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Pursuit

Critique of Microcredit as a Development Model

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The field of microcredit (otherwise known as microfinance, microlending, or microcapital) has expanded rapidly since the 1980s as an economic means of lifting people out of poverty. Generally, microcredit has been accepted as an effective method for empowering both individuals and communities. In recent years, however, critics have brought to light some of the problems associated with microlending, such as the complex socioeconomic factors that can cause loan programs to fail. These problems stem from the basic tenet of microfinance: the need for lending programs to be managed locally in order to understand the needs of a community and assess the sustainability of each project. Lending programs vary a great deal around the world due to cultural differences, and the success of each must be evaluated in a geographic context. The industry of microfinance cannot be standardized due to these vitally important differences, and there are few organizations which have the ability to watch over the practices of individual lenders. As a result, microfinance institutions are largely free to practice autonomously; this independence is vital to the success of each project but also creates a void of authority.

This paper investigates the microfinance crisis of 2010 in Andhra Pradesh, India, during which a large number of Indian farmers committed suicide. The global community connected the suicides to the excessive pressure of lending institutions on Indian villagers to repay exploitative loans, and the crisis now represents a major change in the international attitude towards microfinance. The deaths sparked global controversy about the lack of regulation in microfinance, which had allowed institutions to exploit the poor in the name of third-world development. In light of the developments in India, the microcredit industry warrants renewed investigation. This paper will investigate how the microcredit crisis in India reflects larger issues in the field of microcredit.

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History of Microcredit

Generally, banks only offer loans to people who can provide collateral in case they default on their loan payments. As a result, people without traditional forms of collateral are usually unable to borrow sizable amounts of money to invest in a business. Additionally, their financial standing is damaged by investments considered 'irresponsible' by lending banks, such as the payment of dowries. People who do not qualify for formal loans often participate in informal savings systems which have limited funds, rigid requirements, and little security (CGAP). 'Loan sharks' often exploit the poor, extorting their money by capitalizing on their lack of other financial options. The Microcredit Summit of 1997 defined microcredit as "programmes [which] extend small loans to very poor people for self-employment projects that generate income, allowing them to care for themselves and their families." Acknowledging that such programs vary from country to country, the Summit also discussed the defining criteria of microcredit and came up with several factors. Microcredit is defined by small size; target users (microentrepreneurs, low-income households); utilization (income generation and enterprise, community health and education); and terms and conditions (flexible, comprehendible, suited to local conditions). Across the globe, credit programs target different types of loan applicants and business investments; accordingly, their lending strategies and repayment plans vary. (Srinivas)

Microcredit was pioneered in Bangladesh, which experienced extreme poverty for decades. In 1974, Bangladesh experienced widespread famine and countless Bangladeshis died in the streets as the government struggled in vain to provide enough food. At the time, Muhammad Yunus was an associate professor of economics at the University of Chittagong, in southeastern Bangladesh. Witnessing the suffering inspired him to investigate why Bangladeshis were unable to feed themselves. He visited the nearby town of Jobra and brought students to help improve its farmers' agricultural productivity. While working with the villagers, Yunus discovered that the very poorest were trapped in a cycle of borrowing-and-repaying to make a living and were unable to advance because they had no capital of their own. Specifically, Yunus observed women whose entire income came from making bamboo stools but who earned only pennies each day due to exorbitant interest rates on their raw materials. He learned that these 42 women owed a total of $27 to their suppliers, and that their permanent debt prevented them from earning any profit. Yunus felt ashamed that such a small amount of money was stopping the women from escaping the cycle of debt. Realizing that the villagers already had marketable skills that required no further training (farming, cooking, sewing), Yunus decided that they needed access to loans with reasonable terms. (Yunus 1998)

By 1975, Yunus had become a full professor of economics and been named the director of the Rural Economics Programme at Chittagong University. In 1976, Yunus launched the Grameen Bank Project in Jobra to experiment with a credit system that would provide banking services for the rural poor. Grameen ("Village") Bank opened with the five following objectives:

- Extend banking facilities to the poor
- Eliminate exploitation of the poor
- Promote self-employment for rural, unemployed Bangladeshis
- Include the most disadvantaged (especially women) in leadership roles

- Reverse the cycle of "low income, low saving & low investment" to "low income, injection of credit, investment, more income, more savings, more investment, more income"

Grameen flourished and received sponsorship from several banks. The project was extended to another district in 1979, and, with continued success, to several others (Grameen Bank a).

In October 1983, the government of Bangladesh passed special legislation to transform the Grameen Bank Project into an independent bank. Currently, borrowers of the Grameen Bank own 95% of its shares, while 5% of shares are owned by the government of Bangladesh. As of September 2011, Grameen had lent money to 8.34 million borrowers, 96% of whom are women. Grameen has lent a total of $11.21 billion since inception, with an unprecedented loan recovery rate of 96.53%. Further, Grameen offers reduced interest rates on loans: 20% for income-generating loans, 8% for housing loans, 5% for student loans, and 0% for loans to 'Struggling Members' (beggars). In contrast, the Bangladeshi government offers a 22% interest rate on loans and the Microcredit Regulatory Authority suggests a range of 25-33% interest rates. As a measure of success, the Grameen Bank estimates that since its opening in 1983, 68% of borrowers' families have risen above the poverty line (Grameen Bank b 2011).

With the Grameen Bank, Yunus developed an innovative lending technique that resulted in unprecedented success. He lent to poor female heads-of-households, who proved more reliable than men because they invested the loans directly in their families rather than repaying previous debt. Yunus also realized that Bangladeshis would be motivated to repay loans if they felt socially obligated to do so (a sort of 'social collateral'). Therefore, he extended loans to groups, correctly predicting that a sense of collective responsibility and fear of public shame would discourage loan defaults. Loaning to 'joint liability groups' resulted in unparalleled rates of repayment, which in turn enabled him to offer more loans to the poorest villagers. Yunus's model requires prompt repayment of small loans (usually around $250) which allows money to be recycled quickly to new borrowers (Rai 2011). Due to such radical lending practices, Yunus witnessed exceptional rates of repayment. He is now considered the pioneer of microfinance and still works to promote Grameen and other international microcredit ventures.

After the founding and rapid growth of the Grameen Bank, international interest in microcredit grew dramatically. Other microenterprise programs adopted Yunus's model by helping poor women invest in small businesses, allowing them to retain assets and thereby better their households. In the 1980s, social entrepreneurs in India established self-help groups (SHGs) of 10-20 women and then linked them to banks to encourage responsible lending (CGAP b). These programs inspired nongovernmental organizations (NGOs) to provide some financial services for the poor, which expanded to offer formal savings programs by the 1990s (Kiva). The United Nations declared 2005 the "International Year of Microcredit" to encourage global awareness and action, and in 2006 the Grameen Bank and Yunus jointly won the Nobel Peace Prize for their combined efforts to empower the poor (Kiva).

Today, microfinance is one of the most well-known and popular investment strategies to lift people out of poverty. Borrowers use their loans to launch or expand small businesses such as farming, construction, taxi-driving, and renting out cell phones in rural areas. MFIs may be non-profit organizations or commercial banks, with differing attitudes towards the balance of financial profit and social justice. In particular, this balance causes much controversy as critics examine the lending rates of MFIs. MFIs and traditional banks must offset the same lending costs (paying employees, educating borrowers, compensating for defaulted loans, etc.), but MFIs must offset these unavoidable costs on significantly smaller loans. As a result, all MFIs must charge higher interest rates on loans than traditional banks do. But since the microcredit industry is relatively new and constantly growing, individual organizations may fix lending rates largely without regulation. As a result, there is a poorly defined boundary between assistance and exploitation, and complaints of administrative corruption have surfaced in recent years. Additionally, critics question if microcredit can realistically be maintained as a sustainable tool for empowering the poor worldwide.

Case Study: India

As a country with a significant poor rural population, India has attracted many MFIs. In 2010, India had an estimated population of 1,170,938,000 (World Bank b). In 2005, approximately 42% of Indians lived below the World Bank's official poverty line of $1.25 per day, and 24% below $1 per day (World Bank c). Approximately 90% of Indians lacks access to formal financial services, and their desire and need for microfinance has attracted many lending institutions (Chau 2011). In fact, "from 2003 to 2009, the number of microloans extended to the poor in India grew from 1.0 million to 26.7 million" (Chau 2011). As of January 2011, India's microfinance sector was valued at approximately $7 billion (Rai 2011). Interest rates vary across the country, from an annual rate of 24-30% to the high but not uncommon rates of 36-120% (Biswas 2010). Until recently, the microfinance industry of India was highly regarded as a viable and efficient means of offering banking services to the poor.

Andhra Pradesh, India's fifth largest state with an estimated population of 80 million, is one of India's poorest provinces and thus a major center for MFIs (World Bank a). A third of all loans in India are made in Andhra Pradesh alone (Rai 2011), holding a value of approximately $2 billion, or 80 billion rupees (Biswas 2010). The microfinance industry of Andhra Pradesh grew very quickly, resulting in a rapid and widespread increase of borrowers who use multiple loans. In fact, about 83% of households in Andhra Pradesh received loans from more than one source, including moneylenders (CGAP). This phenomenon is troubling because it implies that borrowers were not fully aware of the magnitude of their various debts. The Indian government estimates that households in Andhra Pradesh have an average annual income of $1,060 but an average debt of $660 (Biswas, 2010).

During the summer of 2010, a number of Indians committed suicide after defaulting on their microloans. International media immediately focused on Andhra Pradesh because the state represented a large portion of India's microfinance industry, and found that most of the suicide victims in Andhra Pradesh were rural farmers. Many journalists concluded that the suicides could be directly connected to the farmers' inability to repay debt. The deaths represent the largest crisis in the history of India's growing microfinance industry because they revealed deep flaws in a previously unchallenged practice. The crisis sparked investigations into corruption in Indian MFIs as well as research on different loan programs worldwide.

In early 2010, the microfinance industry of India began to receive a great deal of criticism when a major lender revealed that its major goal was the maximization of profit. SKS, a powerful microfinance institution throughout India, issued a document that showcased the potentially enormous profit that it could make in microfinance and proposed considerable pay increases for company executives. The Indian media widely publicized the document, criticizing the company for its unabashed interest in profit. Conflict escalated over the summer as more people investigated the methods and questioned the intent of SKS. (New York Times 2010)

During the summer of 2010, a sense of defiance grew in the borrowers, encouraged by politicians who "egged on [borrowers to default on their loans, accusing] the industry of earning outsize profits on the backs of the poor" (Bajaj 2010). Defaulting, previously seen as a shameful report of disability, came to represent a social statement on borrowers' rights. Thus, as defaulting became a means of protesting unjust lending practices, MFIs lost a crucial element of their industry: the concept that the social humiliation of defaulting on a loan would encourage repayment. According to Mahajan, head of India's Microfinance Institutions Network, loan recovery in Andhra Pradesh reached an astonishing low of 10% during the crisis (Rai 2011). In response, banks and investors drastically reduced funding for MFIs in order to avert major financial loss. Over just a few weeks, the nationwide default froze the liquid assets of local lenders by virtually stopping both loan repayment by borrowers and investment from larger banks (much like the subprime mortgage 'meltdown' in the United States).

This crisis in confidence amplified the asset freeze in the microfinance industry. Indians could not access money, even long-established loans, and began to distrust their banks; MFIs, which depended on quick turnovers to ensure continuous expansion of loans, found their daily business stalled by a lack of loan applications. The microfinance network began to freeze as interactions between banks and borrowers virtually stopped in just a few months, and the microlending system of India seemed on the brink of collapse. (CGAP a 2010)

In October 2010, the chief minister of Andhra Pradesh released an ordinance which increased regulations on MFIs to prevent the industry from further disaster, and to combat the effects of the microfinance meltdown. He designed the legislation to protect borrowers by reducing irresponsible lending as well as preventing aggressive loan recovery tactics. But the ordinance caused an abrupt halt in the cycle of loans and repayments. As MFIs struggled to formulate policies that would conform to the new rules, local lending activity slowed dramatically. Lending agencies felt endangered by the low rates of repayment at the time, and responded by drastically cutting back on lending. Indians found that they suddenly had no access to even long-established loans, and lost confidence in their MFIs. In this environment, when the future of MFIs seemed extremely tenuous, borrowers began questioning their obligation to repay loans and defaults became more common.

While the microfinance industry slowed to a halt, reports of Indian suicides began to receive attention from the international media. By late 2010, over 200 Indians had killed themselves; significantly, all were indebted to MFIs and other lenders (Associated Press 2012). Onlookers interpreted the suicides as attempts to regain control in the face of overwhelming shame; in this case, critics argued that the Indians were ashamed of their inability to repay debt. Many blamed the MFIs' questionable lending practices for the recent defaults. Reports by the Indian government attribute the suicides directly to "pressure put by the micro-finance institutions for repayment" (Biswas 2010). But while pressure by lenders may have been the immediate cause of the suicides, it does not explain why the Indians were unable to repay their loans in the first place. The cause of the mass defaulting has not yet been fully determined, but most critics agree that the crisis represents a profound failure on the part of MFIs.

Vijay Mahajan, chairman of India's Microfinance Institutions Network, stated that the industry's crisis resulted from "multiple lending, over-indebtedness, coercive recovery practices and unseemly enrichment by promoters and senior executives" (Biswas 2010). In other words, Indian finance companies provided loans without fully investigating their clients' ability to pay. MFIs felt highly assured of repayment because in addition to lending larger sums to more Indians, they increased interest rates to 60% and more to balance any losses (Rai 2011). With such liberal terms, the borrowers began using their loans for non-investment purposes such as paying off previous debt and drinking alcohol (Rai 2011). The MFIs pushed loans to more and more Indians with little regulation and allowed villagers to pile up debt as they borrowed more. To pay back their loans, villagers turned to unofficial lenders such as loan sharks. As repayment became more and more difficult, Indians protested that the system once again resembled the entrapping cycle of lending that Muhammad Yunus had broken. Reports surfaced that Indians were committing suicide in poor states because they could not repay their loans. MFIs began to pressure borrowers for payments to avoid financial losses, suddenly nervous that they had lent too much money to too many people. They employed aggressive loan recovery practices to force Indians to rapidly pay months' worth of interest rates (Rai 2011). Suicides and desperation increased as more Indians could not repay their loans and MFIs increased pressure; these factors bounced back and forth until a state of crisis.

Even after the crisis had been deflated by further government interference, many industry authorities have concerns about the future of microfinance. MFI leaders have expressed concern that larger banks will continue to withhold funds in an effort to prevent major losses, should another mass defaulting occur. Additionally, they worry that those large institutions will pressure them to repay outstanding loans from the crisis period. If this occurs, the entire microcredit system could truly collapse simply because MFIs will be unable to withdraw money from larger institutions and thus unable to offer loans. The network still faces uncertainty because the entire industry depends on the open flow of liquid assets from borrower to MFI, and from MFI to a larger bank; this flow depends on a trust which has not yet fully been restored. (Rai 2011)

On a larger scale, the global community's perception of microfinance has been sorely damaged by the crisis of Andhra Pradesh. Some critics say that these loans were not only irresponsible, but intentional exploitation by aggressive salesmen of poor and ill-educated people who lack access to certain services and therefore must rely on MFIs to avoid expensive, local, private services (Biswas 2010). If this accusation is true, such abusive policies undermine all the original values of Yunus and the foundations of microcredit. Vijay Mahajan, of India's Microfinance Institutions Network, comments that "the market-driven business model [of microcredit] will have to be replaced with a legitimate, more sustainable model with social objectives" (Rai 2011).

Critique

The case study of microfinance in Andhra Pradesh suggests that the lending industry, although perceived as a champion of alleviating poverty, must be evaluated by the same standards applied to for-profit businesses. The microfinance crisis of 2010 in India brought to light many issues of microfinance that were not previously addressed by the global community. Yet since the creation of the Grameen Bank, academics have investigated the realities of microfinance, such as how to best measure the success of a program, evaluate potential corruption, and assess which groups are most affected by microloans. In particular, development scholars have studied microcredit in depth.

Many academics use the Grameen Bank, the model for many other lending institutions, as a basis for analyzing the effectiveness of microcredit. In 2003, three economists published an influential article in the *Journal of Development Economics* which quantitatively assessed the Grameen Bank's borrowers. Using data from 229 borrowers' households, the three economists conclude that "while microcredit is successful at reaching the poor, it is less successful at reaching … the group most prone to destitution, the vulnerable poor" (Amin 2003: 59). To further criticize microfinance, other researchers have found that the long-term effectiveness of microlending is limited. For example, an article published two years later in *Progress in Development Studies* uses data from the Grameen Bank and finds a correlation between the length of time that a borrower has access to microloans and the effectiveness of those loans: "Our two main findings are, first, micro-credit is associated with both lower objective and subjective poverty and, secondly, the impact of micro-credit on poverty is particularly strong for about six years with some levelling off after that point" (Chowdhury 2005: 298).

Another significant area of academic critique is the symbolism of microcredit in a neoliberal economy. Researchers such as Lamia Karim connect the roles of gender and economy in Bangladesh, analyzing repayment rates in the context of neoliberalism. Karim focuses on four major lending institutions in Bangladesh to describe "how Bangladeshi rural women's honor and shame are instrumentally appropriated by micro-credit NGOs in the furtherance of their capitalist interests" (Karim 2008: 5). Although she acknowledges the success rates of microfinance, Karim probes the techniques used to encourage repayment and suggests that, although it has helped in lifting women out of poverty, microcredit furthers the subjugation of Bangladeshi women by promoting the manipulation of traditional cultural values. Another author agrees that "microcredit thus constitutes social citizenship and women's needs in a manner consistent with neoliberalism" (Ranklin 2001).

In conclusion, the microfinance crisis of Andhra Pradesh reflects many larger issues of microfinance around the world, such as whether MFIs should be held to international standards or be allowed to self-govern, how to most effectively apply the techniques of microlending, and how to balance profit with social justice. Most critics agree that microfinance is an extremely valuable tool for alleviating poverty around the world; however, they also conclude that lending institutions must be run very carefully to avoid such sudden disasters as the one that occurred in India.

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About the Author

Grace Levin is a third-year student in the Chancellor's Honors Program at the University of Tennessee. She will graduate in 2014 with double majors in the interdisciplinary programs Sustainability and Global Studies, as well as minors in Geography and French. She is interested in sustainable development, especially the relatively new concept of microfinance and how it has affected the global community. In spring 2012, she presented her findings on the microfinance crisis in India to the judges of the EUReCA poster competition at U.T., and won an award in social sciences. She has been invited by UT's Office of Research to present this project to Tennessee legislators in spring 2013. In June 2012, she accompanied her mentor, Dr. Micheline van Riemsdijk, to Oslo, Norway, to participate in a research project on migration funded by the National Science Foundation. She plans on continuing studies of sustainable development by attending graduate school.

About the Advisor

Dr. Micheline van Riemsdijk studied in Norway and the Netherlands before coming to the United States, where she received her M.A. in Scandinavian Languages and Literatures in 1998 from the University of Minnesota and her Ph.D. in Human Geography in 2008 from the University of Colorado at Boulder. She is an assistant professor in the Department of Geography at the University of Tennessee, where she has worked since 2008. Her research interests are in international migration and the operation of global labor markets. In December of 2010, she received a grant to travel to Bangalore to interview Information Technology specialists and Human Resource managers at large IT firms.