Micro-Credit Ratings International Ltd

602 Pacific Square, 32nd Milestone NH8, Gurgaon 122 001, INDIA
Tel: +91 124 405 0739, 426 8707, 230 9497; Fax: +91 124 230 9520
e-mail: ***attouchement@m-cril.com*** website: ***www.m-cril.com***

15 May 2011

Dear Executive Committee Members of CGAP

How to revive the collapsing bull

I am writing this letter on the eve of your Annual Meeting in Cambodia having become aware of the meeting mainly by the chance of seeing Geeta Goel of MSDF in the lounge at Delhi airport last night. This letter is a follow up to my earlier note (of which many of you will be aware), **How to Calm the Charging Bull**, written in June 2010 (http://www.m-cril.com/BackEnd/ModulesFiles/Publication/10-03-16%20-%20How%20to%20calm%20the%20charging%20bull.pdf)

The purpose of the "Charging Bull" piece was to draw attention to some of the emerging issues in microfinance that I felt CGAP urgently needed to address at a time when it was in the process of recruiting a new CEO and had recently appointed a new chair for its ExCom. At this time, it was apparent that the microfinance industry worldwide and most particularly in Asia was heading towards a major crisis; a crisis that sadly became a reality a few months later. I write now to draw additional attention (and to provide a revised agenda) for some of the actions that I think CGAP needs to take in the present situation of the microfinance industry, to support and sustain it as an important element of the global financial inclusion framework.

I write, as many of you will know, from the perspective not just of India but more generally of Asia though some of the ideas I set out below are equally applicable to many other parts of the developing world. I trust you will take these suggestions into account in your discussions over the next few days.

I know that the crisis in India will be uppermost in your minds so I will begin with the root causes of that crisis.

1 High growth and the capital raising conundrum

1.1 The lessons of the Indian crisis – promote measured growth

In sum, the crisis was caused by unmanageable growth rates in an environment where the industry was increasingly exposed to public scrutiny both on account of its growing significance in local economies (AP and a few other states of India) and due to the deliberate decision of some microfinance promoters to draw attention to themselves in an effort to raise the bar on funding for microfinance by capital markets (through IPOs). That this was seen in part to be driven by a combination of hubris and greed is almost incidental; the fact is that there existed an almost incontrovertible logic in the microfinance world which ran like this:

a There remain large numbers of financially excluded low income families not yet served by MFIs or any other formal financial service provider
b These represent a vast untapped market
c In order to reach them, MFIs must raise large sums of money, a substantial part of which can come from lenders provided there is equity capital to show that owners have a stake
d Therefore, there is a need to raise substantial equity capital.
e There is some equity flowing through MIVs and more of it starting to flow from venture capital and private equity funds who see the opportunity for medium term gains resulting from the expected high returns on equity to be delivered through high growth.
f There could be even more equity if the capital market tap represented by stock markets could be opened properly,
g Therefore, we need IPOs in the style of Compartamos which will enable the investing public to see short as well as longer term gains and will bring more funds flooding into microfinance.

All of this was watched by organizations like CGAP, international donors and industry observers with growing excitement, each with their own perceptions of what heights the flow (or flood) of investor money would enable the industry to reach. Everyone forgot that capital raising and IPOs have a logic of their own; they entail the demonstration of profits that are as high as possible, in as short a time frame as possible (in order to catch investor interest). Some of the most respected names in Indian microfinance had succumbed to the above logic by the time the crisis flared out of control in October 2010.

Raising capital from private investors entails the demonstration of the ability to grow fast; a demonstration that investment hungry Indian MFIs provided in good measure during 2005-2010. They expanded inexorably, creating in their wake all kinds of problems

- Multiple lending, as staff in the field inevitably targeted easy to reach clients
- Over-indebtedness, as an environment of easy money built up
- A vexed control environment, as the combination of large numbers of new staff and geographically over-extended operations tested everyone's ability to maintain it, and
- Client protection issues, as MFIs steeped in the culture of "zero delinquency" had incentive systems skewed towards collection at any cost and no policy for addressing the issues of clients in genuine difficulty.

As you know, it was all these issues combined with the increased public scrutiny invited by the SKS IPO that brought the industry in India to a crashing halt. Indeed, the success of the IPO itself became a problem, tempting SKS promoters to take ill-timed management decisions which invited further scrutiny and precipitated the AP government's intervention.

So, where does this situation leave us in the matter of growth and capital raising? It is apparent that 80-100% annual growth rates work fine when an industry is small, clearly such rates do not work when it is large. Organisations even with 5,000 employees clearly cannot expect to train another 6-8,000 over the next year in order to double operations and cope with high staff attrition rates besides.

It may be a case of closing the stable door after the horse has bolted, but even at this stage there are parts of the world (much of Southeast Asia, China) where MFI promoters have not fully appreciated the benefits of **measured growth**. **CGAP could play an important role in educating the microfinance world about this lesson of the Indian crisis** – and indeed those of Bosnia, Morocco, Pakistan and elsewhere – **ensuring that the mistake of high growth microfinance is not repeated**.

1.2 Where should the on-lending funds come from? The need for deposits…

It has become received wisdom in the world of microfinance that "the poor" (financially excluded) need deposit services as much as they need loans. However, success at persuading regulators that MFIs should be allowed to offer deposit services has been patchy at best. As I understand it, CGAP has commissioned studies around the issue of deposits and those studies are in the public domain. However, reading studies and assimilating their conclusions is not the strength of most institutions in the developing world. Engaging with CGAP staff and learning from discussions with them works in some countries but not in many of the larger ones. Large country regulators are also unwilling to learn from smaller countries, so the possibility of persuading the Indian regulator, for instance, on the basis of experience from the Philippines, Nepal or Cambodia, is quite small. In this situation, the only strategy is to persuade an international agency respected by regulators, such as the Basel Committee, that this is a matter that needs to be taken up urgently. Indeed, it is my perception that it is <u>only</u> the Basel Committee that will be able to persuade the Reserve Bank of India to take a more developmental approach to deposit taking by MFIs – under however restrictive conditions to begin with.

Combined with measured growth, **a balanced approach to raising on-lending funds** that **includes deposits along with equity and debt** would have the effect of developing a two-way relationship between MFIs and their clients which has been sadly lacking in the monoculture of lending that has been prevalent until now. It is this monoculture that has facilitated rapid rates of growth while MFIs have dumbed down their relationship with clients to that of mere moneylenders. In the process costs have been reduced and economies of scale achieved (increasing profits to the satisfaction of investors – see **Exhibit 3.8** of the **M-CRIL Microfinance Review 2010**) but ultimately portfolio quality and the control environment have suffered. Thus, measured growth will reduce the relentless chase for equity and deposit taking will round out the relationship between the MFIs and clients. [I have heard it said that deposit taking by MFIs did not prevent the Bosnian crisis; but the international flavor of the time was to pursue high growth, so the message of measured growth along with deposit taking MFIs is what is different now].

I would suggest that **CGAP engages with the Basel Committee in developing the understanding of regulators about the importance of deposit products and in devising ways of ensuring that the concerns of those regulators are addressed in a more developmental framework than the total ban on deposit taking by MFIs that some of them favour.**

One such innovation – though not specifically related to deposit taking – has been suggested by M-CRIL to the RBI. It entails, varying the CAR (capital adequacy ratio) requirement inversely with the extent of financial inclusion in a district, thereby incentivizing MFIs to work in under-served areas rather than in those with high levels of multiple lending.

2 MFIs and their products – loan conditions that meet the needs of clients; microfinance must facilitate livelihoods not just consumption smoothening

While the dumbing down of the relationship between MFIs and their clients has facilitated growth, reduced costs and increased profits it has had an additional effect that goes beyond the mere retailing of money that I have described until now. MFIs have limited the design of their products to plain vanilla Grameen type loans – disburse a small sum of money, and collect it in equal weekly (fortnightly or monthly) instalments without much regard to the real needs of clients . The resulting small loan amounts (typically $150-200 for a first loan in much of Asia) do not meet the capital needs of even the smallest agricultural landholding, or of a viable animal unit or provide adequate finance for a worthwhile enterprise. Thus, in practice, microfinance has become, in most cases, a means of augmenting working capital or, equally often, a consumption smoothening device. While this is useful, it does mean that anyone looking for real productive capital must perforce borrow from other sources to fulfill their requirements.

Indeed, in spite of having made some efforts, livelihoods promotion organizations like EDA Rural Systems (M-CRIL's parent company) have found it impossible to forge adequate linkages between their livelihoods promotion programmes and MFIs precisely for this reason. We had to fall back upon the ever-reluctant banking system for obtaining the $500-1,000 loans that most livelihoods enterprises and smallholder farmers need.

While there is nothing intrinsically wrong with multiple borrowing, each lender assesses the borrower's ability to pay a $200 loan whereas by the time she has fulfilled her needs, the client has perhaps borrowed $1,000. Though the MFIs are happy that they have limited their risk to $200, in practice they have collectively taken a $1,000 risk without undertaking any real loan assessment because they each thought they were lending only $200. This is a classic case of information asymmetry that we are told will be resolved when the multiple credit information bureau initiatives in a variety of countries come to fruition. These initiatives will alert MFIs to total current reported liabilities, but will not solve the problem of credit assessment for a $1,000 loan. MFIs today (in much of Asia) deploy systems designed to eliminate the appraisal process altogether; their staff have neither the skills nor the qualifications to undertake such appraisals. Knowing that a borrower has outstandings of $800 will not eliminate the problem for the fifth MFI to lend another $200 to her. Ultimately, it is only a revamped lending technology that incorporates larger (more useful) loan sizes (and commensurate conditions) extended on the basis of proper loan appraisals that will solve this problem. **CGAP would do well to be quite energetic in promoting the re-engineering of microfinance products and their delivery systems, and to link this to defining different market segments.** Many MFIs may, thereby, have to change their outlook on their business completely, but that is necessary in a changing world.

3 It is not only MFI promoters that have been to blame – promote responsible investment, responsible lending

Another important issue in the context of the current crisis is the supply of funds from investors (not just the demand from MFIs). There are dozens of microfinance investment vehicles (MIVs) today and CGAP has (for a few years) been doing a survey that collects data from them as a parallel to the MFI data collected by the MIX. Most if not all of these MIVs claim to be socially responsible investment vehicles, providing debt or equity funds to MFIs all over the world. They receive funds from socially minded individuals, foundations or corporations simply by virtue of investing in microfinance. Yet, when the industry was spinning out of control in the 2005-2010 period, few if any of these funds had any qualms about encouraging outrageous business plans projecting high levels of growth; focusing on the expected profit rather than on the development impact of the MFI investee's operations. Many banks as lenders to MFIs, both internationally and in India, behaved in the same way. Ultimately, the aggregate size of their microfinance investment portfolio was more important than (having evidence for) its social value – signs of investor hubris (if not greed), to match the promoter hubris referred to earlier. It is indicative that despite enthusiastically endorsing the idea of the rating of MFIs (since the rating reduced their own due diligence costs) many MIVs resisted the idea of a social/financial rating of their own operations when M-CRIL offered them this service in 2009-10.

Learning from the events of the past few years, the UN Secretary General's Special Advocate on Inclusive Finance, Princess Maxima has promoted a set of Principles for Responsible Investment in Microfinance. Given her influence, particularly in Europe, a significant number of MIVs and investors have signed up to these principles. However, such principles will only become meaningful when some substance is attached to them in the form of a reporting and review mechanism. Promoting the idea of responsible investing is a promising step forward in ensuring responsible microfinance. **CGAP should actively promote the development and application of a reporting and review mechanism for those MIVs and banks endorsing the investor principles**. Some effort at publicizing and promoting the use of review processes for investors, would reinforce the measured growth referred to earlier and would enhance microfinance's contribution to financial inclusion.

There are, of course other issues and matters of detail that could be addressed, but there is a limit to what can be considered at one meeting and I am sure you already have a full agenda. I trust, nevertheless, that you will consider the issues I have raised here and that CGAP will re-focus its vision on ensuring a responsible industry by taking practical steps (including those outlined here) in that direction.

I would be happy to discuss some of these issues individually with some of you when we meet somewhere at conferences, et al.

Yours sincerely

Sanjay Sinha
Managing Director