extreme indebtedness led to tragedy:

Rama clutches a photograph of her daughter, Mounika, as she explains to reporters her experience with microcredit. Earning a living by rolling cigarettes she was not the example often portrayed by the media of a small entrepreneur who would take out a loan, expand her business and use the profits to pay off her debt. Rama had no intention of expanding her business or any idea about how to increase her modest income. Nonetheless a microfinance representative offered her a loan that she happily accepted in order to buy household supplies, pay for medical treatments for her family and celebrate a birthday. When the time came to start paying back the first loan Rama had no trouble finding a second MFI to give her another loan that she then used to start making payments on the first.

Thus began a cycle of debt that became all too common in India during the second half of 2010. Eventually Rama had taken out five loans from five different MFIs but had no means of paying down the principle as the income she earned selling her cigarettes averaged less than $1 per day.

As the debt grew so did pressure from loan collectors who would visit daily, often times harassing her in front of her neighbors. They would stress that she was better off dead than stuck in debt as at least her death would allow the MFIs to collect insurance on the owed money.
Overwhelmed by the pressure facing her family and misunderstanding the terms of the loans, seventeen year old Mounika doused herself in kerosene and lit a match believing that her death would solve her mother’s debt problems. Two days later Mounika would succumb to the self-inflicted wounds and be added a list that would top eighty suicide victims statewide linked to microcredit and over indebtedness (Flintoff, 2010).

**Buildup to a Crisis**

The liberal economic reforms in India in the 1990s saw the rise of two very distinct forms of financial institutions aimed at aiding the country’s rural poor. First the launch of the government funded ‘Self Help Group’ Bank Linkage Programme (SBLP), focused on providing financial services to the most impoverished, and second, the growth of MFIs, with support from private banks, in parts of the country that had previously gone without formal banking services.

Initiated and backed by two state-run banks, the SBLP encouraged the formation of ‘Self Help Groups’ (SHGs) comprised of, on average, 14 members. Once a SHG had proven itself capable of maintaining savings accounts and accurate bookkeeping over a period of six months it became eligible to be linked with state run banks which provided access to formal financial services including microcredit (Ghate, 2007). This program operated under the idea that, lacking any form of collateral, the rural poor should be eligible to borrow money only after they have proven themselves responsible enough to manage their own accounts.

During the SBLP’s initial years in operation, India also saw the creation of a number of MFIs that would grow to become important players in the rural India; namely, BASIX, Spandana and a few years later SKS Microfinance. As both financial programs continued to grow in the first years of the 21st century a major difference between the two became clear: Where the SBLP model was based on a foundation of clients creating and managing a savings account,
MFIs in India, unlike in many countries, were legally blocked from accepting any deposits from clients, leaving them to function solely as microcredit institutions.³

Without access to client savings the Indian MFIs were dependant on outside sources of finance in order to expand operations; this hurdle slowed the development of the industry compared to SBLP which served nearly 40 million clients in 2006 compared to only 10 million by Indian MFIs. This trend however changed rapidly beginning in 2007 as the microfinance industry growth rapidly accelerated, first due to a policy change within India’s borders and second from an influx of outside capital.

THE PRIORITY SECTOR

Since the 1970s, the Reserve Bank of India (RBI) has mandated that banks operating within the country’s borders had to distribute between 32% (for foreign banks) and 40% (for domestic commercial banks) of their loans to what the RBI deemed ‘priority sectors.’ This rule was meant to ensure that funds would be directed to the agricultural sector and small scale industries which were typically neglected due to the high risk when compared to large industrial houses (Dasgupta, 2002). The program stipulated that any bank that did not meet this benchmark was required to make up the difference by investing in what are known as NABARD bonds offered by the National Bank for Agriculture and Rural Development. The NABARD bonds insured that banks could meet their priority sector quota, but they only paid, on average, 3 – 4% interest.

In 2007, the RBI revised its priority sector guidelines to include loans made from commercial banks to MFIs (“RBI Revises Priority Sector Lending Norms”, 2007). Almost

---
³ The Indian National Government has claimed this ban was due to the security issues that could arise if MFIs were made responsible for such large amounts of cash although it is suspected to be a result of pressure from formal banks that did not want the added competition (Ravi, 2011)
immediately money that had previously been invested in NABARD bonds was shifted to MFIs, who promised a return on equity (RoE) between 12 -13%. While both MFIs and the SBLP would continue to see their client base increase in the years between 2006 and 2009, as seen in the figure below, the 167% increase in MFI clients far outweighed that of the SBLP and in four years their market share grew by over 10%.

*Figure 1: Number of Clients: SBLP and MFIs from 2006 - 2009 (in millions)*

<table>
<thead>
<tr>
<th>Year</th>
<th>SBLP</th>
<th>MFI</th>
<th>MFI % of the Market</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>38.0</td>
<td>10.0</td>
<td>20.8%</td>
</tr>
<tr>
<td>2007</td>
<td>47.1</td>
<td>14.1</td>
<td>23.0%</td>
</tr>
<tr>
<td>2008</td>
<td>54.0</td>
<td>22.6</td>
<td>29.5%</td>
</tr>
<tr>
<td>2009</td>
<td>59.6</td>
<td>26.7</td>
<td>30.9%</td>
</tr>
</tbody>
</table>

Source: Microfinance in India, State of the Sector Report 2010

In a country with an estimated 645 million people living at or below the poverty line,4 80% of whom live without access to formal financial services (Radcliff, 2006), the demand certainly existed for the microcredit products offered by MFIs. Once the potential for profit was recognized, international financial institutions quickly began providing the funding needed to close the gap between supply and demand (Singh Panwar, 2011). In 2007, a Deustche Bank report titled, “Microfinance: An Emerging Investment Opportunity,” predicted a tenfold increase in the amount of outside funding channeled to Indian MFIs between 2006 and 2015:

The microfinance sector currently has an estimated total loan volume of USD 25bn. Yet, it is unable to serve more than a fraction (less than 100m) of today’s total sector demand of roughly 1bn micro-borrowers. This situation translates into an immense funding gap estimated around USD 250bn…By 2015, we expect institutional and individual investments in microfinance to rise sharply [from USD 2bn in 2006] to around USD 20bn (Diekmann, 2007).

---

The same report told potential investors that the leading 176 MFIs had exhibited a RoE averaging 17.6%, which, in many cases was better than returns earned by conventional banks (Diekmann, 2007).

As funds began to rush in, the lack of any formal regulations by the Indian government became apparent. By 2008, thirty different countries had adopted microfinance regulation legislation (Duflos, 2008), but the Indian government chose to take a hands-off approach leaving most decisions on how to guide the industry’s development “to [the] discretion” of MFIs (Vijayendra, 2008). The single piece of regulation in place was the aforementioned ban on MFIs accepting deposits from clients that could have limited the dependence on outside funding and the need to pursue such high levels of profitability. Figure 3 below gives an overview of how regulations, or a lack thereof, affected and continue to affect the microfinance industry today.
This laissez faire attitude towards microcredit combined with rigid savings specific regulations by the Indian government left MFIs without the ability to collect deposits from clients thus focusing almost exclusively on loans. As explained in a 2011 report by the United Kingdom's All-Party Parliamentary Group on Microfinance, when facing a situation where only single financial service is available, people will access that service even if it is not what they need:

---

5 In September of 2010 the government launched an initiative to create a national ID system, the first step in creating a credit bureau: [http://online.wsj.com/article/SB10001424052748704652104575493490951809322.html](http://online.wsj.com/article/SB10001424052748704652104575493490951809322.html)

6 Defined as imposing unfair or abusive loan terms on borrowers

Where the only product available is a loan, customers will take a loan even if it is not the most appropriate solution to their financial needs. Poor people need access to savings, perhaps even more than access to loans, as well as insurance, safe remittances and other services. Until we extend comprehensive financial services to all we cannot truly claim to be ‘democratising financial services’, let alone contributing fully to the fight against poverty (Heales, 2011).

**Mercurial Growth**

As the rate at which financing to large MFIs like BASIX, Spandana and SKS continued to increase, lacking any sort of regulatory framework, market forces were left to guide the industry. MFIs began aggressively courting new clients in order to put their newly acquired funds to work. These new clients were happy to have access to formal banking services and all over India women like Rama, with no means to pay the interest on one loan, soon found themselves responsible for four or five, all from different MFIs.

The figure below shows the amount of money in outstanding loans that was owed by MFIs to the Small Industries Development Bank of India (SIDBI), one of the largest financers of MFIs in the country. While the funds being channeled into the industry were already growing at a rapid rate from 2002 through 2007, the years that followed the inclusion of MFIs in the priority sector definition set a new standard.
Fueled by this unparalleled influx in funding and government regulations, which promoted quantity of loans over quality, MFIs and microcredit in India continued to grow fueled also by positive media coverage that only served to spread the popularity of the movement to other parts of the globe. This positive press would continue until November 2010 when Oprah Winfrey would name microfinance website Kiva.org as one of her ‘Favorite Things of 2010.’ The announcement would be made just a few weeks after news broke of the first wave of suicides in Andhra Pradesh (White, 2010).

**THE BUBBLE BURSTS**

On July 28th, 2010, SKS Microfinance debuted on the Bombay Stock Exchange becoming the world’s second MFI to publicly trade shares. Vikram Akula, founder and chairperson of SKS, claimed that the initial public offering (IPO) had been made in order to raise

---

8 Mexico’s Banco Compartamos went public on April 20th, 2007
funds to meet the massive demand for microcredit within India. Their goal being to effectively double the number of clients served to reach 15 million by 2012. (“What Does the SKS IPO Mean for Poor People?”, 2010) Anneloes Mullink-Bos of the Netherlands Development Finance Company, an investor in SKS, defended the projected growth in a statement made just a week after the IPO:

Scaling up can result in economies of scale, resulting in lower interest rates for clients. Indian MFIs only cover a small part of the demand, and many people are still not being served. In order to include them in the financial system, the microfinance sector needs to grow and develop. An IPO can help to achieve this” (“What Does the SKS IPO Mean for Poor People?, 2010).

This optimistic view painted a best case scenario picture in which both investors and impoverished clients would benefit from SKS’s growth; but not everyone was convinced. Critics of the move argued that serving the poor and providing shareholders with profits would prove to be a conflict of interest and that eventually shareholders’ priorities would take precedence; but with the $350 million generated by the IPO, SKS ignored the warnings and began aggressively pursuing its target.

As the figure below shows, shares in SKS opened at roughly 1,000 rupees ($22.55) in early August and by late September had increased in value roughly 40%. However, the rapid gains did not last.
In October, as the first round of suicides became public, news broke that seventeen of the first thirty victims were clients of SKS and prices of the stock began to drop precipitously ("30 Commit Suicide in 45 Days to Escape Microfinance Agents", 2010). Stories of repeat borrowing, over indebtedness and aggressive collection tactics brought to light the darker side of for-profit MFIs. While SBLP groups depended on the development of savings accounts in order to gain access to credit services, once MFIs had access to outside capital their success and profitability became linked to the quantity of loans that could be given out with little regard for quality.

The impacts of the suicides were soon felt industry wide when, on October 16th, the Andhra Pradesh state government passed an ordinance effectively stopping all microfinance
activity within its borders (Ramana, 2010). In one of India’s most impoverished states, and home to nearly a quarter of all microcredit activity in the country, banks were no longer allowed to make loans to MFIs and the default rate on loans from MFIs to their clients grew from roughly 2% to nearly 90% as the government stripped MFIs of their ability to enforce the terms of their existing contracts (Sarma, 2011).

Just as MFIs like BASIX and Spandana were set to follow SKS’s lead and turn public, the industry that had been so highly praised for its potential to provide the poor a path out of poverty came to a crashing halt and a bitter battle between the government of Andhra Pradesh and the Reserve Bank of India would erupt over who had the authority to finally begin regulating the crippled industry.

WHAT WENT WRONG?

Although the crash of the Indian Microfinance industry was by far the most severe the world had seen, it was by no means the first. In an article published eight months prior to the first wave of suicides in Andhra Pradesh, CGAP detailed similar crises that had affected Morocco, Pakistan, Bosnia and Herzegovina and Nicaragua between 2008 and 2009 (Chen, 2010). They argued that three characteristics were common to each crisis; eight months later observers would identify the same characteristics in India:

1) Industry fueled by abundant funding – As soon as the Indian government ruled that banks could fulfill their priority sector quota through loans to MFIs the industry had more funding than it was capable of dispersing.

2) Deterioration of credit quality and multiple borrowing – As previously mentioned, Andhra Pradesh was home to 25% of India’s microcredit clients while only claiming 7% of the
country’s population. This concentrated growth took place, much as it did in Morocco, Pakistan, Bosnia and Herzegovina and Nicaragua, because MFIs chose to focus on regions in which microcredit was already established targeting clientele who were comfortable with the workings of MFIs and therefore less hesitant to take on additional loans as compared to those in areas with no exposure to microcredit. This led to high levels of competition for the same clients, a relaxation of standards for borrowers and eventually clients with multiple loans from multiple MFIs.

3) Growth led by credit services rather than savings – As stated in the CGAP article, “savings was neither a major service nor a large source of funding,” in any of the countries discussed. In India, with regulations against MFIs accepting deposits, organizations like BASIX, Spandana and SKS focused solely on credit, leaving their clients with no savings options to consider (Chen, 2010).

This lack of savings led to a situation in which, according to “Microfinance India: State of the Sector Report 2010,” the ten largest MFIs in the country had roughly $2.3 billion in outstanding loans but only $630 million in actual equity. The money used to finance the industry’s expansion, the report states, had come in the form of $2.7 billion in loans, meaning that almost 82% of the funding for the ten largest MFIs in India had been borrowed. This over extension by MFIs left them without the type of safety net that a healthy savings portfolio would have provided when the repayment crisis hit in late 20109 (Srinivasan, 2010).

In her article, “On Microfinance: Who’s to Blame for the Crisis in Andhra Pradesh,” the managing director of the Center for Financial Inclusion, Elisabeth Rhyne, echoes this argument and chastises the Indian government for refusing to permit MFIs the ability to accept deposits:

---

9 For a complete breakdown of India’s ten largest MFIs in terms of outreach, outstanding loans, own funding and amount borrowed see Appendix 1
Deposit-taking, properly supervised, would have allowed the MFIs to raise funds locally, both from clients and others in their neighborhoods. It would have created a balanced portfolio of products and revenue sources, rather than exclusive reliance on the micro-loan mono-product. Instead of unbalanced mono-product giants, MFIs like SKS might have grown up to look more like Mibanco in Peru, Equity Bank in Kenya or BRI in Indonesia, all with solid loan and deposit bases (Rhyne, 2010).

Economist David Roodman elaborated on the importance of an MFI’s credit to savings ratio when he analyzed data from 2007 collected by microfinance watchdog Mix Market comparing the twenty five largest microfinance markets and the breakdown of how their MFIs were being funded:

*Figure 5: MFI Sources of Funding (%)*

**Financing structure of MFIs in the top 25 countries based on outstanding loans, 2007**

<table>
<thead>
<tr>
<th>Country</th>
<th>Borrowings from Investors</th>
<th>Deposits</th>
<th>Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td>India*</td>
<td>80</td>
<td>4</td>
<td>15</td>
</tr>
<tr>
<td>Morocco*</td>
<td>80</td>
<td>0</td>
<td>20</td>
</tr>
<tr>
<td>Nepal</td>
<td>72</td>
<td>19</td>
<td>9</td>
</tr>
<tr>
<td>Afghanistan</td>
<td>69</td>
<td>8</td>
<td>22</td>
</tr>
<tr>
<td>Nicaragua*</td>
<td>64</td>
<td>15</td>
<td>20</td>
</tr>
<tr>
<td>Pakistan*</td>
<td>63</td>
<td>11</td>
<td>27</td>
</tr>
<tr>
<td>Bosnia and Herzegovina*</td>
<td>61</td>
<td>21</td>
<td>18</td>
</tr>
<tr>
<td>Ethiopia</td>
<td>43</td>
<td>31</td>
<td>25</td>
</tr>
<tr>
<td>Egypt</td>
<td>41</td>
<td>0</td>
<td>59</td>
</tr>
<tr>
<td>Nigeria</td>
<td>41</td>
<td>29</td>
<td>30</td>
</tr>
<tr>
<td>Ecuador</td>
<td>31</td>
<td>50</td>
<td>19</td>
</tr>
<tr>
<td>Peru</td>
<td>31</td>
<td>49</td>
<td>20</td>
</tr>
<tr>
<td>Bolivia</td>
<td>28</td>
<td>55</td>
<td>17</td>
</tr>
<tr>
<td>Cambodia</td>
<td>27</td>
<td>57</td>
<td>16</td>
</tr>
<tr>
<td>Bangladesh</td>
<td>27</td>
<td>47</td>
<td>26</td>
</tr>
<tr>
<td>Philippines</td>
<td>25</td>
<td>53</td>
<td>22</td>
</tr>
<tr>
<td>Indonesia</td>
<td>23</td>
<td>57</td>
<td>20</td>
</tr>
<tr>
<td>Colombia</td>
<td>22</td>
<td>65</td>
<td>13</td>
</tr>
<tr>
<td>Sri Lanka</td>
<td>18</td>
<td>69</td>
<td>13</td>
</tr>
<tr>
<td>Mexico</td>
<td>17</td>
<td>62</td>
<td>21</td>
</tr>
</tbody>
</table>
The chart shows that all five countries that suffered microfinance crises over the past three years rank in the top seven in regards to the percentage of their finance which is drawn from outside loans; each at over 60%.

Figure 6: Baseline statistics: Countries that suffered microfinance crises from 2008 - 2010

<table>
<thead>
<tr>
<th></th>
<th>India</th>
<th>Morocco</th>
<th>Nicaragua</th>
<th>Pakistan</th>
<th>Bosnia and Herzegovina</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Population</strong></td>
<td>1,189,172,906</td>
<td>31,968,361</td>
<td>5,666,301</td>
<td>187,342,781</td>
<td>4,622,163</td>
</tr>
<tr>
<td><strong>Urbanization</strong></td>
<td>30%</td>
<td>58%</td>
<td>57%</td>
<td>36%</td>
<td>49%</td>
</tr>
<tr>
<td><strong>GDP - per capita</strong></td>
<td>$3,700</td>
<td>$5,100</td>
<td>$3,200</td>
<td>$2,800</td>
<td>$8,200</td>
</tr>
<tr>
<td><strong>Below Poverty Line</strong></td>
<td>25%</td>
<td>15%</td>
<td>48%</td>
<td>24%</td>
<td>18%</td>
</tr>
<tr>
<td><strong>Agricultural Labor Force</strong></td>
<td>52%</td>
<td>44%</td>
<td>28%</td>
<td>43%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: CIA World Factbook

Figure 7 shows population and economic statistics for these same five countries and shows little correlation that could aid in explaining the failure of their microfinance systems. Stark differences between population, urban verses rural divide, GDP per capita, and poverty levels serve to substantiate the arguments made by CGAP and Roodman that the cause of these crises are directly related to dangerous divide between borrowings and savings undertaken by MFIs in these countries.

With 80% of its funding borrowed, India stands out as a country where the existence of a large, highly agricultural market with no access to formal banks met government regulations that did nothing to protect its citizens. The government’s actions, rather than promoting the proliferation of safer financial services such as savings accounts, instead encouraged the
growth of an industry whose mission of helping the poor climb the ladder of development became hijacked by the promise large returns and the pursuit of profit.

As the following chapter will demonstrate, the crises of 2009 and 2010 are not isolated examples of rapid growth threatened a country’s microcredit industry. Ten years earlier the industry’s pioneer, Grameen Bank, with its high profile founder, Muhammad Yunus, followed down the same path that eventually halted microfinance in India. Given the flexibility of being a non-profit organization Grameen was able to alter their practices and emerge with a model that has thus far proven capable of sustaining low risk growth. How this model can be applied to for-profit MFIs will be discussed later when looking at the case of Ecuador.

CHAPTER 2: GRAMEEN BANK AND THE EVOLUTION OF MODERN MICROFINANCE

Guideline 1 - Poor people need a variety of financial services, not just loans. In addition to credit, they need savings, insurance, and money transfer services (CGAP, 2006).

In 2006, CGAP issued a list of “12 Good Practice Guidelines” by which MFIs should operate. The first guideline explicitly states the importance of diversifying financial services outside of microcredit alone. This chapter focuses on the case of Grameen Bank in Bangladesh, which followed the same growth trajectory and microcredit-centered business model as SKS, pushing them to the brink of a similar crisis is 1998. After restructuring their loan products Grameen emerged with a model that has resulted in a dramatic increase in the size of both their savings and loan portfolios. The story of Grameen provides further evidence of the danger of unregulated microcredit growth as well as an example of how emphasizing the savings sector can bring stability as well as growth to the microfinance industry.
JOBRA VILLAGE, BANGLADESH – 1976

As an economics professor at Bangladesh’s Chittagong University, Muhammad Yunus’ job required him to teach his students the theoretical principles that drove the world’s markets. Over time as he came to know the impoverished neighborhoods that surrounded the university he became struck with much more practical questions surrounding the economic plight of his fellow countrymen:

Twenty-one year old Sufiya Begum stood in her doorway holding the youngest of her three children as she explained her economic situation to Professor Yunus. Every morning she borrowed the equivalent of $0.22 from a middleman in order to buy bamboo. This money was loaned to her under the condition that at the end of the day she would return to the middleman with a bamboo stool that he would then buy from her for $0.24. An entire day’s worth of work would net her $0.02 in profit; barely enough to survive.

Returning to the university, Yunus pondered the relevance of the economic theory he was teaching his students in relation to the immediate needs of the hordes of impoverished people he saw on a daily basis in rural Bangladesh.

Over the course of the next week Yunus compiled a list of all the people in Jobra who found themselves in a similar situation to Sufiya. The list totaled forty-two people and the total amount needed to free them from the shackles of their middlemen was a mere $27. Forty-two micro-entrepreneurs, as Yunus would refer to them, who were condemned to poverty, “not because they were stupid or lazy … they were poor because the financial institutions in the country did not help them widen their economic base. No formal structure was in place to cater to [their] needs” (Yunus, 2007).

The next day the Muhammad Yunus loaned the $27 necessary to liberate the forty-two people on his list under the condition that they pay back the loan when possible. With those
forty-two loans the foundation for what would become Grameen Bank had been laid (Yunus, 2007).

**The Industry’s Model**

In the years that followed Yunus’ initial $27 loan Grameen would grow, “from an idea, to a project with [Yunus’] students, to a formal branch of a state bank, [and finally] to an independent bank. By the mid-1990s, the Grameen Bank was a national operation with a global reputation” (Roodman, 2010). The bank would eventually offer various loan products but all would be administered through the same self-help group model as described in India in the previous chapter. Groups of five women from the same village would join together to form a cell in which each women took collective responsibility for the repayment of any loan given to the group. Six cells would join together to form a *kendro*, or center, where, at a set time each week the members would meet to apply for loans and make repayments. These loans would come to be known as the Grameen Classic System or Grameen I.

The 1980s and 1990s saw a period of expansion for Grameen Bank fueled by a similar flow of capital that Indian MFIs saw in the buildup to their crisis. Functioning as a nonprofit MFI, the bank was dependent on grants and contracts with aid agencies in order to expand operations. These funds proved easy enough to secure as nearly every large aid organization was represented in Bangladesh, and most were frustrated with the corruption and lack of accountability common in working with the country’s government agencies (Hulme, 2008). Yunus’ passionate and straightforward approach to running Grameen led to a steady flow of funding that would eventually allow expansion across the whole of Bangladesh.

At the same time as Grameen Bank focused on domestic expansion the Grameen model was being exported across the globe. After initially offering improvised training sessions for the
staff of foreign MFIs, Grameen senior management soon found themselves focusing more time on assisting Grameen replicators across the globe than managing day to day operations in Bangladesh. University of Manchester professor David Hulme writes of his experience with Grameen in the late 1980s:

I first became acquainted with the Grameen model in 1987, while researching rural finance in Sri Lanka. At the time it seemed that almost every NGO and donor project I visited had staff who had recently returned from a visit to the Grameen Bank. Most of these staff were very impressed with what they had seen and talked of ‘replicating’ the model... The Bank moved from mounting ad hoc visitor programmes to regular programmes for replicators. It targeted not only developing countries and was proud to announce Grameen transfers to the USA and Canada. By the mid-1990s Yunus was increasingly spending his time travelling overseas, sitting on the boards of Grameen replicas (such as Amanah Ikhtar Malaysia), visiting aid donors, and addressing academic, policy and public audiences (Hulme, 2008).

Yunus continued to enthusiastically promote the Grameen model as poverty’s panacea, watching microcredit grow across the globe; seemingly oblivious to the crisis that loomed back in Bangladesh.

A LESSON TO BE LEARNED

Much as would be the case in India, as funds increased and the number and size of loans offered by Grameen grew, the quality of those loans began to decrease. According to Hulme:

Client numbers grew steadily, but the portfolio grew more quickly as clients took bigger ordinary loans and new types of loans (especially housing). Those of us working in Bangladesh increasingly heard that repayment rates were falling, but that branch managers were massaging their performance figures by issuing new loans to defaulters. These were immediately used to pay off the outstanding loan and hide the problem of non-repayment (Hulme, 2008).

Supporting the claims of multiple borrowing was evidence that many prospective clients were posing as micro-entrepreneurs in order to secure a loan which would then be spent on food,
medical services, education or even dowry (Pearl, 2001). While one would never question the validity of these expenses, without a means of increasing their income most borrowers would have no way to repay their loan without taking on a new one; thus beginning the same cycle of debt that would plague India a decade later.

The figure below compares the growth of Grameen’s outstanding debt and the value of their savings portfolio between 1983 and 1998:

*Figure 7: Growth of Grameen Bank 1983 - 1998*

Source: Grameen Bank, see Appendix 2

With a small savings deposit a mandatory element of Grameen I microcredit services, savings rivaled outstanding loan totals in the bank’s early years. Collected under the name ‘group tax,’ for every loan a group took out they were forced to turn over a small percentage to a ‘group fund’ that was meant to be used in case of an emergency. This fund served as the only savings reserve Grameen could access if the bank itself suffered any sort of funding crisis.
However as Grameen expanded and loan sizes and quantity increased, their outstanding loan balance grew exponentially while savings lagged behind. By 1998, the value of outstanding loans ($166 million) was nearly two and half times that of the bank’s savings accounts ($73 million).

Never satisfied with the size or scope of Grameen’s operations, Yunus made his intentions to clear; universal access to financial services. Driven by this desire to expand, quantity of loans eventually took precedence over quality leading to a situation that would mirror the buildup to the crises the world would see a decade later. Grameen was suffering from the same three symptoms that were common in India, Morocco, Pakistan, Bosnia and Herzegovina and Nicaragua, namely an industry fueled by abundant funding, deterioration of credit quality and multiple borrowing, and growth led by credit services rather than savings. Grameen branches across Bangladesh were using new loans as stopgap measures to prevent default; masking the dire status of their loan portfolios as continued growth.

In 1998, as the foundation of Grameen Bank continued to deteriorate under the weight of high-risk loans, heavy rains caused the Ganges, Brahmaputra and Meghna rivers to flood, leaving nearly two thirds of Bangladesh underwater, crushing the country’s largely agrarian economy and effectively shutting down Grameen’s operations. While devastating, the floods gave Yunus and the bank’s management a chance to reevaluate the organization’s operations and implement changes to address the systemic issues that likely would have led to a repayment crisis had the floods not caused one first.

Hulme (2008) suspects that Yunus was able to tap into the aid community as well as the Bangladeshi government to secure emergency funding portraying the bank’s dire financial

---

10 This ‘group tax’ was constantly a source of animosity among borrowers and lead to numerous small scale repayment strikes where borrowers demanded easier access to the funds. This was eventually granted in the mid-nineties and savings reserves shrank. (Pearl, 2001, Yunus, 2011)
situation as being caused entirely by the floods. In reality, without the emergency funding Grameen Bank would have collapsed not because of the natural disaster, but because abundant funding, deteriorating loan quality and an ever growing focus on microcredit rather than savings had created a vicious cycle in which clients became dependent on their loans but lacked the means to pay them back and Grameen did not have enough savings to cover their bad loans.

FROM MICROCREDIT TO MICROFINANCE: GRAMEEN GENERALIZED SYSTEM

With funds to clear a number of toxic loans from their books, Grameen Bank reemerged with clean slate, a new strategy and a new product aimed at avoiding past mistakes. Testing of the new system began in April of 2000, and two years later the transition would be complete with every branch having switched from the Grameen Classic System to the Grameen Generalized System or Grameen II. Grameen II brought simplicity to the loan process by offering a single primary loan product, the Basic Loan. As Yunus explained:

Gone are the general loans, seasonal loans, family loans, and more than a dozen other types of loans; gone is the group fund; gone is the branch-wise, zone-wise loan ceiling; gone is the fixed size weekly installment; gone is the rule to borrow every time for one whole year, even when the borrower needed the loan only for three months; gone is the high-level tension among the staff and the borrowers trying to steer away from a dreadful event of a borrower turning into a “defaulter”, even when she is still repaying; and gone are many other familiar features of Grameen Classic System (Yunus, 2011).

Yunus based Grameen II around his idea that the poor always pay back. And while there will always be valid reasons as to why a borrower might not be able to stick to a fixed repayment

---

11 These suspicions were shared by the Wall Street Journal’s Daniel Pearl who published a highly critical article on Grameen at the end of 2001, just two months before being killed in Pakistan.

12 A housing loan and higher education loan would be available but only to borrowers who started with the Basic Loan and were in good standing with the bank.
schedule, as long as the bank provides adequate safety nets borrowers will eventually be able to pay off their debt.

The two principle features in Grameen II’s safety net were the option of an emergency “flexi-loan” for borrowers who came upon difficult times and more importantly the inclusion of three different obligatory savings accounts as a part of each loan.

In a break from the one size fits all methodology of Grameen I, the new Grameen II allowed individual borrowers to customize their basic loans with repayment periods that could last as little as three months or as long as multiple years. Borrowers who were unable to make their regular payments would be offered the emergency flexi-loan and the ability to renegotiate the terms of the original basic loan. In practice this would give a borrower with a one year loan the option of converting it into a three year loan thus lowering their weekly payment.

In addition to the flexi-loan Grameen altered the ‘group tax’ to reflect its new focus on individual rather than joint accounts. The ‘group tax’ was recreated as an ‘obligatory savings’ and would be split between two separate accounts that bore the individual borrower’s name, not the group. 2.5% of the total loan would be immediately deposited into a personal savings account upon disbursement, and another 2.5% would be deposited into what was known as a “Special Savings Account.” The personal account was money that the borrower was able to access at any point without penalty. The special account was money that had to remain untouched for three years at which point the borrower would have the option of withdrawing money from the account or leaving it untouched for another three years.

On top of the two mandatory savings accounts, any borrower taking a loan that exceeded $138 (Tk 8,000) automatically had a pension fund with Grameen Bank opened in their name. With this account borrowers would be required to deposit a minimum of $0.86 (Tk 50) per
month into the fund which they were not permitted to access for at least ten years; the idea being that it will serve them later in life as a sort of individual retirement plan.

While providing security for their borrowers, the implementation of these savings accounts also freed Grameen from the burden and risk of relying on finance from outside institutions or governments. As Yunus himself explained:

Grameen Bank can now rest assured that it will have enough of its own money to expand its lending operation in future. By the same token, branches will now have enough money to carry out their lending programs with their own deposits. All GB branches can look forward to becoming self-financed (Yunus, 2011).

The years that followed the switch to Grameen II confirmed this new direction as the gap between savings and outstanding loans, which had grow consistently throughout the nineties, quickly vanished and in early 2003, the value of Grameen Bank’s savings portfolio was greater than the amount the MFI was owed by its clients for the first time in their history. Figure 6 below shows how this trend continued in the six years that followed, leaving Grameen with a security net similar to the one that the Grameen II products provide their clients.
Just a decade after Grameen nearly folded under the weight of its increasingly toxic portfolio the bank’s outstanding loan to savings ratio had shifted from 2.5:1 in 1998 to nearly 0.67:1 in 2009. Returning to CGAP’s three criteria that led to crisis, the shift to Grameen II has managed to mitigate two of them. While Grameen’s growth continues at a rapid pace, the mandatory safety nets put in place have insured that loan quality cannot deteriorate to previous levels and the bank’s growth is now primarily driven by savings rather than credit.

DIFFERENCES BETWEEN GRAMEEN AND SKS

The buildup to the crises which plagued both SKS and Grameen share many similarities, while their lasting effects on the two organizations appear to be very different. The crisis in 2010 managed to cripple SKS’s operations to a degree from which they have still been unable to
recover. Grameen on the other hand was able to endure its 1998 repayment crisis, restructure its business model and emerge as a stronger organization. While Grameen’s ability to withstand the crisis had more to do with their status as a non-profit and their access to more flexible types of outside funding, the low risk growth they sustained in the decade following the shift to Grameen II brings to the forefront the importance of savings and question of government regulation. As this chapter has argued, the key difference in the growth seen from 1983 – 1998 under Grameen I and the growth seen from 1999 – 2011 after the switch to Grameen II was the added emphasis on collecting deposits and growing Grameen’s savings portfolio in order to lessen the organizations dependency on outside funding. This shift had the added benefit of creating a safety net for their clients leading an overall stronger loan portfolio. As a leader in the industry Grameen’s model has been replicated by numerous other MFIs within Bangladesh as evident by Roodman’s data in Table 3 which shows that unlike India’s ratio of 80% financing from outside investors and only 4% from deposits, Bangladesh only takes 27% from investors and 47% from deposits.

The fact that the Bangladeshi government permitted MFIs to collect deposits allowed Grameen and its competitors a way forward not available to MFIs like SKS in India. In 1998 however, the government of Bangladesh did not have regulations in place to prevent the crisis from arising in the first place. The lack of any consumer protection regulation left undereducated borrowers vulnerable to lenders, and the lack of a credit bureau prevented MFIs like Grameen from fully understanding their client’s debt history before when offering them loans. Thus, while the case of Grameen provides tangible evidence of the benefits a strong savings portfolio can have on a country’s microfinance industry, the case of Bangladesh does not offer a complete

---

13 As of November 2011, SKS’s stock value has dropped to 10% of its IPO and the founder Vikram Akula was forced to resign.
14 In particular the MFI BRAC which has a similar savings and loan structure as Grameen and has grown to be the largest MFI in Bangladesh
example of how government regulations could have helped to prevent the repayment crises seen in recent years. For such an example the final chapter will analyze microfinance in Ecuador, the regulations enacted by the government in 2007 and their impact on the growth of the industry.

CHAPTER 3: ECUADOR AND THE REGULATION OF STABLE GROWTH

We don't need the Hollywood version of microcredit…Studies [have] found some substantive positive impacts, but not always through the celebrated entrepreneurial mechanism. More broadly, we need to think harder about microfinance, not just microcredit (Karlan, 2011).

Yale Economist Dean Karlan uses the term “Hollywood version of microcredit” to describe the tales of impoverished families taking out loans, starting businesses and watching as their lives changed. While these cases do exist, they were not a ubiquitous as some journalists and media sources would have had their readers believe. As we turn to the case of Ecuador we see a situation in which the government has taken the necessary steps to effectively protect their citizens from the dangers of microfinance while still providing an atmosphere in which MFIs are able to succeed. Government regulations have enabled small cooperatives to thrive in rural areas because of their emphasis on savings while interest rate caps have seen the larger MFIs focus more heavily on the middle class rather than the poorest of the poor. This version of microfinance is not without its flaws, but in the years following the new regulations Ecuador has seen positive growth trends and succeeded in avoiding the types of crises that have plagued so many other developing nations.
The majority of microfinance cases are not the extremely positive or heart wrenchingly tragic cases that made international headlines. The majority of microfinance cases are individuals or families accessing the financial services available to them in order to make day-to-day ends meet and if possible plan for the future:

Beatriz greets a customer from behind the counter of her small shop just off Highway 21. Her little town is a far cry from Guayaquil, Ecuador’s economic hub and biggest port, even though it sits less than 25km up the road. The shelves stocked with beer, soda, water bottles and various snacks are a testament to her skills as a businesswoman and money manager.

Three years ago Beatriz and her husband took out their first in a series of loans, which they would use in order to diversify the products in her store and to pay off medical bills. With the expansion of her business she is now able to provide nearly 20% of the family’s income; a modest amount she admits, but more than she has ever been able to provide in the past. She has also been able to maintain a savings account for the first time in her life. She currently has $70 saved at the local cooperative which she says she will hold onto until the next medical emergency. Beatriz claims that episodes of hunger and lack of money have become less frequent in the last three years but admits that they still occur. And although she knows her family is still quite poor she sees progress and believes that her children have a brighter future ahead of them (Jarrell et al, 2011).

**Ecuador’s Microfinance Landscape in 2007**

Compared to Asia, the microfinance industry in Latin America got off to a slow start. In 2002, Ecuador’s MFIs counted approximately 60,000 clients or less than 0.5% of the
However, the slow start would give way to rapid growth as the four years that followed would see gains in the total number of microloans offered increase an average of 87% annually. By 2007, nearly 5% of the country’s population was the client of at least one MFI (Palan Tamayo, 2010), these MFIs predominantly fell into one of two categories:

1) National/multinational banks (NMBs) – Banks whose business was primarily focused on the urban centers of Quito and Guayaquil before they expanded into microfinance and began operating in more rural parts of the country. These banks rarely have a physical presence in rural communities and don’t offer those clients the option of opening savings accounts. In practice, they send loan officers from their nearest office out to rural communities where they travel house to house offering loans and collecting payments. Though not the most efficient method, with real interest rates typically ranging from 40 – 80% these banks were earning enough profit on microloans to justify allocating the resources. These banks offer loans through a combination of outside financing and savings portfolios (Palan Tamayo, 2010).

2) Savings and loan cooperatives or COACs (Cooperativas de ahorros y credito) – COACs operate throughout Ecuador offering rural communities a variety of financial services. They are considered MFIs due to the fact that the loans their clients require rarely surpass $20,000. COAC offices are typically the only brick and mortar banks to be found in most rural parts of Ecuador. While the interest rates they offered were equally as high as those offered by NMBs, their ability to offer lines of credit depended solely on the strength of their savings portfolio (Spurrier, 2010).

3) While hard data on the Ecuadorian microfinance industry is elusive the Red Financiera Rural (Rural Financing Network) has published quarterly digests that

---

16 As defined by the Ecuadorian government microcredit is any loan less than $20,000USD
report on a number of the country's MFIs. With data only reaching as far back as 2004 it is impossible to understand long term trends within the industry, but even analyzing the three years following the publication’s release provides some insight into the direction the industry was heading:

![Figure 9: Number of New Clients, Percent Increase 2005 - 2007](image)

<table>
<thead>
<tr>
<th></th>
<th>2005</th>
<th>2006</th>
<th>2007</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>NMB Loans</strong></td>
<td>8.7%</td>
<td>13.5%</td>
<td>14.9%</td>
</tr>
<tr>
<td><strong>COAC Loans</strong></td>
<td>30.5%</td>
<td>32.9%</td>
<td>39.3%</td>
</tr>
<tr>
<td><strong>COAC Savings</strong></td>
<td>27.0%</td>
<td>30.8%</td>
<td>24.7%</td>
</tr>
</tbody>
</table>

*These numbers are based on an analysis of eight COACs and three of the country's largest NMBs

Source: Boletín Microfinanciero 1 – 16

Although the numbers are not nearly as dramatic as those seen in India or Bangladesh, both NMBs and COACs showed clear gains in the rate by which their loan base was growing. COAC savings accounts on the other had show a slight net loss of the course of the three years.

Turning to the criteria CGAP found common in all five countries that experienced microfinance crises in the late 2000s, Ecuador did not appear to be in a dire situation in 2007, although there was certainly cause for concern:

1) Industry fueled by abundant funding – There is no evidence which points to Ecuadorian banks overborrowing in order to develop the microfinance industry. In a country where the market is much smaller than that in India or Bangladesh banks seemed capable of meeting demand without taking on significant debt.

2) Deterioration of credit quality and multiple borrowing – Although the establishment of a credit bureau in 2002 mitigated the risk of multiple borrowing from MFIs, lacking any
regulations on interest rates or fees, borrowers were regularly finding themselves strapped with significantly more debt than they anticipated when they initially borrowed. Loans advertised at a rate of 12.5% often had a real interest rate of over 60% when all the fees associated with managing the debt were taken into consideration (Palan Tamayo, 2010).

3) Growth led by credit services rather than savings – According to the Red Financiera Rural’s study, “10 Anos de Microfinanzas en Ecuador” (10 Years of Microfinance in Ecuador), in 2007, NMBs could count 386,000 of an estimated 724,000 microfinance clients in the country as their own. With a growth rate that had increased from 8.7% to 14.9% in only two years they were showing signs of accelerated growth. This growth posed the same risk in Ecuador as it did in Bangladesh in 1998 and would in India in 2010. Without a safety net in the form of a savings account borrowers could easily become dependent on loans in order to survive. And while the credit bureau would assist formal banks in avoiding high risk loans, they could do nothing to prevent borrowers from taking their business to the local chulco (Black market money lender).

Such an analysis shows that while Ecuador in 2007 was nowhere near the catastrophic situation in which India found itself in 2010, the industry’s credit growth and savings contraction was certainly cause for concern.

A PREEMPTIVE STRIKE – LEY DE REGULACION DEL COSTO MAXIMO DEL CREDITO

In June of 2007, the government under Rafael Correa enacted the Ley de Regulacion delCosto Maximo del Credito (Law Governing the Effective Maximum Cost of Credit) that would ensure that the growth sustained by Ecuador’s microfinance industry over the coming years would draw more similarities to the savings based model offered by Grameen II and not those of Grameen I or SKS. The law contained two key changes to the system that would have clear impacts on the industry’s growth First, interest rates for both NMBs and COACs would be
capped bringing the average interest rate down to roughly 24%.\textsuperscript{17} Second, the law created a transparent pricing framework where MFIs were not allowed to charge any fees outside of an \textit{encaje} (initial loan fee) and the published interest at a declining rate.\textsuperscript{18}

A study on interest rates across various countries undertaken by the organization MF Transparency clearly shows the effects this law had on rates in Ecuador relative to countries where market forces are left to determine rates. The figure below depicts the average interest rate by size of loan for eight countries around the world. Of these countries Ecuador is the only one where rates are capped.

\textsuperscript{17} The cap would actually define three categories of loan each of which would be subject to a different rate of interest meaning some products could have rates as high as 35%.

\textsuperscript{18} A transcript of the \textit{Ley de Regulacion del Costo Maximo del Credito}: http://www.sbs.gob.ec/medios/PORTALDOCS/downloads/normativa/Ley_regulacion_costo_credito.pdf
This figure clearly shows that, regardless of loan size, the rates in Ecuador are lower than those in any of the other countries surveyed.
The inclusion the transparent pricing initiative in the Law Governing the Effective Maximum Cost of Credit has resulted in a near complete elimination of microcredit products that use flat interest rates. MF Transparency found that in 2011 only 2% of Ecuador’s microcredit products used flat interest rates, the lowest of any country surveyed and a dramatic 57 percentage points lower than the rate in India. This requirement by the government ensures that borrowers only pay interest on the outstanding balance of their loan rather than paying a flat rate based on the initial principle regardless of the outstanding balance (Flat vs Declining Balance Interest Rates, 2011).

Both the interest rate cap and the transparent pricing initiative have significantly aided microcredit borrowers in Ecuador as the terms of their loans are much more straightforward and the costs associated significantly lower than in countries lacking such regulations.

**Post Reform Operational Changes: From an SKS Model to Grameen II**

As to be expected, the most obvious effect of Law Governing the Effective Maximum Cost of Credit on MFIs in Ecuador is that profits decreased. Forcing transparent pricing, eliminating superfluous fees and capping interest rates stripped MFIs of their ability to openly or discretely overcharge their clients. For the NMBs, this decrease in profits rendered their previously growing business model unprofitable.

With the ability to charge interest at whatever rate they chose, MFIs like Banco Solidario, ProCredit and FINCA were able to overcome the high operational costs involved in sending representatives from Quito and Guayaquil out to rural parts of the country in order to promote new loans and collect payments; however once interest rates were capped this practice quickly became too costly. As the NMBs restructured their business model to focus more on the
wealthier urban classes, the COACs were left as the primary banking option for those living in rural Ecuador.

The figures below expand on Figure 10’s look at the growth rate in loans and savings accounts for Ecuador’s MFIs from 2005 – 2007. In adding the rates from 2008 – 2010 the immediate effects of the Law Governing the Effective Maximum Cost of Credit become clear. The growth of NMB loans slows in 2008 before contracting in both 2009 and 2010, while for COACs the growth of their savings portfolio overtakes that of their loan portfolio starting in 2008 and continuing through 2009 and 2010. This growth mirrors that of Grameen after the shift from Grameen I to Grameen II.

*These numbers are based on an analysis of eight COACs and three of the country's largest NMBs

Source: Boletin Microfinanciero 1 – 16, Red Financiera Rural
With a sample size of three years the figures above are clearly insufficient for drawing sweeping conclusions; the true test of the Ecuadorian regulations will be a continuation of the trends witnessed seen since their implementation. The most important of these trends being that COAC savings rates, much like during the shift between Grameen I and Grameen II, have overtaken loans in terms of growth and that the rate of growth for NMBs, whose business model most closely resembles that of SKS, has decreased. Moreover, although the overall growth rates of the COACs have slowed when compared to pre-regulation numbers, growth continues at a health rate of 10% for loans and 14% for savings.

Returning for a last time to CGAP’s criteria common to previous microfinance crises, a continuation of these trends will support that argument that regulations put in place by the Ecuadorian government diminish the likelihood of their country falling victim to a microfinance crisis:

1) Industry fueled by abundant funding – Not an issue in Ecuador prior to the passing of the law and no more likely to occur after.

2) Deterioration of credit quality and multiple borrowing – The passing of the law improves the quality of credit in the country as borrowers are dealing with more favorable terms and more straightforward pricing.

3) Growth led by credit services rather than savings – In the first three years since the passage of the law savings rates have growth faster than credit rates, showing growth trends similar to those seen by Grameen II.

The data obtained only allows for a snapshot into the short term effects of the Ecuadorian government’s regulations; however a continuation of these trends would see rural banking in Ecuador dominated by small COACs whose microcredit growth can only be realized through growth in their savings portfolio. Ideally this will lead to a situation similar to that in
Bangladesh where client’s savings accounts protect borrowers from the inevitable shocks that can often lead to default. These same savings accounts and lack of large-scale debt can protect the COACs in the unlikely event that an Indian style repayment crisis does occur.

A continuation of these trends in Ecuador would provide governments around the world with a blueprint that could be used to protect citizens against predatory lending practices and aid in the development of microfinance industries where the likelihood of the types of crises that have been seen in recent years is significantly diminished.

CONCLUSION

As MFIs across the world continue to issue loans, reports continue to be released showing little evidence that microfinance is substantively alleviating poverty. In November of 2011, CGAP released a report entitled “Latest Findings from Randomized Evaluations of Microfinance.” This report analyzes twenty recently published studies and concludes once again that microcredit is not having a significant positive impact on borrower’s income. The study also finds that taking a loan only increased a borrower’s likelihood of starting a business by 1.3% casting further doubt as to the industry’s effectiveness in its current state. Acknowledging the shortcomings revealed by the results, the report attempts to portray the conclusions drawn from the study in as positive a light as possible:

The [microcredit] industry has focused almost exclusively on the rhetoric of entrepreneurship and has overlooked the many important benefits to households that are using loans to accelerate consumption, absorb shocks, or make household investments (Bauchet et al., 2011).

Statements such as these highlight the danger of microcredit as loans intended to promote income generating activities become many borrower’s means to make everyday ends meet. If a borrower who is unable to put aside enough money to maintain a savings account takes out a
loan strictly for consumption or “shock absorption” purposes, these short term “important benefits” touted by the study eventually lead to a long term cycle of debt and the type of repayment crises that destroyed the microfinance industry in India as well as the lives of many borrowers.

This is not, however, a condemnation of microfinance as an industry or microcredit as a product. Numerous impoverished microfinance clients have been able to smooth consumption, manage economic shocks and in some cases start or grow businesses with the help of microcredit, savings accounts, or a combination of the two. The question now has to become, how can these successes be replicated and scaled while providing adequate safety nets for clients?

Much like Grameen I more than a decade before, SKS and the microfinance industry in India was praised as a success before suffering a catastrophic collapse. Unlike SKS, Grameen was able to learn from its mistakes and evolve into a stronger organization on the back of safer more diversified financial offerings with an emphasis on savings. Since 2002 they have provided a model for other MFIs that unfortunately has yet to gain traction on a large scale; as evident by the number of MFIs that have replicated the Grameen I model of rapid expansion and eventually collapse. In his article, “What the World Can Learn from the Indian Microfinance Crisis,” the director of Microcredit Ratings International (M-CRIL), Sanjay Sinha addresses this issue and concludes:

In recent years, many countries – Bosnia, Morocco, Nicaragua, Pakistan amongst others – have suffered microfinance crises for similar if not the same reasons. Unfortunately, many more – Cambodia, Georgia, Nepal, Nigeria, the Philippines – are also ripe for such troubles if corrective action is not taken. The fate of the Indian charging bull has caused some sober reflection; but there is an overwhelming tendency in international development for local operators to plead regional uniqueness as a reason for not learning lessons from others. MFIs everywhere would do well to learn the lessons of the Indian crisis. The issues discussed…are mainly generic; becoming a charging bull is not the path to long term success, the key is to understand how to evolve from a nimble hare into a sleek mare (Sinha, 2011).
It is hoped that the multiple crises witnessed in recent years will put an end to the regional uniqueness argument and countries across the globe will recognize the generic nature of the problem. While countries are justified in arguing their individuality, the outcome for MFIs in Bosnia, Morocco, Nicaragua, Pakistan and India were almost exactly the same. Nowhere exemplifies this point better than India, where a decades old protectionist domestic policy (priority sectors) met the rise of a new global industry (microfinance) and resulted in regulations that fostered the growth and bust of a spectacular bubble. The details of the rise and fall of microfinance in these other countries are not the same, but in the end the broader lesson is: An overemphasis on microcredit and a marginalization of savings led to banks with no safety net completely vulnerable to the shocks that so often plague their clients.

The stable growth of Grameen Bank after its shift to Grameen II provides a solid operational model going forward, but it is predicated on gradual growth and the slow accumulation of client’s savings as opposed to a rapid influx of outside investment. Non-profit banks such as Grameen who prioritize their social mission over a financial one have proven capable of learning these mistakes and taking a more long term approach, but the majority of MFIs around the world operate as for-profit businesses and will not be as easy to convince. The responsibility lies with individual governments that need to analyze their unique situation and adopt regulations that protect their citizens while ensuring that the microfinance industry is able to succeed and grow.

Ecuador provides a great example of a government with the foresight to adopt such policies, which, in the short term, have proven successful. A microfinance system that had been following a microcredit dominated growth trajectory similar to India’s, has, in the three years since implementing savings promoting regulations, reversed course without stifling the overall growth of the industry. While three years is not nearly long enough to deem the Ecuador
example a complete success, the short term success warrants close monitoring and continued analysis of the industry over the years to come.

Achieving universal access to financial services would be a giant step forward in the long-term struggle to alleviate poverty. But these services must be offered with caution. The world has now seen the damage that the promotion of microcredit alone can cause. As this thesis argued, the prioritization of savings before microcredit can ensure security not only for microfinance clients, but for the MFIs themselves and the industry as a whole. However, the industry cannot be left to regulate itself, and vulnerable, undereducated clients will continue to fall prey to predatory MFIs unless governments pass regulations to prevent the continuation of credit-driven business models as seen in India. Not all financial services are created equal and access to some while being denied access to others can cause more harm than good.
SOURCES

1) "30 Commit Suicide in 45 Days to Escape Microfinance Agents." Economic Times (2010) www.indiaeveryday.in


8) Bauchet, Jonathan; Cristobal Marshall; Laura Starita; Jeanette Thomas and Anna Yalouris. Latest Findings from Randomized Evaluations of Microfinance. CGAP (2011) http://www.cgap.org


15) Feasley, Ashley, "SKS Microfinance and For-Profit MFI's, Unscrupulous Predators or Political Prey? Cornell Law School Inter-University Graduate Student Conference Papers (2011): http://scholarship.law.cornell.edu


41) Singh Panwar, Jaideep. "Microfinance in India Mission or Misery?." Responsible Research (2011)
### APPENDICES

#### Appendix 1: Client and Funding Numbers for the Ten Largest Indian MFIs (2010)

<table>
<thead>
<tr>
<th>Name</th>
<th>Clients (in millions)</th>
<th>Outstanding Loans (USD)</th>
<th>Own Funds (USD)</th>
<th>Amount Borrowed (USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td>SKS</td>
<td>5.79</td>
<td>654.9</td>
<td>213.9</td>
<td>602</td>
</tr>
<tr>
<td>Spandana</td>
<td>3.66</td>
<td>476.3</td>
<td>108</td>
<td>489.5</td>
</tr>
<tr>
<td>SHARE</td>
<td>2.36</td>
<td>379.3</td>
<td>66.2</td>
<td>454.2</td>
</tr>
<tr>
<td>Bandhan</td>
<td>2.31</td>
<td>266.8</td>
<td>44.1</td>
<td>299.9</td>
</tr>
<tr>
<td>AML</td>
<td>1.34</td>
<td>242.6</td>
<td>44.1</td>
<td>315.3</td>
</tr>
<tr>
<td>SKDRDP</td>
<td>1.23</td>
<td>136.7</td>
<td>8.8</td>
<td>130.1</td>
</tr>
<tr>
<td>BASIX</td>
<td>1.11</td>
<td>134.2</td>
<td>44.1</td>
<td>213.9</td>
</tr>
<tr>
<td>Equitas</td>
<td>0.89</td>
<td>105.8</td>
<td>61.7</td>
<td>97</td>
</tr>
<tr>
<td>GV</td>
<td>0.77</td>
<td>90.4</td>
<td>15.4</td>
<td>110.3</td>
</tr>
<tr>
<td>Vijivan</td>
<td>0.57</td>
<td>83.8</td>
<td>24.3</td>
<td>52.9</td>
</tr>
<tr>
<td>Total</td>
<td>20.03</td>
<td>2328.2</td>
<td>630.6</td>
<td>2765.1</td>
</tr>
</tbody>
</table>

*All numbers are in millions of USD*


<table>
<thead>
<tr>
<th>Year</th>
<th>Loans</th>
<th>Savings</th>
<th>Year</th>
<th>Loans</th>
<th>Savings</th>
<th>Year</th>
<th>Loans</th>
<th>Savings</th>
</tr>
</thead>
<tbody>
<tr>
<td>1983</td>
<td>0.97</td>
<td>0.25</td>
<td>1992</td>
<td>42.81</td>
<td>29.41</td>
<td>2001</td>
<td>149.57</td>
<td>104.01</td>
</tr>
<tr>
<td>1984</td>
<td>2.39</td>
<td>0.52</td>
<td>1993</td>
<td>83.32</td>
<td>42.57</td>
<td>2002</td>
<td>141.01</td>
<td>127.35</td>
</tr>
<tr>
<td>1985</td>
<td>3.04</td>
<td>1.07</td>
<td>1994</td>
<td>107.2</td>
<td>59.65</td>
<td>2003</td>
<td>203.86</td>
<td>198.85</td>
</tr>
<tr>
<td>1986</td>
<td>4.11</td>
<td>1.65</td>
<td>1995</td>
<td>112.14</td>
<td>64.42</td>
<td>2004</td>
<td>255.05</td>
<td>279.96</td>
</tr>
<tr>
<td>1987</td>
<td>6.18</td>
<td>2.79</td>
<td>1996</td>
<td>116.74</td>
<td>70.28</td>
<td>2005</td>
<td>369.69</td>
<td>427.82</td>
</tr>
<tr>
<td>1988</td>
<td>9.77</td>
<td>4.38</td>
<td>1997</td>
<td>143.1</td>
<td>78.43</td>
<td>2006</td>
<td>445.15</td>
<td>598.3</td>
</tr>
<tr>
<td>1989</td>
<td>13.45</td>
<td>7.65</td>
<td>1998</td>
<td>166.43</td>
<td>73.02</td>
<td>2007</td>
<td>491.03</td>
<td>701.59</td>
</tr>
<tr>
<td>1990</td>
<td>17.16</td>
<td>11.5</td>
<td>1999</td>
<td>149.12</td>
<td>81.26</td>
<td>2008</td>
<td>559.95</td>
<td>867.26</td>
</tr>
<tr>
<td>1991</td>
<td>21.42</td>
<td>18.66</td>
<td>2000</td>
<td>141.01</td>
<td>89.34</td>
<td>2009</td>
<td>739.38</td>
<td>1120.99</td>
</tr>
</tbody>
</table>

*All numbers are in millions of USD*