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Initial Public Offerings:

The field's salvation or downfall?

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Initial Public Offerings (IPOs): The field's downfall?

Introduction:

The motivation behind microfinance IPOs was summed up in CGAP Focus Note 42, on the controversy surrounding the Banco Compartamos IPO in Mexico in 2007, "Compartamos had a preference for truly commercial investors (the kind that bought shares during the IPO) because it wanted the Mexican financial sector to see microfinance as real banking, not the preserve of socially motivated, not-really-hard-headed, investors. It believed that truly commercial investment was the best path to reaching massive numbers of clients."[1] The promoters of SKS, undoubtedly, make a similar argument for their July 2010 venture into the world of commercial investment.

Yet, no event in microfinance has generated more debate than the two major IPOs in microfinance – the Compartamos IPO of 2007 in Mexico and the SKS Microfinance IPO of 2010 in India. The Compartamos IPO generated debate for its implications for profit making at the expense of the poor. In its immediate aftermath, the SKS IPO raised similar issues.

Writing as we are in the midst of the "great Indian microfinance crisis", the subject of debate and speculation throughout the microfinance world, the sentence highlighted above may appear to be an over-statement. In fact, this paper argues that it is not an over-statement; the "great Indian microfinance crisis"[2] is directly attributable to the success of SKS at raising funds from commercial sources over a number of years and more specifically to its IPO which followed from Compartamos' successful first foray into the public capital market. While the success of SKS in raising substantial funds in the years that preceded the IPO may have seemed to be the industry's salvation, in practice it has turned out to be its downfall. Microfinance in India, and much of the rest of the world, may never be the same again; but then, perhaps we should not want it to be.

1 But first, IPOs as the industry's salvation…

There is no doubt that the phenomena of poverty and financial exclusion affect substantial proportions of the population of the world. In OECD countries, financial exclusion still affects 10-20% of populations while in transitional and developing economies it can range from 40% in Eastern Europe to 60% in India and as much as 90% in many parts of Africa. With perhaps a billion people living in absolute poverty and another billion financially excluded if marginally non-poor, the need to accelerate the spread of financial services is apparent. In the absence of effective mechanisms for expanding the formal financial system and enabling the urban poor as well as remote rural populations to be served by commercial banks, the need to grow and expand innovative non-banking approaches to spreading financial services is apparent.

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[1] Rosenberg, Richard, 2007. **CGAP Reflections on the Compartamos Initial Public Offering: A case study on microfinance interest rates and profits.** Washington DC: CGAP Focus Note 42.

[2] Referred to henceforth as "the Indian crisis" or even as "the crisis".

1.1 400 million excluded low income families need at least $200 billion of loan funds

Financial inclusion in the near future means expanding microfinance initiatives both in terms of the number of institutions and (as some would argue) increasing the size of microfinance institutions to reach larger numbers of people. Either way, reaching an additional two billion people in the world (living in perhaps 400 million family units) is a substantial challenge. Even assuming a minimal average fund requirement of $500 of credit outstanding per family (in the range $200-$2,000), the need for funds for lending would amount to $200 billion. Such funds can come from donor grants, from the deposits of (otherwise) financially excluded families themselves, or from loan or equity funds obtained from commercial markets. The issues associated with such funding are

- **Grants** – total development aid amounted to $127 billion in 2009 and somewhat lower amounts in the previous years. According to OECD data, total international aid over the 3 years 2007-09 averaged $120 billion. Just 3.7% (or $4.5 billion) of this was allocated to banking services (including microfinance). Even if a generous allowance is made for the fund raising undertaken by international NGOs, it is clear that grants cannot make a substantial contribution to the worldwide requirement of funds for microfinance.

- **Deposit** mobilization whether from microfinance clients or from the general public is seriously hampered by the conservatism of regulators (often, central banks). There are serious issues that arise from the risk of microfinance managers collecting deposits from low income families and then losing the savings of those families through mis-management or fraud. As a result, deposit taking by microfinance institutions is allowed by regulators only under very limited conditions – very high minimum capital requirements and stringent "fit and proper" criteria for managers. In countries such as India deposit taking by non-bank financial institutions is not allowed at all and in other countries (Pakistan, Nepal, Cambodia) relatively few institutions are licensed for deposit taking. As the experience in all three of the latter countries shows, recently licensed MFIs in any case face a trust deficit amongst the public, which results in customer reluctance to place significant sums with MFIs.

  On the other hand, the experience of well established MFIs with long records of providing financial services (SEWA Bank, Grameen Bank) is that micro-clients have a substantial need for financial services resulting in deposits with these institutions far exceeding their ability to lend. In recent years, SEWA Bank's deposits have amounted to three times their loan book and deposits with Grameen Bank at the end of 2009, were 1.5 times the bank's outstanding portfolio. This emphasizes the current orthodoxy amongst microfinance practitioners that low income families need deposit services as much, or even more, than they need credit; deposits create a nest-egg that can be used for income smoothening or investment more readily and flexibly than the use of credit, which is hampered by delays in availability and (at least nominally) by rules of use.

  However, as is apparent from the above discussion, even if regulators were to become more liberal in their approach to deposit licensing, the trust deficit means that this is at best a very long term solution to the fund constraint for lending to low income families.

This leaves the possibility of generating loans and equity funds from commercial markets as the only serious, medium term option for financing the credit needs of low income families. It is this perception that led Compartamos and SKS to seek funding initially from socially motivated investors and, then, believing that insufficient funds would be available from them in the immediate future, to push the envelope on commercial funding.

1.2 Full speed ahead on the "capitalist road"

The stories of Compartamos and SKS are both well documented. Compartamos was established in 1990 with international grants and soft loans of $4.3 million. It transformed into a finance company in 2000 and received a banking licence in 2006.[3] It made a public offering in 2007. By then, the original equity investment of $6 million made during the period 1998-2000 had grown to a book value of $126 million with the accumulation of retained earnings from on-lending substantial borrowings from both public development institutions and from commercial lenders/investors. It also recorded a very high profit rate which contributed to its growth by generating substantial additional capital as surpluses from its operations. The book value of returns on equity averaged over 53% per year during 2000-06, the period after transformation to commercial operations. Over 80% of the profits of the company were retained in order to grow operations and enhance share value via that high growth. As documented by Rosenberg, the high profit resulted from its very high interest yield on portfolio, 86% for 2005 (albeit not exceptionally high in relation to the rest of the Mexican financial sector).

When Compartamos shareholders sold 30% of their holdings in the IPO, they received around $450 million or more than 12 times the book value of those shares at that time. As calculated by Rosenberg, this represented a 100% compounded annual return over eight years. While most of the sale proceeds went to public development institutions like IFC, ACCION and the Compartamos NGO, about a third accrued to the early private shareholders of the MFI. Thus, Compartamos had led, if not pioneered, the commercial funding pathway now so familiar in the world of microfinance. **Figure 1** (following page) sets out the six key steps in the pathway leading to commercial *nirvana* via the IPO, in theory, to enable microfinance to become accepted as an integral part of the commercial finance system, never again to need subsidies and development funding.

There are many MFIs that were encouraged in the early 2000s by the pro-commercial mantra of international microfinance to start along this pathway. The thinking behind this approach was impeccable and is set out in the first paragraph of this paper; there were (and are) insufficient development funds to provide financial services to all the world's financially excluded, low income families, therefore, commercialization is necessary to reach them. SKS was one of the foremost, and perhaps the most successful traveler along this pathway, perhaps even more successful than Compartamos.

Following the pattern outlined in the pathway, SKS was established as an NGO (a registered Society) in 1997, and worked initially with donor funds and borrowings from development

[3] Rosenberg, 2007, op cit

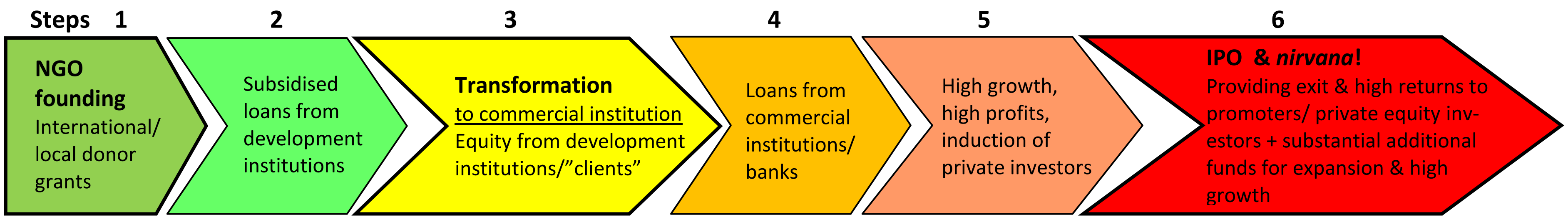
lenders like the Small Industries Development Bank of India (SIDBI). The process of transformation to a commercial entity started in 2003. A company titled, SKS Microfinance Limited was registered and to fulfill the requirements of the regulator, applied for registration to function as a finance company (known in India as a non-bank finance company, or NBFC). However, in order to qualify for registration as an NBFC, a company must have a minimum equity capital of Rs2 crore (~$450,000). At this stage of development of the microfinance industry no investors were available to provide capital of this magnitude and, even if they had been, the founder, Vikram Akula, would not have been able to retain management control of the company if he had accepted equity investments from another party. In Mexico, the problem of minimum capital could be easily resolved by the NGO investing directly in the new commercial company but Indian law does not allow a Society (a "not for profit" institution) to invest in any form of equity or for-profit structure.

In order to overcome this problem an ingenious solution was found; the 16,600 borrowers (clients) of SKS society at that time were formed into five Mutual Benefit Trusts (MBTs) and a donation by the Society to the clients as individuals was deposited with the MBTs. As private trusts, the MBTs were permitted to invest their funds in any way mandated by the members of the trust. The members having reposed their "trust" in the trustees, consisting of three employees of SKS and two beneficiary members each, were advised to invest their money in the NBFC making, thereby, a start-up equity contribution of Rs2.05 crore – sufficient to meet the Reserve Bank of India's minimum capital requirement for SKS Microfinance to be registered as an NBFC.[4]

[4] This mechanism for obtaining the minimum required share capital investment in SKS Microfinance Limited is documented in the company's "red herring" prospectus for the IPO and has also been written about in Sriram, MS, 2010. **Commercialisation of Microfinance in India: A Discussion on the Emperor's Apparel**. Indian Institute of Management Ahmedabad, March. This is not a device uniquely employed by SKS but was used around the same time by others amongst India's leading MFIs and has been used (with minor variations) multiple times by others since then.

Figure 1

International microfinance: Six steps to commercial bliss



It took SKS a while to overcome the hump of RBI registration, receiving the NBFC licence only in late 2005 so that the complete transfer of portfolio to the new NBFC could not take place conveniently until the end of March 2006 (the end of the Indian financial year). At this point SKS Microfinance Ltd had a readymade portfolio of Rs78 crore ($17.5 million) which was transferred from the society. At the launch of NBFC operations, SKS also received additional equity capital from SIDBI, the Ravi and Pratibha Reddy Foundation, the Unitus Equity Fund and a high net worth individual, Vinod Khosla – all development investors. Further funds of Rs4.5 crore ($1 million) were transferred from the society to the NBFC as equity via the MBTs as client equity.

Over the next four years a series of private investors put equity capital into the company which grew at fantastic rates. Its portfolio increased from just over $20 million at end-March 2006 to around $960 million under management by end-March 2010, a compound growth rate of 161% per annum. The number of its borrowers (clients) grew from just 173,000 in March 2006 to 5.8 million in March 2010 – a compound growth rate of 140% per annum.

In order to enable this high growth rate, SKS naturally had to raise additional capital from equity investors and, with Vikram Akula's PR skills and connections via his earlier work with McKinsey, it was able to do this most successfully. Thus, as set out in the company's IPO prospectus, SKS had a galaxy of private equity investors both international and Indian by May 2010. In addition, Vikram himself and some of the top executives of the company had acquired significant shareholdings through devices such as sweat equity contributions and share allotments at discounted prices.[5] To be fair, the shares of the MBTs had also multiplied in the meantime through bonus issues resulting in their holding 16.1% of the pre-issue share capital of over 10 million shares, having started in 2006 with just over 6.5 million and an investment of $7.1 million. At the pre-IPO selling price of Rs636 ($14.15) per share, this was worth $146 million or over 20 times the original nominal investment. Other promoters – Sequoia, SKS Capital and Unitus – having paid somewhat higher average prices for their shares stood to earn lower but still very high multiples on their equity holdings at this time.

The total shareholding in SKS NBFC before the IPO consisted of 64.5 million shares valued at a total of $911 million. With a net worth of around Rs9 billion at the time, this represented a price to book value ratio of the order of 4.5 and a price to earnings ratio of around 16. In the event, with the share issue oversubscribed 13.7 times, the price settled at Rs954 ($21.20). Thus, SKS was valued at a total of $1.5 billion at a price to earnings ratio of around 25 with the price at around 7 times book value. The $368 million raised via the IPO was less than the $450 million proceeds of the Compartamos sale but it increased the SKS capital of around $200 million by over 80% (or $163 million) while the proceeds of the Compartamos sale went exclusively to the existing shareholders. Thus, SKS greatly enhanced its ability to leverage further growth. The subsequent rise in the value of the share on the stock market to a peak of Rs1,490 ($33), over 50% higher than the issue price, within two months of the IPO, shows how brightly investors viewed the future prospects of SKS until the Andhra Pradesh (state) government intervened in the practice of microfinance in the state, causing

[5] Whether this was done by means fair or foul is not discussed here. Sriram, 2010 argues that the means were possibly more foul than fair but that is not strictly important to this discussion.

a major crisis in Indian microfinance. In a sense SKS had proved its ability to raise increasing sums of commercial capital from the capital markets in order to "eradicate poverty…by providing financial services to the poor…"[6] If this experience could be repeated by other MFIs it would release substantial and growing sums of money for on-lending to low income families (if not necessarily the poor). Was this the nirvana sought by microfinance promoters; was this the salvation of microfinance?

2 …has the makings of the industry's downfall

2.1 …as the high growth fever catches on

While the development-oriented SKS was, thus, fully launched on its mission to "eradicate poverty" through fund raising via the "capitalist road", it is interesting to examine the timing of its actions along the way. **Figure 2** shows the pattern of growth of the leading Indian MFIs during the period 2006 to 2008 – around the time of the Compartamos IPO. It is apparent that while some of the largest rivals of SKS were growing fast during this time, SKS was growing even faster (albeit from a smaller base) and in the financial year 2007-08 accelerated its growth. While in the previous year it doubled the number of clients and tripled its portfolio size, in the following year (on a substantially larger base) it grew its portfolio four times and client numbers by a factor of five. It is interesting that the Compartamos IPO occurred in April 2007, the first month of the Indian financial year in which this acceleration took place. While other leading Indian MFIs also accelerated, the SKS acceleration was dramatic suggesting that the success of Compartamos (immediately world famous due to the controversies surrounding its valuation and the profits accruing to its investors) may have played an

Figure 2

Portfolio growth of the leading Indian MFIs, 2006-08

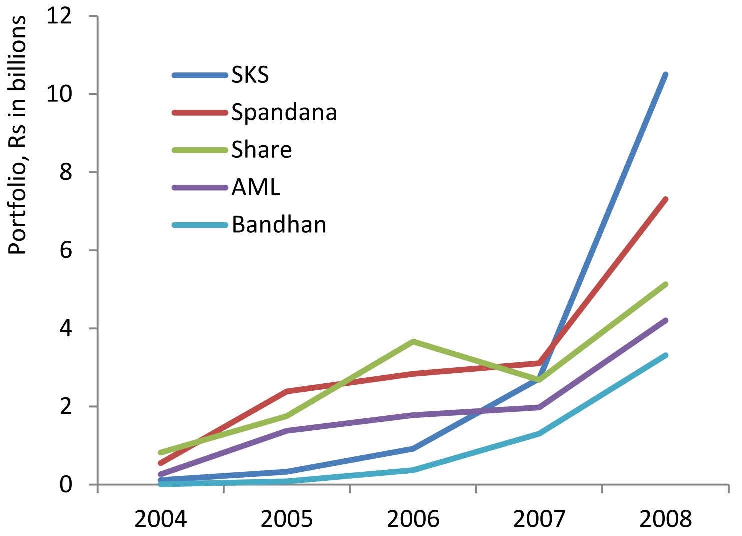
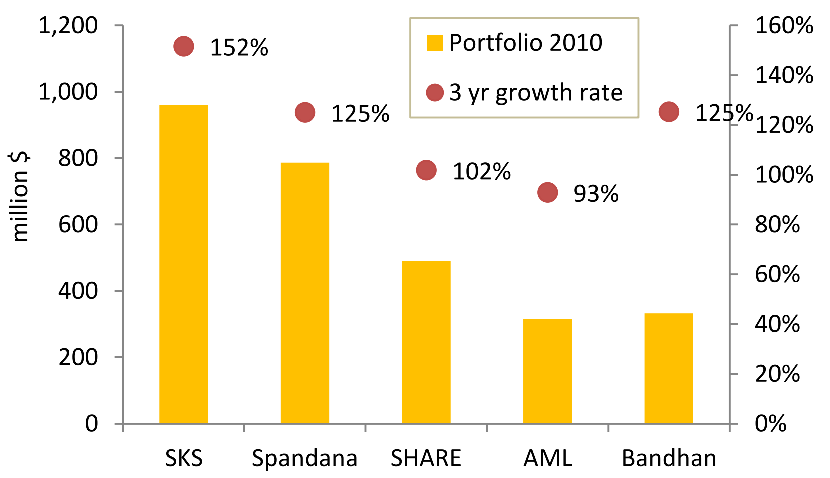


Figure 3

Relative size and growth rates of leading Indian MFIs, 2007-2010



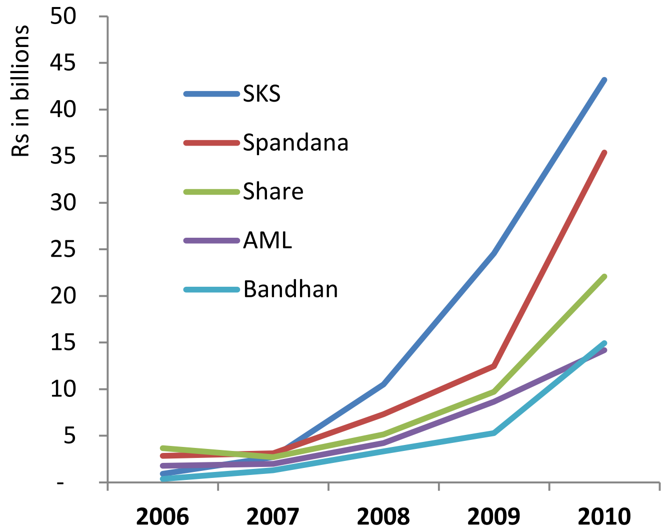
[6] Quote from the company's website.

important role in SKS growth policies. Thus, it is more than likely that the inflection in its growth path occurred because SKS decided that fund raising from the public capital market was possible and it should, therefore, fast-track its own progress towards an IPO.

Figure 3 (previous page) shows that while SKS may have been influenced in its decision to move towards an IPO by the success of Compartamos, its leading competitors in the Indian market were also growing fast. By March 2010, the four largest competitors of SKS – Spandana, SHARE, Asmitha (a sister company of SHARE) and Bandhan – had 1.3 million to 3.6 million borrowers and portfolios to match (ranging from $300 million to $800 million). By 2009, with increasing talk of an SKS IPO, each of these had set its sights on an IPO. The impact on their growth rates was salutary. It is apparent from **Figure 4**, that 2009 saw another inflection point in the growth of the largest MFIs. While SKS continued to grow along the path it embarked on in 2007, the others visibly accelerated in 2009-10, in order to prepare for their own IPOs as soon as the results of the SKS foray were known. The result was that despite the large numbers of borrowers already covered by Indian microfinance by then, around 15 million clients by end-March 2009, growth continued at the same blistering pace seen over the past few years.

Figure 4

Portfolio growth of the leading Indian MFIs, 2007-10



Calculations by M-CRIL (the author's organization) show that MFI growth in India during 2009-10 was 61% in terms of the number of borrowers and 88% in terms of portfolio. As a result, the claimed outreach of Indian MFIs reached around 27 million clients by the end of March 2010 and over 30 million clients six months later.

2.2 …and promoters focus on profitability rather than value to customers

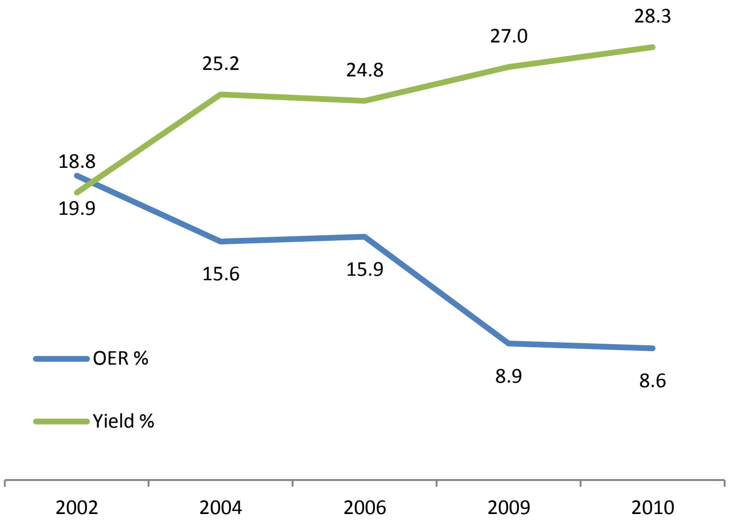
In the meantime, not only did the intensifying competition not bring down the cost of loans to borrowers, it actually increased it. The 2010 biannual review of Indian microfinance by M-CRIL[7] shows how the portfolio yield has increased over the past few years and particularly in the period since 2006 (**Figure 5**). This is contrary to expectation, with increasing competition in Indian microfinance there ought to have been a downward trend in yields but the reality points to oligopolistic behavior as each of the leading MFIs pursued the goal of maximizing profitability as well as growth.

[7] **M-CRIL Microfinance Review 2010: Microfinance contributes to financial inclusion**. Micro-Credit Ratings International Limited, Gurgaon, India.

This goal was pursued also via the device of minimizing expenses; the figure alongside shows that average operating expense ratios in Indian microfinance declined during this period falling from nearly 16% in 2006 down to below 9% in the latest two financial years. M-CRIL's assessment is that this "improvement" is attributable not just to the achievement of economies of scale but also to an oversimplification of the relationship between MFIs and clients resulting in little time spent on group formation or group development processes. In the late 1990s a self-help group was expected to be in existence for a minimum of 6 months before it became eligible for an MFI loan. Even a Grameen type solidarity/joint liability group was required to meet regularly for a minimum of 8 weeks before it became eligible for an MFI loan and, crucially, members were required not to have a loan from any other source.

Figure 5

Trend in portfolio yield vis-à-vis OER



Client acquisition at a hectic pace: By the time the race for growth became the norm around 2007, MFI loan officers had abandoned all concern for group processes and single source lending; the situation was reached where, in the extreme, an MFI loan officer waited outside a group meeting organized by another MFI in order to offer the same group another loan or to collect from the same group (since it had been previously enrolled by him). In the short term, this created a win-win situation for both MFIs and clients: it helped the MFI loan officer to meet his targets as easily as possible thereby helping his MFI to maximize its growth and it helped the client to gather ever larger sums of money in relatively short periods of time in order to meet her investment (and, in many cases, consumption) needs – whether or not she was in a position to repay. As one MFI client in Kolar retorted to the author,

> "If someone offered you money with little paperwork and no collateral, would you not take it?"

"Maintaining" portfolio quality: The MFI perspective, in this situation, was that as long as overall loan recovery did not fall below 1-2% of overall portfolio they could carry on growing. Both the big rating agencies (without a specialized knowledge of microfinance) and, by extension, the commercial banks (as lenders/providers of funds to the MFIs) also bought into this line of thinking. They all forgot the first lesson of microfinance performance: large recent disbursements mask portfolio quality ratios because the denominator of the ratio (total portfolio) grows faster than the numerator (quantum of bad loans). Worse, as recently as 2010, branch level loan portfolio audits of some of the largest MFIs by M-CRIL indicated PAR of the order of 5-7% at a time when the same MFIs reported PAR_{30} of less than 0.5% in their transparency reporting to the MIX. It is apparent that as the large MFIs expanded operations at a hectic pace, their internal control systems were unable to keep pace and the practice of refinancing borrowers in difficulty became increasingly widespread amongst far-flung branch managers anxious to maintain their portfolio quality in order to maximize incentive payments. The fact that clients were getting increasingly into trouble was simply not considered. This was a repeat of the earlier experience of Grameen Bank, ignored on the argument that the large Indian MFIs had cultivated a "professional" work culture whereas the Grameen culture was apparently "social".

Multiple lending in well-served areas: M-CRIL estimates that these practices resulted in around 40% overlap in those easy to reach clusters (nationwide) where microfinance operations became established. These overlaps reached the extent of 200% and more in some of the more microfinance oriented parts of states like Andhra Pradesh, Tamil Nadu and West Bengal – so acute was the problem in some places that borrowers in Kolar district of Karnataka reported running from one meeting to another and/or spending as much as 2.5 hours per weekday at meetings where no more business was undertaken than making repayments, completing loan applications and receiving repayments.[8] This effectively reductionist approach meant that the relationship between the MFI and the client was reduced to one that is little different from retailing; the development solidarity, preventive health and basic literacy objectives of the MFI group meetings of the 1990s were abandoned in the rush for growth.

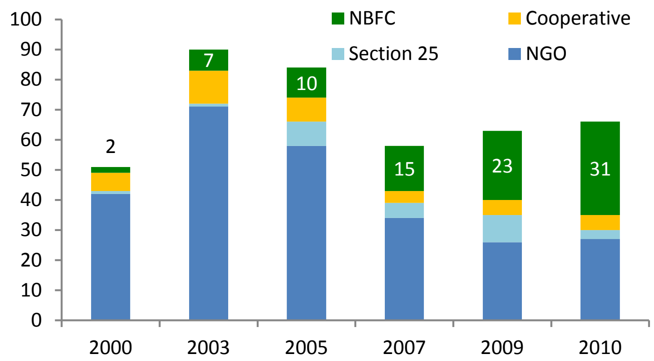
…and the continued exclusion of those in the least developed regions: Yet there are other parts of the country, many parts of Bihar and UP, much of the north-eastern region, the least accessible parts of Vidarbha and Orissa and even the less developed areas of south India (northern Karnataka, parts of Telengana,) where the outreach of microfinance was and continues to be limited if not non-existent. The cost of developing new operations in such areas relative to offering multiple loans in developed areas is high and the rewards of being the first mover are limited; in such a highly charged atmosphere as soon as an MFI opened a new area, others rushed in to capitalize on the investment of the first mover. Thus, large numbers of the poorest families in India were (and continue to be) excluded even as others, better off due to their locational advantage, were increasingly falling into a debt-trap due to the culture of easy money. Thus, yet another of the development objectives of microfinance, outreach to the poorest, was abandoned in the quest for low costs and high growth.

Increasing yields despite cost savings: Increasing yields apparent from the figure, point to the fact that none of the apparent improvements in efficiency indicated by the declining operating expense ratio were passed on to clients. It is not surprising that the weighted average return on assets of the largest ten MFIs in India during the financial year 2009-10 was as high as 7.9% and 6.8% for the larger sample of 65 MFIs studied by M-CRIL, compared to 2.1% in 2005. And, a natural corollary of this was increasing commercialistion of

[8] Documented by M-CRIL's parent organization EDA Rural Systems Pvt Ltd in EDA, 2010. **Microfinance and the Role of External Agents**: A study of the Kolar delinquency crisis. Undertaken for the Association of Karnataka Microfinance Institutions (AKMI).

microfinance as more and more NGOs converted to commercial NBFCs. This was in the hope of obtaining large quantities of highly leveraged debt from commercial banks which would lead to high growth and, following the example of SKS and its peers (Share, Spandana and others), would lead to high profitability which attracts equity capital (from private investors) at high valuations enabling the original promoters to make dramatic fortunes in the space of a few short years. **Figure 6** (following page) shows the progressive transformation of Indian microfinance from a predominantly NGO oriented sector to a substantially commercial one. By March 2010, over 80% of active borrower accounts[9] serviced by Indian MFIs were with (commercial) NBFCs.

Figure 6 Transformation of the legal structure of MFIs in India
[number of Indian MFIs covered by M-CRIL Review]



2.3 …in order to obtain high valuations

The advent, meanwhile, of high valuations in return for expected future profits – which sparked this rush to commercialization – began with the sale by SKS of its shares to Sequoia (a private equity firm) and continued with the sale of the equity of SHARE Microfin Ltd to Legatum followed by other similar deals. Each of these is reported to have fetched the promoters fantastic valuations in the range 5-11 times book value. A CGAP study that documented and analysed the equity valuations of MFIs worldwide found the median price to book value ratio of equity transactions involving Indian MFIs (at 5.9) to be by far the highest for MFIs in the world (with the next highest being 2.1 in Mongolia and 2.0 in Ghana.[10] The paper also found that there was no direct correlation between microfinance equity transactions and returns on equity indicating that investors were swayed more by the expectation of future profits than by historical returns. In the Indian context, it is apparent that equity investors were swayed both by the ability to grow (and simultaneously generate profits) and by the tantalizing prospect of a huge and still apparently underserved market. The total apparent size of this market amounting to some 140 million financially excluded families was served only to the extent of around 20% (by MFIs) even if the figure of 27 million MFI borrower accounts at end-March 2010 is assumed to apply to unique borrowers (and multiple lending is ignored).

3 The industry's downfall, or the "great Indian microfinance crisis"

As indicated earlier, the process of capital raising by SKS was an absolute triumph for the growth strategy, PR skills and self confidence of its promoters, particularly Vikram Akula. It appeared, to many, that the industry's future (not to mention the futures of dozens of other "me-too" promoters of commercial MFIs) was secure. In the event, it was precisely those qualities that were the downfall of microfinance.

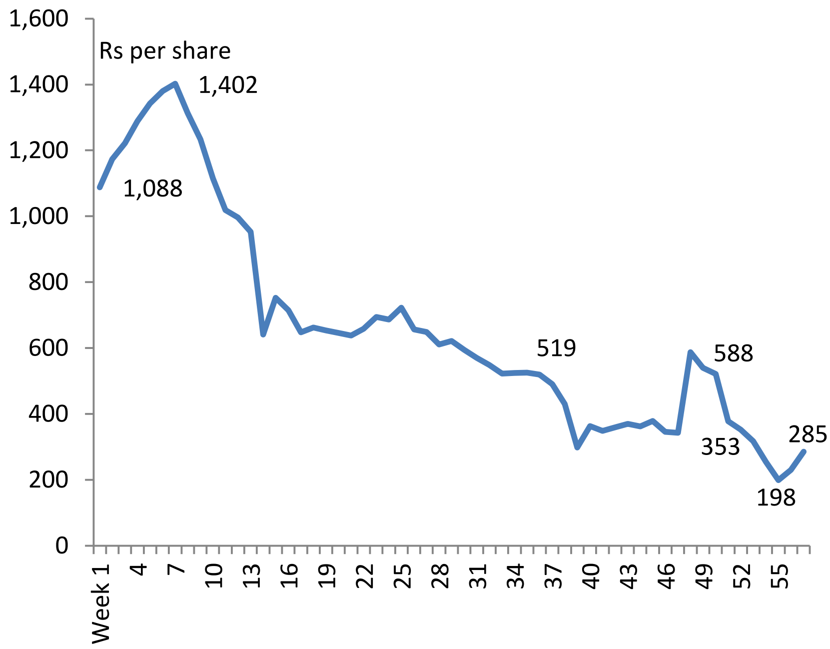
[10] Given the high but still unenumerated amount of multiple lending by Indian MFIs it is no longer possible to talk of borrowers though M-CRIL estimates that the actual coverage by March 2010 amounted to 18-20 million

[10] CGAP, March 2010. **All Eyes on Asset Quality: Microfinance global valuation survey 2010**. Washington DC, CGAP Occasional Paper 16.

Upon listing on 16 August 2010, the SKS share price jumped up 11% and climbed steadily thereafter until 28 September to a peak as high as Rs1,490 ($33), more than 50% higher than the final IPO price of Rs985, though the closing price on that day was Rs1,402 as shown in **Figure 7**. Thereafter, the price started to fall and, but for a few kinks, has been in steady decline since. At the time of writing (in mid-September 2011) the share price is down to Rs285 ($6.34) just over a quarter of the Rs1,088 closing price on the date of listing and just 29% of the IPO price.

Figure 7

Movement of the SKS share price since listing

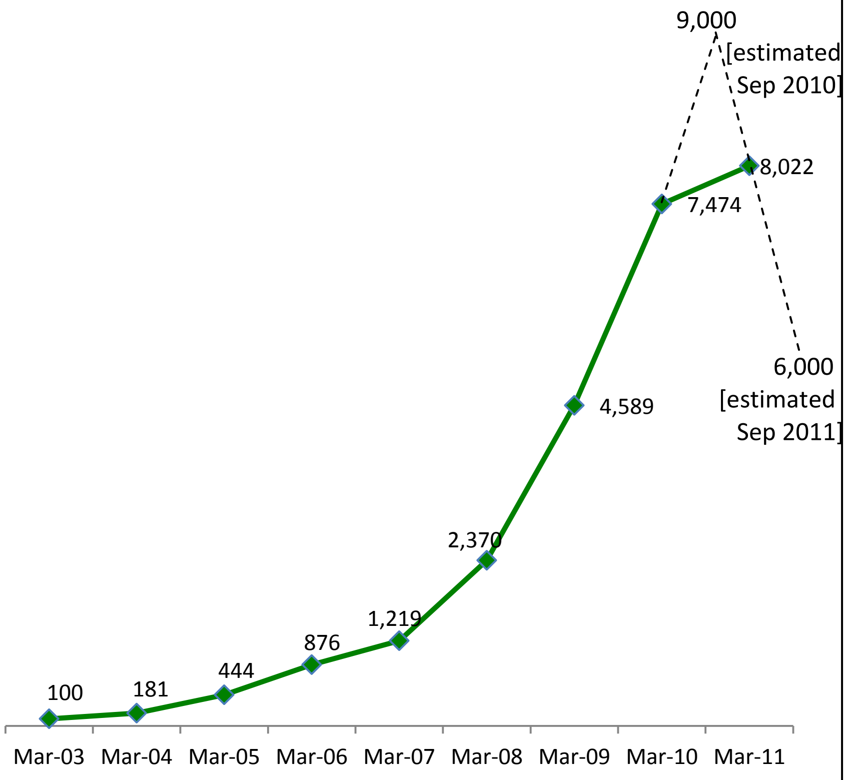


The decline started with rumours about a dispute between the promoters of SKS and the CEO at the time of the IPO, Suresh Gurumani. This culminated in the sacking of the CEO on 5 October. Whatever the reasons for the sacking, it was too close to the IPO (just 10 weeks after) for the comfort of India's securities regulator (SEBI) who asked the company for an explanation. There was also a challenge in the courts by investors aggrieved that they had not been informed about the promoters' lack of confidence in their CEO at the time of the IPO; surely, the promoters could not have been happy with him in late July if they sacked him in early October. This shocking event also drew media attention back to SKS and to microfinance. Not only was there substantial speculation about the reasons for the sacking but it provoked renewed muck raking by journalists who had earlier raised similar issues about the functioning of Indian microfinance when discussing the forthcoming IPO. Within days of the sacking, articles about the over-indebtedness of microfinance borrowers were back in the media and numerous recent instances of suicide by low income women in Andhra Pradesh were directly attributed to this situation.

On 14 October 2010, the Andhra Pradesh (AP state) government promulgated its now well known ordinance apparently aimed at protecting microfinance borrowers as consumers. The ordinance placed severe restrictions on the practice of microfinance in the state. It effectively made it impossible to continue the microfinance business in the state reducing MFI collections to 10-20% of expected levels and making disbursements virtually impossible in the near future. A few weeks later, the AP ordinance was converted into a regular law having been passed by the state legislative assembly. Spooked by this event, the commercial banks, hitherto providers of over 70% of the funds deployed in Indian microfinance, started to hold and delay their disbursements to MFIs all over India, not just to those operating in AP. While commercial bank lenders to microfinance continued to demand their repayments on time, they disbursed only small sums of money and, in sharp contrast to their earlier enthusiasm, with considerable reluctance. As a result, by end-March 2011 the portfolios of leading MFIs in India were reported to be down by between 20-30% from the levels six months earlier. In practice, what the world knows as the "AP microfinance crisis" has turned into the "great Indian microfinance crisis". Let alone downfall, the industry has been in free fall over the past 12 months. M-CRIL estimates that by 30 September 2011, the size of the industry in the country as a whole had fallen by 33% from its end-September 2010 peak – from a CRILEX index of around 9,000 to just 6,000 (as shown in **Figure 8**).

Figure 8

CRILEX, the M-CRIL's microfinance growth index



4 Summary analysis – how the success of the SKS IPO lulled the sense…

Clearly, the sacking by SKS of its CEO was not the only cause of the crisis but it was certainly the proximate cause. It drew attention back to the microfinance industry at a time when media and government attention was starting to shift to other issues in the Indian economy. Perhaps the promoters and management of SKS were confident that with their PR skills and excellent business connections they would be able to manage any fallout from the sacking. In practice, it appears to be hubris augmented by the success of the IPO that was their downfall, a case of too much money lulling the sense.

It is the argument of this paper that the pursuit of commercial capital required both high growth and concomitant high profits. Once the promoters had sold dreams of high profits resulting from high growth in an "acutely under-served" Indian microfinance market to private investors, they had to deliver on that growth and those profits. The initial successes of SKS in its strategy led others to follow the same path of high growth and the peddling of dreams.

As discussed earlier, the consequence of this situation has been the development in significant pockets of the country of an environment of micro-money circulation that resembles a hot house in which women from low income households must shuttle to 2-5 meetings per week while managing households, families and contributing to micro-enterprises at the same time. Unfortunately, in obtaining "easy money" from multiple agencies, a few microfinance clients have mismanaged their financial affairs, as people tend to do at any level of society, and cases of over-indebtedness have emerged. Even if it is assumed that this is a very small proportion of the total number of clients, say just 0.05%, this would amount to 9,000 such cases and the emergence from these of a few cases of suicide cannot be ruled out. Whether or not these suicides are attributable to coercion by staff with limited understanding of their employer's social responsibility to clients in genuine difficulty is a matter of debate. Mix into this situation the shamelessly unethical behaviour of a few MFI promoters provoking media muck-raking, and populist attention seeking by politicians, the resulting restrictive legal measures by the Andhra Pradesh state government – apparently for the protection of clients – were inevitable; hence the crisis in Indian microfinance; hence the downfall.

Sadly, similar hot house conditions exist in microfinance in many Asian countries – Bangladesh, Cambodia, Nepal, parts of Pakistan and the Philippines – and beyond in countries like Georgia, Bosnia and Morocco. Though unrealistic investor interest may not always be to blame, the personal hubris of promoters certainly is. And many in these countries have openly followed similar paths.

Clearly, the revival of the Indian microfinance sector needs multiple actions at many levels: the central bank for regulation, the government for calibrated responses to the issue of client coercion and, above all, the MFIs to ensure more measured growth and better control systems. <u>It also requires more informed investor behavior</u> to ensure that capital flows to socially responsible institutions in support of the long term economic benefits of financial inclusion rather than in pursuit of short term financial gains. At the time of writing (September 2011) a complete solution is yet to emerge but clearly a major churning in international microfinance – a rediscovery of development objectives and a better understanding of the needs of microfinance clients, both the poorest and the not-so-poor – is necessary.

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