# A Case Study on the Ethical Issues in MFIs

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**Abstract** *Presently, many micro financial institutions (MFIs) are moving towards the market and are exposing themselves to a cut-throat competition in the name of lending to the poor. In the process they have started chasing targets and numbers. It seems that the social and developmental considerations, which have traditionally motivated microfinance, may have lost their importance as some MFIs have become radically commercial (Sriram, 2010). There are certain costs and benefits associated when a Microfinance NGO transforms to a Non-Bank Financial Company (NBFC). The charge against these MFIs who are transforming into NBFCs and now aspiring to make an initial public offering (IPO) is that they are enriching themselves and their shareholders at the cost of poor people. Therefore, this commercial success of microfinance sparks a eyebrow raising question of whether microfinance actually lead to sustainable development or are the MFIs drifting from the second objective of being socially sustainable in order to fulfill the first objective i.e. being financially viable. In our study we have taken account of the MFIs which are transforming into NBFCs and studied their mode of operation. Our study highlights the money laundering practices, sustainable investment or corporate governance issues, role of stakeholders in the process of transformation and discusses them from various ethical perspectives.*

**Keywords** *Microfinance, Business Ethics, Triple Bottom Line, Sustainability*

## INTRODUCTION

Microfinance has established itself as an integral part of financial sector policies of emerging and developing countries in the past decade. However, the high interest rates charged by micro financial institutions (MFIs) to maintain their operations' economic sustainability, has led critics to think that they are not being true to their social function and ethical content (Argandoña, 2006). Microfinance is one of the most ‘‘effective and flexible strategies'' in the fight against global poverty (Grameen Foundation). It should be and can be implemented on a large scale in order to respond to the urgent needs of the world's poorest, as it focuses on the moral consequences of financial exclusion (Hudon 2009). On the one hand, some studies suggest that the increased social outreach through transformation does not come at a zero cost. Woller (2002) argues that the transformation might lead to a possible ‘‘mission drift.'' On the other hand, there is no compelling evidence that the transformation leads to a mission drift among microfinance institutions (Voluntas, 2010). The charge against the MFIs who have taken the route to becoming non-banking financial companies (NBFCs) and are now aspiring to make an initial public offering (IPO) is that they are enriching themselves and their shareholders at the cost of poor people. Sensing the growth and profit opportunity, and given the low default rates, some NGOs – like SKS, Spandana, Asmitha, and Share – have transformed themselves into NBFCs, raising equity through private placements.

There are certain costs and benefits associated when a Microfinance NGO transforms to a Non-Bank Financial Company (NBFC). More specifically, how does organizational form affect a Microfinance Institution's ability to achieve success both by financial and social standards? It might also be the case that the pressure to become profitable might lead MFIs to target better off borrowers, offer fewer products and services, and therefore inadvertently lower their poverty impact. And thus somewhere the concept of ethics come to limelight. As it has been evident that the commercial model of microfinance in India, with its minimalist and standardised model of lending, would grow into a bubble and may face trouble, many MFIs have entered the market in search of profits and are competing to lend to the poor. In the process they keep the needs of the poor aside and have started chasing targets and numbers. For these institutions, as Sriram (2010), noted that the poor are not seen as human beings with individual identities rather they perceived as data points that add up in their profit statements. Some recent events in microfinance raise questions as to whether the commercial approach is dominating over the social approach which is gradually loosing its importance.

## MICROFINANCE: THE CURRENT SCENARIO AND CHALLENGES

The development of basic principle of microfinance is contributed by Muhamad Yunus, the founder of Grameen Bank in Bangladesh, and the recipient of the Nobel Peace Prize in 2006. He developed the concept of microfinance with the idea that credit is a fundamental human right. This concept guides the primary mission of microfinance which is, therefore, to help poor people in assisting themselves to

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become economically independent. With the objective of self-employment and for financing additional income generating activities, the credit or loan is given to the people who needed it. As the conventional banking system recognized the poor as not-credit worthy, microfinance stood as an alternative. Loan facility is provided based on the belief that the bank should approach the people rather the people will go to bank. Microcredit refers to programmes, originally and in many cases still donor or NGO sponsored, that primarily provide credit in tiny amounts for self-employment but also other financial and business services (including savings and technical assistance) to very poor persons, mainly women. Microcredit began in the early 1970s in Latin America with experimental programmes by NGOs like Opportunity International, and in Bangladesh in 1974 with the Grameen (village) banking programme.

Among the estimated at 10,000 plus global MFIs , there are those that have made the transition from solely NGO-funded programmes to self-sustaining independent financial institutions, with a variety of domestic and international funding sources. A few of these have become purely for-profit operations. Most still have some reliance on soft capital sources for their equity i.e. donors and socially responsible investment funds. Sources of funds for on-lending to borrowers include commercial bank loans, sometimes supported by donor guarantees, and for those licensed to take them, savings deposits. A few MFIs have been set-up from the beginning as commercial operations.

As shown in the table, penetration of microfinance among poor families worldwide varies greatly, with Asia far in advance of other regions.

Generally Indian Microfinance Segment has been divided into three segments. The first one is SHG bank linkage programme which is slow growing, informal and community based. the second one is the NGO MFIs and cooperatives characterized by moderately growing and not for profit and the last one is non banking finance companies (NBFCs) which is fast growing, regulated and commercial in nature . According to Reserve Bank of India, 2009 report, by 2008-09, the number of bank linked SHGs was around 45 lakh and the cumulative bank loans availed by SHGs is around Rs. 22000 crore. A report by CRISIL (2009) shows the top 50 MFIs claim an outreach of more than 1.2 crore clients and portfolio outstanding worth Rs. 7650 crore during September 2008. The top 10 MFIs (7 of which are NBFCs) account for 77 per cent of the portfolio and 75 per cent of the clients. CRISIL data shows that during 2007-08 Spandana Sphoorty Financial Ltd, the second largest MFI in the country increased its net profit by 1700 per cent, while SKS, the market leader, registered a rise in net profit by 700 per cent.

Data with reference to the Hindu, Kinetz (2012) reported that more than 200 poor, debt-ridden residents of Andhra Pradesh killed themselves in late 2010, according to media reports compiled by the State government. The State blamed microfinance companies which give small loans intended to lift up the very poor compelled the poor to be over-indebt, and then pressuring borrowers by stripping their utensils, furniture, mobile phones and other accessories what forced the borrowers to commit suicide. It follows huge number of suicide cases in many parts of the state. But the question arises how and why the crisis unraveled: First, MFIs were in a hurry to grow fast as most of the MFIs growth rate witness this. Second reason contributing to the crisis is that concept of self help group (SHG) was not properly being followed. SHG involves forming groups of 15-20 women, who meet regularly, understand each other's problems and are expected to save a small amount, keep the money in bank and earn interest. This concept was not properly followed and later on substituted by another option called the Joint Liability Group (JLG) method. Here the MFI's agents would persuade five members to form a group and each guaranteed the others' loans. Third, the MFI interest rates were non-transparent and effective rates often were over 27 per cent, considering loan processing fees, penalties and hidden charges. It is claimed by most MFI that they have lent for income-generating activities. But in reality, most lending has been for consumption purposes which is a main cause of encouragement of the indiscriminate lending and irresponsible borrowing

India, being the hub of Microfinance Institutions (MFIs) in the globe is facing a severe crisis. The sources and events leading up to the collapse are unclear. The collapse has been brewing since 2010, when questions concerning the unusually high profits from microfinance projects in India were analyzed. Regulators are now taking on a more serious role to address predatory lending and favoritism within the microfinance sector. The unethical practices have been compared to the predatory financial institution practices in the United States

**Table 1 Region**

| | Asia | Africa and Middle East | Latin America & Caribbean | Europe and NIS |
|---|---|---|---|---|
| Number of poorest families (million) | 157.8 | 61.5 | 12.1 | 3.5 |
| MFI outreach (Number of families) | 59.9 | 5.2 | 1.4 | .06 |
| % coverage | 38 | 8.5 | 11.6 | 1.7 |

Source: adapted from Figure 2, p26. "State of the Microcredit Summit Campaign Report 2005". Note: Poorest families defined as those living under $1 per day adjusted for PPP that have been credited with the economic downturn in the US, and consequentially globally. Not only microfinance be seen and operated as a business with high interest rates but also strict collection rules, brutal ways of dealing with clients are other issues that come to the limelight after the crisis. On October 15, the government of Andhra Pradesh issued an ordinance with an objective to protect women who "are being exploited by some MFIs through usurious interest rates and coercive means resulting in their impoverishment and in some cases leading to suicides.

## Dealing with Multiple Lending: an Ethical Challenge

Some of the microfinance institutions (MFIs) operate in the one geographical area and trying to reach out to the same set of poor. Thus in other words, they are competing among themselves which is resulting in multiple lending and overburdening of rural households. In order to expand aggressively, some of the MFIs have been blamed of poaching clients, thereby lowering their group mobilization costs. Although on financial terms, this sounds reasonable, but it vitiates the group building process. Many MFIs supported by banks were not promoting capacity building and empowerment of the groups to the desired and effective extent. The MFIs were disbursing loans to the newly formed groups within 10-15 days of their formation, in contrast to the practice obtaining in the SHG - Bank linkage programme which takes about 6-7 months for group formation / nurturing. Banks, as principal financiers of MFIs, do not appear to be engaging them with regard to their systems, practices and lending policies with a view to ensuring better transparency and adherence to best practices. With regard to MFI staff, Indian microfinance sector witnessing a very interesting pattern of crisis with problems like multiple lending, frauds, high levels of intentional default ,as reported by Arunachalam (2011). The staff frequently jumps from one MFI to other with an expectation or lure of promotion and career growth. These staff use their past knowledge and skills to enable new MFIs to lend to the older Joint liability groups (JLGs) or (SHGs) and this leads to multiple lending in the areas. They tell clients to not repay older MFIs and provide them fresh loans in higher amount from their new institution and thus set the trend for wrong or defaulting behavior by clients. This kind of behaviour by clients has been witnessed in some parts of southern India.

## Transformation from MFIs to NBFCs: Is Anything Going Wrong?

Worldwide, several NGO MFIs like Caja Los Andes, a microfinance organization in Bolivia have transformed themselves into 'for profit' regulated entities to achieve higher growth. In India also there are instances (like SKS) where the MFIs substantially increased their outreach and portfolio within a short span after transformation to NBFCs, by infusion of commercial capital from private equity funds. Most of the NGO MFIs had initial funds as grants to be revolved for further lending. The prime reason for the NGO MFIs to transform to a regulated entity is its potential to attract capital. Some of them gained large client outreach and became sustainable within a short span of time. However, to grow further and reach more number of poor they needed equity funds and access to debt funds. Commercial investors would not be ready to invest in entities that cannot share profits. This created a need for the 'not for profit' entities to transform their legal structure to a more regulated form suited for capital infusion. So the question comes whether they are able to achieve their dual objectives by transforming themselves or they are merely a for profit entity without fulfilling the social need.

## THE ETHICAL PERSPECTIVES

While recent evidence has raised major concerns in MFIs, with lots of ethical issues in various parts of the country, research in ethical issues in this sector beckon the researchers. Ethics is the discipline that studies the moral standards of a society. In the line of traditional ethical analysis given by (Velasquez, 2006), we can distinguish the ethical issues in microfinance sector into three kinds. Weber (2006) pointed out the impact of capitalism or neoliberal policy reforms on microfinance activities. Thus the first issue comes, which questions about the economic, social, legal and political system within which the MFIs emerges. As in developing countries there was a historical exclusion of credit and high rates of interest by informal sector, microfinance proponents started claiming to bring social benefits.

The second kind of issue is the behavioral issue i.e. the nature of pressure exerted by the credit officer to get the weekly installment of the borrowers. Regardless of the lending model, clients interact with their MFI through a loan officer or credit officer. Loan officers are the primary point of contact between an MFI and its clients. They are charged with loan promotion, credit analysis, loan approvals, loan management, and collection activities. Clients establish a credit relationship with their MFI through a single loan officer. The poor are driven to take their own lives because of their burden of debt and the brutal methods used in collecting the loans by these loan officers.

The third kind of ethical issue includes the organizational or institutional issue questioning the morality of organization, policies or structure of an enterprise as a whole. It is true that, a sense of respect have been earned from the society by MFIs over the decades by adhering to the social goal. However, with the passing of time, critical voices have also emerged on some of the features like joint liability. Many authors also give reasons against joint liability; for example, it raises free rider problems (Stiglitz and Weiss 1981), the fact that liability is accepted jointly may attract potential borrowers with a higher risk (adverse selection) and encourage higher risk behaviors (moral risk). It may also have another kind of effect called "domino effect" (Schreiner 2003), when non-payment by one member of the group induces the others to be a defaulter, if the liability they would incur is too burdensome. Other questionable aspects, such as the high interest rates charged by the MFIs have placed increasing emphasis on their operations, economic sustainability. This evidence leads to think that they were not being true to their social function and ethical content. A large part of the debate between people with two different mindsets (Institutionalist and Welfarist), is concerned with the high interest rates charged by the MFI (Cull et al, 2008). This raises three economic and ethical issues. The first one is whether these high rates justified, second one is what should be the interest rate stipulated for each operation and the third one is, as seems logical, a high interest rate discourages the poorest clients, does this give rise to a moral duty for the MFI? As it is assumed that moral hazard problems arise in MFIs because the financial institution cannot observe such returns and thus borrowers have incentives to pretend that their returns are low or default on their debt obligations. Most of these issues in microfinance are related to some strategy decision such as population targeted or the pricing. Thus these three categories of issues can be linked.

Three major arguments explain the ethical justification of microfinance. The first one is directly related to the poverty of those financially excluded by traditional financial institutions. A win-win approach as (Morduch, 1999) explains where both clients and institution benefited. The second argument is related to the financial product itself, credit. Contrary to grant or direct subsidies, credit involves compensation and therefore responsibility and dignity in the use of financial instruments. The third argument concerns additional financial margin gained with microfinance which can come from profit generated. This argument is based on the consequentialist approach for microfinance practitioner (Sinnott-Armstrong, 2006). Consequentialism deems whether an act is morally right on the sole basis of its consequence. It opposed to views concerned on the circumstance or the intrinsic nature of the act or anything that happen before the act. Here in microfinance, the usury law that fixes high interest rates to protect very poor citizen, regardless of the impact of the credit is against the consequentialism.

The two ethical dimensions of the conflict between the social approach of microfinance for which it actually stand and the commercial approach to which it adheres, reflect a long standing debate in ethics. Thus in ethical terms, it is the conflict between two ethical positions called the "ethics of conviction" and the "ethics of responsibility". The "ethics of conviction" proposed by Emmanuel Kant in 18th century is widely held even in the present context. He proposed that an action can be assessed only on the basis of the ethical principles, or the intentions, which it is intended to implement. The opposing position is the "ethics of responsibility" as proposed by Max Weber. It said that the ethically good actions are only those that can be expected on the basis of careful analysis and planning, to produce positive effects. These two philosophies clearly draw a line between the microfinance experts. There are people who takes the side of Yunus seem to adhere to the Kantian position, while the other group supports the commercial approach are much closer to Weberian position.

## The Triple Bottom-line Perspective

The notion of "Triple Bottom Line" (3BL) has become increasingly fashionable in management, consulting, investing, and NGO circles over the last few years. It defines an organization's ultimate worth in financial, social, and environmental terms. The idea behind the 3BL paradigm is that a firm's ultimate success or health can and should be measured not just by the traditional financial bottom line, but also by its social/ethical and environmental performance. In MFIs also the TBL approach helps in poverty alleviation through expanding services to include the very poor. MFIs that are concerned with their triple bottom line focus on the economic, social and environmental impacts of their clients' activities. A firm's social responsibility is defined as the list of obligations towards society and to its Stakeholders. These stakeholders are the owners, employees, trade unions, customers, suppliers, local community, society in general, regulatory authorities and government. We can define these obligations as the moral duties that are common to all individuals who perform actions and, therefore, incur moral and social responsibilities arising from such actions and the consequences for themselves and for others (Argandon˜a 2006). The main social function of a MFI is to provide intermediary services that facilitate the flow of savings towards investment (Argandon˜ a 1995, De la Cuesta-Gonza´ lez et al. 2006). MFIs that really want to contribute to sustainable development should prioritize the environmental dimension too. It has been seen that the micro and small entrepreneurs working in agriculture and other productive sectors potentially cause environmental damage or be exposed to hazardous working conditions. This can have consequences for developmental impact of MFIs. Donors, lenders and investors especially social investors pose more stringent criteria to MFIs are increasingly interested in the quality of the MFIs' loan portfolio. Due to this the MFIs should be transparent on their impact and contribution to sustainable development. . It has been recognised that incorporating environmental concerns into the heart of enterprise decision-making can result in significant economic and social dividends (Pallen, 1997). Allet (2011) proposes a new tool to measure the environmental performance of microfinance institutions called the Microfinance Environmental Performance Index (MEPI). This tool is based on management performance indicators that have been adapted to the specificities of the microfinance sector.

## Global Justice Theory and MFIs

Global justice theory is founded upon the moral and political claim that, in today's globalizing world, our duties and obligations to other persons extend beyond state borders. Two frontiers of the current theory and practice of global justice are poverty reduction and environmental sustainability. Although the high interest rates are sometimes being discussed and challenged inside the microfinance sector, the new and growing ethical inflection is currently coming from outsiders, these being the civil society or world of politics (Hudon, 2007). A number of people in developed countries have been convinced that they have an obligation to do something to change the morally arbitrary and unjust structures that affect the lives of people in developing countries. This also includes the objective to substantially increase the scale, outreach, and financial sustainability of microfinance institutions (MFIs). When applying Rawls' theory to the specific case of interest rates of microcredit to poor people in developing countries, it turns out that very high prices can lead to injustice in the system. A Rawlsian interpretation of the fairness of price is also unwieldy in terms of ethics (Hudon, 2006). Although there is not direct condemnation of prices in Rawls theory, nevertheless, even if prices are only secondary norms, high prices can lead to injustice in the system and thus unfair. Dehejia et al. (2005) found empirical evidence for this: the demand for credit by the poorest customers has been proven more sensitive to interest rate increases than for wealthier borrowers. Very high prices can thus also potentially entail moral consequences. In recent years, some MFIs have been able to substantially reduce and in some cases eliminate their reliance on grants and subsidized loans. Bolivia's Bancosol, the Bank Rakyat Indonesia, the Foundation for International Community Assistance (FINCA) in Uganda, and the Philippines' Centre for Agriculture and Rural Development (CARD) are some of the MFIs that have made a successful transition to financial sustainability through the adoption of commercial banking techniques. These examples are small in numbers compared to the global need for microfinance services, but they are operating at levels of efficiency and growth that were rare if not unheard of even five years ago.

## From the Perspective of Due Care Theory of Ethics

According to the Due Care theory, company or MFIs owe a caring responsibility to customers or clients SHGs and JLGs because customer interests are very susceptible to company purposes as the MFIs have knowledge about the scope of the financial products developed by them and ability to manipulate the market that customers do not have. As MFIs are in advantageous position compared to the clients, it is necessary for them to give warranty that customers' interests are protected by the service that they are offering. As the clients are dependent on MFIs ability, so not only it is necessary for the MFIs to give the appropriate services to the clients with they claim to give, but also be careful about the service design, delivery process and selection of the employee providing the service. Moreover, this makes it necessary on the part of organization to take care of the holistic well being of the clients by being conscious and cautious while lending to the clients of the issue of greediness of becoming rich within a short span of time and force them to borrow from multiple agencies beyond their capacity of repaying and ultimately fall in a debt trap and become further poor than their present status.

# SUGGESTIONS: POSSIBLE WAYS TO DEAL WITH SUCH ISSUES

As part of their core business, MFIs can also work on improving their social performance results. Thus it is highly demanding to measure the triple bottom line performance and issuing public reports on their policies, management and achievements. As it has already mentioned that firm's Corporate Social Responsibility (CSR) is the obligations to stakeholders. These obligations must take into account the firm as an economic institution bounded by a certain social duties. Therefore, a firm's CSR will have the generic moral and social content with some social functions like satisfaction of community needs, value creation, job creation, the human development of its stakeholders, etc (Argandona, 2006). As far as the MFI are concerned, the various social functions include evaluating and managing the borrower's risk which accounts the problem of adverse selection; ensuring that the borrower uses the loan prudently, so as to maximize the probability of repayment which deals with the problem of moral hazard as discussed earlier. Monitoring the success of the borrower's project contributes the auditing problem. Enforcing loan repayment when the borrower attempts to default deals is another social function. These actions not only contribute to economic growth but also the alleviation of poverty and the welfare of society.

Various social performance indicators have been developed by different agencies. The Imp-Act Consortium defined Social Performance Management (SPM) as a way of translating organization's mission into practice, setting social objectives, tracking social performance and further to improve practice by using information. They developed the Social Performance Management (SPM) framework which checks the strategic fit between mission, strategies and outcomes. So the tools and methods that can be used by MFIs to pursue their social mission have to be given more importance and need to develop more technically. It is believed that MFIs will be more successful in achieving their social goals if they can measure, monitor, and manage these processes more effectively. The MFIs can benefit by adopting these strategies which allow them to protect and enhance their reputation. It also helps them attract, motivate, and retain talent, manage and mitigate risk, improve operational and cost efficiency. As a result they can develop new business opportunities and build stable and prosperous operating environments.

The MFIs can promote and improve the internal and external dialogue on the organisation's mission, goals and performance. Through this process different parties or stakeholders are interviewed on their views regarding the organisation's goals and impact regarding key economic, social and environmental issues. The decision-makers within the MFIs are engaged through strategic meetings and thus will come with a final approval. Finally, the MFI management presents the final report of the approval to the employees and other stakeholders.

These indicators include not only the traditional social indicators such as "outreach to the poor" but also the triple bottom-line social responsibility to clients.

It has been argued that the group lending methodology can potentially mitigate moral hazard problems. Moral hazard problems arise from the fact that financial institution unable to monitor the borrowers effectively and thus cannot write a convincing contract that enforces sensible behaviour. Stiglitz (1990) explains that under group lending methodology, group members agree to accept a monetary penalty in the case of default by a peer. The group members can also have to monitor each other, and can potentially threaten to impose ''social sanctions'' when subjected to a risky project. As Grameen model prescribed the Group lending with joint responsibility can however lower the incidence of strategic default when project returns can be observed by the borrowers' neighbors. Thus on the fear of suffering from social sanctions, borrowers will declare their true return and repay their debt obligation (De Maghion and Murdoch, 2005). The debate on microfinance services pricing policy is not only about ethics. It is also pragmatically crucial since each of the parties will always be at risk for the success of the transaction by the actions of the other one. The feeling of fairness, even if irrational, can play a major role in such a transaction. In the case of lending, if the client does not consider the interest rate policy fair, he or she could well choose not to repay.

As far as the behavior of staff is concerned, there is a need for a proactive strategy in hiring the staff. There is need for a thorough background check where applicant's earlier work profile has to be cross checked. Apart from this requisite training for the job is also demanding. Through training the staff can understand the mission of micro-finance which can drive growth, scale and profits of the organization. Socializing new staff regarding their interaction with clients at different steps of delivering the service is another issue to take care of. The level of frustration among many genuine staff in MFIs is very high. So keeping that in mind, an effective grievance handling procedure is also required which enables the employees faced with such situation to voice theirconcerns to the appropriate authority in the organization..

## CONCLUSION

So to combat the battle against the ethical issues in microfinance, these are some of the issues that the regulators, industry associations, MFIs and other stakeholders must focus on and attempt to redress immediately through various mechanisms. Thus it is imperative for the Indian micro-finance industry to start looking inward and to address immediately the prevalent human resource problems as well as the ethical issues. Until that is done, neither can the objective of triple bottom line nor client protection nor responsible micro-finance is achieved in any significant measure.

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