CONFESSIONS OF A MICROFINANCE HERETIC

How Microlending Lost Its Way and Betrayed the Poor

HUGH SINCLAIR

Foreword by DAVID KORTEN, author of *When Corporations Rule the World*

An Excerpt From

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Foreword

By David Korten

Confessions of a Microfinance Heretic provides an insightful, well-documented, and devastating look into the tragic reality of how a good idea was derailed by the same mindless pursuit of financial gain that caused the global financial crash of 2008. It is essential reading for anyone involved in microcredit and for all who are committed to ending global poverty and injustice.

For some twenty years we have heard the story that microcredit is the cure for global poverty:

An amazing visionary economist in Bangladesh named Mohammed Yunus founded the Grameen Bank and demonstrated a simple, effective way to end world poverty. Small, low-cost loans to the poor unleash their entrepreneurial potential and allow them to start profitable businesses that bring prosperity to themselves, their children, and their communities.

It is a win–win solution that doesn't require charity, redistribution, rethinking economic policy, or restructuring existing economic institutions and relationships. Global investments of a few billion dollars can earn an attractive financial return for socially responsible investors and simultaneously banish the scourge of poverty.

That's the widely received story. The reality that Hugh Sinclair documents in this book presents a very different picture.

Too Good to Be True

Microfinance is now a $70 billion industry and some investors and microfinance institutions enjoy eye-popping returns. The industry falls far short, however, of fulfilling its promise to end poverty. Indeed, as Hugh Sinclair spells out in detail, many microcredit programs are nothing more than predatory lending schemes rebranded as socially responsible investment opportunities.

There are effective microcredit programs. Sinclair describes one in Mongolia that truly serves the poor with low-cost loans used to fund successful microbusinesses. Tragically, these may be more the exception than the norm.

I lived and worked in Asia from 1978 to 1992 as part of the foreign aid establishment. During this time I regularly served as a consultant to several Bangladeshi nongovernmental organizations (NGOs) that were pioneering microfinance along with other innovative programs serving the poor. Two that I particularly admired at the time as world-class models of positive NGO leadership are now major players in the international microfinance industry.

Even back in the 1980s, I was concerned that microlending programs could draw energy away from efforts by these same NGOs to address the deeper structural causes of poverty. I also worried that such programs might leave the poor even more dependent on financial institutions over which they had no control.

The microfinance industry Sinclair documents has been corrupted far beyond my worst fears.

Our Human Capacity for Self-Deception

Sinclair predicts that microfinance insiders will seek to discredit him and use vicious attacks to dismiss his conclusions. I urge those who may feel persuaded by these attacks to bear in mind what Nobel Prize winner Muhammad Yunus said in a 2011 *New York Times* op-ed. He noted that when he founded Grameen Bank in Bangladesh in 1983, "I never imagined that one day microcredit would give rise to its own breed of loan sharks. But it has."

Some of those responsible for the corruption of a noble idea may be true scoundrels. Several of the organizations Sinclair implicates in this

volume, however, are led by individuals I have known personally as people of admirable ability, ethics, and intention.

Sinclair's insightful assessment of how even the industry's most honest and respected leaders become trapped by the imperatives and self-justifying stories of the institutions they head is an important contribution of *Confessions*.

I can relate to their experience. I worked in various capacities with and within the foreign aid system for some thirty years—rarely questioning its basic premise. It was little more than two months after leaving my post with USAID as Asia Regional Advisor on Development Management that a fresh insight hit me. Foreign aid, as practiced, is almost inherently destructive, because it increases the dependence of poor countries on the goods, technologies, markets, finance, and expertise of rich countries and leaves them exposed to classical colonial exploitation in a new guise.

It is hard to see the truth of a system on which your pay and prestige depend.

Follow the Money

To my surprise and shock, I once heard a microlending advocate make the amazing claim that high interest rates are a rich people's concern. They don't matter to the poor. To benefit the poor, microcredit need only offer lower interest rates than local money lenders.

Those who work in microfinance commonly view the system from the perspective of the investor rather than that of the community and thereby lose sight of the bigger picture. Tara Thiagarajan, chairperson of Madura Micro Finance, a for-profit microcredit program in India, is an all-too-rare exception—as revealed in her insightful May 2, 2010, blog:

> The local moneylender … may charge a higher interest rate, but being local will probably spend most of that income in the village supporting the overall village economy. So potentially, local lending at higher rates could be more beneficial to the village if the money is in turn spent in the village, compared to lower rates where the money leaves the village.

Suppose that a microloan extended by an outside agency actually supports an increase in village production. To cover the net outflow of rupees required to make loan payments, the village must sell to outsiders more of what it produces just to get rupees that immediately flow back out as loan payments. At the usurious interest rates often involved, this can result in a substantial net loss. When the loan does not contribute to an increase in productive output, which Sinclair notes is the most common case, the net rate of outflow of both real wealth and rupees is even greater. The same dynamic plays out at national and global levels.

Suppose that an investor in the United States invests in one of the microcredit programs in India described by Sinclair. The investor provides loan or equity financing in U.S. dollars and expects payment of interest and dividends in U.S. dollars. The transaction between microlender and borrower in India, however, is in Indian rupees. The invested dollars are exchanged for rupees in the foreign exchange market and become part of India's foreign exchange pool. The rich who need foreign exchange to buy things abroad get the dollars. The poor microloan borrowers get the rupees.

Interest on the rupee microloan flows quickly back out of the village in rupees to the national microfinance institution. A portion of that outflow is then converted to dollars that go to the U.S. investor abroad. This creates a negative drain on India's foreign exchange reserves that, given the rates of interest and profit Sinclair documents, may add up to several times the original investment dollar inflow. To pay this dollar obligation, India must produce goods and services for sale abroad. Or it may sell or mortgage assets to foreigners, creating additional future claims against its production and real assets.

In return for a short-term inflow of credit, the village and India as a country bind themselves to a long-term outflow of claims on their wealth—supporting a classic pattern of colonization and wealth concentration beneficial only to foreign interests and their local accomplices.

Grameen Is a Bank

The key to fixing microfinance is to recognize the critical differences between the Grameen Bank and the vast majority of microcredit institutions that claim to be its replicas.

- Grameen is similar to what Sinclair calls a "regular" bank. Its lending is mostly self-funded by local deposits in Bangladesh's national currency, the taka.
- Grameen offers depository services with generous interest rates designed to help its members build a financial asset base.
- Grameen extends loans to its members at a maximum interest rate of just over 20 percent, a fraction of what many other microlenders charge.
- Owned by its member savers and borrowers, Grameen is rooted in and accountable to the community it serves. Profits and interest continuously recycle locally to support productive local exchange and build real community wealth.

Grameen has its flaws, as does every institution, but it is designed to be locally accountable and to build rather than expropriate community wealth.

Most of the microcredit programs that claim to replicate the Grameen model resemble it only in the fact that they make loans to poor people. They are not "real" banks with regular depository services. They are not owned by their borrowers. Some charge interest rates of more than 100 percent. Interest and profits are siphoned off by distant managers and foreign investors rather than recycling within the community. Whether on Wall Street or in the villages of India, control of money by distant financiers rewarded for seeking maximum personal financial gain is a path to outsized wealth and power for the few and debt slavery for the many.

Even member/owner accountable banks that lend at reasonable rates are not a magic-bullet solution to poverty. Grameen Bank, however, demonstrates that they can be one useful tool.

It is time to rethink and restructure the microfinance industry in ways that take the best of the Grameen model seriously. Instead of restructuring microfinance institutions into publicly traded for-profits that sell shares to foreign investors, the goal should be to restructure them as cooperative banks owned by their local borrowers and funded in their national currency.

This model will not generate profits for foreign investors. That, however, was never a proper purpose of microfinance.

Preface

The microfinance community often resembles a religious cult. Criticism is considered heresy and is not tolerated. Impact on poverty is dogmatically claimed but demonstrated in only exceptional cases. Above all, the sector is highly profitable, and the origin of this profit is simple: the poor.

Criticizing microfinance thus antagonizes those who have power and money at stake—the owners of the microfinance institutions (MFIs) and those who control their funding. The goal of my heretical act in writing this book is to shed light on the actual practices of the microfinance sector and to prompt changes that will skew the odds slightly in favor of the poor.

I tried to influence microfinance from within, during a decade of work in the sector across three continents and in a number of institutions. I tried logic and reason first, but that strategy failed. I pointed out the immorality of exploiting the poor, but this argument was ignored. Good, honest, hard-working microfinance practitioners were gradually replaced with unscrupulous players with a simple motivation: profit. This was disguised as a beneficial development, with coordinated publicity and attendant hype. Naïve celebrities were employed for PR purposes, and large commercial banks soon realized that there was a whole new client group to profit from.

Unfortunately, only negative publicity seemed to actually shake people

into corrective action, albeit begrudgingly. Slowly the popular press became aware of some of the atrocities and touted them as typifying the sector, which was not necessarily accurate; but such is the tendency of journalists seeking a scoop. Specialized academic texts questioning the validity of the claims of the microfinance sector do exist, but they are mostly technical, dry, and inaccessible to the average reader. The book you hold in your hands attempts to bridge this gap.

I have attempted to go beyond the dinner table description of microfinance and explain how the various players in the sector operate *in practice*, without venturing into excessive technicality. I use the decade in which I worked in microfinance as a backdrop. This decade coincided with the adolescence of microfinance, which before 2002 was a somewhat obscure niche of the financial sector. It is now a $70 billion business and is featured on *The Simpsons*.

I beg the reader to not throw out the baby with the bathwater. Some microfinance is extremely beneficial to the poor, but it is not the miracle cure that its publicists would have you believe. Microfinance has been hijacked by profiteers, and we need to reclaim it for the poor. The problem is not with a few rogue operators, alas, but with systemic flaws that permeate the sector. I offer no easy solutions to fix this problem, but the first step is to acknowledge it and identify its causes. In the concluding chapter I offer the reader some tangible suggestions as to how best maneuver within the microfinance sector.

We need to develop microfinance 2.0—a model that takes the lessons of the last decades and applies them cautiously and prudently to the benefit of the poor. Making modest profit from a well-run, competitive MFI is not unethical. Making millions of dollars for a few individuals by charging eye-watering interest rates to vulnerable poor women who cannot read the loan contracts they sign with a fingerprint is unethical. Expecting a client to repay a loan is reasonable. Hounding a delinquent client unable to repay her loan to the point of suicide is not. Claiming miraculous results with scant evidence is optimistic at best, and more likely deceptive. Rigorous research by independent, qualified academics and practitioners on the actual impact of microfinance on the poor is the only way we will gather the data to understand what is actually happening and how we can improve.

Microfinance 2.0 needs to be evidence-based and to balance fair returns with a focus on positive impact. There is no room for exploitative greed in such a model. Microfinance 2.0 will therefore require a culling of the less scrupulous players, who will not go without a fight. Were the substantial sums of capital currently deployed in the microfinance sector wisely applied, we could have a far greater impact on poverty. Instead, we have settled for a poor substitute that enriches a few while enslaving many with debts they can barely afford to service, let alone benefit from. We can do better.

The current state of the microfinance sector is simply unacceptable. The time for playing ball with those responsible for this deception has now ended, and I urge others who retain any faith in microfinance to do likewise. Microfinance 2.0 cannot be created by individuals, but must be reconstructed collectively. This book is therefore a call to action.

I have worked in microfinance for ten years. Since 2008 I have limited my work to ethical, genuine microfinance operators, and my client list is correspondingly short. Prior to this I was an insider, though one with ever increasing skepticism. I must therefore acknowledge my own role in the rise of microfinance. But to become a whistle-blower, or a heretic, one must first have been a member of the cult. Only by working in these institutions, with many of the people mentioned in this book, was I able to see what was actually taking place.

I remain convinced that well-designed, targeted microfinance to a subset of the poor can have a positive impact. Microfinance is not suitable for all poor people, and it needs to complement rather than replace other development strategies. Mohammed Yunus set out with a grand vision to eradicate poverty with fairly priced microfinance loans provided by institutions whose goal was to reduce poverty. But there was a problem with the implementation of his vision—most MFIs do not offer fairly priced loans and do not aim to achieve this goal. They have a myriad of excuses to justify this, but the outcome is the same.

This book is aimed at those with a general interest in microfinance; industry insiders; those who invest in microfinance via websites or dedicated microfinance funds; celebrities who may have supported the sector with less than a thorough understanding of what they were actually supporting; regulators who are charged with protecting the interests of

the poor and those of the investors in microfinance; and the broader development community.

To respect the privacy of those individuals appearing in the book who are not public figures, I have changed the names of most persons named in these pages. The exceptions are senior figures and executives in the world of microfinance: the names of these individuals have an asterisk on their first appearance, signifying the use of their actual names.

Emails and documents referred to or quoted from will be available on the book's website with footnotes inserted in the text where appropriate. Links to websites will be relegated to footnotes and also placed on the book website. Where incriminating websites have been subsequently removed, the original screenshots will be uploaded. One audio recording is reproduced in full in the text and will be available to listen to on the website. A second audio recording is produced only partially in the text due to its length, but the full audio recording and transcript will be available on the website. Dialogue from a hearing of the U.S. Subcommittee on International Monetary Policy and Trade is transcribed directly from the video footage available online.

For all other conversations and dialogue where a recording is not available, I have reproduced these as accurately as possible, but these should *not* be considered as verbatim. I apologize for the abundance of endnotes, but given the magnitude of the claims and accounts of events that take place here, a rigorous approach to qualifying such comments is prudent. The interested (or astonished) reader can verify the sources at will. Most information is already publicly available, and the rest soon will be; see www.microfinancetransparency.com.

Those with nothing to hide have nothing to fear.

1

Thou Shalt Not Criticize Microfinance

"I'm a dodgy moneylender, exploiting the poor with useless, overpriced loans, ideally obliging their children into forced labor in the process."

This did not go down well. I had been introduced to yet another gathering of bright-eyed microfinance experts at yet another microfinance conference, and I had incorrectly assumed that irony and sarcasm were within their grasp. They were not. I attempted to redeem myself.

"Guys, I'm joking … it was a joke. I'm a microfinance consultant, we're all cool … sorry."

I had broken the golden rule of microfinance, the unwritten code that bonds its practitioners together. I had criticized microfinance and, perhaps worse, I had implicitly challenged the developmental claims the sector proclaims so vehemently. This is unacceptable from an insider. But none of the experts offered a defense or rebuked my confession. Such comments cut a little too close to the nerve to warrant further conversation. It is usually better to discuss the weather or the palatial décor of the conference rooms instead.

Lack of tact had once again led me into an awkward situation, but it could have been worse. Twice I have narrowly avoided being punched in conferences for daring to suggest that microfinance was in fact falling a little short of miraculous.

There is actually surprisingly little evidence supporting microfinance

as a practical tool of poverty reduction, but this rather critical detail is ignored within the microfinance sector for one simple reason. Microfinance does not apparently require evidence to prove it works—since, on the face of it, it seems to work. It works because the poor repay loans, and this is all the proof the sector requires. Some 200 million people now receive microfinance loans,[1] most of whom repay the loans. Therefore they miraculously became better off in the process. So the argument goes.

The majority of credit card holders in the U.S. and Europe pay their bills eventually, so therefore they too are becoming wealthier by the day thanks to Visa, MasterCard, and American Express. The argument is no more complex than this. The fact that a large proportion of these microloans are used for consumption, or to repay other loans, or to pay off the evil village moneylender, is irrelevant.

The fact that crippling poverty persists in countries like Bangladesh, India, Nicaragua, Nigeria, and Bolivia is seen as an irrelevant detail. The persistence of poverty means that we need *more* microfinance. When Indian women started poisoning themselves under the burden and shame of chronic overindebtedness, or when the citizens of an entire country refused to repay their microfinance loans claiming unfair treatment, those who provided the loans remained silent or claimed thathild it all had nothing to do with them.

Many people do rather well out of microfinance, and celebrities from Bono to the Clintons, President Fox of Mexico, and the Queen of Spain have jumped on the bandwagon. The sector is of course extremely proud of its Nobel Peace Prize–winning godfather, Muhammad Yunus.* Yunus had embarked on a courageous mission to rid the world of poverty using fairly priced microloans to entrepreneurs. Alas, those charged with achieving this globally had a slightly different vision. Even Yunus himself has criticized the microfinance sector for the extortionate interest rates some microfinance institutions (MFIs) charged, accusing such institutions of becoming precisely the loan sharks that microfinance had initially sought to replace. Yunus's flagship institution, Grameen Bank, with whom he shared the Nobel Peace Prize, charges interest rates of about 20 percent[2]—enough to make any mortgage-holder in the developed world weep, but actually very reasonable in the microfinance world. The fact that Grameen Foundation USA had inadvertently supported and invested

in at least one bank that charged rates six or seven times higher has been largely ignored.[3]

Microfinance is a $70 billion industry, employing tens of thousands of people, predominantly managed by a closed group of funds based in the U.S. and Europe acting as gatekeepers of the private capital available, and increasingly some of the public funding as well. The industry is largely unregulated, opaque, and hard to investigate in practice. A tireless PR machine recruits spokespeople, advertises on television, and holds endless promotional events. An almost cultlike aura surrounds the sector. Insiders are expected to toe the party line. It's to all of our advantage to belong to such an epistemic community with a common set of broadly held beliefs.

The cracks started appearing when Compartamos, a Mexican MFI, did the first big stock market flotation of a supposedly "social" bank, netting a tidy $410 million for a handful of lucky investors, financed in large part by ridiculously high interest rates that the poor seemed bizarrely happy to pay. A few maverick academics had been trying to sound the alarm for some years, and some insiders began to question the fundamentals of pumping credit into mostly ineffective "businesses" at suspiciously high prices. But as with all nascent bubbles, promoters perpetuated the hype. Compartamos had woken people up to the fact that it was not merely a fringe of the poor who would reliably pay interest rates of 100 percent or more for a loan of $200, but hundreds of millions of them—the profit potential was massive. Forget sub-prime—sub-sub-sub-prime was way better, and what's more, there were few pesky regulators to keep an eye on such inconveniences as consumer protection. A new gold rush began.

The Department for International Development (DFID, the UK equivalent of USAID), a traditional supporter and investor in microfinance, funded a major study of the research surrounding microfinance and concluded that the entire exercise had been mostly ineffective:

> [I]t might have been more beneficial to explore alternative interventions that could have better benefitted poor people and/or empowered women. Microfinance activities and finance have absorbed a significant proportion of development resources, both in terms of finances

> and people. Microfinance activities are highly attractive, not only to the development industry but also to mainstream financial and business interests with little interest in poverty reduction or empowerment of women.... There are many other candidate sectors for development activity which may have been relatively disadvantaged by ill-founded enthusiasm for microfinance.
>
> However, it remains unclear under what circumstances, and for whom, microfinance has been and could be of real, rather than imagined, benefit to poor people... Indeed there may be something to be said for the idea that this current enthusiasm is built on similar foundations of sand to those on which we suggest the microfinance phenomenon has been based.[4]

While I do not refute the findings of this important report, I equally cannot refute the evidence I have seen with my own eyes: that *some* microfinance is very beneficial to the poor. I hope to explain how this dichotomy of opinions arises within the microfinance sector.

I stumbled into the microfinance sector in 2002. Initially I shared the naïve belief that microfinance was "the next big thing" and could genuinely assist the poor. The initial signs looked promising to an untrained eye, and I joined the club in promoting the panacea of microfinance.

The underlying concept of microfinance sounds so seductive. Ask a microfinance expert what microfinance is and they will recount a heartwarming tale of a woman living in a hut in some poor country who gets a minuscule loan to buy a productive asset, often a sewing machine or a goat,[5] and by working hard she builds up a small business that receives successively larger loans until she is eventually catapulted out of poverty. Depending on the creative flair of the storyteller, the loans may also lead to amazing benefits to her children and community, and phrases like "female empowerment," "human dignity," and "harnessing entrepreneurial flair" will be slipped in periodically.

This concept appeals to people in the "developed" world, many of whom are increasingly skeptical of simply handing money to traditional charities after apparently so few results of decades of this practice. Helping people to help themselves appears more compatible with the ethos of

developed countries: hard work and ambition, competition, and developing new markets. The heroes of the NASDAQ are the pioneers who take a simple idea and propel it to become a huge multinational business—why not in developing countries also, on a smaller scale?

Microfinance touches on the core values of entrepreneurial vision, of teaching a man how to fish rather than handing him a fish on a plate. It appears to be such an excellent idea. Capital is loaned, invested wisely, recycled to the next wave of poor people, investors in Geneva and Washington make a reasonable return in the process, and soon poverty vanishes altogether. It appeals to the positive aspects of capitalism and economic development, and it leverages the positive desire to work hard and provide for one's family. Everyone's a winner. So how dare anyone ever criticize it?

The problems with these crass descriptions of microfinance blurted out at dinner parties by zealous microfinance experts are numerous. Insiders are conditioned to reel them off automatically, but many privately agree they are mostly fantasies. But the fantasy is more palatable than to admit to having negligible impact while charging high interest rates to the poor. We promote an end to poverty if only the poor would take out a never-ending series of overpriced loans.

To cite a selection of the flaws of the romanticized image of the female microfinance client living in the hut with the sewing machine:

1. Such cases are surprisingly hard to find in practice. Men often send their wives to get loans because they know they are more likely to be approved.
2. Loans are almost invariably not spent on the productive sewing machine or goat, but on a TV, repaying another loan to a very similar bank, paying other bills, or general consumption. The benefits of the loan quickly disappear, but the debt remains, accumulating interest at an alarming rate, often encouraging the client to obtain another loan elsewhere to meet the repayments, often from the very moneylenders the microfinance community claims to replace.
3. Interest rates on loans, when all the various hidden charges are considered, are substantially higher than those stated. Interest rates under 30 percent a year are disappointingly rare, and rates of 100

percent or higher are common. One celebrated MFI in Mexico charges up to 195 percent per year.[6]

4. The small business is rarely able to generate sufficiently massive returns over prolonged periods to cover these interest payments. And even if the loan does result in some genuine improvement to the life of the individual entrepreneur, it is quite possible that this is at the expense of other people in the marketplace. When Walmart opens in a town in America, many smaller shops are driven out of business. According to the microfinance sector this phenomenon does not occur in developing countries. We ignore the businesses that fail.
5. The number of people catapulted out of poverty is minimal, and no widespread measurable reduction in overall poverty has been detected. At best, a few individuals see their situations improve, and these lucky few provide the examples for MFI marketing materials. The real debate about actual poverty reduction fluctuates between it being marginal or negative. Serious belief in Muhammad Yunus's suggestion that poverty will be eradicated from the planet and become a historical curiosity in "poverty museums" within a generation or two is hard to find in practice.
6. It is assumed that every poor person is a budding Bill Gates. A quick glance at the overwhelming majority of businesses that receive microloans hardly suggests cutting-edge innovation—most market traders sell precisely the same products as everyone else in the marketplace. Not everyone in Europe or the USA is a budding entrepreneur, so why would we expect anything different in developing countries?
7. The use of child labor is a carefully avoided question. The reality is that many families involved in labor-intensive micro-enterprises employ their own children, and no one knows the impact of such labor in the long term. As universal education becomes a reality in more and more countries each year, particularly in Latin America, it is likely that some of these children are stacking shelves or selling cellphone cards at the expense of getting an education. Conveniently, few microfinance banks and only one microfinance fund have policies on child labor.[7] The self-regulatory watchdogs

carefully avoid discussion of child labor in their "Client Protection Principles."

8. Most microfinance clients are not part of the "extreme poor." In fact, quite a few are perhaps best described as lower middle class, and while it is a pity that commercial banks will not lend them money on reasonable terms, it does not follow that an MFI offering them a loan at 60 percent interest per year to buy a TV is necessarily contributing to development.
9. The clients of most MFIs are not generally covered by the regulatory protection afforded to people in more developed countries.
10. When joining groups of borrowers who guarantee one another, one rather unpleasant downside is overlooked for the defaulting client—not only do they incur the wrath of the MFI, which can be quite oppressive, but they also lose their friends, who are obliged to step in and meet the shortfall.

This list of valid questions to challenge the stereotypical microfinance loan is far from exhaustive. In response, the sector is slowly acknowledging that it overhyped microfinance, and that expectations of the imminent eradication of poverty were perhaps optimistic. But the machine has been set in motion. Large commercial banks have entered the sector, lured by the whiff of profit and the appearance of social responsibility. Universities now offer courses in microfinance. There are microfinance MBAs. There are even microfinance T-shirts. (See the appendix, "Microfinance Economics 101," for a quick review, and a critique, of the fundamentals of microfinance theory.)

My concerns about microfinance took a decade to develop and involved extensive travel across the globe, working with many of the key players and seeing microfinance in action (for better or worse) from a variety of perspectives. I drifted into the sector after prematurely finding myself unemployed two weeks after joining the ill-fated Enron. Disillusioned with mainstream finance, microfinance seemed to be an interesting, and perhaps more constructive, way to deploy a finance background. I thus packed my bags and headed to Mexico full of optimism. As cracks began to appear in the overall microfinance model, I initially assumed that they were exceptions, teething problems, or temporary blips. But

the cracks did not vanish, and as the sector matured (if that is the right word), the propaganda machine worked overtime to disguise rather than repair them.

There do exist cases where microfinance is genuinely benefitting the poor, but in my experience these are few and far between. Accepted wisdom has come to believe that access to microfinance is a necessary step in the direction of development. We have managed to create a buzz around the very word *microfinance* that attracts volunteers, the media, and celebrities. Muhammad Yunus goes as far as to suggest that access to microfinance is a human right.

According to the generally accepted belief, the recent financial crisis was caused by reckless bankers designing esoteric and complex financial products, and providing loans to people who perhaps should not have bought a $1 million home in the first place. Entire European nations racked up debts of astronomical proportions. People began defaulting on their loans, governments could no longer service their debts, and the house of cards began to collapse, necessitating the mother of all bailouts that generations to come will have to repay. Meanwhile, MFIs across the developing countries continued to hand out ever more over-priced loans to the poor, and many of the investors in these MFIs managed to get a tax credit for such behavior since these were considered *ethical* investments.

A few hiccups along the way were covered up, but dissenting voices began to raise concerns. Some simply quit the sector entirely. A few funds closed the doors to further microfinance investments. The first country to spectacularly and publicly collapse was Nicaragua (previous collapses had been less public, such as Bolivia in 1999/2000). This raised some concerns, and cost the microfinance funds in Europe and the USA some painful losses. Never mind—it wasn't their money in the first place, and the collapse was blamed largely on "the populist government." Critical documentaries and books began to emerge, and then scandals involving the darling of the sector, Grameen Bank, finally hit the mainstream press.

With the benefit of hindsight most calamities can be avoided, but to understand the crisis in microfinance, we must look beyond the propaganda. Histories of the microfinance sector do exist, and they are generally pretty dry texts. The public impression that microfinance was in-

vented by Muhammad Yunus in some Bangladeshi village in the 1970s is probably the industry's foundational myth.

During the colonization of Indonesia in the early nineteenth century the Dutch developed a system of financial services across the sprawling colony that bore a striking resemblance to the current microfinance sector. Bank Rakyat Indonesia (BRI) was formally founded in 1895, and to this day BRI is one of the world's largest, if not the largest, microfinance banks.[8]

Wilhelm Raiffeisen founded a credit union in 1864 specifically to provide affordable credit to farmers who otherwise relied on exploitative moneylenders for credit. In Quebec, Alphonse and Dorimène Desjardins founded a credit union in 1900, a forerunner to the North American credit unions, again in response to high interest rates. Desjardins Group remains active in microfinance to this day. Although many current microfinance operators have limited pedigree, Accion was founded in 1961 and began microfinance operations in Brazil in 1973. ShoreBank International was launched in 1988. It largely depends on how we define microfinance, but it is likely that some form of small lending activities predated even the Raiffeisen model.

Yunus was certainly a pivotal pioneer in the sector. He provided the sector with an iconic figurehead from a poor and downtrodden country. By the end of the twentieth century, microfinance was sandwiched awkwardly between the traditional development sector and the formal financial sector. It was the unwanted child of each. Many development specialists were skeptical of a practice so overtly commercial and capitalistic in nature. Bankers were skeptical of a practice that focused exclusively on poor people without collateral.

Early applications of microfinance beginning in the 1970s had yielded some positive results, and practitioners began to dream of it becoming a key tool in the eradication of poverty. There was certainly some profit to be made from microfinance for those who provided the original capital if the banks could reach a sufficient scale. It would require public acceptance to propel microfinance from the fringes of development and finance to the forefront of the battle against poverty. The microfinance strategy also fit well with a general disillusionment with traditional aid sectors. Unleashing entrepreneurial flair was a more attractive proposal

than handing out free food. Bono summarized this succinctly: "Give a man a fish, he'll eat for a day. Give a woman microcredit, she, her husband, her children and her extended family will eat for a lifetime."[9] The general public was ready for a new approach to development.

Thus after extensive campaigning, the UN declared 2005 as the year of microcredit, and the following year it gained its ambassador. Muhammad Yunus received the Nobel Peace Prize, and microfinance stepped onto the main stage. It was now firmly acknowledged as a principal tool for development. Accelerated growth began, hugely profitable stock market flotations were launched, and microfinance became a household name. Presidents and rock stars opened conferences; specialist investment funds began sprouting up like mushrooms; universities began offering courses in microfinance; and the television messages of the "new cure for poverty" were beamed into living rooms across the planet. But by 2011 Muhammad Yunus had been unfairly fired from Grameen Bank under political pressure, the sector was facing widespread criticism in the media, microfinance clients in India were committing suicide by the dozen under the pressure of massive accumulated debt, and the sector was attempting to reinvent itself.

Was Muhammad Yunus's original dream flawed, or had the sector morphed into an entirely different beast that now faced a serious challenge? When did the crisis start?

I realized the magnitude of the crisis permeating the sector in 2009 when I received a call from the managing director of Deutsche Bank asking me to cease my criticisms of microfinance. I had been raising some awkward questions about a particularly questionable microfinance bank in Africa that appeared to be making incredible profits by exploiting the poor with extremely high interest rates. It had attracted some of the largest investors in the entire sector, including Deutsche Bank, many of whom claimed to be ignorant of the MFI's underlying activities.

Senior people in the sector had invested in the African MFI in question, and they were now appealing to me to keep quiet. I had visited this bank extensively, and I had seen the poor women struggling to repay loans costing them over 100 percent per year. It angered me and saddened me that the sector had morphed into little more than yet another means for the rich to exploit the poor. I declined the offer to back down.

Some months later the incident landed on the front page of the *New York Times,* explicitly naming Deutsche Bank, Calvert Foundation, and the darling of the public face of microfinance—Kiva. The article caused a major stir in the sector, yet another blow to the ludicrous hype that had been perpetuated for a decade about the miracle cure for poverty. I played a significant role in getting this article into the *New York Times*, and I knew that in fact this example was only the tip of the iceberg.

A subtle shift had occurred in the microfinance sector that Mohammad Yunus himself pinpointed perfectly: "I never imagined that one day microcredit would give rise to its own breed of loan sharks."

A key problem in the sector is the distance, not simply physical, between the poor recipients of microloans and those sitting in air-conditioned offices in Europe and the USA running the sector. The words *loans* and *clients* are used interchangeably. Most of those directing the capital that drives the microfinance sector have spent limited time actually *with* the poor. Photos and stories are meager substitutes for meeting and knowing the poor. In our case, and wife and I have spent eight of the last ten years living in developing countries. The staff and clients of MFIs were not mere curiosities to visit on a two-day trip to assess a potential investment in an MFI—they were our neighbors and friends. We attended their weddings, and they ours. We bought stuff from their shops and ate with them. We found that their situations are complex and challenging and not easily resolved with a $100 loan.

I enjoy visiting their small businesses and chatting with them about how their markets operate, the competition they face, their future plans. But I often leave wondering if credit is what they actually need. Some modest training, some advice on managing inventory, or strategic help on how to turn their plans into reality—these may be far more helpful than a $100 loan at 60 percent interest a year, but this kind of assistance is generally not available. Some MFIs offer such support, which I applaud. But I believe that in the sector's quest for relentless growth we have lost sight of the human element at stake: the poor are *people*. They *may* deserve access to credit, but they *certainly* deserve respect and fair treatment.

During my decade in microfinance I worked with countless individual MFIs, the rating agencies, and other transparency initiatives and service

providers, including consulting boutiques and IT providers to the microfinance sector. I worked with microfinance funds and peer-to-peer lending platforms that channel money from investors to the MFIs. I worked with large microfinance networks with global operations, spoke in various conferences, and had some modest interaction with public multilateral investors such as the Inter-American Development Bank. I was fortunate to witness the rise and fall from grace of microfinance over this period, from a variety of perspectives.

This period may be best described as the *commercialization* of microfinance sector, when big banks and political ideology infiltrated microfinance to the highest levels. What began as a good idea was gradually hijacked by large investors and a new wave of dot-coms, muddled with media hype. Poverty reduction has been marginal. Some clients have found microfinance more a curse than a blessing, at times driving them to suicide. Most investment funds, acting as the principal intermediaries between those with capital and the MFIs pumping out the loans to the poor, have little idea about microfinance in practice, and are motivated by a perverse set of incentives that benefit neither their own investors nor the poor.

Each time a scandal erupts the microfinance funds are placed in an awkward position. If they admit they knew of the practices but did not challenge them, they seem to have betrayed their very raison d'être. If they claim they had no idea, they admit that their due diligence is sloppy. They are damned either way. Best to avoid the question altogether.

The average person on the street has been spoon-fed a deliberately naïve view of microfinance. Most individuals who have invested in microfinance have little idea how their funds are deployed in reality, and many would be disturbed to find out the truth. They cannot board a flight to Burkina Faso to check whether their $25 investment is being used wisely, so they entrust their money to a fund or a website that offers assurances of incredible impact. They read the website and magazines produced by their chosen intermediary and assume the claims to be true. Little do they know that these institutions are largely unregulated in practice and have a rather different view of microfinance from that presented in their magazines, stuffed full of photos of poor women in action poses, bouncing out of poverty every second of the day thanks to $25 loans.

Meanwhile the poor largely remain poor, even as billions of dollars in interest payments are extracted from their pockets justified by a few isolated but celebrated cases of successful tomato vendors splashed across the promotional materials of the companies leading the sector. An article in *Time World* summarized it succinctly: "On current evidence, the best estimate of the average impact of microcredit on the poverty of clients is zero."[10]

To highlight the unusual range of opinions, contrast this with the conclusion drawn by two-time Pulitzer-winning *New York Times* columnist Nicholas Kristof: "Microcredit is undoubtedly the most visible innovation in anti-poverty policy in the last half century."[11]

In my opinion the truth is likely closer to the former than the latter. While the poor are being deceived about the impact an over-priced loan will have on their actual situation, so are many of the well-meaning investors who believe their money is being put to good use. Microfinance can and does work if applied correctly. In practice it largely does not. This is a pity, and a missed opportunity. It was not always like this, and need not be like this. The sector morphed gradually over the last decade into its current state of crisis. I saw this happen from the inside, and this is my story.

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by Hugh Sinclair

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