Corporate governance and Ethical issues in Microfinance Institutions (MFIs) - A study of Microfinance crises in Andhra Pradesh, India

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Abstract
Absence of formal employment make the poor non bankable. This forces them to borrow from local money lenders at exorbitant rates of interest. The main aim of Microfinance institutions (MFIs) is to serve the poor through providing financial services such as giving loans, provision of insurance coverage and a channel for their savings. Ethical behavior in business practices determines success or failure of an organization and it is not an exception to MFIs. The crisis happened in Andhra Pradesh was not the first crises to happen in microfinance industry; However, it was unique and significant in terms of the severity of the crisis. The industry hasn’t taken any lesson from Microfinance crisis happened in other countries in previous years.

1. Introduction
The main aim of Microfinance institutions (MFIs) is to serve the poor through providing financial services such as giving loans, provision of insurance coverage and a channel for their savings. Corporate governance in Microfinance is a mechanism where board of directors establish an appropriate business environment to follow the day to day activities of the management and to achieve mission and vision of the MFI (Ledger wood and White, 2006). Thus, the board should maintain a sound control and risk management framework to make strategic decisions. Every member of the board should internalize the framework and the risk model should be designed to accommodate such changes. Proper monitoring and control of activities are the bases for ethical growth and sustainability of MFIs.

Ethical behavior in business practices determines success or failure of an organization and it is not an exception to MFIs. Unethical practices are claimed as the causes for microfinance crises in different countries. For example, In Latin America, Bolivia has faced microfinance crises in 1999–2001. It was characterized by competition among existing microfinance players and consumer lenders which lead to over-indebtedness of clients (Constantinou and Ashita, 2011) and recently a magnified crisis is recorded in India. The crisis erupted in early October 2010 in Andhra Pradesh. There are many Microfinance institutions in Andhra Pradesh which resulted in to a strong competition among them. What the MFIs did was a strategy is increasing their capital base, so that they can build strong lending position. Hence, they were among the first MFIs to attract significant investments from private equity players.

2. Meaning
Micro Finance (MF) is a, financial service such as saving A/c, Insurance coverage and credit provided to poor and low income clients so as to help them to raise their income and there by improve their standard of living. The main features of Micro Financing are that small amount of loan is given without security to people Below Poverty Line (BPL).

Community banks, NGOs and grassroots savings and credit groups around the world have shown that these microenterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies.

3. How Different From Micro Credit
Micro Finance is different from Micro Credit. Under Micro Credit small amount of loans are given to the bor-rowers but under Micro Finance besides loans many other financial services are provided such as Savings A/c, Insurance etc. Therefore Micro Finance has wider concept as compared to Micro Credit.

4. Reasons For Their Growth
Traditionally, banks have not provided financial services, such as loans, to clients with little or no cash income. An analysis of 28 studies of informal money lending rates in 14 countries in Asia, Latin America and Africa concluded that 76% of moneylender rates exceed 10% per month, including 22% that exceeded 100% per month. Hence there is mushroom growth of MFIs, in view of high profitability.

5. Different Types Of Financial Needs Of Small Borrowers

a) Lifecycle Needs: such as weddings, funerals, childbirth, education, homebuilding, widowhood and old age.

b) Personal Emergencies: such as sickness, injury, unemployment, theft, harassment or death.
c) **Disasters**: such as fires, floods, cyclones and man-made events like war or bulldozing of dwellings.

d) **Investment Opportunities**: expanding a business, buying land or equipment, improving housing, securing a job (which often requires paying lump sum amount)

6. **Why Big Financial Institutions Prefer Bigger Loans**
Organized financial institutions are reluctant to provide loans to small borrowers because of the following reasons:

a) **High Credit Risk**
b) **High transaction and service cost**
c) **Irregular flow of income due to seasonality**
d) **Lack of tangible proof for assessment of income**
e) **Unacceptable collaterals such as crops, utensils etc**

7. **How MFI’s Are Helpful**
Microfinance is useful to poor households helping them raise income, build up assets and/or cushion themselves against external shocks.

Absence of formal employment make them non bankable. This forces them to borrow from local money lenders at exorbitant rates of interest. Many innovative institutional mechanisms have been developed across the world to enhance credit to poor even in the absence of formal mortgage.

**Why big financial institutions prefer large loans;**

a) A large number of small loans are needed to serve the poor, but lenders prefer dealing with large loans in small numbers to minimize administration costs.
b) They also look for collateral with a clear title - which many low-income households do not have.
c) To the extent that microfinance institutions become financially viable, self sustaining, and integral to the communities in which they operate, they have the potential to attract more resources and expand services to clients.

Governments provide an enabling legal and regulatory framework which encourages the development of a range of institutions and allows them to operate as recognized financial intermediaries subject to simple supervisory and reporting requirements.

Microfinance institutions also serve as intermediaries between borrowers and the formal financial sector and lend funds backed by a public sector guarantee. Business-like NGOs can offer commercial banks ways of funding micro entrepreneurs at low cost and risk, for example, through leveraged bank-NGO-client credit lines.

8. **The Existing Informal Financial Sources:**
The informal financial sources generally include funds available from family sources or local money lenders. The local money lenders charge exorbitant rates, generally ranging from 36% to 60% interest due to their monopoly in the absence of any other source of credit for non-conventional needs. Chit Funds are other forms of credit system operated by groups of people for their mutual benefit which however have their own limitations.

9. **The example of Grameen Bank of Bangladesh**
The concept is the brainchild of Dr Muhammad Yunus of Chittagong University who felt concern at the pittance earned by landless women after a long arduous day’s work laboring for other people. He reasoned that if these women could work for themselves instead of working for others they could retain much of the surplus generated by their labors, currently enjoyed by others.

The Grameen Bank lending system is simple but effective. To obtain loans, potential borrowers must form a group of five, gather once a week for loan repayment meetings, and start with, learn the bond rules and "16 Decisions" which they chant at the start of their weekly session. These decisions incorporate a code of conduct that members are encouraged to follow in their daily life.

Some of the important are:

a) production of fruits and vegetables in kitchen gardens,
b) investment for improvement of housing and education for children,
c) use of latrines and safe drinking water for better health,
d) Rejection of dowry in marriages etc

10. **Indian Scenario;**
In India, 90 percent of the population does not have any kind of social security. Insurance remains to be ‘sold’ rather than a ‘to be bought’ product. Due to emergencies like sickness, accidents, death loss of assets due to natural calamities, social customs and traditions etc, the poor are forced to borrow from unorganized markets at very high rates interest, because they do not and cannot plan for these risk managements by way of either saving or insurance. Thus they get trapped into vicious circle of poverty. Further in spite of repeating problems also they do not plan for risk management techniques.

11. **Growth of MFIs in India:**
India is a country where about 70 percent of the people are in villages with little/ no access to main stream financial organizations. Hence they depend on micro financial institutions, both organized and unorganized, with minimum and no collateral for their financial requirements. There is a mush room growth of these insti-
tions because of their high profitability. The study has presented implications followed by the suggestions for the overall microfinance industry.

12. Literature Review
Constantinou and Ashta (2011) revealed that high growth is motivated by increased demand for liquidity, profitability, sustainability or to beat competitors. What happened in Andhra Pradesh is growth of the MFIs was not genuinely motivated by liquidity, but by motivated to maximize a profit whatever the situation is. Hence, the MFIs opened many branches and made efforts to reach as many poor as they can and lend to less credit worthy borrowers with less evaluation of credit worthiness. Basically what the loan officers was focusing on was to lend as much as they can so that they can get commissions and percentages. In such a case rapid growth can always be considered good by management and employees of the MFI, but it can also be a problem. It can weaken governance of the MFI by hiding fraud, malpractices, over-indebtedness, saturation of the market etc (CERISE and IRAM 2005). Hence, the objective of this paper is to identify the corporate governance and ethical problems noticed in Andhra Pradesh microfinance crisis in India.

12.1 Theories and Concepts of Ethics in Business
Ethics is a moral judgment and acceptable standards of a society for guiding behavior of individuals and groups with reference to societal norms and expectations (Chiejine 2010; Velasquez, 2006 cited in Hudon 2011). Hudon (2011) identified three kinds of ethical issues in Microfinance. The first is concerned with economic, social, legal and political system, the second is related with individual behaviors like loan officers manners towards borrowers and the third is corporate or institutional ethical issues.

12.2 Does Competition In Business Result In Unethical Issues
The expansion of commercialized MFIs in Andhra Pradesh created a stiff competition among the MFIs. Thus, some of the MFIs shifted from social objectives to complete profit maximization like a conventional private money lender. Some other Microfinance organizations like SHGs and rural associations claimed that the industry is ruined by the profit motivated MFIs (Franke, Kläntschi, Meibauer and Talmo 2011). Of course, the Microfinance sector is currently criticized for a shift of focus from clients to MFIs’ profit maximization (Nair, Postmus and Pradhan 2009). It is obvious that MFIs are known for their double bottom line objectives. However, some MFIs believe both social and financial objectives can’t be attained at the same time, but only through paradigm shift towards profitability and sustainability.

Then only rapid growth can be fostered that can be used for expansion to reach the poor. That rapid growth can also be achieved through over selling of credit and motivating loan officers to do that (Shah 1996; Marr and Tubaro 2011). However, Shah (1996) emphasized that the incentive granted to agents and loan officers to disburse and collect loans faster than competitors lead to complications and inefficiencies.

Usually the loan officers hurry to disburse and collect the loans like money lenders, aggressively without spirit of microfinance. The over-supply of microcredit is made with little control on clients’ creditworthiness and without much consideration of the fragility of the poor people, thus it has increased over-indebtedness of clients. It is also noted that lack of diversification and concentration of the MFIs in few areas aggravated the crises (Marr and Tubaro 2011; CGAP, 2010).

Many of the MFIs accounted rapid growth. During the period, the MFIs neglected to recognize and assess the risks involved in new products and activities and did not improve their internal control along with the complexity of products and services. The MFIs had weak Management Information System (MIS) , accounting system, inadequate internal control, high employee turnover. Loan officers were entitled to handle high amounts of cash which lead to frauds and misappropriation. With all of these weaknesses the MFIs were not in a position to hold the rapid growth and it was reaped in blowing ground (Arunachalam 2010). The board and management of the MFIs lack adequate oversight and accountability and failed to develop a strong control culture to maintain high level of control consciousness (Arunachalam 2011; Franke et al 2011).

The MFIs lack the capacity for forecasting of expected risks that can erode the sustainability of their organizations. The management and board were single minded focusing on growth, increasing profit, promoting equity investment. In many MFIs, the Board neither reviewed nor provided guidance about the alignment of overall company strategy with risk-appetite and the internal risk management structure. Risks identified by lower management perhaps never reached the board (Arunachalam 2011).

Marr and Tubaro (2011) pointed out that the excessive growth in the microfinance sector was resulted due to exorbitant interest rate which is blamed for triggering clients’ over-indebtedness. Arunachalam (2011), Franke et al (2011) and Marr and Tubaro (2011) on the other hand revealed that core cause of the crisis lays on lack of control and monitoring of operational activities by board and management. The problem was aggravated because boards were not truly independent, even institutional...
nominee directors were in active and lack diligence in controlling the activity of the MFIs. They turned blind eye when MFIs disbursing excessive loans and selling of IPOs.

12.3. Corporate Governance Theories And Ethical Issues

The ownership structure of Indian MFIs is dominated by family and friends groups. Family and friends are board members, thus the board structure is characterized by inadequate checks and balance of executives, lack of transparency in reporting, lack of independent board nomination, insufficient transparency about ownership and conflict of interest at various levels of management (Arunachalam 2010). Moreover, remuneration payments were very irrational and unusually high. It is characterized by unplanned bonuses, granting of shares and non transparent pricing of shares. It is also noted that related party transactions were not transparent and MFIs provide huge loans to founders and board of directors to buy their own company shares (Arunachalam 2011).

Despite the fact that MFIs in India recorded a rapid growth, in the end big MFIs have incurred losses and clients committed suicides due to pressures from MFIs to pay back their loan. At the end, the crises shaded dark to the reputation of Microfinance industry in the globe. Thus, it was evidenced that the general crisis lays on the corporate governance failure of the MFIs.

Following to agency and stakeholders’ theory there are two models of corporate governance where companies use as a guide to successful management style. These known corporate governance models are Anglo-American model and Continental European and Japanese models. These models justify morality by the fact that they assure goodness to their success at the best interest. West (2009) stated that Anglo-American model supports agency theory concepts and depict that there is no ethical problem in prioritizing self interest. The model tried to be justified by the utilitarianism morality which refers generating the greatest good by appealing to the positive overall consequences of shareholders interests and not affected by other stakeholders.

This is linked to free market theory and supported by morality of self interest, right of self determination and the right of free voluntary contracting. But opponents of this model emphasize that, it is immoral to do good for self interest at the expense of others. Hence, they argue that interests of different stakeholders should be taken into consideration which is explained by the continental Europe and Japan model.

Demise (2005) described that the model supports stakeholder theory, furthermore, it is considered moral be-
14. Discussion And Policy Implications
The crisis happened in Andhra Pradesh was not the first crises to happen in microfinance industry; However, it was unique and significant in terms of the severity of the crisis. The industry hasn’t taken any lesson from Microfinance crisis happened in other countries in previous years. Thus, it is quite unavoidable to give a focus on such issues, identify cause of the problem and forward policy implications, so that such crises at least can be reduced to happen in other countries especially in developing countries like Africa. Therefore the following policy implications are discussed under this study.

Management should not be dominated by family and friends, hence, other representatives should get a room to actively participate as independent members. The independent directors should ensure that the tendencies of inefficiency, extravagance, overestimated expenditure and diversion of funds are cramped. The independent directors will be nominees of different stakeholders, in turn; nominators should maintain a transparent and effective process of appointing and should follow their activities.

Management should design a cooperative policy to manage delinquency and late repayment. Management should monitor loan officers’ manners in treating clients. Incentives made to loan officers on the basis of distance should be revised. Much time should be spent in assessing the creditworthiness of the clients to minimize over-indebtedness. Management should also design a sound risk management framework to work out how to identify, monitor and control risks of the MFI. Sound corporate governance can enhance the quality of risk management. Risk management framework should be designed in a way to commensurate the interest of different stakeholders and should ensure that the system as a whole is geared to support the overall corporate and business strategy. Moreover, it should not make investment in few areas, rather diversification should be made. Rapid growth in the MFIs should be accompanied by equal improvements in the operational environment of the MFI. Employee should be trained with service delivery mechanisms and the internal control system should be investigated periodically to assess whether the operations are conducted meticulously or not. The internal control system should be maintained to accommodate the changes. Malpractices, frauds by loan officers lending to fictitious borrowers and over estimating disbursements, embezzlement of cash by employees due to lack of verification, reconciliation and segregation of duties and non transparent transactions with related parties, corruption by higher management should be treated by the internal control system. The management should give due emphasis to insight preventive and remedial actions.

Interest rates should not be increased only with the aim of moving to higher growth, rather it should be justified to the ground of the ability to pay by the clients and the price should be clear and transparent.

Furthermore, remuneration of board should be clear and transparent. Payments should be accounted based on the progress of the industry. It should not be compared to payments made in profit motivated companies, which is usually high. For microfinance, as the mission is to serve the poor and unbanked people, therefore the expense of the sacrifice of the poor people, board members should not enjoy an irrational and non-transparent higher remuneration. Higher interest rates and over selling of credits should not be tipped to higher remuneration payment.

To sum up, the MFIs should take care of the shareholders joining the company. To maintain the double bottom line objectives, investors of MFI should be responsible governed by social responsibility. Profit motive investors will drive the institution to lose its picture through increasing price and rushing for growth, without much emphasis to the practices of the clients.

15. Conclusions And Suggestions:
1. One way of expanding the successful operation of microfinance institutions in the informal sector is through strengthened linkages with their formal sector counterparts. Therefore, formal sector finance institutions could form a joint venture with informal sector institutions in which the former provide funds in the form of equity and the later extends savings and loan facilities to the urban poor.
2. Another form of partnership can involve the formal sector institutions refinancing loans made by the informal sector lenders.
3. Poor people require more than subsidies they need access to credit.
4. The principle of safety, profitability and liquidity should be followed in loan sanctions.
5. The persons with banking experience/knowledge have to be co-opted as directors in the Board.
6. The guidelines issued by central banks have to be followed to day to day functioning.
7. There should be proper monitoring and follow up of loan sanctions.
8. They should reduce hidden costs like processing charges, renewal charges etc.

References


