THE INDIAN MICROFINANCE CRISIS:

THE ROLE OF SOCIAL CAPITAL, THE SHIFT TO FOR-PROFIT LENDING AND IMPLICATIONS FOR MICROFINANCE THEORY AND PRACTICE

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Abstract

This paper uses India's microfinance crisis as a context for evaluating alternative theories of microfinance. By contrasting Bangladesh's highly successful Grameen model with the allegedly "universalizable" version of India's SKS Microfinance (that precipitated the crisis), we isolate trust or social capital – not just narrowly interpreted within standard economic theory, but more broadly construed – as the essential element accounting for the early success of microfinance. We show that the microfinance experience has been widely misinterpreted, both in analytical and policy terms. Our analysis suggests inherent limits in extending the model to for-profit institutions and to the pace of scaling-up.

Keywords: Microfinance – Microfinance and Social Capital – Indian Microfinance Crisis – Microfinance For-Profit – Asia - India

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1. INTRODUCTION

For the past three decades, microfinance inspired tremendous confidence in development circles as an effective way of reducing poverty. But today, microfinance is in crisis in countries as diverse as Nicaragua, Bolivia, Mexico, Nigeria, Pakistan[1] and – most notably – India and Bangladesh.[2]

In this paper, we analyze global developments in the microfinance industry in the context of the recent crisis in Indian microfinance – attempting to develop a coherent theoretical account of them. These experiences help, we believe, to shed light on a longstanding controversy: what attributes of microfinance are *essential* to its success. Our analysis lends support to the idea that the key factor sustaining its success is what is variously described as "social capital" or "trust"[3] – a hypothesis put forward in (Haldar & Stiglitz, 2008).[4]

In the first part of this paper we summarize the extensive theory that has emerged to explain the early success of the microfinance experiment, while in the second part we identify the factors accounting for the unraveling of the model. In particular, we argue that the Indian crisis is not just a symptom of the "growth pangs" of the industry – the inevitable result of tensions confronted by an essentially localized institution attempting to develop into a universal model. Rather, the failure arises from the fact that the practice of microfinance today has strayed from its original vision.

A brief history: Microfinance began as a series of lending experiments in the villages of Bangladesh in the 1970s (associated in particular with Yunus and the Grameen Bank[5], but also with other major Bangladeshi MFIs like BRAC[6]). Grameen now lends to approximately 8.4 million women and has replicas in 84 different countries,[7] while BRAC boasts 7 million borrowers in Bangladesh alone and a global reach over 100 million. Microfinance, as a whole, has evolved into an institutional structure extending to close to a billion borrowers worldwide, with loans totaling close to $ 70 billion.[8]

The initial impetus for microfinance was to provide respite from the dominance of traditional moneylenders, who were viewed as exploiting poor borrowers, often charging usurious interest rates.[9] The resulting reluctance to deal with traditional moneylenders reduced credit, thereby reducing productive investments and livelihoods.[10]

In its original vision, microfinance entailed providing small loans, mostly to women – for productive purposes. Repayment rates were remarkably high – in the vicinity of 98 percent[11] and were achieved in the absence of either collateral or any formal contract between the Microfinance Institution (MFI) and borrower.[12] Its success led the model to be embraced around the world.[13] But while the data surrounding the poverty-alleviating effects of the institution sometimes seemed less convincing than its most ardent advocates thought,[14] there was much evidence of its socially transformative effects – including with regard to women's empowerment.[15]

Ironically, the very success of the model may be contributing to its unraveling. Beginning in the early 2000s, the industry began to display an "irrational exuberance" – a dramatic proliferation in MFIs, accompanied by an aggressive approach to extending the borrowing base – accompanied by increasing reports of the use of coercion. The pressure to repay, coupled with the increased availability of credit from a multiplicity of lenders, resulted in “overlapping” – or borrowers taking loans from one MFI to pay back another – and thereby getting caught in a debt-trap. These incipient changes were observable in microfinance sectors in countries across the world – including its original home, Bangladesh.[16] But nowhere did they occur more rapidly than in India. Consequently it was in India this process reached its logical conclusion: the eventual inability of borrowers to repay loans, and the resultant risk of the collapse of the system.[17] To some, microfinance in India was that country’s sub-prime crisis, marked by similar reckless expansion and predatory lending that characterized lending to the poor in the United States.[18]

2. TOWARDS A THEORY OF MICROFINANCE

In spite of its importance, the theoretical foundations of microfinance remain disputed.[19] Those who work on microfinance on the ground argue that most of the extensive theoretical literature misrepresents the reality of the functioning of the system and is out of touch with recent institutional developments. In this section, we combine the theoretical literature with extensive qualitative data from original field research to describe more accurately the microfinance mechanism, at least in the pre-crisis era.[20]

Since we argue that the key to the success of the model lies in the “institutional detail”, [21] in the first part of this section we provide a detailed descriptive account of the working of the institutional structure. Although the Grameen Bank provides the paradigmatic instance, the account holds true for the experience of “first” generation (mid 1970s to late 1980s) and “second” generation (late 1980s to around 2005) microfinance more generally.[22] In the second part of this section, we attempt to tease out of the descriptive account the systemic elements that explain the working of the microfinance mechanism, focusing, in particular, on the ways in which the dialogue with the empirics inform – and challenge – the established theoretical literature on microfinance. In the final part of this section, we confront one of the most vexing theoretical conundrums not only in the theory of microfinance but institutions more generally – the issue of institutional replication.

(a) The microfinance model: The case of Grameen Bank

(i) The group mechanism

The core of the original microfinance model is "the group". Borrowers at most MFIs are organized into groups comprising five to ten members. The central theoretical question is, why group lending is effective (e.g. in promoting high repayment rates.)[23] There are three alternative theories:[24] The first, which has been central to the theoretical literature beginning with (J. Stiglitz, 1990) is that joint and several liability provides for an effective – and informationally efficient – enforcement mechanism, based on the advantages of peer-monitoring.[25] But the change in contractual arrangements, discussed below (whereby individuals are not jointly and severally responsible for the debts of other members of the group), suggests that something else is at play.

The other two are based on the notion that the group replaces standard collateral with "social collateral".[26] Moreover, the group acts as a social support base for individual borrowers.[27] One variant of these is based on the economists' standard formulation of "social capital" – modeled as repeated interactions in which failure to comply with the cooperative action leads to punishment. In these models, individuals are individually rational in engaging in cooperative actions (repaying loans, providing support to each other to enhance their ability to repay). This group of models can be simply seen as a multi-period enforcement version of the simpler joint and several liability model. The alternative – and less widely accepted – approach focuses on broader theories of human behavior, where relationships and social connectedness may affect behavior even in the absence of any well-specified (or even tacit) set of consequences associated, say, with non-repayment.[28]

In the paragraphs below, we describe in some detail, the nature and history of Grameen groups, with particular reference to those aspects that might shed light on the alternative explanations for why microfinance schemes work – and when and why they might fail.

The formation of a group is premised on certain conditions. In the case of the Grameen Bank, for instance, the conditions are that all members must be "poor"[29], live close to one another in the village, have no blood-ties, and be from roughly similar economic conditions.[30] Many of these factors contribute to the "information advantages" of monitoring that are key to the success of the model.[31] At Grameen, group members undergo seven days of intensive training, of which one day involves the participation of the husband or the "guardian". Further, each member contributes ten Takas (Tk.)[32] per day to the training program, which is used to open a savings account (with an initial deposit of Tk. 70).[33] These practices contribute to the "social capital building" and "norm creation" aspects of the microfinance model.[34] Finally, membership is subject to an interview with the Branch Manager. Approximately ten groups form a "Centre" with 50 to 80 members. Each center elects a center leader who acts as its representative vis-à-vis the center Manager (a Grameen employee).[35]

It is significant that *today most MFIs insist that repayment is not organized through a group guarantee – with joint liability*.[36] The system of joint liability which motivated peer-monitoring was in operation under the "classical" Grameen model at the time the first theoretical analyses of Grameen were conducted (J. Stiglitz, 1990).[37] But this system was replaced by the "generalized" Grameen system in 2000, and the "classical" model is now only used by some replicas of the Grameen model abroad. According to Yunus, under this new system, sometimes referred to as Grameen II, "Repayment responsibility rests solely on the individual borrower, while the group and the center oversee that everyone behaves in a responsible way and no one gets into repayment problems".[38].

Indeed, according to Grameen itself, the relationship between group and individual lending is much more subtle than portrayed by standard economic theory. Even before the "official" introduction of this new system, they claim the group was always more important from the perspective of what they call "loan utilization security" rather than "recovery security", i.e. the group played a more important role in monitoring the use of loans (to ensure that it was used for the purpose for which it was granted) than it did in ensuring loan repayment.[39] There were few (if any) instances in which the non-payment by one member of the group led to recovery from others.

Under Grameen's new system, the procedure for loan approval still requires a high measure of cooperation – at least half of the Centre's members must support the proposal for the loan to be sanctioned. This process plays a crucial role in maintaining institutional discipline – to the extent that individual performance will have an impact on the rating of the group and thereby the ability of others within the group to borrow, strong incentives exist for group members to monitor each other's behavior.[40] Even without joint and several liability, group members have an informational advantage in and incentives for peer monitoring and for "peer selection" – selecting against those who would, even with effective peer monitoring, be unlikely to repay.[41] In cases where a group member attempts to "cheat", a group meeting is called to deter the errant member from further deceptive behavior. The consequences of a failure are more diffuse than in the joint liability model: It is not that other members of the group will have to make up for a non-payment, only that the group's reputation and access to credit will be adversely affected.

Further, the size of an individual loan is also linked to the group. The "basic loan" issued to members in the first instance is Tk. 7000, but may be increased after three years. Members are awarded points to determine the size of the loan for which they are eligible. The normal increase in borrowing after three years is 25 percent – ten percent is awarded for individual performance, ten percent for group performance and five percent for center performance.[42]

But it is not just these economic incentives that may lead to better performance. The social connections associated with the groups may lead directly to more responsible behavior. There is an analogy in incentive structures in labor markets. Many firms pay workers at least in part on the basis of team performance. Economists have been skeptical about the effectiveness of such schemes involving more than a few individuals, because in standard economic models, everyone has an incentive to be a free rider. In fact, the evidence is that they can be highly effective, and partly for some of the same reasons that microfinance schemes can be effective. Individuals create bonds with other members of the team; it would be socially unacceptable to free ride.

(ii) Other financial safeguards

While the group mechanism lies at the heart of the microfinance model, a number of other practices have contributed to the success of MFIs. These practices are motivated by dual purposes – augmenting the financial security of the bank, but also the welfare of the borrower (thereby further bolstering the trust and loyalty of borrowers).[43]

Although Grameen does earn profits,[44] these profits are ploughed back into the expansion of its operations, used to subsidize investment instruments offered to borrowers or distributed as dividends to shareholders (who are also borrowers) – all actions which increase the bonds between Grameen and its borrowers.

The way Grameen handles troubled loans contributes to its financial sustainability and "social capital." If a loan is not paid back on time, it is converted into a "flexible loan" – borrowers are allowed to repay reduced amounts to help tide them over emergencies such as natural disasters, illness and business failure. A 50 percent provisioning for overdue loans is done on the last day of each month. At the end of the second year of non-repayment, a 100 percent provisioning is done. In the third year, if the loan remains in arrears, the debt is completely written-off, even if some loan repayment continues.[45]

In addition, most MFIs (including Grameen) are increasingly setting in place insurance mechanisms to offset the risks of default by borrowers. The Grameen, for instance, has a forced-saving program where Tk. five a week is compulsorily deposited in their personal savings accounts.[46] This savings account is the first recourse if a borrower defaults, and is intended to discourage members from defaulting.[47] When savings amount to Tk. 100, the member can buy a share in Grameen with voting-rights.[48] Anything above this amount, however, can be withdrawn. If a member takes a loan of over Tk. 8000, she is required to deposit Tk. 50 per month in a pension scheme for ten years – at the end of which she gets back double the amount.[49]

Grameen also provides other types of insurance facilities for members: (a) Loan insurance – pending payments are fully insured in the event of death of a borrower, paid for by a premium of three percent of the amount borrowed.[50] This serves the twin purposes of avoiding MFI losses and saving the borrower's family from indignity.[51] Borrowers who live and repay have the premium returned to them with 13 percent interest.[52] Borrowers can also insure themselves in case of the death of their husbands; (b) Life insurance - families of Grameen's deceased borrowers receive a life insurance benefit of Tk. 1500 – this is a benefit that comes with Grameen membership[53]; (c) Disaster Relief – the fund for Disaster Relief was created by Grameen share purchases. But, for the first time, in 2006, the Grameen declared a dividend for its shareholders of 100 percent. In 2007, a dividend of 20 percent was announced, which rose to 30 percent in 2008. Grameen has also established a Dividend Equalization Fund to ensure minimal dividend-fluctuation.[54]

(iii) Other Social Aspects

In addition to the core of the group mechanism that intertwines the fate of the individual borrower, the group and the Centre, certain other practices – for instance, its treatment of members and employees – contribute to the efficacy of its system. Indeed, the fact that it acts in ways that show that it is not just a profit making organization, but one with a social agenda, may (as we emphasize in the next section) be critical to its success: There is more than a contractual (monetary) bond between the borrower and the lender. The lender is not seen as just trying to extract as much out of the borrower as he can, and the "good will" is reciprocated by a greater effort to repay (and a greater effort to comply with the Bank's strictures designed to enhance repayment.)

The social agenda of Grameen was evidenced from the start by the policy of lending mostly to women. This contributed to the high repayment rates[55] and has a number of other positive developmental effects (relevant for Grameen, but not necessarily for an entity devoted purely to profit-maximization).[56] At present, about 96 percent of Grameen borrowers are women.[57] Grameen's commitment to women's empowerment was further evidenced when it introduced mortgages, when it insisted that the mortgages be put in the women's name, partially in an effort to discourage traditional divorces in which women had no rights.

Moreover, MFI membership is associated with various practices that reinforce the group identity. In the case of Grameen, for instance, membership is conditional upon memorizing the “sixteen decisions” – a set of commitments that members bind themselves to upon entering the organization. These commitments emerged out of a deliberative process involving the Bank and borrowers.[58] Continuing membership requires that borrowers attend weekly group meetings – and maintain close relations between group and center members.

Further, both the ownership and administration of Grameen are inherently participatory. Not only are a large majority of Grameen shareholders its borrowers, but nine of its 13 Board Members are elected from amongst its members. Members exert an important say in the running of the organization – from becoming a group "chairperson", to center leader, to, eventually, a Board Member.[59]

Finally, part of the success of the Grameen Bank is attributable to the relatively low levels of corruption amongst employees. This has been established partly through financial incentives (e.g. after ten years employees are entitled to retirement benefits in cash),[60] but more importantly, through purely social rewards for good performance (e.g. a scheme that awards "stars" of different colors to a center based on a variety of performance criteria)[61].

All of these aspects of the microfinance mechanism play an important part in the "social capital building" and "norm creation" functions that are so crucial to its success.[62] In particular, they ensure that microfinance is not seen as just a commercial relationship.

(b) Elements of a theory of microfinance

The account of microfinance just provided paints a picture of an institution motivated by a certain economic rationale and based on some economic safeguards, but most of all, on an intricate network of social relations.

The single most remarkable feature of microfinance is its stellar repayment rates. An adequate theory of microfinance must answer the question: Why do poor borrowers repay?

The current theory of microfinance has explained this in terms of joint liability. "Social capital" – to the extent it plays a role – is interpreted as enhanced enforcement capacity in a multi-period game, and not surprisingly increases repayments.[63] In the light of the account provided above, we attempt to develop a more holistic – and nuanced – perspective.

To simplify issues, we view the provision of credit as a contract – implicit or explicit – between lender and borrower. Standard formal, Western-style legal systems (say in advanced countries) rely on "external enforcement," i.e. on an established third-party authority (that is typically, but need not be, the State) to enforce explicit contracts.[64] The institutional innovation of microfinance lies in its ability to induce widespread entry into the lending contract (i.e., a high rate of loan disbursement) and compliance with its terms (i.e., high repayment rates) by "informal" means. The implicit contract entails no collateral requirement and no formal legal contract.[65] We argue that the enforcement mechanism is neither external nor that associated with one variant or another of joint liability, [66] but is a result of what is perhaps better described as "pro-social disposition".[67]

(i) Contract Design

Collateral

The insight that collateral is not central to the success of a credit-delivery mechanism in the developing world context (where claiming it through the judicial process is nearly impossible) has been one of the most important factors contributing to the success of microfinance.[68] Grameen's success demonstrates the relative importance of other factors like monitoring and screening[69]. Grameen has broken the link between prior ownership of assets as a pre-requisite for obtaining credit, enabling several million Bangladeshi women to gain access to credit where they would otherwise have found it impossible to do so. [70]

While the MFI's practice of holding borrowers' savings and insisting on contributions to the "disaster fund" reduces lender losses when borrowers face adverse events, and may be considered somewhat paternalistic, its benefits go beyond mere loss-reduction.[71] Forced savings provides insurance for the borrower in times of need,[72] while the "disaster fund" has served the Bank and its workers particularly well during the frequent periods of floods (when the Bank assumes responsibility for substantial reconstruction).

Flexibility of the Contract

Another aspect of the microfinance model that accounts for its success is the flexibility of the informal – or implicit – contract. On the demand side – or from the perspective of borrowers – the fact that the terms of the contract are more malleable encourages more people to borrow where they would normally have been deterred by the more restrictive terms of a formal contract.[73]

While the terms of a formal contract are largely fixed and changing them could be an expensive process, the flexibility of the informal system allows shocks to be better absorbed,[74] as demonstrated by the recovery of Grameen in the wake of the 1998 floods.[75] (The "social contract" may play an important role both in preventing borrower abuse of this provision and the creditor taking advantage of the admission of weakness on the part of the borrower to drive a hard bargain.)

(ii) Contract Enforcement

An extensive survey of the literature as well as wide-ranging field interviews provides competing accounts of the success of microfinance in ensuring the repayment of loans without the security of either formal legal contracts or collateral. We summarize the alternative explanations before presenting our own interpretation.

Credibility of the Threat of Punishment

There are two distinct theories about why individuals repay loans: because of the consequences *to themselves* that follow from non-repayment or because it is the *right* thing to do, that is, they have been *socialized* to repay – they internalize the social consequences of non-repayment (when they could have repaid.)[76] Interestingly, there may be greater certainty of even the direct consequences of non-repayment in an informal system than in a formal system: the threat of punishment via the State legal system may often appear empty in the context of a country like Bangladesh.[77]

There are, in turn, several distinct categories of consequences of non-repayment in informal markets. Under the joint liability system, others bear some of the consequences for non-repayment – intended to incentivize peer-monitoring, cooperation, and selection, but in practice there is little evidence that others have had, in fact, to pay in the event of default by the borrower.

The most obvious "incentive" is the threat of not refinancing borrowers who default. Access to credit is valuable, and the Grameen model – where those who behave well get access to increasing amounts of credit – enhances the penalty of non-repayment.[78] (For the termination of credit to provide an effective incentive, it must, of course, not be possible for the borrower to obtain credit at comparable terms, say from informal money lenders – making it imperative for microfinance lenders to keep interest rates, at least relatively, low.)[79]

An increasingly important feature contributing to the desire for borrowers to maintain a positive reputation is the increasing inter-linking of markets, or, the expansion of most major MFIs into other markets that impact borrowers, thereby increasing the stakes in the relationship between bank and borrower.[80] Grameen has now diversified into areas as varied as electricity generation, information technology, education, telecommunications and textiles – these enterprises permeate the lives of borrowers in a variety of different ways.[81]

The Use of Coercion

Some critics of microfinance (and especially of Grameen) claim that an incentive mechanism, akin to that of the old moneylenders (including the Mafia in the US), is common: Brute force, intimidation, and threats by MFI workers.[82]

The reports of the use of force, although not uncommon, are anecdotal (an instance of refusing to let the dead body of a member be removed till debts were cleared[83]; pulling down tin roofs of the huts of villagers[84]; threatening mothers about the safety of their daughters and even driving women into prostitution in order to pay back debts[85]) – and consequently plagued with the problems of verifiability endemic to such accounts. It is consequently difficult to ascertain the frequency with which coercion is employed, though even a few instances can make coercion an important part of repayment incentives. But if these reports are true, MFIs are just "the new money-lenders".[86] Indeed, according to some observers, the use of force in loan collections – both violent and in the form of psychological pressure – has long been the norm rather than the exception. To Grameen's critics, such coercion is a natural consequence of the priority placed on repayment.[87]

(Under the joint liability system, the fact that other members of the group will bear the consequences of one's not repaying naturally leads to pressure from these individuals for repayment. The fact that repayment rates have remained high, even as the joint liability system has been abandoned, implies that this pressure was *not* the critical factor in repayment.)

Some criticism is partially a consequence of the nature of "implicit" contracts versus explicit contracts. Lawyers and human rights activists, in particular, expressed concerns about lack of procedural propriety in MFI practice. They emphasized the importance of a "rights-based" approach to lending so that borrowers do not start to feel as though the loan provider "owns" them.[88] Indeed, on this view, requiring collateral is procedurally preferable to using force to recover loans [89]; loan repayment pressure, even psychological rather than physical, can be a source of domestic violence and heightened social unrest, among a host of other social ills.[90]

Representatives of the MFIs and sympathetic observers, however, denied that the use of coercion is a major driver in the success of the microfinance experiment.[91] While they admit that lapses into the use of coercion may occur, they argue that they are sporadic rather than a trend, and that without a very high measure of consensus the scheme would have been unsustainable.[92]

There is, however, one factor that may have, in some places, given rise to increasing use of coercion. One of the consequences of increased entry into micro-lending (discussed below in the context of India) is increasing competition in the microfinance industry and the occurrence of "overlapping" whereby borrowers have loans from several lenders. This means that MFIs have to compete with each other to be repaid – and thus resort to "arm twisting" tactics. [93]

Social Capital and Norm Creation

An alternative set of explanations focuses on "social capital" (Haldar and Stiglitz, 2008). The term social capital is used in two different senses. One is just another name for "implicit contracts" or "social contracts" enforced through a repeated game, where the members of the society (group) have strategies which serve to enforce the desired behavior.[94] This is simply a generalization of the incentive structure discussed earlier, the withdrawal of future access to credit by someone who doesn't repay. But social cohesion, thus defined, can be broader: cooperation may entail helping other members of the group with their productive activities, thereby enhancing their ability to repay. While joint and several liability may enhance the incentives to engage in these kinds of cooperative activities, they are not necessary. The dependence of an individual's access to credit on the repayment of others in the group incentivizes this kind of cooperative behavior within the group. This is important, because repayment rates held up even when Grameen switched from Grameen I to Grameen II, in which joint and several liability was abandoned.

There is another broader interpretation of social capital, which sees individual well-being closely related to connectedness, and maintaining the affection and respect of those with whom one is closely connected, as an essential aspect of advancing an individual's own sense of well-being.[95] Indeed, there are at least two significant strains of literature supporting the hypothesis that behavioral norms are not merely those supported by repeated games – one stemming from evolutionary biology and grounded in genetic characteristics[96] and the other derived from sociology that talks about the cultural determination of preferences (for instance, that I feel good about myself for having treated others fairly)[97].

We believe that a major factor contributing to the efficacy of the microfinance model is successful attempts at social capital building (in this broader sense) and establishment of positive norms (concerning not just repayment but support for other members of the group) that are internalized by members.[98] This was partly the result of the institutional innovation of the "group mechanism", which was structured to strengthen social capital. The cultivation, and use, of social capital is facilitated by the criteria for selection of members to constitute the group – lending to groups of relatively homogenous women turned out to be far more effective than more mixed groups (in terms of both gender and social class).[99] Further, it is important that the group develops a meaningful *social identity* before the economic calculus enters the picture; this is aided by the organizational ritual surrounding group formation, like the weekly meetings. But in their attempt to create social capital, both BRAC and Grameen went well beyond the group mechanism, e.g. in BRAC, with education, legal assistance, and health programs. As one observer put it: “The broader impact of [microfinance] is not in the economic arena but in the psychological, socio-cultural domain. The real change is occurring in the realm of ideas”.[100]

Yunus’ original idea, focusing on lending to women among the poorest of the poor was intended to change the political balance of power within the community and the family, and this in itself may have contributed to a sense of identity among the broader members of the microfinance community.

One means of probing whether the “economic” or the “social” rationale is driving repayment is analyzing what happens when borrowers think that the lender is “going under”: the fact that there were no mass defaults when the Grameen’s future was cast in doubt by the floods of the1980s provides evidence for the proposition that it is, indeed, creating norms amongst members, going beyond pure economic interest.[101] As summarized by one commentator: “[…In Bangladesh it has now become a social norm to repay MFIs. The theoretical literature variously attributing repayment to group liability, peer pressure, and so on, is therefore irrelevant.” [102]

If this account of the reasons that underlie repayment success is true, then critical to the success of the microfinance enforcement mechanism is its essentially participatory character that allows the problem of apathy (or antipathy) of agents towards the system to be overcome and enforcement to be achieved through internal legitimacy rather than third-party enforcement.

Peer-monitoring and Information

The formal economic literature growing out of Stiglitz (1990) has tended to explain the high repayment rates of MFIs in terms of peer monitoring incentivized by joint liability. Since the "mutual enforcement model" (Dasgupta, 2003) or informal law requires that breaches be observable but not necessarily publicly verifiable[103], the information costs associated with it are inherently lower. This model has significant informational advantages over formal regulation since the community is far better poised than formal institutions to monitor the actions of borrowers. Though Stiglitz did not focus on the problem of adverse selection, peers are also in a better position to ascertain who are most likely to repay. Thus, the Grameen model is able to address better both problems of "moral hazard"[104] and "adverse selection".[105] These informational advantages are also a critical factor in allowing the flexibility of design discussed above. This enables strategic defaults (i.e. an attempt at evading repayment) to be relatively easily distinguished from genuine ones (i.e. due to some unforeseeable circumstance such as a natural disaster or sickness in the family). Not only does this imply that these contracts have better in-built mechanisms of insuring against risk – but they allow the lender to give loans to those considered riskier borrowers as well, making the system inherently more inclusive.[106]

However, as we have already noted, the fact that repayment rates remained high even as the joint and several liability system was abandoned suggested that something else accounts for the success of the Grameen model.[107]

Peer monitoring, *seen as part of "social capital"* can, however, be an important part of the explanation of the success of microfinance. Individuals' behavior is affected by whether their behavior is observed by those whose respect they want to earn and maintain. While some individuals may repay loans simply because it is the right (moral) thing to do, other individuals may be more likely to repay if others are observing their behavior.

Concluding comments

(Dasgupta, 2003) identifies different systems of contract enforcement: The first, "mutual affection," is based on group members caring about each other. The second is "pro-social disposition," based on norms of reciprocity, such as might arise out of evolutionary development and socialization. The third is "mutual enforcement" based on fear of social sanction in the context of long-term, settled relationships in a community where people encounter each other repeatedly in the same situation.[108] These three enforcement mechanisms are central to "informal" legal systems. The fourth is, of course, external enforcement that characterizes formal legal systems, or coercion within an informal system.

The success of the enforcement mechanisms adopted by the microfinance model probably lies in a combination of all of these elements. They are, for the most part, not mutually exclusive, though the use of coercion is likely to undermine social capital. Although there does appear to be evidence of the sporadic use of force, it appears unlikely, on balance, that the membership base of Grameen – and other MFIs – could have reached millions if this were the dominant mode of enforcing repayment.[109]

While it is important to determine the relative importance of these factors in accounting for the success of microfinance, especially as the model gets replicated around the world, the answer to this question may vary depending on context, on the country or the stage of evolution of microfinance.[110] Still, in Bangladesh, where microfinance has been the most successful, and given credit for affecting even aggregate statistics, social capital and norm setting seems as or more important than any other explanation – not just in the narrower sense of self-interested action motivated by repeated games but in the broader sense that we have presented.

(c) Institutional Replication

Grameen and BRAC's early success in Bangladesh provided an impetus for wide replication of the model. But the question remained: was this an idiosyncratic institutional response – an aberrant "island" of institutional functionality rooted, for instance, in the special conditions of that country – or was microfinance a replicable new tool for increasing the well-being of the poor in developing countries (or perhaps even in middle income or advanced industrial countries)?

(Rodrik, 2000), for instance, draws a distinction between what he calls "tacit" or "specific" institutions that are essentially local or rooted ("informal" institutions are generally of this type) and "general purpose" models or "blueprints" that are defined by their qualities of replicability ("formal" institutions usually fall into this category).[111] Navigating the transition from being a "local" institution to a "global" one, i.e. the process of formalization, entails successfully mediating the tensions between the dual objectives of flexibility and replicability.

One way of looking at it is that institutions are, in essence, emergent and localized reactions to coordination or collective action problems, with the most effective institutions being those that are cognitively most understandable to agents.[112] (This was precisely the appeal of the early microfinance experiment.) But even successful localized institutions will, at some point in their evolution, have to confront the problem of generalization. Indeed, the process of formalization itself may be seen as a mechanism for embedding informal structures, or archiving informal institutional learning in a form that lends itself to replication and sustainability. On this view, the law may be seen as a means of capturing knowledge about "successful" solutions to collective action problems at the local level (i.e, efficient and viewed as "fair" by the affected population). But formalization will almost inevitably introduce new rigidities. Thus, the trade-off between the advantages of formalization (in terms of the diffusion and replication of knowledge) and a loss of responsiveness of the formal elements of the system to societal change appears to form the basis of an unavoidable institutional conundrum.

Microfinance is in the throes of confronting this tension. The success of microfinance has led, in recent years, to an era of irrational exuberance in the industry, including its original home, Bangladesh – evidenced, in particular, by a dramatic increase in the number of microfinance providers in the country.[113] This proliferation has led to the problem (noted briefly earlier) of “overlapping” – or borrowers taking loans simultaneously from more than one MFI, often resorting to borrowing from one to pay back another thereby getting caught in a “debt trap”.[114] Thus one microfinance institution exercises an externality on others, and these externalities may not be effectively regulated through informal mechanisms. Formal structures (including legal requirements concerning information sharing, e.g. about debt obligations) may be necessary.

The expansion of the sector has also been associated with an increase in the incidence of fraudulent activity. In this case – it is obvious – self-regulation (or implicit contracts) will not suffice.[115]

Thus, while the microfinance sector in Bangladesh was small – dominated by a few key players – entry into the sector did not need formal regulation, but as the number of players increased and incidents of fraud began to occur, there has arisen a need to regulate the sector.

Microfinance, at least in Bangladesh, has found an innovative solution: while the loan contract itself continues to rely on informal mechanisms for its enforcement, the government has taken a growing role in regulating the sector (whereas in the past the industry operated without any formal regulation). This process started with the *Palli Karma Shohayok Foundation* (PKSF) and has now been extended to the Microcredit Regulatory Authority (MRA).[116] Moreover, the "social businesses" – higher scale business ventures that poor families would be unable to establish in their own right that either provide crucial services to the poor, often at subsidized rates, or allocate part of their surpluses to poor people – which are increasingly the focus of established MFIs are, for the most part, regulated like any other business enterprise, by formal law.[117] These developments indicate that while a trust-based system seems to work effectively in regulating small transactions between the microfinance organization and a network of up to several million individuals, as the size of transactions get bigger and the unit of regulation becomes larger (i.e. organizations rather than individuals), formal law may become necessary.[118]

These empirical developments accord with the predictions of theory. (Dixit, 2004) has stressed that the expansion of the market may demand a more generalized form of trust that will allow anonymous actors to transact with each other on a wider scale on the basis of a mutual trust in the *institutions* of the economy rather than a network in which – as Dasgupta (2003) puts it – “names” and “faces” matter. This is somewhat analogous to the move from the barter to the money economy, facilitating exchange on a wider scale.[119] (J. E. Stiglitz, 2000) argues that development (in particular, the resulting greater mobility that may weaken the enforcement ability of implicit contracts) may, itself, limit the scope of informal regulation.[120]

While the Bangladeshi microfinance sector appears to have suffered some losses in the replication and formalization process, careful handling of the situation has contained the damage. We turn, in the next section, to the Indian experience where a range of different tactical choices in navigating the replication process has had catastrophic results: when the informal system started to confront its limits in Bangladesh it took the turn towards formalization, but the turn that was taken in the Indian case was an altogether different one – the reversion to the most primal of contract enforcement mechanisms, brute force and coercion.

3. THE CRISIS IN INDIA

In November 2011, the Indian microfinance industry – one of the biggest, and the fastest growing in the world – was paralyzed as a result of the most major repayment crisis that it has confronted in its history.[121] This led to an almost-immediate government take-over of the situation and a freeze on the operations of the country's biggest MFI – and was accompanied by instant media reports labeling this breakdown the Indian equivalent of the subprime mortgage crisis.[122]

The immediate trigger for the crisis in India was a rise in village suicides, particularly in the state of Andhra Pradesh. This was linked, in the eyes of most, to the arm-twisting tactics increasingly used by the microfinance industry in ensuring loan repayment – and resulted in the enactment of state legislation imposing serious restrictions on loan collection by microfinance institutions (MFIs).[123] But how did the use of coercion – until recently only a sporadic phenomenon in the microfinance industry – come to become, or at least be perceived to become, the key mechanism employed to enforce loan repayment?

The central player in the crisis – SKS Microfinance – was founded by the high-profile Vikram Akula and, until recently, rated as second in importance, globally, only to the Grameen Bank.[124] Crucially, the crisis followed close upon the heels of a shift by SKS to a for-profit lending model: in 2010 it issued an IPO raising $350 million from major corporate investors.[125]

The significance of these events is immense. Andhra Pradesh, for example, with total lending by MFIs amounting to 80 billion rupees or approximately 2 billion dollars is home to a third of India's microfinance industry, with an estimated 26.7 million borrowers.[126] Many feared that the crisis would spread to the mainstream Indian banking sector with its heavy investment in the microfinance industry.[127]

The central bank – the Reserve Bank of India – responded by instituting the Malegam Committee, which made several recommendations on the reform of the microfinance sector including limiting competition[128], a cap on interest rates and a ceiling on per-household lending.[129] Its report is the precursor to national legislation to regulate the sector.[130] With regulation on the way and the threat to the Indian banking industry deemed to be minimal, relative calm appears to have been restored and the crisis more or less contained. But trust in the microfinance industry has been shaken the world over, and the impact of regulation remains uncertain.[131]

4. TAKING STOCK OF THE MICROFINANCE EXPERIMENT

While the microfinance industry the world-over is in a state of flux, the magnitude of the crisis in Indian microfinance makes it appear that it was the product of the erosion of something *fundamental* to the model. In particular, the Indian crisis helps to focus attention on the question of why microfinance had been so successful in its early days in Bangladesh: in this version of the attempt to replicate, was some of the essence of microfinance, some indispensible feature contributing to its success, lost? In this section, we identify the major trends that have precipitated the crisis. We argue that the unfolding of the crisis provides support for our hypothesis – that the driving force behind the success of the microfinance experiment is social capital, broadly construed. The way India's microfinance industry evolved undermined this essential element that has, for so long, sustained the model.

(a) Microfinance and Market Competition

The first signs of a deeper malaise in the microfinance system were provided by the phenomenon of overlapping.[132] Overlapping has been an open secret in the microfinance community for several years, yet members did not "speak up".

Why did peer monitoring break down so dramatically in the case of overlapping? There are several possible responses to this question. One possible response may be that it was the shift away from joint liability that contributed to this lapse – under a stricter regime of joint liability, it is more likely that someone would have blown the whistle. Another may be that it was inherent in the informal system that if there was *mass* defection from a norm that there would be no sanction – as a new norm was being created.

But we argue that our account of the functioning of microfinance provides a better explanation: the social capital that sustained microfinance is undermined fundamentally by market competition – the greater the number of MFIs, the lower the levels of loyalty of members to each one. Outside the context of the "gift-exchange" paradigm on which conventional microfinance was based, borrowers no longer felt an obligation to behave "responsibly"[133] – this was particularly true of its relationship with the newer, often fly-by-night, MFIs with which the borrowers had a purely commercial relationship. Thus, the ties on which the success of the early microfinance experience were based were weakened irreparably by the entry of a multitude of players, and especially so when they were seen to be just commercial lenders.

Again, this suggests that the crucial factor in the functioning of microfinance is not the possession of information by members *per se*, but rather their inclination to actively monitor other members.

(b) Mass Manufacturing Microfinance

The success of microfinance naturally led to pressures on the microfinance industry to "scale-up".[134] It was partially in response to this that SKS Microfinance explicitly set out to develop an "assembly line", or the Coco-Cola or McDonald's version of microfinance – an efficient, replicable system that would ultimately achieve more or less universal coverage of its target market. As the SKS website states:

> "With rapid scaling comes the challenge of building organizational capacity. Rather than look at conventional microfinance models, SKS based its business strategy on principles borrowed from fast-scaling consumer businesses. SKS standardized its products and front-line processes and adopted factory-style training models that have helped corporate giants scale up rapidly – thereby boosting our own workforce capabilities and growth."

But is this vision – the effort to reap economies of scale in mass-manufacturing microfinance – feasible? We argue that the attempt to mass-produce will erode the very core of the microfinance mechanism, and that the attempt itself is rooted in a fundamental misunderstanding of what *really* lies at the heart of the institution. (There is a broader critique of these attempts at *rapid* scaling up: the history of credit is marked by credit market failures associated with excessively rapid expansion of financial institutions.)[135]

In a departure from the more state-of-the-art microfinance practice (at Grameen and other older MFIs) described above, SKS Microfinance opted for the joint liability model as its key enforcement mechanism.[136] In the standard "economic" interpretation of microfinance replication is straightforward; indeed, if joint liability were the central explanatory factor behind the working of microfinance, we would be left without a basis to understand the Indian crisis.

The crisis in India underscores the fallacy of the standard economic characterization, illustrating that microfinance – far from being the impersonal economic model that much of the literature has portrayed it as being – is one that works when situated within the context of a particular type of social relations. From the outside, the SKS version of microfinance was, for the most part, indistinguishable from the Grameen version – retaining several of the community-building practices traditionally associated with microfinance such as regular group and center meetings, as well as relationship-building visits from MFI workers. But these practices became increasingly ritualistic. The newer MFIs (like SKS) were increasingly emulating the form rather than the spirit of earlier initiatives – a fatal error in the case of a fundamentally non-formalistic model.

Indeed – as the account in Section 2 amply illustrated – the success of the first and second generation of MFIs was attributable not only to its ability to appeal to a narrow economic calculus for borrowers, but rather a host of other "intangible" factors that the newer MFIs overlooked. The early success of microfinance was mostly the result of a careful and long-term process of social capital building undertaken by MFIs (especially those like Grameen and BRAC that established the institutional base for the sector more broadly). The mechanisms that enabled the informal lending contract to work were premised on the cultivation of strong vertical (between the MFI and the borrowers) and horizontal (between borrowers themselves) ties. It was this relationship of trust that sustained the repayment rates that microfinance boasted for over thirty years. But as the newer MFIs, in their quest for rapid corporate-style growth, became increasingly nameless and faceless entities, the substance of the relationship was increasingly diluted. In doing so, not only did they destroy the fragile equilibrium of trust that sustained earlier programs, but fell into the trap of generations of failed institutional reforms of the past (including large-scale legal formalization efforts in many parts of the developing world) – attempting transplantation without proper groundwork.[137]

Trust was based in part on the fundamental difference between microfinance and the traditional money lender: the latter was designed to maximize the exploitation of the borrower (subject, of course, to the constraints imposed by law and competition), while the objective of NGO's like BRAC and Grameen was to improve the well-being of the borrowers, the poorest of the poor, subject of course to the constraints imposed by the resources provided to the NGO's and the sustainability of their "model."

Indeed, the bulk of the attention surrounding the microfinance experiment has been on its economic aspects, not just in analytical terms but policy terms as well – its capacity to wipe out poverty single-handed (as many of its advocates – including Yunus – claimed), or more efficient utilization of female labor.[138] But as we have argued elsewhere, we believe that its main legacy is the process of change within borrowers – the building up of social capital – that it motivated with significant positive societal spillovers[139] and that its institutional genius lay in its ability to harness this process of internal change to maintain its repayment rates.

(c) Microfinance for Profit

SKS Microfinance had a well-articulated justification for making the shift to a for-profit model: the ability to raise private equity investment so that the drive for expansion was not curtailed by availability of funds.[140] SKS was not the first MFI to make the shift to the for-profit model – despite notable detractors of the for-profit model like Yunus, various MFIs had already made this move, most significantly Compartamos in Mexico.[141] The difference in the case of SKS was that it was one of the most major MFIs to do this while maintaining that its goal was the alleviation of poverty. But is it possible to reduce the poverty of borrowers while making profits for shareholders? We argue that there is a fundamental conflict between the two objectives.

The introduction of the profit motive fundamentally commercializes the relationship between the MFI and the borrower, making it bear an uncanny resemblance to the relationship that the borrower had with the traditional moneylender. Most fundamentally, the old moneylenders were, it could be argued, simply profit maximizing. Perhaps they had learned a few tricks from Grameen, to increase their profitability. But why would one expect these new tricks to change the fundamental problems, the exploitive nature of a relationship marked, for instance, by asymmetries in bargaining power? In short, the irrational exuberance for microfinance seemed to have gone so as to simply endorse the expansion of profit-maximizing money lending! The impact of this reversion is not only normatively problematic (the "reverse Robin Hood" phenomenon, or the rich making profits at the expense of the poor), but has adverse economic consequences as well: the social capital that the early MFIs built up was – as is increasingly recognized even within the economics literature – extremely economically valuable. In a recent theoretical paper (De Quidt, Fetzer, & Ghatak, 2012) argue that a for-profit lender can exploit social capital to design more efficient contracts. But while it is true that social capital can improve the functioning of markets (Arnott & Stiglitz, 1991), and that under perfect competition that the gains from social capital will accrue to borrowers – in most real world settings, the shift to for-profit lending will (and did, in the case of SKS) erode social capital. A central thesis of this paper is that social capital is endogenous, was enhanced by the not-for-profit MFI's in Bangladesh, and was eroded by the for-profit MFI's in India. Thus, the shift to for-profit lending – in an attempt to exploit the gains of early microfinance to the fullest – ended up, proverbially, killing the goose that laid the golden egg.

The consequences of the switch to for-profit lending were manifested in a number of ways. The search for profits provided a range of incentives for excess lending – fuelling a drive to increase loan disbursement at all costs, often irrespective of borrowing capacity. As in the case of the subprime crisis, this is particularly problematic when borrowers are uneducated, uninformed and financially unsophisticated (as borrowers from MFIs, by design, are) – making rent extraction, and even deception, far too easy. Moreover, the shift to the for-profit model is typically accompanied by a hike in the already-high interest rates (necessitated by the high transactions costs) in the microfinance industry.[142] As a result, within the for-profit model, the MFI starts to regard the borrower as a means to its own end, and stops caring about the well-being of the borrower: it is hard, in this context, to build up trust.[143]

The shift to the for-profit model gives rise to a host of agency problems, which are particularly acute given the deliberately paternalistic role that MFIs have traditionally played vis-a-vis borrowers, i.e. the older MFIs are assumed to – and have established a track-record for – acting in the interests of borrowers, making this repuation extremely vulnerable to abuse by the new breed of MFIs (with very different motivations). These agency problems played out in India similar to how they did in the US subprime crisis, including woefully inadequate vetting of borrowers. In particular, the drive to maximize profits by expanding as rapidly as possible led to an increasing shift from lending for productive purposes to consumption loans (even in cases where this shift was not explicit, MFIs often "looked the other way"), weakening the core of the repayment mechanism. Even if the lenders had not behaved as badly as they did, there might have been a problem in building up trust. There is a natural conflict of interest between borrower and lender, with a *for profit* lender attempting to extract as much from the borrower as possible. It took a variety of actions by Grameen to establish firmly that its interests were broadly coincident with those that it allegedly was trying to help.

Irrational exuberance leading to excessively rapid increase in lending is often a pre-condition for failure in any credit system. But more than this was at play: we have argued that the shift to a for-profit model led to the destruction of the social capital that had been the basis of the success of microfinance in Bangladesh.

(d) **Political intervention**

There have always been tensions latent in the relationship between highly successful microfinance institutions and the State, simply because these NGO's play a central role in the lives of citizens, improving their well-being in ways that the state is supposed to, but often fails to, do. (This was especially so as some NGO's, like BRAC and Grameen, pursued an agenda that went well beyond lending.) This became especially evident in the crises in microfinance in India and Bangladesh. Indeed, the role of the Andhra Pradesh government in the Indian crisis was pivotal: the government raising questions about the legitimacy or survival of an MFI – or the industry as a whole – can cause a marked increase in defaults and an unraveling of the trust-based co-operative equilibrium (though note that in Bangladesh, where trust in Grameen had been established, even when that institution was under threat, repayment continued). Moreover, the actions of the Andhra Pradesh government are part of a broader phenomenon of increased political intervention in microfinance by developing world governments – ranging from Daniel Ortega's government in Nicaragua to, most notably, Sheikh Hasina in Bangladesh.[144]

How can this pattern be explained? We argue that while the answer to this question lies, in some cases, in the imprudent actions of MFIs themselves – having made themselves more vulnerable to scrutiny with their breakneck speed of growth and their shift to the for-profit model – that there may also be an element of political opportunism in the actions of these governments.

The space yielded to the microfinance industry for so long by the Bangladeshi government remains a mystery – especially given that Yunus overtly set out to bring about a "social revolution", albeit a quiet one. The secret may simply be that the government had failed to anticipate what a formidable force microfinance would emerge as. But while it is surprising that microfinance had not been subject to political intervention earlier, its position as an engine of social transformation and an alternate power centre in a variety of developing world contexts (particularly Bangladesh, and increasingly, India) has become increasingly undeniable. In the spate of clampdowns on microfinance, while governments may be acting to safeguard the interests of their people, it is also possible that they are taking advantage of an opportunity to undermine the credibility of their perceived rivals.[145] In particular, given the traditional unpopularity of moneylenders, governments could be cashing in on ready political capital by characterizing MFIs as "new-age moneylenders".[146]

Further, the formal regulatory frame that MFIs are increasingly subject to – in India, Bangladesh and elsewhere – will fundamentally alter the traditional practice of microfinance. There arise questions about whether regulation will be effective and the extent to which operating within the regulatory framework will drive up costs. But it also remains to be seen whether the reversion to a more conventional institutional framework regulated by formal law will weaken what has been the very core of microfinance for all these years: the relationship of trust between the bank and borrower. It is conceivable that the new regime will actually destroy the trust-based system of microfinance, and unless government acts to create effective and honest alternative rural financial institutions (as in Thailand and Indonesia), poor farmers will have to revert to the old exploitative local moneylenders.

5. CONCLUSION

The crisis in Indian microfinance has done incalculable damage to an industry that has sustained itself on the basis of reputation and trust. In an emblematic victory for the traditional microfinance model, Akula admitted at a recent public appearance that he was wrong and Yunus was right: "Bringing private capital into social enterprise was much harder than I anticipated."[147] In this paper we have argued that the reason for this is that it was actually social capital – not just interpreted in narrow economic terms, but rooted in a broader notion of human altruism and reciprocity – that was the foundation for the success of microfinance, and that this key element was eroded by the shifts in Indian microfinance. The profit motive was championed because it provided a system of effective incentives, and these might enable the rapid expansion of finance to the unbanked. But the profit motive ran counter to an essential aspect of what had contributed to the success of MFIs.

While some of the changes occurring in the world of microfinance are the product of the inevitable institutional pressures of replication and "scaling up", in India, microfinance took the wrong turn. While the new generation of MFIs retained much of the *form* of earlier ventures (from the outside SKS closely resembled Grameen) they lost sight of the *spirit* of many of the original practices, as well as their objectives – enhancing the well-being and empowerment of the poor, driven essentially by a largely altruistic commitment rather than commercial advantage. It would have been hard for a for-profit institution to succeed in the best of circumstances.

We have argued that the current crisis in microfinance is rooted in a fundamental *misinterpretation* of the institution itself – both in analytical terms (much of the literature – focused on joint liability as the key enforcement mechanism – saw microfinance as a fundamentally "economic" rather than "social" institution, thereby trivializing the replication process) and with respect to its impact (its main contribution was considered to be directly in the economic domain of poverty-alleviation rather than the social domain of trust-building and the economic leverage that this process would allow).

While the founders of microfinance almost certainly claimed too much – it now looks very unlikely, for instance, that microfinance alone will make poverty a thing of the past – in ameliorating abject economic exclusion, bringing about social change and building community networks, the original breed of MFIs performed crucially important functions. The challenge for microfinance, then, is fundamentally to regain what it once built itself on – trust. It is unlikely that this can be achieved without a reversion to the not-for-profit model and the careful cultivation of social capital – but this will place inherent limits on the speed at which microfinance can be scaled up.

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ENDNOTES

[1] To provide a few examples: In Mexico, there are reports of microfinance institutions charging interest rates in the region of 125 percent, see (MacFarquhar, 2010); In Nicaragua, "movimiento no pagio" - or, the no-pay movement – was started by farmers who could not pay their debts, and supported by the President, see (V. Bajaj, 2011a). We will return to these themes in Section 4 below.

[2] In Bangladesh, it was alleged by the government that Yunus was older than the mandatory retirement age at Grameen, but most commentators agree that his removal was politically motivated. See further, (V. Bajaj, 2011b). In July, 2012, Bangladesh's government changed the Grameen's charter in a way which critics alleged effectively nationalized it. The Indian debacle is the subject of Section 3 below.

[3] (Coleman, 1988) was one of the first authors to use the term "social capital," but it has also been popularized by (R. Putnam, Leonardi, & Nanetti, 1993),(R. Putnam, 1995), (R. Putnam, 2000). Despite the how widely the concept is used, it is difficult to find an authoritative definition of the term. Putnam defines it as follows: "By analogy with notions of physical and human capital – tools and training that enhance individual productivity – 'social capital' refers to features of social organization such as networks, norms and social trust that facilitate coordination and cooperation for mutual benefit" (Putnam, 1995, p. 66). Its benefits, he argues, include fostering norms of reciprocity and social trust, facilitating coordination, cooperation and communication, amplifying reputations, facilitating the resolution of collective action

dilemmas, reducing incentives for opportunism, widening the templates of cultural collaboration and, finally, increasing the "taste" for collective benefits (Putnam, 1995). Coleman does not provide a definition of social capital, but, instead, describes it as an intangible resource that pertains to relations among persons: "Just as physical capital and human capital facilitate productive activity, social capital does as well. For example a group within which there is extensive trustworthiness and extensive trust is able to accomplish much more than a comparable group without that trustworthiness and trust" (Coleman, 1988, p. 101). Coleman distinguishes between three forms of social capital: obligations, expectations, and trustworthiness of structures; information channels; and norms and effective sanctions. Thus "social capital" and "trust" – although closely related – may be distinguished from each other; trust may be seen as a sub-set of the concept of social capital. Nonetheless, for the purposes of this paper the two terms will be used more or less interchangeably.

[4] While the literature on the role of social capital in microfinance began with (Besley & Coate, 1995), there has, in the recent past, been a resurgence of roughly contemporaneous research on the topic. See (Haldar & Stiglitz, 2008), as well as (Dowla, 2006). For a number of excellent recent papers empirically demonstrating the importance of social capital in microfinance, see (Karlan, 2007), (Cassar, Crowley, & Wydick, 2007), (Cassar & Wydick, 2010) and (Feigenberg, 2010). The discussion below highlights important differences in the usage of the term social capital and the mechanisms through which it operated among these authors.

[5] For a history of the Grameen Bank through the eyes of Yunus, see (Yunus, 1998). See also http://www.grameen-info.org/

[6] See http://www.brac.net/

[7] (Yunus, 2008), p. 2.

[8] Recent estimates point to a borrowing base in the region of 91 million worldwide, with Indian and Bangladeshi borrowers accounting for half this number, see (V. Bajaj, 2011a).

[9] This makes the recent accusation, discussed below, that the new MFIs have degenerated into playing exactly the same role as traditional moneylenders particularly ironic.

[10] As (Emran, Morshed, & Stiglitz, 2007) show, one of the consequences (given imperfections of labor markets) was that rural labor was vastly under-employed.

[11] The exact figure is disputed, but it is broadly accepted that repayment rates in the microfinance industry have traditionally been extremely high especially when compared with conventional banks. See for an early estimate of Grameen repayment rates, (Hossain, 1988)

[12] The factors that sustained these repayment rates are discussed at length below. For a detailed analysis of the merits of an informal contract over a formal one, see (Haldar & Stiglitz, 2008).

[13] The model was adopted by the United Nations, the World Bank, and governments the world over. International recognition of microfinance culminated in Yunus being awarded the Nobel Prize in 2006. In his Nobel acceptance speech, Yunus suggested that microfinance would put "poverty in museums" within our lifetimes.

[14] (Khandker, 2005), for instance, estimates that microfinance in Bangladesh has only reduced poverty in Bangladesh by one percent per year - still, that means that over the thirty years since the beginning of Grameen, the poverty rate has been reduced significantly. Any discussion about the impact of microfinance programs is, however, mired in the methodological controversies of the Pitt-Morduch debate: Using the same dataset, (Morduch, 1998) arrived at a very different (and largely, much more negative) set of conclusions about the impact of microfinance from (M. M. Pitt & Khandker, 1998). Morduch explicitly challenged their findings, mainly on grounds that were based on a number of methodological flaws (e.g., Pitt and Khandker's calculation of land ownership by beneficiary households, village fixed effects and so on). (M. Pitt, 1999) responded, in turn, with a defense of the original methodology. The exchange illustrates the difficulties that underlie "impact assessments" of development programs in general, including large-scale quantitative studies based on substantial datasets and rigorous econometric analysis – and the consequent difficulty of arriving at a definitive pronouncement on the success or failure of a program.

[15] One very obvious manifestation of this repeatedly reported in interviews was an observable increase in female mobility, or women being seen outside the home. For other instances see (M. M. Pitt, Khandker, & Cartwright, 2006) and (Sidney Ruth. Schuler, Hashemi, & Riley, 1996). This is discussed further below.

[16] On the "irrational exuberance" of the microfinance sector in Bangladesh, see (Haldar, 2011), Ch. 3. These developments were paid relatively little attention by the academic community, but the crisis in India would have come as less of a surprise if the warning signals in Bangladesh had been heeded. The difference in the Bangladeshi case was that pre-emptive measures were taken to prevented a full-blown crisis (like the establishment of the *Palli Karma Shahayak Foundation* and Microcredit Regulatory Authority), and, crucially, that the biggest players in Bangladeshi microfinance did not make the shift to the for-profit model. These issues are discussed in Section 4 below.

[17] The media coverage of the Indian microfinance crisis explicitly compared in with the Global Financial Crisis, see Section 3. There are several similarities between the two crises in terms of over-lending driven by an irrational exuberance, with particularly dire consequences as a result of lending to very vulnerable communities.

[18] This includes former Governor of the Reserve Bank of India, Y.V. Reddy (Nayak, 2010).

[19] See, for an overview, (B. Armend√°riz de Aghion & Morduch, 2010).

[20] Intensive field research was conducted in Bangladesh (January- June 2009). The results are more fully reported in Haldar (2011). The qualitative data – mostly from in-depth interviews – is presented is supporting evidence largely in the endnotes rather than the main text.

[21] This phrase is borrowed from (Ostrom, 1990), p. 22.

[22] Although this "generational" system is not universal terminology, one useful way of diving up the microfinacnce experience is to view the period from the early 1970s to the late 1980's (when microfinance was a "boutique" – and essentially Bangladesi – phenomenon) as "first generation" microfinance, and the era from the late 1980s to the mid 2000s (when microfinance went "gobal" – but, although modifications were attempted, remained essentially loyal to the original model) as "second generation" microfinance.

Within this lexicon, the developments described in Section 3 – and those leading up to the global crisis – and the features of "third generation" microfinance.

[23] Interestingly, Yunus described the group system – now the hallmark of the microfinance model – not as a premeditated strategy for ensuring repayment but, rather, a feature that emerged organically, and originally had little to do with what is today perceived its central virtue, improved debt "enforcement": "We started with a system of individual loans and daily repayment. But soon we found that we were having trouble keeping track of and recording payments, so we made a shift to weekly meetings where installments would be collected. But even this started getting very chaotic. So we started dividing the borrowers into first two and then three groups to meet in and so on. Then, we had the idea to divide the groups into functional categories like the 'chicken group' (members of which had taken loans for poultry farming), the 'cow group' (members of which had taken loans for fattening cows), the 'rickshaw' group (members of which had taken loans to buy rickshaws) and so on. But sometimes the purpose for which the loan was taken would change, and this led to further confusion. Also, the members of the group did not know each other and we noticed a certain distance between group members and group leaders that was problematic. So, next we did away with the idea of functional divisions and had the idea of bridging the gap between leaders and members by allowing people to form voluntary groups of between five and ten, specifying that relatives could not be in the same group. It was seen that five was the natural tendency. The group was given the responsibility for loan collection. Then we introduced the system that the Chairman of the group needed to recommend a member for a loan. We observed that the Chairman quite enjoyed this power, but then we added that the Chairman was also responsible for loan repayment. The main function of the group was social, based on creating a sense of community." (Personal interview, Grameen Bank Headquarters, Dhaka, April 20, 2009.)

[24] There was a fourth theory, popular in the early days of microfinance, arguing that they were not really successful, but they survived on the basis of subsidies, largely from donors. (The benefit of high repayment rates was partially offset by the high transactions costs inevitable in dealing with very small loans.)

[25] The joint liability literature began with (J. Stiglitz, 1990) but led to a burgeoning economic literature analyzing microfinance. See, as examples, (Varian, 1990), (Ghatak, 1999) (Ghatak & Guinnane, 1999) and (Beatriz Armend√°riz de Aghion, 1999).

[26] This term – originally coined by (Besley & Coate, 1995) – is widely used by MFIs.

[27] Especially since the borrowers are largely women who find themselves in unfamiliar positions both as active economic agents and in breaking out of their traditional social roles.

[28] For instance, in an excellent review article, (Ernst Fehr & Fischbacher, 2003), p. 85-6) discuss the concept of "strong reciprocity" that extends beyond reciprocal altruism and reputation based cooperation: "Strong reciprocity is a combination of altruistic rewarding, which is a predisposition to reward other for cooperative, norm abiding behaviours, and altruistic punishment, which is a propensity to impose sanctions on others for norm violations. Strong reciprocators bear the cost of rewarding or punishing even if they gain absolutely no economic benefit whatsoever from their acts. Strong reciprocity thus constitutes a powerful incentive for cooperation even in non-repeated interactions and when reputation gains are absent, because strong reciprocators will reward those who cooperate and punish those who defect." They show, further, that "the interaction between selfish and strongly reciprocal individuals is essential for understanding human cooperation…identify[ing] conditions under which selfish individuals trigger the breakdown of cooperation, and conditions under which strongly reciprocal individuals have the power to ensure widespread cooperation." See also (Ernst Fehr, Fischbacher, & Gachter, 2002), Gintis (2000).

[29] A family is defined as "poor" by the Grameen if it owns less than 50 decimals of land and earns less than Tk. 3000 per month.

[30] These conditions are interesting in that they are designed to simultaneously tap into pre-existing social capital – and to build on it. Large disparities in economic circumstances might be viewed as an impediment to building the necessary bonds across the members necessary for the functioning of the system. So too, if the primary function of the groups was joint and several liability, it can be shown that individuals would want to join groups that are similarly situated (at least in a context in which it is not possible to charge differential access fees for group membership.). At the same time, limitations on blood relationships may

play an important role for two reasons: first, it may lead to excessive forbearance, insufficient social pressure to repay in certain circumstances; and secondly, if can undermine the (perceived) cohesiveness of the group, especially if, say, half the members of the group belonged to one family, half to another. (Social capital among members of a family might arguably be especially strong, and thus it is noteworthy that this constraint was imposed.)

[31] See Section 2(b)(ii). Note that having blood ties might provide an informational advantage, but it would have adverse effects on enforcement.

[32] The currency of Bangladesh.

[33] These other financial safeguards are discussed further in section 2(a) (ii) below.

[34] See Section 2(b)(ii).

[35] The participatory character of the model is important.

[36] Yunus (2008), p. 2. The debates on the possible explanation for the high repayment rates are considered in Section 2(b).

[37] Although it is clear that joint liability was the enforcement mechanism formally in force at the Grameen prior to 1998, it is unclear whether it was ever strictly enforced. Bank workers claim that it was always a disciplining mechanism and one used to underwrite the system, but was never strictly applied. Indeed, given how high repayment rates were, little occasion arose to invoke joint liability.

[38] (Yunus, 2008), p. 2. This change was put in place between 2000-02 and started as a response to a 1998 repayment crisis resulting from severe floods in Bangladesh. The opportunity was taken, however, to incorporate structural changes to the system in order to make it more flexible. Some of the changes are as follows: (i) The various categories of loans were dispensed with and reduced to the "basic" loan, housing loan, and higher education loan (with a 50 percent reservation for girls); (ii) The rigidity of loan amounts, repayment schedules, and duration were removed and borrowers could now get customized loans on the basis of their repayment record and the discretion of the banker; (iii) Group lending was replaced with individual lending and groups were retained for the purpose of positive reinforcement only; (iv) The "flexi-

loan" was introduced to enable borrowers to deal with repayment problems whereby borrowers facing difficulties were able to merely reschedule repayment; (v) The "Beggar Program" disbursing loans to beggars with no repayment rule attached was started; (vi) The system of positive incentives was reinforced with the "star scheme" for branches and employees that met targets and "gold membership" for borrowers with an untarnished record; (vii) The introduction of a pension and insurance scheme, in addition to obligatory savings. On Grameen II, see further Yunus, 2002 and (Dowla & Barua, 2006)

[39] Personal interview with a senior Grameen Bank officer at the Grameen Bank Headquarters (Dhaka, March 7, 2009).

[40] On the other hand, in a fully "rational" model (with no "social" social capital) the lowest risk half of the group would always veto a loan to anyone who was in the bottom half, since that would lower the group's chance of getting further credit. Overtime, that would lead to increasingly restrictive access to credit. That this did not occur reinforces the view expressed in this paper that one cannot fully explain the performance of microfinance schemes using traditional economic models.

[41] This is discussed further in Section 2(b)(ii) below.

[42] Members are also eligible for various other types of loans like the Micro-enterprise loan, the Housing Loan, and Education loans, adding to their incentives to maintain a good reputation with the MFI.

[43] Both as a financial education program, and by offering subsidized financially-attractive investment opportunities.

[44] Grameen has recorded a profit in nearly every year of its operation (except 1983, 1991 and 1992). In the recent past loans have almost entirely been financed out of deposits (rather than either donor funding or corporate investment) – 54 percent from borrowers. [Data from (Yunus, 2008)]. The spread between lending rates and deposit rates suffices to pay the considerable costs of loan administration and the low costs of default, and still leave a profit. The reliance on deposits has, however, necessitated closer monitoring, since there is ample opportunity for abuses (taking deposits without adequate safeguards to

ensure the ability to repay.) Monitoring microfinance institutions as depository institutions may be very expensive, because of the large number of very small loans.

[45] These conservative accounting and provisioning practices should be contrasted with those employed by the US banks in the aftermath of the breaking of the bubble: even impaired loans could be kept on their books at full value with no provisioning. In 2007, the balance in the loan loss reserve stood at Tk. 4.66 billion (US $ 67.98 million) after writing off Tk. 0.74 billion (US $ 10.85 million). Out of the total amount written off in the past, Tk. 0.74 billion was recovered in 2007 (Yunus, 2008), p. 15.

[46] It may appear strange that the deposit amount is not related to the size of the loan, but there may be several essentially "socially" motivated reasons for this. To begin with, the savings requirement is motivated as much by an attempt to inculcate the habit of saving among borrowers as it is to act as a financial safeguard for the bank, and the fixed requirement simplifies the scheme. Further, a proportionate savings requirement may deter borrowers from taking larger loans, so a nominal requirement is retained.

[47] Some commentators argue that this is effectively the same a collaterisation of loans. This claim is discussed further in Section 2(b)(ii) below.

[48] Grameen claims that 95 percent of shares are owned by borrowers, with the government retaining 5 percent ownership.

[49] While it may appear peculiar from the perspective of conventional banking that the deposit amount is not correlated to the size of the loan, the rationale is similar to the one for the fixed savings requirement. Also, from the point of view of traditional banking practice, the interest rate on these deposits may appear unusually high – but, again, the goal from the perspective of Grameen is as much to augment the financial security of the borrower as it is its own, and the fact of not being driven purely by the profit-motive allows certain subsidies.

[50] That this is regardless of the length of the loan may appear counter-intuitive from the perspective of conventional banking, but is – again – adopted for simplicity.

[51] This is an important aspect of all of these provisions—encouraging “individual responsibility” and enhancing self-respect.

[52] This may well involve a subsidy on the part of the bank.

[53] This scheme is, for instance, entirely funded by the Bank out of its profits – thereby helping to build group loyalty and social capital.

[54] (Yunus, 2008), p. 5.

[55] One of the key factors that may account for this is the traditional role of women in Eastern societies as the “custodians of family honour”. MFIs initially started out lending to men, and then mixed groups of men and women, with mediocre results – but subsequently switched to a system of lending almost exclusively to women, with a dramatic impact on repayment rates. Aspersions have been cast on the motivations of Grameen for lending to women: (Mallick, 2002) argues that this choice is prudential rather than ideological, since women borrowers are easier to administer than men. This accusation is reiterated by some Bangladeshi NGOs such as *Nijera Kori*. But irrespective of the initial impetus for the switch to lending to women, the social impact of the choice has been very positive.

[56] An instance of this is that various studies have found that participation in a microfinance program leads to increased contraception use by women, see (Sidney Ruth Schuler & Hashemi, 1994), (Amin, Li, & Ahmed, 1996) and Schuler, Hashemi, and Riley (1997).

[57] (Yunus, 2008), p. 2.

[58] The “sixteen decision” are as follows: 1) The four principals of the *Grameen Bank* – discipline, unity, courage and hard work – we shall follow and advance in all walks of our lives, 2) We shall bring prosperity to our families, 3) We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses as soon as possible, 4) We shall grow vegetables all year round. We shall eat plenty of them and sell the surplus, 5) During the plantation season, we shall plant as many seedlings as possible, 6) We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health, 7) We shall educate our children and ensure that they can earn to pay for their education, 8) We shall always keep our children and the environment clean, 9) We shall build and use pit latrines, 10) We shall boil water before drinking or use alum to purify it. We shall use pitcher filter to remove arsenic, 11) We shall not take dowry at our sons’ weddings; neither shall we give dowry at our daughter’s weddings. We shall keep the center free from the curse of dowry. We shall not practice child marriage, 12) We shall not inflict injustice on anyone; neither shall we allow anyone to do so, 13) For higher income we shall collectively undertake bigger investments, 14) We shall always be ready to help each other. If anyone is in difficulty, we shall help them, 15) If we come to know of any breach of discipline in any Centre, we shall all go there and help restore discipline, 16) We shall take part in all social activities collectively.

[59] Although this is objectively a rather remote possibility for an individual member, several borrowers interviewed talked about the psychological influence of seeing a woman “like them” on the Board of an important institution. Consequently, even if each individual member does not concretely contemplate the possibility of becoming a Board member, the existence of the possibility has an impact both on the individual member’s view of the Bank and of her own prospects more generally.

[60] The lure of this reward provides an incentive for employees to attempt to retain their positions for a ten-year period, rather than be removed on grounds of corruption. An anecdote that famously circulates at Grameen is that Yunus once sent a memo around working out – with detailed calculations – how it would be in an employee’s financial interest to stay in the job and get the reward, since the reward amount is greater than the sum that the employee could feasibly make through theft and bribery.

[61] This is further evidence of the non-pecuniary incentives system that Grameen has been so effective in establishing. Although the "star" system – where points are distributed against different indices of good performance (like 100 percent repayment) – does not translate into monetary benefits for employees, it influences behaviour as a result of the prestige attached to the system within the institution. This is another example of "social" rather than "economic" incentives influencing behaviour.

[62] This is discussed in Section 2(b)(ii) below.

[63] If individuals do not interact repeatedly, then, of course, repeated games do not provide an effective enforcement mechanism. When they interact across a broader range of areas, there are a broader range of sanctions that can be imposed for non-cooperative behavior. See (J. E. Stiglitz, 2000).

[64] A major development in the theoretical work questioning the centrality of the "external enforcement model" is Ostrom's work on common pool resources. See, for instance, (Ostrom, Walker, & Gardner, 1992).

[65] It is a matter of some controversy whether a legal obligation – and hence a contract – between Bank and borrower "exists" in law or not. While there is certainly no written contract between Bank and borrower and the Bank neither intends that a contract exist nor takes legal action against borrowers in a court of law – it may be that the law, nonetheless, imputes a contract contrary to the intentions of the Bank. Since no legal action has in fact been taken by the Bank against a borrower, this remains a point of academic debate.

[66] Implicit contracts (repeated games) can be enforced even without joint liability.

[67] The shift from one model to the other is associated with the shift from *Grameen* I to *Grameen* II discussed briefly in Section 2(a)(i) above. While *Grameen* I can be seen as the "learner" microfinance model by simple, rigid rules, *Grameen* II is meant for borrowers familiar with the microfinance philosophy but requiring greater flexibility. In addition, there is extensive evidence to suggest that even when "group liability" operated in theory, the group worked more as a monitoring, motivational and support device rather than financial joint-liability being strictly enforced. See, for example,(Jain, 1996).

[68] Of course, much lending in advanced industrial countries is also not collateral based, but there are effective enforcement of credit contracts through courts, making the wealth of the corporation or the individual (that has not otherwise been put up for collateral) act effectively as collateral. Interestingly, the increasing use of collateralized obligations by banks and other financial institutions may be "crowding" out non-collateralized lending in some advanced industrial countries. The economic consequences of this are the subject of ongoing research.

[69] As former a former Governor of Bangladesh Bank put it: "The key lesson for conventional banks is that collateral is not so important, especially given how difficult it is to claim through the judicial process. Another lesson that conventional banks can learn is the importance of monitoring – especially a careful review of the lender profile." Personal interview at his residence in Baridhara (Dhaka, April 21, 2009). He adds an interesting insight: it may be possible to introduce some elements of "peer-monitoring" or "peer pressure" into commercial lending by getting Chambers of Commerce and other such organisations to exclude defaulters from their activities.

[70] According to a well-known human rights activist, although the MFIs claim not to hold collateral, in effect, their practice of forced savings and the forced contribution to the "disaster" fund amounts to demanding collateral, since the forced contributions amount to an insurance fund for the MFI (Personal interview at the headquarters of prominent Bangladeshi NGO *Nijera Kori*, Dhaka, April 24, 2009). But such collateral typically offsets only a small part of the potential loss. Moreover, these claims ignore the far more important role of these benefits in enhancing social capital, described below.

[71] Personal interview with a Grameen Bank "center manager" on a field trip to Tangail (March 21, 2009).

[72] A senior lawyer-developmentalist, for instance, argued that these forced savings were part of the explanation for the high repayment rates of MFIs (Personal interview, Centre for Governance Studies, BRAC University, March 24, 2009).

[73] Of course, in principle, a formal contract can build in flexibility, with automatic contingency clauses or broader clauses providing for renegotiation under certain circumstances. This is a context in which there

may be an important difference between (formal or informal) contracts between borrowers and for-profit lenders and not-for-profit lenders. Especially in times of crisis, the borrower will not have access to alternative suppliers of credit, and so he is likely to be in a very disadvantageous bargaining position, and there may be a (rational) fear that a for-profit lender may take advantage of the unfortunate borrower in these circumstances. One might have hoped that "lender reputation" would mitigate these risks, but even in the best of circumstances (and poor developing countries do not provide the best of circumstances) it may take a long time for creditors to establish such good reputations. In advanced countries, loan flexibility provides an important advantage of *institutional* provision of credit (that is, through banks, engaged in a long term relationship, rather than through capital markets). See (Greenwald & Stiglitz, 1992)

[74] Typically, however, even within a formal system there is scope for renegotiation, subject to the concerns raised in the preceding footnote. Note, however, the special problems posed by a natural disaster: while the necessity of renegotiating large numbers of contracts may make such a strategy infeasible, the problems of moral hazard are somewhat mitigated. Note too, however, that concerns about agency problems by mortgage service providers resulted, in the US, of lenders imposing constraints in debt contracts restricting the possibility of renegotiation.

[75] Redrawing of repayment schedules allowed a significant recovery of losses, see further, (Dowla & Barua, 2006). See also (Nayar & Hasan Faisal, 1999).

[76] (Coleman, 1988) distinguishes between two types of norms: The first is what he calls "internalised" norms. Breach of internalised norms leads to feelings such as anxiety, guilt and a lowered sense of self-worth. The second type of norms is "shared" norms. These norms involve sanctioning for non-conformity by others who are part of the same group and exhibit social displeasure if the norm is breached. Shared norms are frequently internalised, and when this happens, the costs of a breach are both social and psychic. Further, Coleman argues that the greater the scope for reinforcing shared norms, the stronger they are. An example of a norm that is "internalized" and further reinforced by "sharing" in the US is tipping.

[77] This factor is anticipated in the theoretical literature by Stiglitz (1990), as well as (Besley & Coate, 1995), and was stressed by several interviewees in the field. As one prominent legal expert in Bangladesh

explained: "The threat of social and financial sanction on which microfinance organisations operate is far more real than the formal sanction of law courts. Even in the absence of an explicit contract, local forces are used to make sure that people comply. A lot of contractual relations in Bangladesh don't work because the threat of being taken to court is meaningless. The sense of impunity is quite high and there is very little sense of redress." (Personal interview, Office of the Institute of Governance Studies, Dhaka, March 24, 2009).

[78] See Stiglitz (1990), based on work of (Braverman & Stiglitz, 1982) and (Besley, 1995). One extremely eminent development economists interviewed stressed this factor, in particular: "The MFIs are a great boon to the poor in their struggle for survival – they realize that if they don't repay, their access will be cut off." (Personal interview, Bangladesh Institute of Development Studies office, Dhaka, April 18, 2009.)

[79] Notice this incentive was at the heart of (Eaton & Gersovitz, 1980) and (Eaton, Gersovitz, & Stiglitz, 1986) analysis of sovereign debt, where the same issue arises: why do sovereigns repay, in the absence of a credible legal enforcement mechanism? (J. Stiglitz & Weiss, 1983) show how the threat of termination of credit can be an effective incentive device even within a competitive credit market.

[80] (Hoff & Stiglitz, 1990) emphasize the importance of interlinking markets. Some of the *Grameen* enterprises include *Grameen Shakti* (energy), *Grameen* Phone, *Grameen* Telecom, *Grameen* Cybernet, *Grameen* Communications, *Grameen* Solutions Ltd., *Grameen* IT Park, *Grameen* Information Highways Ltd., *Grameen* Trust, *Grameen* Fund, *Grameen Shikkha* (education), *Grameen* Star Education Ltd., *Grameen* Knitwear, *Gonoshastaya Grameen* Textile Mills Ltd, *Grameen* Bitek Ltd, *Grameen Uddog* (Enterprise), *Grameen Shamogree* (Products), *Grameen* Capital Management Ltd, *Grameen Byabosa Bikash* (Business Promotion), *Grameen* Health Care Trust, *Grameen* Healthcare Services Ltd, *Grameen* Veolia Water Ltd. and, the world's first "social-business enterprise," *Grameen* Danone Food Ltd. It is notable that *Grameen Bank* does not own any share in these companies. They are independent companies registered under the Companies Act and bound by all the tax and other obligations of any other company in the country. The only exceptions to this are the *Grameen Krishi* (Agricultural) Foundation and *Grameen Motsho* (Fisheries) Foundation, which were started by the *Grameen Bank* as separate legal entities. In

addition, *Grameen Bank* stood guarantor for *Grameen Shakti* and *Grameen Motsho* (Fisheries) Foundation when they took loans from the government and other financial bodies. See, further, (Yunus, 2007)

[81] Thus, a person may not only be a Grameen borrower, but Grameen may, at the same time, be her employer, bank, source of infrastructural facilities, provider of goods and services and run her daughter's school. The omnipresence of *Grameen* and some other leading Bangladeshi NGOs has led to speculation about their having become para-governmental organizations, see (The Economist, 2001). Of course, for the interlinking to provide enhanced incentives, it must not be possible for borrowers to obtain the given services at comparable prices elsewhere in the market.

[82] This allegation was made in the academic literature early on by (Rahman, 1999) and (Mallick, 2002), and such claims have since become more widespread. These concerns were raised especially after Grameen went to Grameen II (no joint and several liability).

[83] Personal interview with a prominent Bangladsehi international lawyer at his Gulshan residence, Dhaka, April 3, 2009.

[84] Personal interview with a well-known Bangladeshi economist (formerly at Dhaka University and, now, founder of his own think tank on development) at the ,*Unnayan Parishad* Office, April 27, 2009.

[85] Personal interview with an extremely high-profile lawyer with close ties to the Hasina adminstration at the Sonar Bangla Hotel, Dhaka' April 3, 2009.

[86] This is specifically the allegation that Sheikh Hasina, the Bangladeshi Prime Minister, makes against Yunus, see Section 4.

[87] According to one human right activist interviewed, the use of force – both violent and in the form of psychological pressure – is the norm rather than the exception: "These are situations in which the MFI is forcing people to repay who can't. For the ground staff, everything – from their salary to their prospects of promotion – depends on their being able to collect repayment" (Personal interview, *Nijera Kori* Office, April 24, 2009). Another well-known economist put it as follows: "The purpose of the MFIs is to collect

money; they will use any means available." (Personal interview, Bangladesh *Unnayan Parishad* Office, April 27, 2009).

[88] Personal interview with a promiment human rights activist at the *Nijera Kori* Office, April 24, 2009.

[89] One senior advocate at the Supreme Court and veteran politician, was especially emphatic, arguing that the mode of recovery adopted by the *Grameen* amounted to legal "molestation" (Personal interview, Sonar Bangla Hotel, Dhaka, April 3, 2009.) Despite the fact that the functioning of the Bank is authorized by the Grameen Bank Ordinance Act 1983, he argued that its operations were "unlawful". He pointed out that under The Usurious Loans Act (1918), The Money Lenders Act (1933) and The Money Lenders Act (1940) two features emerged – the regulation of the quantum of interest and the modalities of recovery – by which the *Grameen* ought to be bound. Under this body of law, the creditor has certain facilities for pursuing the debtor. For instance, the loan officer has the powers to act as a certificate officer and is allowed to make a determination, in writing, as to whether there was a failure to pay. Further, since 1940, if recovery was not elicited through written notice, this would be called "molestation". Not only, he argues, does the *Grameen Bank* never issue written notice, but all the devices they use would, according to him, fall into the category of "molestation".

[90] A well-known Dhaka University Professor emphasised that internal coercion can be very problematic as well: "Since 90 percent of the time the person using the credit is the husband, and the person repaying the loan is the wife, the women spend many sleepless nights. In fact, polygamy is re-emerging as a function of microfinance since the more wives a man has, the more credit he can access. This, combined with the fact that there are many different MFIs providing loans means that there is a lot of credit in circulation, leading to borrowers being caught in a debt-trap. This makes ensuring repayment even harder for the MFIs and leads to the further use of force, higher interest rates and so on. It also results in greater domestic violence and heightened social unrest." (Telephone interview, May 2, 2009.)

[91] Yunus put it as follows: “Even if we could use force in Bangladesh, could we do that in New York, or in the many other countries in which we operate? It is not true that our borrowers have no ‘voice’. Even if they are not educated, their children are. Do you think that they would stay silent?” (Personal interview, Grameen Bank Headquarters, April 20, 2009.)

[92] According to a senior associate at BRAC the use of coercion is sporadic rather than a trend: “If pressure, extortion and intimidation were the norm, the whole scheme would have failed. To what extent can you intimidate, and how would the NGOs have achieved this?” He reiterated that without co-operation at a very high level, the scheme would not have worked, and that lapses are very much the exception or aberration to a scheme supported by a very high measure of consensus. He emphasised that maintaining discipline is essential, training borrowers to understand, observe and enforce rules, but that some NGO workers may “miss the wood for the trees” and take things too literally. This, according to him, is the main source of the lapses. In addition, microfinance projects tend to be very labour intensive, and for them to be sustainable, it is important that a business-like perspective be adopted, especially since a large majority of MFIs are now striving to be self-sustaining (Personal interview, BRAC Institute of Governance Headquarters, March 24, 2009.)

[93] This factor was stressed by one extremely prominent long-time microfinance researcher in particular – attributing the problem of the use of coercion to the growing competition in the microfinance sector in Bangladesh and to what he calls “management failure”: “The average loan size for an MFI is very small, Tk. 5000-6000. Therefore there has not been much growth in the size of loans. The problem of 'overlapping' is occurring because MFIs are being risk averse in not increasing the size of loans, and the current size of individual loans does not satisfy demand. As a result of 'overlapping', however, the 'weakest lender' gets paid off last. This is the main inducement to use force. The increase in coercion is essentially a function of the fact that there are too many players. The smaller MFIs are the biggest problem...There are bound to be some lapses, especially since credit officers are under pressure to both disburse and collect loans, as is necessary for MFIs to run. But in most cases, the use of coercion is a function of management failure. For instance, there are many instances of one group member taking loans from everyone else in the group. But a good manager would have formed the groups better. The manager is cheating and trying to

make his life easier by allowing members with a greater credit absorption capacity into the group." More controversially, however, he appeared to imply that using coercion against borrowers may sometimes be justified: "What people don't is that there are crooks among the poor. It is these crooks that are punished." He did add, however, that the use of force by bank workers is taken very seriously by BRAC, recounting a 2008-incident involving a long-term defaulter who was physically abused by BRAC branch officers, loan collectors and other group members. The legal aid branch of BRAC took legal action against BRAC, compensation was paid to the family and the amount was deducted from the employee's salary. (Personal interview, BRAC Centre, April 29, 2009)

[94] It should be emphasized that socially desirable behavior can be so enforced, but so too can less desirable forms of behavior, such as caste, race, and gender discrimination See, for instance, Fukuyama (2000).

[95] See, for instance, Putnam (2000) (J. E. Stiglitz, Sen, & Fitoussi, 2010).

[96] See, for instance, (Wilson, 1975) where he popularized the study of sociobiolgy, a field that attempts to explain social behavior of animals in terms of genetics, evolution, and natural selection. While there is hefty debate as to the exact evolutionary drive behind eusocial behaviors such as cooperation and altruism [See for a review (Nowak, 2006)] it is agreed upon that eusocial and prosocial behavior evolved over years of natural selection, and that these behaviors are inherent in our genes.

[97] For instance, in a study on "ethics and compliance" initiatives in the corporate world, (Tyler, Dienhart, & Thomas, 2008) found that the "values and integrity" approach to promoting compliance was far more effective than the traditional "command-and-control" approach. See also (Paine, 1994) and (Trevino, Weaver, Gibson, & Toffler, 1999).

[98] These factors were discussed in some detail in Section 2(a) above.

[99] A senior associate at BRAC emphasized the aspects of the group mechanism that promote loan repayment: "The fact that groups are homogenized and lending is mostly to poor women is important. In the early 1970s, with non-homogenous groups, the system didn't work. Mixed groups of men and women were highly ineffective. Money entered the picture much later, when members of the group already knew

each other. The social function of the selection of women as borrowers is crucial since the sense of responsibility of women, their commitment to the household and children and their traditional role as custodians of 'family honor' lend themselves well to the functioning of the mechanism". (Personal interview, BRAC Institute of Governance, Dhaka, March 24, 2009)

[100] A former Bangladeshi cabinet minister (in the "caretaker government") – trained as both sociologist and economist – explicitly highlighted the building of social capital: "One of the key reasons for the success of the borrower-lender relationship within the microcredit paradigm is the mobilization of social capital and the ability to tap into it. The second reason for its success is its specificities: the ritual surrounding the formation of the group, the idea of the weekly meetings and so on, help to create a strong group identity over and above the economic rationale of microcredit...The wider impact of the Grameen is not in the economic arena but in the psychological, socio-cultural domain. The real change is occurring in the domain of ideas." (Personal interview, Power and Participation Research Centre (PPRC) Office, Dhaka, March 29, 2009.)

[101] This factor was alluded to by an internationally renowened economist and microfinance researcher interviewed. (Personal interview at the office of the BRAC Institute of Development Studies, Dhaka, April 17, 2009.)

[102] Personal interview with the former Chairman of the *Palli Karma Shohayok Foundation* (PKSF) the Institute of Microfinance at his Motijheel residence, April 1, 2009. PKSF will be discussed below.

[103] Typically a "lower" standard, i.e. many observable breaches may not be easily verifiable by an independent court, especially when courts are circumscribed in the kinds of evidence that are admissible, and borrowers know this.

[104] This is a technical term used in the economic literature to describe the difference between a person insulated from risk and another fully exposed to risk in a particular situation. On the advantages of the microfinance model in avoiding this problem, see (Arnott & Stiglitz, 1991)

[105] This is an economic term that refers to "bad" results in market processes that arise from buyers and sellers having asymmetric information. On the benefits of the microfinance model in dealing with this problem, see (Ghatak, 1999).

[106] (Wydick, 1999) finds evidence of this insurance dimension of group lending.

[107] See, for example, (Jain, 1996). We have, however, already noted that, even in the absence of joint and several liability, cooperative behavior can also be induced by making access to future credit dependent on group repayment.

[108] It should be clear that social sanctions are, for the most part, still individually applied, i.e. there is no group decision to impose sanctions, simply a set of incentives (associated with repeated interactions), including sanctions imposed against those that do not impose sanctions, see (D. Abreu, 1988) and (D. Abreu, Pearce, & Stachetti, 1990).

[109] Indeed, the far-reaching public indignation in the face of the Indian crisis – precipitated by the more aggressive use of coercive tactics – seems to support the claim that the use of force was not the dominant enforcement mechanism in the early era of microfinance.

[110] The experience of Grameen Bank appears to bear this out. The shift away from relying on formal legal sanction to enforce the credit contract (the efficacy of which is highly questionable in the context of the developing world) appears to have been key to its success – but the central "informal" enforcement mechanism at play, although always in combination, appears to have varied from period to period: In the early stages of the Grameen Bank, the dominant mechanism of enforcement may loosely be described as the peer-monitoring or joint liability mechanism (although more as a disciplining device rather than a strictly enforced system), but this shifted over time to a more social capital driven system – initially in the more narrow sense and increasingly in the broader sense. The use of coercion, as with many systems, may have been an underlying threat, but was only invoked in extreme situations.

[111] But this distinction is far from absolute. Microfinance has always been a hybrid institution. Indeed, although it is accurate to classify the Grameen Bank as substantially informal in its relationship with

borrowers – especially since there exists no formal contract between Bank and borrower, and default on the part of the borrower is not regulated by formal legal sanction – the Grameen itself is not an entirely "informal" institution. As described above, it started as a series of experiments in various Bangladeshi villages – but consolidating those experiments into what is now the Grameen Bank required formal law, i.e. the Grameen Bank Ordinance Act 1983. Thus, despite the fact that the Grameen is able to maintain contractual relations with so many million borrowers without needing to resort to formal law – the institution operates within the framework of a more formal legal system in Bangladesh.

[112] This is captured by the emergent literature on law as a "cognitive institution," grounded in a broader systemic approach to the law, see (Teubner, 1993) and (Luhman, 1995).

[113] Although data on the exact scale of the phenomenon are not available, one eminent microfinance expert estimated that there are over 1000 MFIs operating in Bangladesh in total. (Personal Interview, Institute of Microfinance Office, April 19, 2009).

[114] Concern about overlapping was expressed almost across the board – by human rights activists (e.g., personal interview, *Nijera Kori* Office, April 24, 2009, microfiannce experts (Personal Interview, Institute of Microfinance Office, April 19, 2009), and even representatives of the MFIs (including Yunus, personal interview, Grameen Bank Headquarters, April 20, 2009).

[115] A recent incident of fraud underscoring the need for regulation was Jubo Karmasangsthan Society (JUBOK). See, for instance, (Chowdhury, 2006).

[116] See further, http://www.pksf-bd.org/ and http://www.mra.gov.bd/

[117] Examples of this include Grameen Danone, Grameen Veolia and Grameen Uniqlo. See futher (Yunus, 2007)

[118] It is well known, of course, how important non-formal aspects of business, even between very large organizations, are. See, for instance, (Macaulay, 1963).

[119] For instance, a Grameen Phone subscriber purchases a subscription not on the basis of a personal trust in the service provider, but rather, as a more impersonal market transaction. Grameen Phone is both one of the earliest and most successful of Grameen’s "social businesses". It is a joint venture between Grameen Bank and the Norwegian telecommunications company, Telenor. It is now the largest telecommunications service provider in Bangladesh. The reputation of the Grameen Bank is, however, a crucial factor behind the success of the venture.

[120] It was thought that as markets get stronger and communities less close-knit—or at any rate more mobile—the settled communities on which *Grameen* relies may be destroyed. The experience of *Grameen America*, the new Grameen Bank branch in Jackson Heights, New York – belies this intuition. Despite operating in the US and in an urban context, repayment rates have been around 99 percent. See http://www.grameenamerica.com/

[121] Vikram Akula in an interview with NDTV estimated that repayment rates in the immediate aftermath of the crisis had dropped to 43 percent, but that they have fallen further since then to 10 percent (NDTV, May 13, 2011). But the international media has reported default figures in the range of 90 percent (V. Bajaj, 2011d).

[122] See (Polgreen & Bajaj, 2010).

[123] The October 14 Ordinance. This is now the Andhra Pradesh Microfinance Institutions Act, 2010. It is debatable whether this legislation “saved the day”, or was unnecessary interference on the part of the government. This is discussed further in Section 4.

[124] Microfinance Information Exchange (MIX Market), 2010.

[125] See (Strom & Bajaj, 2010).

[126] See (Nayak, 2010).

[127] National Bank for Agriculture and Rural Development, March 2010. This dramatic increase in commercial lending to MFIs was partially the result of a government requirement to apportion a certain

percentage of credit to “priority sectors” – further strengthening the analogies with the US subprime mortgage crisis.

[128] Limiting competition has two effects: first, it reduces the problem of overlap noted earlier; and secondly, it increases the franchise value (the on-going value of an enterprise), which provides enhanced incentives for “good behavior,” e.g. not engaging in excessive risk taking, or bad or fraudulent lending practices. See (Hellman, Murdoch, & Stiglitz, 2000)

[129] See further RBI (2011).

[130] The legislation – The Microfinance Institutions (Development and Regulation) Bill 2012 – was introduced in Parliament earlier this year. See (Jogota, 2012).

[131] Although the full impact of the microfinance crisis in India and elsewhere remain to be seen, some interesting developments are already observable: For instance, SKS is retracting substantially from the original microfinance model by shifting an increasing part of its lending portfolio to collaterialized lending, namely issuing business loans against gold as collateral (V. Bajaj, 2011c)

[132] There was relatively little acknowledgement of this phenomenon in the academic literature, but (Haldar, 2011) provides a detailed account of it in Bangladesh.

[133] It is, of course, also true that the *consequences* of non-repayment are reduced, since an individual might be able to borrow from another MFI.

[134] See Section 2(c).

[135] See (Bhattacharya et al., 2005).

[136] On group formation the SKS website says: “Women form self-selected five member groups to serve as guarantors for each other. Experience has shown that a five-member group is small enough to effectively enforce group peer pressure and, if necessary, large enough to cover repayments in case a member needs assistance.”

[137] The failure of many legal reform programs in the developing world is attributable to excessive focus on replicating the institutional model and inadequate attention to institutional detail – factors like the specific context in which the institution was to be placed, the receptiveness and familiarity of those intended to be governed by the institution to its rules and so on. As the experience of several failed legal formalization programs would indicate, the model is often hollow without the detail. Haldar (2011) illustrates this with the example of the land titling program in Peru.

[138] See (Emran, et al., 2007)

[139] One instance of this in the case of Bangladesh, was the election of a number of Grameen members to local government institutions: In the 2003 local government election (the *Union Porishad*), 7442 *Grameen* members contested the reserved seats for women and 3059 members got elected – this accounts for 24 percent of the total women's reserved seats (Yunus, 2008, p.16). There were other effects in terms of female empowerment and fertility. See further, (Haldar & Stiglitz, 2008).

[140] The inevitablity of the shift to the for-profit model to fuel expansion is cast in doubt by the Bangladeshi experience, where nearly univesal coverage was achieved by the microfinance industry without making this shift.

[141] On Compartemos, see (Malkin, 2008). On Yunus' response to the turn taken by microfinance to the for-profit model, see (Yunus, 2011)

[142] According to some estimates, interest rates charged were between 30 – 65 per cent (V. Bajaj, 2011d)

[143] The high interest rates raise fundamental questions about the ethics of the rich earning profits at the expense of excessive borrowing by the poor, driven by desperation or ignorance. From the perspective of this paper, however, more important is the fact that the appearance of an exploitive relationship undermined social capital, and thus the social obligation to repay.

[144] Sheikh Hasina started out as a supporter of Yunus and microfinance, but her relationship with Yunus took a sharp turn for the worse after he made an attempt to form his own political party and enter politics

during the rule of the military government just preceding her election in 2007. See (V. Bajaj, 2011a) and (Mahmood & Magnier, 2011; Nolan, 2011).

[145] For a critical perspective on government intervention in India, see (Kazmin, 2010).

[146] Sheihk Hasina, for instance, famously referred to Yunus as "shoudkhor" – a highly derogatory Bengali term for moneylender. (Personal interview with a senior journalist at Bangladesh's leading English language daily, *The Daily Star*, May 5, 2009).

[147] This comment was made at the Social Enterprise Conference at Harvard University (N. Thirani, 2012). Amidst much pressure, Akula resigned as Chairman of SKS in late 2010 (V. Bajaj, 2011d). See also, for Yunus' vesion, (N. Thirani, 2012).