

# Group Lending, Joint Liability, and Social Capital: Insights From the Indian Microfinance Crisis

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**Antara Haldar**

*University of Cambridge*

**Joseph E. Stiglitz**

*Columbia University*

## Abstract

This article grapples with the causes of India’s microfinance crisis. By contrasting Bangladesh’s highly successful Grameen model with the allegedly “universalizable” version of India’s SKS Microfinance (which precipitated the crisis), trust or social capital is isolated—not just narrowly interpreted within standard economic theory, but more broadly construed—as the essential element accounting for the early success of microfinance. It is argued that the microfinance experience has been widely misinterpreted, in both analytical and policy terms. This article suggests inherent limits in extending the model to for-profit institutions and, in particular, to the pace of scaling up.

## Keywords

microfinance, microfinance and social capital, Indian microfinance crisis, microfinance for-profit, Asia, India

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## Corresponding Author:

Antara Haldar, University of Cambridge, Peterhouse, Trumpington Street, Cambridge CB2 1RD, UK.

Email: [ah447@cam.ac.uk](mailto:ah447@cam.ac.uk)

Exactly ten years ago, microfinance was awarded the Nobel prize, promising to “put poverty in museums.” Today its legacy is quite different: 10 million defaulters in India alone.

The experience of microfinance in South Asia—the frontier of the industry globally—presents a puzzle.<sup>1</sup> For over three decades, led by the Grameen Bank and BRAC,<sup>2</sup> microfinance achieved, in its native Bangladesh, what few institutional experiments in rural and small scale lending had in the region before: repayment rates in the range of 90 percent across a borrower base of close to 25 million. Moreover, these rates remained resilient in the face of floods and a range of other crises, largely without deploying the coercive methods used by traditional moneylenders.<sup>3</sup> Its subsequent importation into neighboring India, however—especially in the wake of the mutations introduced by SKS Microfinance<sup>4</sup>—quickly resulted in breakdown in the form of mass default. How can this contrast—the success of one and failure of the other in these geographically contiguous regions—be accounted for? And what does this tell us about the microfinance model?

In this article, we trace the roots of the crisis in Indian microfinance that started in November 2010, making international headlines, by analyzing the reasons behind the differential performance of paradigmatic instances of Indian and Bangladeshi microfinance (i.e., the Grameen Bank and SKS Microfinance).<sup>5</sup> In particular, we argue that the crisis was predictable given that the SKS version was premised on a misinterpretation of the model that had come to be standard in economic theory, namely, that the logic of its Bangladeshi predecessor was based on a purely “economic,” rather than a primarily “social,” calculus—and that, as a result, even its rapid replication was trivial.

Although the crisis in Indian microfinance was, ultimately, the product of a complex range of factors and broader developments in the industry (not least the interlinked phenomena of “irrational exuberance” and “overlapping,” and the advent of for-profit lending), its magnitude helps, we believe, to shed light on a longstanding controversy in the theory of microfinance: what attributes of microfinance are *essential* to its success? Our analysis lends support to the idea that the key factor sustaining its achievements is what is described as “social capital” (a concept borrowed from sociology, originally coined by Coleman in 1988—now popular among economists),<sup>6</sup> and “trust,” or merely reciprocity—a hypothesis put forward by us in 2008 and 2013.<sup>7</sup> In particular, we argue that the Indian crisis is not *just* a symptom of the “growth pangs” of the industry—an inevitable result of tensions confronted by an essentially localized institution attempting to develop into a universal model, or the “boom-bust” cycles endemic to credit markets. Rather, we assert that the failure arises from the fact that the SKS iteration strayed from what lay at the core of the original model of microfinance.

## A Brief History of Microfinance

The forty-year history of microfinance can broadly be divided into three phases, or “generations”—the first generation runs from the mid-1970s to the late 1980s, the second from the late 1980s to around 2006, and the third from the mid-2000s to the present. The critical shift is from the “Grameen model” of microfinance, archetypal in the first and second generations, to the “SKS model” that became increasingly dominant in the third.

## *The Boutique Moment: “Bicycle Bankers and Basket Weavers” in Bangladesh*

Microfinance began as a series of small-scale lending experiments in the villages of Bangladesh in the 1970s—associated in particular with the Grameen Bank,<sup>8</sup> but also with other major Bangladeshi microfinance institutions (MFIs) such as BRAC and ASA.<sup>9</sup> As mythologized, this was the era of “bicycle bankers and basket weavers”—marked by a small group of novice bankers (economics professor and Grameen founder, Muhammed Yunus, and his students) trying a social experiment on a category of people deemed ineligible for credit by formal lenders—women involved in a variety of “cottage” industries, who needed loans for their raw materials. The surprisingly positive results of this experiment, especially in terms of repayment rates, paved the way for the microfinance model.<sup>10</sup> The initial impetus for microfinance was to provide respite from the oppressive regime of traditional moneylenders—the only source of credit available to the demographic being targeted by MFIs—viewed as exploitative of poor borrowers, and often charging usurious interest rates. The reluctance on the part of villagers to deal with traditional moneylenders reduced the circulation of credit with adverse impacts on the rural economy—reducing productive investments and livelihoods.<sup>11</sup>

In its original vision, microfinance entailed providing small loans for productive purposes. The core of microfinance was “the group”: borrowers at most MFIs were organized into clumps of five to ten members. In theory, at least, lending was based on joint liability—or the idea that a second member of the group could not get a loan until the first paid back, thereby creating an incentive for “peer monitoring” (as first described by Stiglitz in 1990). Groups have served a crucial social purpose in the functioning of microfinance as an institution, and it has been a subject of extended academic debate what precisely their economic function is. We will return to these issues in the following sections.

Whatever lay at the heart of the success of the incipient institutional experiment, there were several remarkable features of microfinance in its early years. First, as we have already mentioned, the repayment rates were extraordinarily high—in the vicinity of 98 percent.<sup>12</sup> Second, these rates were achieved despite a credit contract that was almost entirely *informal* in nature—characterized by the absence of either collateral or any formal contract between the MFI and the borrower. These accomplishments are particularly impressive in the context of a region where repayment rates on loans to the rural and agricultural sectors have, historically, been extremely low—and attempts at institutional formalization have not typically met with great success.<sup>13</sup> Third, MFIs were, for the most part, exempt from governmental regulation. Thus, microfinance, in its initial years in Bangladesh, appeared to set up an ecosystem—albeit a fragile one—that seemed, in defiance of conventional institutional wisdom, to achieve a high degree of functionality, largely informally.

## *The Golden Age of Microfinance: Microfinance Goes Global*

By the 1980s, microfinance had become well known in development circles. The borrower bases of Grameen and BRAC alone extended to several million, thriving against

the backdrop of one of the most dynamic NGO sectors in the world in Bangladesh: Grameen currently lends to approximately 8.4 million women and has replicas in eighty-four different countries,<sup>14</sup> while BRAC boasts 7 million borrowers in Bangladesh alone and a global reach of over 100 million. By the 1980s the borrower bases of both had already reached millions. Its success led the model to be replicated within the country and, increasingly, to be embraced around the world. A defining characteristic of this period in the development of microfinance is that although the model went “global,” replicas maintained fidelity—in the main—to the original, and modifications did not compromise its core character. Thus the model lent itself to emulation on a wide scale with demonstrable success.

Another characteristic of this period was a fundamental shift in lending practices—among the older, more established MFIs—from lending on a joint-liability basis to lending on an individual basis (in the case of the Grameen, this was identified as the shift from Grameen I to Grameen II). While longer-standing borrowers were graduated to individual lending, the original model was often retained for new regions or branches by older MFIs and was usually the model adopted by the new MFIs. Joint liability (or some version of it), thus, persisted as the “learner” model. The organization of borrowers into groups, however, was retained irrespective of the modalities of the loan. It is significant that this shift in lending practices did not lead to any perceptible drop in repayment rates.<sup>15</sup>

Through the 1990s, microfinance emerged as one of the—if not *the*—most important development program on the horizon. It was lent widespread support by international organizations such as the United Nations and the World Bank, and replicas of it sprang up all over the world.<sup>16</sup> The crowning glory vis-à-vis the recognition of microfinance came in 2006 when Yunus and the Grameen Bank were jointly awarded the Nobel Peace Prize, leading Yunus to comment that microfinance would put “poverty in museums.”<sup>17</sup> But while the data surrounding the poverty-alleviating effects of the institution sometimes seemed less convincing than its most ardent advocates thought,<sup>18</sup> there was substantial evidence of its socially transformative effects—including women’s empowerment.<sup>19</sup>

Ironically, the very success of the model may be contributing to its unraveling. Beginning in the early 2000s, the industry began to display an “irrational exuberance,” fueled by the legendary status Grameen had acquired, the easy availability of seed funding from domestic governments, international organizations and, increasingly, commercial sources convinced of the merits of the model, the persistence of large populations without access to finance through formal channels, the apparent ease of replicating the model, and the almost complete lack of regulation of the sector. This manifested itself as a dramatic proliferation in MFIs, alongside an ever-more aggressive approach to extending the borrower base—and started to be accompanied by increasing reports of the use of coercion to enforce loan repayment. But the pressure to repay, coupled with the growing availability of credit from a multiplicity of lenders, resulted in what observers in the field call “overlapping”—or borrowers taking loans from one MFI to pay back another—and thereby getting caught in a debt-trap resulting in increasing calls (at first in Bangladesh, and then radiating out) for formal regulation of microfinance, altering its fundamental character.

## The Age of Crisis

The incipient changes in the functioning of the microfinance sector were observable in countries across the world, including its original home, Bangladesh,<sup>20</sup> but nowhere did these developments unfold more rapidly than in India. Consequently, it was in India that this process reached its logical conclusion: the eventual inability of borrowers to repay loans, and the resultant risk of the collapse of the system. To some, microfinance in India was that country's subprime crisis, marked by a similarly reckless expansion in predatory lending that characterized lending to the poor in the United States.<sup>21</sup>

In November 2010, the Indian microfinance industry—one of the biggest (with an estimated borrower base of 26.7 million)<sup>22</sup> and the fastest growing in the world (reporting 80 percent growth annually in the four year run up to the crisis)<sup>23</sup>—was paralyzed as a result of the most serious repayment crisis in its history, with default rates rising to 90 percent.<sup>24</sup> The immediate trigger for the crisis were village suicides in the state of Andhra Pradesh linked to the arm-twisting tactics allegedly used by the microfinance industry to ensure loan repayment. This led to an almost immediate government takeover of microfinance lending operations and a freeze on the functioning of the country's biggest MFI, the microfinance behemoth SKS founded by Vikram Akula.<sup>25</sup> It eventually resulted in the enactment of state legislation imposing serious restrictions on loan collection by MFIs.<sup>26</sup>

The context of Indian credit markets was rather different from that of Bangladesh. Whereas the microfinance movement started in Bangladesh in the early 1980s, self help groups (SHGs) were the Indian analogue—it was only in the wake of economic liberalization in India in the 1990s that MFIs entered the picture. Although SHGs also involved group lending, they differed from microfinance in the degree of state involvement in the model (particularly on the part of the National Bank for Agricultural and Rural Development, NABARD), as well as in the respect that its repayment rates typically fell far short of its MFI counterparts—with important implications for the financial sustainability of lender.<sup>27</sup> The lending climate in Andhra Pradesh, specifically, is also highly relevant to the analysis. Home to a large number of SHGs, as well as the country's five largest MFIs, it accounted for a third of India's microfinance industry—with total MFI lending amounting to approximately Rs 80 billion, or approximately \$2 billion. This meant that average debt per household in the state was significantly higher than the national average at Rs 65,000 as compared to Rs 7,700.<sup>28</sup> Indeed, studies find that more than 83 percent of households had loans from more than one source (including traditional moneylenders)—with many juggling more than four loans.<sup>29</sup>

Even as many feared that the crisis would spread to the mainstream Indian banking sector, given its heavy investment in the microfinance industry,<sup>30</sup> the central bank—the Reserve Bank of India—responded by instituting the Malegam Committee. Its report made several recommendations on the reform of the microfinance sector including limiting competition,<sup>31</sup> a cap on interest rates, and a ceiling on per-household lending.<sup>32</sup> Its report is the precursor to national legislation to regulate the sector.<sup>33</sup> Since the peak of the crisis, with regulation on the way and the threat to the Indian banking industry deemed minimal, relative calm appears to have been restored and the crisis more or less contained—and, although it has taken several years to recover, even SKS Microfinance

has survived.<sup>34</sup> It has, however, left a legacy of 10 million defaulters in the state of Andhra Pradesh—and, in all but name, abandoned any claim to poverty eradication.<sup>35</sup> The impact of the Indian crisis has, thus, been indelible: trust in the microfinance industry has been shaken, leaving the industry in turmoil in countries as diverse as Nicaragua, Bolivia, Mexico, Nigeria, and Pakistan<sup>36</sup>—and while the regulation of microfinance appears to be here to stay, its long-term impact remains uncertain.

Microfinance once distinguished itself on the basis that it targeted poverty reduction, on the one hand, reaching through informal means populations that formal credit markets neglected and, on the other, that it did not resort to the coercive enforcement mechanisms normally deployed in the informal credit markets. In its struggle to remain both effective and normatively acceptable, however, it is now on the cusp of returning to the traditional menu of institutional options—formalization or coercion.

## The Grameen versus the SKS Model of Microfinance

Microfinance in South Asia alone was a complex multimillion dollar phenomenon of which Grameen and SKS are important—but not definitive—instances. Grameen, for all its attempts at embodying best practice, has been the object of scathing—and some justified—criticism,<sup>37</sup> while the practice of microfinance in India, in general, goes well beyond SKS and has (Andhra Pradesh notwithstanding) proven to be fairly sustainable. Nonetheless, we argue that Grameen and SKS typify, as heuristic devices, fundamentally different institutional approaches that account for the very different experiences of microfinance on either side of the India-Bangladesh border. In this section we contrast, in some detail, the features of the two models that may explain the differences in their performance—and this account provides the detail and institutional texture to the analysis presented in the second half of the article.

It is worth emphasizing, however, that the key distinction between the two models is that while Grameen is quintessentially a “tacit” or “specific” institution—fundamentally local or rooted, as are most “informal” institutions—the SKS gamble was premised on developing a “general purpose” or “blueprint” version of microfinance, imbued with the replicability characteristic of “formal” institutions.<sup>38</sup> In aspiring to become a “global” rather than a “local” institution, however, SKS did not anticipate the losses in flexibility that would accompany gains in replicability—and how essential they were to the success of microfinance in the developing world context.

### *The Grameen Model of Microfinance*

*Group lending as institutional learning.* The traditional model of microfinance established by the Grameen Bank in 1976 was characterized by tremendous attention to detail and contextual specificity, in both design and implementation. Many of the features that lie at the heart of the original microfinance model—the group system and weekly meetings—were described by Yunus not as a premeditated strategy for ensuring repayment but, rather, as features that emerged organically from observation and reaction to the empirical realities on the ground:

We started with a system of individual loans and daily repayment, but found that we were having trouble keeping track of and recording payments—so we made a shift to weekly meetings where installments would be collected. But even this started getting very chaotic, so we started dividing the borrowers into first two and then three groups to meet in and so on. Then, we had the idea to divide the groups into functional categories like the “chicken group” (members of which had taken loans for poultry farming), the “cow group” (members of which had taken loans for fattening cows), the “rickshaw” group (members of which had taken loans to buy rickshaws) and so on—but sometimes the purpose for which the loan was taken would change, and this led to further confusion. Also, the members of the group did not know each other and we noticed a certain distance between group members and group leaders that was problematic. So, next we did away with the idea of functional divisions and had the idea of bridging the gap between leaders and members by allowing people to form voluntary groups of between five and ten. It was seen that five was the natural tendency. The group was given the responsibility for loan collection. Then we introduced the system that the chairperson of the group needed to recommend a member for a loan. We observed that the chairperson quite enjoyed this power, but then we added that the chairperson was also responsible for loan repayment. The main function of the group was social, based on creating a sense of community.<sup>39</sup>

The groups are ideally suited to maximize the “information advantages” of monitoring, for instance by clubbing together those who live in the same part of the village and therefore have tacit knowledge of the activities of other group members—but are not related and, therefore, less likely to be incentivized (or gently socially coerced) into concealing defaults. Group members are also required to be from roughly similar socioeconomic backgrounds in order, for instance, to prevent implicit social domination of one group member over the others. Groups are further organized into “centers”—embedding the groups in the wider community still—classed under the supervision of a “center” manager, a Grameen employee with whom the members have ongoing interaction.

*Lending to women.* The decision to lend largely, or entirely, to women—now a distinctive feature of microfinance globally—was also arrived at by trial and error. Indeed, for the first ten years of its operation, Grameen lent to both men and women, but it was only when the shift was made to lending mainly to women that it achieved the breakthrough in repayment rates that are its hallmark. A senior official at Grameen justified the policy as follows:

The target group for *Grameen* is the family, and it has been found that family welfare is best served with women as the conduit: women are more concerned about family welfare and tend to be more forward-looking than men. Also, when wages are as low at \$2 per day, just one wage earner in a family turns out to be insufficient and getting women of the house to earn augments family welfare. But *Grameen* also benefits the women themselves. Traditionally, there was no interface between commercial banks and women—but the activity of borrowing boosts the confidence of women borrowers, especially as a function of their having to learn to sign their names, learning to administer loans and so on.<sup>40</sup>

The gendered character of microfinance has been the target of much criticism, Rahman<sup>41</sup> argues that 60 percent of MFI finance in Bangladesh is de facto under the control of men—but even if this were true, the control that women have over loan access and use is still greater than in the conventional system. Indeed, studies find that, given the degree of male dominance in Bangladeshi society, the involvement of the husband in the loan venture might even be financially prudent.<sup>42</sup> The broader empirical evidence seems to support the assertion that the targeted choice of MFI clients benefits not only the institution but the borrowers directly (e.g. in terms of decision-making within the household,<sup>43</sup> reduced domestic violence,<sup>44</sup> and even the capacity for collective action<sup>45</sup>), as well as in distributive impacts on family welfare.<sup>46</sup>

*Integrated approach to lending.* Grameen innovated its banking model to customize it to the needs of its unique clientele. Yunus writes at length about how the “bicycle bankers” would ride through the villages acquainting themselves with the coy village women, typically by taking an interest in their children. Going forward, it developed a system of “flexiloans” that does not treat genuine defaults—precipitated, for instance, by natural disasters, illness, or business failure—on a par with strategic defaults, or deliberately not paying when the financial capacity exists to do so. Grameen also built financial discipline in borrowers—while mitigating its own risk—through holding initial deposits (roughly Tk 70) from members and forced savings schemes (e.g., a Tk 5 deposit per week). These deposits are the bank’s first port of call in case of default. Grameen has also, over the course of its evolution, come to offer a range of financial services to its borrowers—including a pension scheme and a range of insurance policies (covering loans, life, and natural disasters).

*Socialization.* In the absence of the formal guarantees normally associated with giving out loans, Grameen relied, instead, on a rigorous process of socializing members—cemented, incrementally, by ongoing ritual. New members would, for instance have to go through an intensive seven-day training program, involving a key family member (typically the husband) for one of those days. This initiation ritual would serve to acculturate the recruit into the “philosophy” of the Grameen, and the participation of a male family member would reduce familial resistance to the program—an instance of insight that only close engagement with the social context on the part of institution builders would yield. Members would also, at this point, be required to commit themselves to the “sixteen decisions”—a list of key aspirational ideals ranging from affirmations of group solidarity to vows to respect household hygiene and use contraception. The most important of these rituals, by far, was the weekly group meeting, which served both as a social occasion and the moment at which members repaid their loan installments—in public.

*Participatory structures/profits distributed to borrowers.* The Grameen also experimented with a participatory structure. Members, newly inculcated into the ambit of credit markets, were given the opportunity to take on the position of group or center leader, and potentially to become one of the nine Grameen Bank board members (of thirteen) drawn from its borrower base. Borrowers with a balance above a certain minimum

level (Tk 100) were shareholders in the bank, and therefore its notional “owners.” Further, while Grameen proudly boasted of its financial sustainability and even profits—these profits were ploughed back into other Grameen enterprises that either provided critical services to borrowers at subsidized rates or were distributed as dividends to the borrower-shareholders. At the other end of the spectrum, the heyday of Grameen was associated with strikingly low levels of corruption on the part of bank employees, in a region notorious for small-scale bribery. This was facilitated by a combination of pecuniary (retirement benefits in cash meted out after an untarnished ten-year record) and nonpecuniary (a “star” system for centers evaluated on various criteria) incentives.

*Gradual shift to individual lending.* In its second iteration, when Grameen lending shifted explicitly from a joint liability system to individual lending, it built off the augmented financial discipline it had cultivated in previous years. The fact that this led to *no appreciable decline in repayment rates* would appear to provide compelling evidence in favor of the proposition that participation in the Grameen program had altered the norm system in a manner that continued to be in force once the ostensible external constraints had been removed—or, in economic terms, that the preferences of economic agents had been shifted in the direction of more cooperative outcomes. Even if the sanctions threatened had played a role (and most interviews in the ground argue that this threat was more “academic” than real), after a period of time, the intrinsic rather than extrinsic factors appeared to be doing the heavy lifting.

The new system continues, however, to intertwine the economic fate of the individual borrower with that of the group—the approval and size of an individual loan depends on the support of the group and the center, while the ratings of the group and center (that determine its credit worthiness) are linked to the performance of its individual members. Thus, while the sanctioning mechanism is more diffuse than having to pay back the loan of a defaulting member (i.e. reputational effects with pecuniary impacts), the system continues to incentivize close monitoring of individual behavior by the group.

### *The SKS Model of Microfinance*

*Joint liability as a formula for rapid replication.* SKS Microfinance, founded much later than Grameen, in 1998, initially showed substantial fidelity to conventional microfinance—building on the successes of the Bangladeshi model and rising to become one of the fastest growing MFIs in history.<sup>47</sup> The drive for this meteoric rise was provided by its founder: Akula, a US citizen, educated at Tufts, Yale, and Chicago, and deeply influenced by the work of Yunus. Akula, himself, emerged by the early 2000s as the new face of microfinance and a much-feted public figure: His list of accolades includes being named a Young Global Leader at the World Economic Forum in 2008, the Ernst and Young Entrepreneur of the Year twice over, in 2006 and 2010—and, finally, one of the world’s 100 most influential people by Time Magazine.<sup>48</sup> Akula boasted a high-profile national and international media presence spanning extensive (often

front-page) coverage in the Wall Street Journal, on CNN, and in Forbes Magazine, among a slew of other platforms. Inspired by the Grameen model, SKS lending was based on joint liability, and it retained several of the community-building practices traditionally associated with microfinance, such as regular group and center meetings, and relationship-building visits from MFI workers. Indeed, the SKS version of microfinance was, for the most part, ostensibly indistinguishable from the Grameen version in the early years.

In the late 2000s, however, Akula decided to try a fundamental innovation on the Grameen model by developing the “scalable” version of microfinance. Attempting to marry Yunus’s novel lending model with “global business best practices”<sup>49</sup>—perhaps the product of the intellectual influences at Chicago (the incubator of classical “law and economics”) or his time spent as a management consultant at McKinsey—had been a longtime project of Akula’s. In contrast with the organic and empirically grounded evolution of the Grameen model, it sought—particularly in the joint liability scheme—a universal formula that could be applied mechanically irrespective of specific social conditions, enabling replication at an unprecedented scale and pace.

SKS Microfinance, thus, explicitly set out to develop an “assembly line,” or the “Coca-Cola or McDonald’s version of microfinance”—an efficient, replicable system that would ultimately achieve more or less universal coverage of its target market. As the SKS website stated:

With rapid scaling comes the challenge of building organizational capacity. Rather than look at conventional microfinance models, SKS based its business strategy on principles borrowed from fast-scaling consumer businesses. SKS standardized its products and front-line processes and adopted factory-style training models that have helped corporate giants scale up rapidly—thereby boosting our own workforce capabilities and growth.<sup>50</sup>

*Shift to for-profit lending.* Following from this was a well-developed justification for making the shift to a for-profit model: the ability to raise private equity investment so that the drive for expansion was not curtailed by availability of funds. The need was particularly acute in the Indian context, it was argued, where MFIs—unlike their Bangladeshi counterparts—were debarred by law from holding deposits from borrowers. On the basis of the track record that SKS had established (albeit on the basis of following the original microfinance template) and Akula’s well-articulated national and international links, it raised \$350 million in 2010.<sup>51</sup> Investors included Narayan Murthy (founder of Infosys, the leading Indian IT company), Bajaj Allianz (a major Indian insurance company), Vinod Khosla (a Forbes-listed billionaire and one of the founders of Sun Microsystems), Sequoia Capital (a California-based venture capital firm) and even George Soros’s Quantum Hedge Fund, in a robust display of faith in the enterprise—and the initial IPO was fourteen times oversubscribed. But although SKS was not the first MFI to make the shift to the for-profit model (various MFIs, despite important detractors such as Yunus,<sup>52</sup> had already made this move—most significantly *Compartamos* in Mexico),<sup>53</sup> SKS was the only major MFI to make the shift while maintaining, at least initially with Akula at the helm, that its goal was the alleviation of poverty.

*Market competition and lack of personal relationships.* The attempt to “mass manufacture” microfinance and the shift to for-profit lending, combined with its operation in an atmosphere of market competition in Andhra Pradesh, in which at least 400–600 MFIs were active,<sup>54</sup> fundamentally altered the traditional relationship between the MFI and the borrower, turning it into a purely commercial transaction. The dynamics of a profit-driven credit provider answerable to shareholders and trying to outcompete other MFIs *rapidly* to maximize market share was at odds with the types of relationship-building initiatives and cross-subsidization that typified the original Grameen model<sup>55</sup>—incentivizing, on the other hand, excess lending by fueling a drive to increase loan disbursement at all costs (often irrespective of borrowing capacity). As Balleem and colleagues observed:

Most MFIs are mono-service credit companies providing standard basic joint liability group (JLG) loans to customers. There has been only a limited focus on clients; be it in terms of assessing their capacity to repay or in developing appropriate products to suit their needs. *Microsave* has often observed that despite the MFI management’s protestation to the contrary, most clients see MFIs as just another source of credit, rather than institutions interested in client welfare. The rapid influx of capital resulted in rapid expansion in scale without adequate investment in building customer relationships. This, combined with intense competition amongst MFIs and the resultant multiple lending, led to a situation where clients refer to MFIs as “Monday MFI,” “Tuesday MFI,” etc., depending on their collection schedules. This clearly demonstrates the lack of relationship between MFIs and their clients.<sup>56</sup>

The implications of this were not only adverse in normative terms, but also purely economically—eliciting less responsible behavior from agents than in the context of the “gift-exchange” paradigm, or crowding out “pro-social” behavior.<sup>57</sup> The actions of SKS ended, in a sense, by slaying the goose that laid the golden eggs.

If joint liability per se were the central explanatory factor behind the working of microfinance—and functioned such that economically rational group members *always* exercised force on individual members who then responded, in the economically rational way, by repaying—we would have no basis for understanding the Indian crisis, given its formal fidelity to the model. Indeed, within the standard “economic” interpretation of microfinance, replication is straightforward. Its failure in the Indian context seems to indicate that it works only when certain supporting social conditions (e.g., sufficient investment in the group to exercise peer monitoring, meaningful personal ties between borrowers and with the bank) are also in place; that is, joint liability does not seem to be a necessary, and sufficient, condition.

*Political intervention and governmental regulation.* Although the space initially yielded by the Bangladeshi government to microfinance is something of a mystery, the unraveling of popular trust in microfinance paved the way for political intervention in the Indian case and, subsequently, elsewhere.<sup>58</sup> In the spate of clampdowns on microfinance, whatever their motivation, the practice will be fundamentally altered. The question is not so much whether regulation is a good or a bad thing, but rather that its introduction detracts from what has, so far, made microfinance unique—and that it will certainly raise costs. It is also far from clear that formal regulation of the sector is

*inevitable*. While governments may be acting to safeguard the interests of their people, it is also possible that they are taking advantage of an opportunity to undermine the credibility of their perceived rivals.<sup>59</sup> In particular, given the traditional unpopularity of moneylenders, governments could be cashing in on ready political capital by characterizing MFIs as “new-age moneylenders.”<sup>60</sup>

*Abandoning the idea of poverty alleviation.* The turn that SKS has taken, abandoning poverty alleviation and empowerment of the poor as goals, indicates that there may be some truth to this allegation. In 2011—when “the firm was facing crisis with mounting losses, deteriorating asset quality, poor loan recoveries, and the absence of fresh funding”<sup>61</sup>—the board of SKS removed Akula as chairman and board member (somewhat ironically given it was an organization he founded).

His exit made room for a fundamental shift in the lending philosophy of SKS. The new approach was summed up in an interview with the company’s new CEO and managing director, M.R. Rao, and chief financial officer, S. Dilli Raj: “When we embraced the for-profit model, we should have discarded the larger-than-life claims and mission statements like empowering the poor and eradication of poverty. The for-profit model doesn’t go with this.”<sup>62</sup>

### *SKS Undermining the Core Institutional Character of the Grameen Model*

Credit markets in South Asia have typically been dominated either by profit-driven formal banks, reliant on an entire panoply of legal regulations that result in transaction costs too high to make the penetration of rural markets economically feasible—or, in rural areas, by traditional moneylenders, charging usurious interest rates and dependent on brute force and coercion as their enforcement mechanism. Against this background, the original Grameen-style microfinance model purported to achieve an important development goal, namely, giving a difficult-to-reach demographic access to credit, without being driven by the profit motive, and while remaining financially sustainable. Moreover, it attempted to reach this goal by maintaining extremely high repayment rates without either relying on formal guarantees or resorting to the use of force. What was the explanation for the efficient functioning of the original Grameen model: economic rationality or social embeddedness? How did the switch to the SKS model undermine it?

### **Analyzing the Roots of the Indian Crisis and Its Implications for Microfinance Theory**

The Indian microfinance crisis was the product of a complex range of factors, but we argue that a deeper analysis of its root cause cuts to the debate that is central to microfinance theory: whether the logic that drives it is essentially “economic” or “social.” In spite of its importance, the theoretical foundations of microfinance—or the factors that, at its heart, account for its success—remain disputed.<sup>63</sup> The institutional innovation, or breakthrough, that microfinance makes is the substitution of the traditional forms of legal security in formal credit markets (i.e., contracts and collateral) with group lending, that is,

the organization of members into groups of five to ten members. What is less obvious is why group lending has proven so effective in promoting high repayment rates.

### *Competing Theories of Microfinance: Economic or Social Calculus?*

Two distinct sets of theories address this question. The first—an older, more established literature premised on the idea of the “rational actor” in economics—identifies the economic calculus of borrowers as the dominant force in the working model, whereas a newer interpretation—drawing on sociology, and a growing literature in social psychology and behavioral economics—argues that the borrower’s social ties or “social embeddedness” is the main factor accounting for its success.<sup>64</sup>

Central to the older theoretical literature is that joint and several liability—the fact that one group member’s ability to borrow depended on the others repaying—provides an effective, and informationally efficient, enforcement mechanism, based on the advantages of peer monitoring. The joint liability literature originated with one of us, Stiglitz—and led to a burgeoning of interest in the topic in the 1990s.<sup>65</sup> But the change in contractual arrangements, discussed below, whereby individuals are not jointly and severally responsible for the debts of other members of the group, suggests that something else is at play.

The other strain of theorizing is based on the notion that the group replaces standard collateral with “social collateral,” a term originally coined by Besley and Coate in 1995<sup>66</sup> and widely used by MFIs—as well as the idea that the group acts as a social support base for individual borrowers.<sup>67</sup> One variant is based on the economists’ standard formulation of “social capital”—modeled as repeated interactions in which failure to comply with the cooperative action leads to punishment. In these models, borrowers are individually rational in engaging in cooperative actions (repaying loans, providing support to each other to enhance their ability to repay, etc.). This group of models can be simply seen as a multiperiod enforcement version of the simpler joint and several liability model. The alternative—and less widely accepted—approach focuses on broader theories of human behavior, where relationships and social connectedness may affect behavior even in the absence of any well-specified (or even tacit) set of consequences associated, say, with nonrepayment. This idea has been popularized in the economic literature by, for instance, Ferh and Fischbacher’s concept of “strong reciprocity.”<sup>68</sup>

### *The Importance of Empirical Evidence From Bangladesh and India*

So how do we adjudicate between the alternative interpretations? We argue that the empirical evidence is critical. In this section, we intertwine theoretical literature with extensive qualitative data from original field research—particularly on the Grameen Bank, the archetype of the traditional Bangladeshi model of microfinance—to develop a more nuanced account of the functioning of the microfinance mechanism (at least in the pre-crisis era) and contend with the empirical challenges to the accepted theory.<sup>69</sup> Indeed, those who work on microfinance on the ground argue that the bulk of the extensive theoretical literature misrepresents the reality of the functioning of the system, and is out of touch with current institutional developments.

Three factors, in particular, indicate that the “social” interpretation of microfinance is the more accurate one: (1) repayment rates did not drop when MFIs switched from the joint liability model to individual lending; (2) a wave of speculative defaults did not occur when the very existence of several MFIs was threatened by floods; (3) despite fidelity to the form of the original model, rapid replication has led to defaults. That is, in the vein of Granovetter’s<sup>70</sup> work on economic action’s being decipherable only in the context of social structure, the evidence would suggest that it is not the model per se that works, but only an embedded version of it.

### *Explaining the High Repayment Rates—Joint Liability or Social Capital?*

The dominant theory of microfinance has focused on joint liability. Social capital—to the extent it plays a role—is interpreted as enhanced enforcement capacity in a multi-period game and, not surprisingly, increases repayments.<sup>71</sup> We argue, however, that this account is at best incomplete.

To simplify the analysis, we view the provision of credit as a contract—implicit or explicit—between lender and borrower. Standard, formal Western-style legal systems (say in advanced industrial countries) rely on “external enforcement,” that is, on an established third-party authority (that typically is, but need not be, the state) to enforce explicit contracts. The institutional innovation of microfinance lies in its ability to induce widespread entry into the lending contract (i.e., a high rate of loan disbursement) and compliance with its terms (i.e., high repayment rates) by “informal” means.<sup>72</sup> The implicit contract, further, entails no collateral requirement and no formal legal contract.<sup>73</sup> We argue that, contrary to what is held by much of the economics literature, the enforcement mechanism in microfinance is neither external, nor can the external enforcement be replaced by one variant or another of joint liability.<sup>74</sup> We elucidate below a range of factors that contribute to the high repayment rates in terms both of the design and enforcement of the implicit contract, but argue that the critical element at play is what is described as “pro-social disposition.”

## **Contract Design: The Shift from Formal to Informal Lending**

Microfinance transformed the face of rural credit markets in South Asia by providing credit to millions typically denied access to finance as a result of costs for formal banks being too high—and thus left at the mercy of traditional moneylenders entrenched within the rural economy, but both extractive and coercive in their practices. It was able to bring more formalized credit (i.e., from the MFI rather than the moneylender) on more preferential terms to this demographic by removing certain barriers (such as collateral and formalities that made bank credit inaccessible) and reducing transaction costs of lending (by dispensing with expensive, often gratuitous, formal procedures and delegating other tasks like monitoring, via peer monitoring, that reduced operating costs). The shift to more informal and flexible lending practices were, thus, critical to the story of microfinance—but these made for a particularly

fragile institutional balancing act. We have provided detailed analysis of this elsewhere, but summarize the arguments below.

### *Collateral*

The insight that collateral is not central to the success of a credit-delivery mechanism in developing countries, where claiming it through the judicial process is nearly impossible, has been one of the most important factors contributing to the success of microfinance.<sup>75</sup> Indeed, that ownership of collateral may have very little role in widening access to credit is illustrated by the evidence on the extremely poor performance of the high profile Peruvian land titling program, that resulted in no appreciable increase in access to credit despite the formalization of millions of plots of land with the express purpose of facilitating access to capital.<sup>76</sup> Grameen's success—as an interview with the former governor of Bangladesh Bank highlighted—demonstrates the relative importance of other factors such as monitoring and screening.<sup>77</sup> Although the claim that Grameen loans are noncollateralized is contested by a small handful of observers on the ground,<sup>78</sup> it is difficult to dispute that by doing away with the requirement of asset ownership, MFIs have enabled several million Bangladeshi women to gain access to credit where they would otherwise have found it impossible to do so.

As apologists have argued, although the MFI's practice of holding borrowers' savings and insisting on contributions to the "disaster fund" may be considered somewhat paternalistic, its benefits go beyond mere loss reduction.<sup>79</sup> Forced savings provide insurance for the borrower in times of need,<sup>80</sup> whereas the disaster fund has served the bank and its workers particularly well during the frequent floods, when the bank assumes responsibility for substantial reconstruction.

### *Flexibility of the Contract*

Another aspect of the microfinance model that accounts for its success is the flexibility of the informal—or implicit—contract. On the demand side, that is, from the perspective of borrowers, the fact that the terms of the contract are malleable encourages those who would normally have been deterred by the more restrictive terms of a formal contract.<sup>81</sup>

Although the terms of a formal contract are largely fixed, and changing them could be expensive, the flexibility of the informal system allows shocks to be absorbed more readily<sup>82</sup>—as demonstrated by the recovery of Grameen in the wake of the 1998 floods.<sup>83</sup> The social contracts in-built in the microfinance model may play an important role both in preventing borrower abuse of this provision and in the creditor's taking advantage of a borrower's admission of weakness to drive a hard bargain.

## **Contract Enforcement: Legal, Economic, and Social Sanctions**

There are two possible reasons why individuals repay loans: either they fear the consequences *to themselves* that follow from nonrepayment (legal, economic, or social

punishment), or they believe it is the *right* thing to do; that is, they have been *socialized* to repay—they internalize the social consequences of nonrepayment (when they could have repaid).<sup>84</sup> The dominant enforcement mechanism in the case of microfinance is plainly not legal (since it entails no formal legal contracts, or collateral)—so the debate is with regard to whether the mechanism is primarily economic (the operation of a universal economic logic that underwrites joint liability, or the functioning of the rational actor model) or social (either fear of sanctions imposed from without, or value systems that flow from within).

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

### *Legal Mechanisms*

The premise of legal sanctions are clear: you are punished by the law if you do not comply with what it requires. To the extent that microfinance lending is based on neither the holding of collateral nor the signing of a legally binding contract, there are few legal consequences of defection or nonrepayment (notwithstanding the theoretical possibility of a contract being imputed by the law). But would the existence of such sanctions have aided the model? It is precisely these sorts of requirements that formal lenders typically rely on—and the expense associated with these procedures has made the disbursement of small loans in far-flung areas highly uneconomical, thereby depriving these regions of access to formal credit. Similarly, state agricultural banks have attempted—unsuccessfully—to rely on formal legal sanctions to recover loans. Indeed, several interviewees in the field reiterated that the threat of punishment via the state legal system may often appear empty in the context of a country like Bangladesh—where the costs and complexities associated with loan recovery by formal means are so great that the threat is, effectively, an empty one.<sup>85</sup>

### *Economic Mechanisms*

*Joint liability.* Under a strict regime of joint liability—where the capacity of one member of the group depends on others repaying—the financial motive to be invested in the compliance of other group members is obvious. Indeed, to the extent that others bear some of the consequences for nonrepayment, it is designed to incentivize peer monitoring (see below), cooperation, and selection. As discussed above, it is this explanation that the formal literature has emphasized—but, in practice, there is little evidence that others have, in fact, had to pay in the event of default by the borrower.

*Reputation and refinancing.* An obvious reason why borrowers repay is the threat that defaulters will not be refinanced. Access to credit is valuable, and the Grameen model—where those who behave well may avail of increasing amounts of credit—enhances the penalty of nonrepayment.<sup>86</sup> (For the termination of credit to provide an

effective incentive, it must, of course, not be possible for the borrower to obtain credit at comparable terms, say from informal money lenders—making it imperative for microfinance lenders to keep interest rates, at least relatively, low.<sup>87</sup>)

An increasingly important feature contributing to the desire for borrowers to maintain a positive reputation through high repayment rates is the ever-growing interlinking of markets, or, the expansion of most major MFIs into other markets that impact borrowers, thereby increasing the stakes in the relationship between bank and borrower.<sup>88</sup> Grameen, for instance, diversified into areas as varied as electricity generation, information technology, education, telecommunications, and textiles—enterprises that permeate the lives of borrowers in a variety of different ways.<sup>89</sup>

*Peer monitoring and information.* The formal economic literature growing out of Stiglitz's 1990 paper has tended to explain the high repayment rates of MFIs in terms of peer monitoring incentivized by joint liability. Since the "mutual enforcement model"<sup>90</sup>—or informal law—requires that breaches be observable but not necessarily publicly verifiable,<sup>91</sup> the information costs associated with it are inherently lower. This model has significant informational advantages over formal regulation since the community is far better poised than formal institutions to monitor the actions of borrowers—and is able to do so far more economically. Though Stiglitz did not focus on the problem of adverse selection, peers are also in a better position to ascertain who are most likely to repay. Thus, the Grameen model is able to address better both problems of "moral hazard"<sup>92</sup> and "adverse selection."<sup>93</sup>

These informational advantages are also a critical factor in allowing the flexibility of design discussed above, enabling strategic defaults (attempt at evading repayment) to be relatively easily distinguished from genuine ones (due to unforeseeable circumstances, such as a natural disaster or sickness in the family). Not only does this imply that these contracts have better in-built mechanisms of insuring against risk—but they allow the lender to give loans to those considered riskier borrowers as well, making the system inherently more inclusive.<sup>94</sup>

The lowering of the information costs of monitoring (by delegating this task to the community through peer monitoring) has certainly been an important feature contributing to the success of microfinance. The evidence seems to suggest, however, that peer monitoring could function even without the strict operation of joint liability, on the basis of the existence of a sense of community—and the fact that repayment rates remained high even as the joint and several liability system was given up suggests that something else is *central* to the success of the Grameen model.<sup>95</sup>

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

## Social Mechanisms

*Social capital and norm creation.* An alternative set of explanations of the working of microfinance focuses on "social capital."<sup>96</sup> The term is used in two different senses. In

the first, it is just another name for “implicit contracts” or “social contracts” enforced through a repeated game, where the members of the society (group) have strategies that serve to enforce the desired behavior.<sup>97</sup> This is simply a generalization of the incentive structure discussed earlier: the withdrawal of future access to credit by someone who doesn’t repay. But social cohesion, thus defined, can be broader: cooperation may entail helping other members of the group with their productive activities, thereby enhancing their ability to repay. While joint and several liability may enhance the incentives to engage in these kinds of cooperative activities, they are not necessary. The dependence of an individual’s access to credit on the repayment of others in the group incentivizes this kind of cooperative behavior within the group. This is important, because repayment rates held up even when Grameen abandoned joint and several liability.

A second, broader, interpretation of social capital, sees being connected, and maintaining the affection and respect of those with whom one is closely connected, as an essential aspect of advancing one’s own sense of well-being.<sup>98</sup> Indeed, there are at least two significant strains of literature supporting the hypothesis that behavioral norms are not merely those supported by repeated games: one stemming from evolutionary biology and grounded in genetic characteristics;<sup>99</sup> and another, derived from sociology, that talks about the cultural determination of preferences (e.g., that I feel good about myself for having treated others fairly).<sup>100</sup>

We believe that a major factor contributing to the efficacy of the microfinance model are successful attempts at social capital building (in this broader sense) and establishment of positive norms (concerning not just repayment but support for other members of the group) that are internalized by members. This was partly the result of the institutional innovation of the group mechanism, discussed at length above—which was structured to strengthen social capital. The cultivation, and use, of social capital is facilitated by the criteria for selection of members to constitute the group—lending to groups of relatively homogenous women turned out to be far more effective than more mixed groups (in terms of both gender and social class).<sup>101</sup> Further, it is important that the group develops a meaningful *social identity* before the economic calculus enters the picture—cemented by the organizational ritual surrounding group formation, such as weekly meetings. But in their attempt to create social capital, both BRAC and Grameen went well beyond the group mechanism: in BRAC, for example, with education, legal assistance, and health programs. A former Bangladeshi cabinet minister (in the “caretaker government”)—trained as both sociologist and economist—explicitly highlighted the building of social capital:

One of the key reasons for the success of the borrower-lender relationship within the microcredit paradigm is the mobilization of social capital and the ability to tap into it. The second reason for its success is its specificities: the ritual surrounding the formation of the group, the idea of the weekly meetings and so on, help to create a strong group identity over and above the economic rationale of microcredit. . . . The wider impact of the Grameen is not in the economic arena but in the psychological, sociocultural domain. The real change is occurring in the domain of ideas.”<sup>102</sup>

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

One means of probing whether the “economic” or the “social” rationale is driving repayment is analyzing what happens when borrowers think that the lender is “going under”: The fact that there were no mass defaults when the Grameen’s future was cast in doubt by the floods of the 1980s provides evidence for the proposition that it had, indeed, created norms of repayment amongst members, that went beyond pure economic interest.<sup>103</sup> As summarized by one commentator: “In Bangladesh it has now become a social norm to repay MFIs. The theoretical literature variously attributing repayment to group liability, peer pressure, and so on, is therefore irrelevant.”<sup>104</sup>

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

**Coercion.** There is one final type of enforcement mechanism—also of a broadly “social” nature, albeit significantly less normatively desirable than “social capital”—that has been used in credit markets since time immemorial: coercion. Indeed, some critics of the original microfinance model (and especially of Grameen) claim that incentive mechanisms akin to those of the old moneylenders (including the Mafia in the United States), are increasingly prevalent: brute force, intimidation, and threats by MFI workers.<sup>105</sup>

Reports of the use of force, even of a rather extreme nature—for instance, refusing to let the dead body of a member be removed till debts were cleared,<sup>106</sup> pulling down tin roofs of the huts of villagers,<sup>107</sup> threatening mothers over the safety of their daughters, even driving women into prostitution to repay debts<sup>108</sup>—have not been uncommon in the context of the microfinance industry. Although these reports have largely been of an anecdotal nature, if true more generally, MFIs have just—as alleged by some in the field—relapsed into the practices of traditional village moneylenders.<sup>109</sup> Indeed, according to some observers, the use of force in loan collections—both violent and in the form of psychological pressure—has long been the norm rather than the exception. To Grameen’s critics, such coercion is a natural consequence of the priority placed on repayment.<sup>110</sup>

Several features of microfinance potentially contribute to coercion being deployed as an enforcement mechanism. The first of these is the emphasis (in contrast to the “soft loans” typically given out by government agricultural banks) on loan repayment. While this characteristic, central to the microfinance model, is motivated by the desire to keep the institution financially sustainable while also building the financial discipline and work ethic of borrowers, there are some allegations of loan repayment being fetishized within the system and taken too literally by bank workers (i.e., as an end in itself rather than a means to an end). Second, the operation of some type of peer monitoring incentivizes group and community involvement in loan repayment— but can,

sometimes, backfire as excessive pressure to repay. Much of this is endemic to the nature of “implicit”—versus explicit—contracts. Lawyers and human rights activists, in particular, expressed concerns about lack of procedural propriety in MFI practice. They emphasized the importance of a “rights-based” approach to lending so that borrowers do not start to feel as though the loan provider “owns” them.<sup>111</sup> Indeed, on this view, requiring collateral is procedurally preferable to using force to recover loans<sup>112</sup>—loan repayment pressure, even when psychological rather than physical, can be a source of domestic violence and heightened social unrest, among a host of other social ills.<sup>113</sup> As discussed above, however, the informal mechanisms employed by microfinance are critically important in lowering costs and enabling it to be more inclusive than formal banks—and, as several interviewees in the field emphasized, psychological pressure to repay loans is not alien to formal credit markets either.

The most pernicious element in giving rise to increasing use of coercion is, however, the following: as discussed above, one of the consequences of increased entry into microfinance is increasing competition in the microfinance industry and the occurrence of “overlapping” whereby borrowers have loans from several lenders. This means that MFIs have to compete with each other to be repaid—and thus resort to “bullying” tactics.<sup>114</sup>

It is clear that there has long been evidence of at least occasional use of force in the practice of microfinance, but the key question is whether, in the context of the original microfinance model, it was the norm or the exception. Representatives of the MFIs and sympathetic observers denied that coercion is *the* major driver in the success of the microfinance experiment.<sup>115</sup> They admit that lapses into the use of coercion may occur, but sporadically rather than as a trend; they argue also that without a very high measure of consensus the scheme would have been unsustainable.<sup>116</sup>

The most compelling evidence for this proposition seems to be provided by its current “era of crisis” (to use the nomenclature from a previous section): in instances or regions where coercion appears to have become the main enforcement mechanism (such as in the SKS case in India or *Compartemos* in Mexico), the operation of microfinance has been met with mass protests and this fundamental shift in character has come to light. Although use of coercive tactics increased progressively in the transition of the original microfinance model from what we have called the “boutique moment” to the “golden age,” it does not follow that, until recently, coercion was dominant in sustaining that model.

## What Made Grameen-Style Microfinance Work?

There are several different types of contract enforcement mechanisms.<sup>117</sup> The first, “mutual affection,” is based on group members caring about one another. The second is “pro-social disposition,” based on norms of reciprocity, such as might arise out of evolutionary development and socialization. The third “mutual enforcement” is based on fear of social sanction in the context of long-term, settled relationships in a community where people encounter each other repeatedly in the same situation.<sup>118</sup> These three enforcement mechanisms are central to “informal” legal systems. The fourth is,

**Table 1.** Credit Market Contract Enforcement Mechanisms.

	Formal	Informal
Legal	Contracts / collateral	
Economic		Rational actors displaying utility maximizing behavior
Social		Social norms / shifting preferences
		Coercion

**Source:** Authors.

of course, the external enforcement that characterizes formal legal systems, or coercion within an informal system. Table 1 summarizes the key enforcement mechanisms typically used by credit providers.

The success of the enforcement mechanisms adopted by the microfinance model probably lies in a combination of all of these elements. They are, for the most part, not mutually exclusive (though the use of coercion is likely to undermine social capital). While there does appear to be evidence of the sporadic use of force, it seems unlikely, on balance, that the membership base of Grameen and that of most other “first” and “second” generation MFIs—could have reached millions if this was the dominant mode of enforcing repayment. Moreover, the reports of the use of coercion increased gradually as the microfinance industry grew—driven by factors that ultimately precipitated the crisis.

While it is important to determine the relative importance of these elements in accounting for the success of microfinance, in Bangladesh, where microfinance has been the most successful, and given credit for affecting even aggregate statistics, social capital and norm setting seems as or more important than any other explanation—not just in the narrower sense of self-interested action motivated by repeated games, but in the broader sense that we have presented.

The original microfinance model discovered, to put it simply, that it was both cheaper and more effective to sanction defaults through social disapproval (e.g., a borrower who willfully does not repay not being invited to the village Eid celebration) than through legal action that is both costly and, frequently, logistically infeasible. But for the social context effectively to change norms or shift preferences—or for community sanctioning to function—it is critical for a meaningful sense of community to exist, and building this can often be a time- and labor-intensive process. In the absence of individual economic rationality, as assumed by the rational actor model (underpinning, for instance, the effectiveness of joint liability), short-circuiting this process—as the SKS model attempted—can be highly problematic.

### Scale and Social Capital: The SKS Experiment

The institutional triumphs of microfinance have been twofold. The first is widening the population that has access to credit by means of sidestepping the traditional legal requirements attached to credit (such as collateral and formal contracts), namely, by

**Table 2.** Microfinance Institutions Compared to Banks and Moneylenders.

Type of Institution	Dominant Enforcement Mechanism	Evaluation
Formal banks (commercial banks & state rural development banks, etc.)	Legal (collateral, contracts, courts)	Expensive & ineffective
Informal moneylenders	Social (coercion)	Expensive, but effective
Microfinance institutions: group lending	Economic (joint liability & peer monitoring) and/or Social (norm creation & preference shifting)	Inexpensive & effective

**Source:** Authors.

means of an informal contract designed to be more structurally inclusive. The second is effectively enforcing the contract by recovering loans without the expense of formal legal methods or, for the most part, by reverting to the method traditional in informal markets, coercion. The novel institutional structure of microfinance—is summarized in Table 2.

The key debate is, then, whether the group lending mechanism around which microfinance is built has been largely “economic” (based on joint liability, or more generally, the economic rationality of actors) or “social” (in the sense of changing social norms or shifting preferences). We have argued that the Indian microfinance crisis helps shed light on this question.

Indeed, the magnitude of the crisis in Indian microfinance—clocking 10 million defaulters in the state of Andhra Pradesh—is such that it appears to be the product of the erosion of something fundamental to the model.<sup>119</sup> The four separate, but related, developments driven by SKS in the context of Indian microfinance outlined above—the attempt to “mass manufacture” or “scale up” microfinance, the introduction of widespread market competition, the shift to the for-profit model and the increasing incidence of political intervention in the industry—had the cumulative effect of destabilizing the performance of microfinance in its area of core competence, achieving high repayment rates.

The issue of replication is an effective means of testing the relative merits of the “economic” and “social” theories of microfinance. The purely economic account of microfinance that interprets the model as merely replacing the external enforcement (via formal contracts and collateral) of traditional credit markets with an equally formulaic solution—joint liability—trivializes the problem of replication: If just putting borrowers into groups of five with joint liability is what accounts for the success of the model, irrespective of social context or social ties, then the organization of lending on that basis should reliably result in the predicted high repayment rates. This was the premise that the SKS model of microfinance was based on—that joint liability could serve as an easy “blueprint” for replication, rather than microfinance being an inherently “tacit” or “specific” institution. If, on the other hand, the social version is the more appropriate one so that social embedding of the model, or establishing social links that

**Table 3.** Effect of Crisis on Microfinance Group Lending.

Pre-Crisis: Group Lending		Post-Crisis: Breakdown of Group Lending	
Economic		Legal	
Joint liability & peer monitoring, and/or	Inexpensive & effective	Collateral, contracts, courts, or	Expensive & ineffective
Social		Social	
Norm creation & preference shifting	Inexpensive & effective	Coercion	Expensive, but effective

**Note:** Post-crisis options represent a reversion to the enforcement mechanism of banks or moneylenders, as shown in Table 2.

**Source:** Authors.

trigger reciprocity, is critical (as the evidence from the Grameen case seems to indicate) then institutional replication becomes a much more complex problem.

The high repayment rates for which microfinance is known can be sustained by means other than building social capital—but the system then reverts to the conventional mechanisms of formal contracts and collateral (with a fraught institutional legacy in credit markets of the developing world and negative impacts on inclusivity), or to the highly retrograde mechanisms of brute force and coercion. Either results in the essence of the microfinance model being lost—making it indistinguishable, at the core, from either formal lenders or traditional moneylenders. This is summarized in Table 3.

In an emblematic victory for the traditional microfinance model, Akula admitted to the greater wisdom of the figure who initially inspired him, Yunus: “Bringing private capital into social enterprise was much harder than I anticipated.”<sup>120</sup> But if Akula, however misguided, was in honest pursuit of an innovative model, the turn that SKS has taken in its new iteration—disavowing any commitment to poverty alleviation—foretells an even more worrying future for the story of microfinance.

The first wave of microfinance almost certainly claimed too much, it now looks very unlikely, for instance, that microfinance alone will make poverty a thing of the past. But in ameliorating abject economic exclusion, bringing about social change and building community networks, the original breed of MFIs performed crucially important functions. The challenge for microfinance, then, is fundamentally to regain what it once built itself on—trust. It is unlikely that this can be achieved without a reversion to the not-for-profit model and the careful cultivation of social capital, which in turn will place inherent limits on the speed at which microfinance can be scaled up. If these brakes fail to be put on the evolution of the industry, the noble vision with which microfinance started runs the risk of being reduced to mere moneylending.

## Conclusion

Microfinance stood out, until recently, as one of the most innovative and promising of development interventions of recent times—in South Asia and worldwide. Approaching

the seemingly vexed institutional problem of lending in rural credit markets of the developing world—it appeared to have developed the revolutionary new technology of “group lending” to navigate a middle ground between the expenses and exclusivity of formal lending and the tyrannical practices of informal moneylenders, while sustaining extremely high repayment rates.

In the light of the Indian microfinance crisis that left a legacy of 10 million defaulters in the state of Andhra Pradesh and damaged the reputation of the industry world over, we set out, in this article, to explain the contrasting experience of microfinance in Bangladesh and India—or to answer the question of why a model that appeared to have emerged as a paragon in one context failed so dramatically in another. The magnitude of the Indian crisis is such, we argued, that it provides evidence of the erosion of something *fundamental* to the microfinance model—and sheds light on the long-standing question of what the *essence* of microfinance really is.

We traced the evolution of microfinance through various “generations”—going from being an intimate small-scale experiment in Bangladesh to being a global developmental phenomenon to, ultimately, being in the throes of crisis. The key change, in this process, as we highlighted, was the shift from the “Grameen model” to the “SKS model” as the focal instance of the practice of microfinance. While the Grameen model situated lending in the context of a complex network of relationships (between bank and borrower, as well as borrowers themselves) involving an explicit focus on social ritual, a self-consciously participatory structure and an institutional presence that went beyond just the credit contract, the SKS model took a more clinical, economic view of microfinance—less focused on what it considered to be the dispensable background conditions that supported the success of the Grameen model, and more on what it deemed the core of microfinance: group lending. In particular, the SKS model aimed to overcome the niche, localized quality that it argued had, thus far, characterized microfinance and to develop the fast-scaling “universal” version of it—fueled by the logic of the market, both in terms of for-profit investment raised from capital markets and the terms of the lender-borrower relationships being defined by market competition.

The formula on which SKS based its rapid replication was group lending—interpreted, in keeping with the dominant economic orthodoxy, as joint liability and the assumption that it functioned mechanically as a matter of economic rationality (irrespective of the framing conditions of the lending relationship). We have argued that this is a misinterpretation of what lay at the heart of the original microfinance model and its success—and is the root cause of its current crisis. We contend, instead, that it is social capital—broadly interpreted in terms of human altruism and reciprocity—that was the *main* factor that accounted for the triumphs of the Grameen version of microfinance in Bangladesh. In adjudicating between the “economic” and “social” accounts of microfinance, the litmus test was the formal shift by Grameen and other first generation MFIs from group to individual lending: with no impact on repayment rates. But, equally, evidence in favor of the social account is provided by the devastating impact of the rapid replication of SKS on repayment rates: demonstrating that the formal application of joint liability—in the absence of social embeddedness—is simply not a sufficient condition for the working of microfinance.

If, as the empirical evidence on the ground seems to suggest, joint liability is a myth—and, as recent developments in behavioral economics and social psychology would indicate, the rational actor model, or pure economic rationality, goes only part of the way in explaining human behavior in credit markets and other contexts—the two enforcement mechanisms available are legal or social. Although legal enforcement of the credit contract may, at least in theory, be the most normatively desirable and procedurally just enforcement mechanism (and formal regulation an increasingly important part of the microfinance industry), for reasons we have discussed at length elsewhere, at least in the context of the developing world, the shift from informal to formal lending will come with significant increases in cost and a concomitant adverse impact on inclusivity. That leaves social enforcement as the most likely choice, at least in the case of rural credit markets of the developing world—and either a reversion to the preferred mode of enforcement of traditional moneylenders, namely, brute force and coercion (of which there are increasing reports in the microfinance industry), or a return to the more innocent, if less ambitious, version of microfinance based on social capital, norm creation, and preference shifting. In resorting to coercion, microfinance sacrifices its normative value, and in lapsing to formal regulation—while preferable—it risks losing its novelty. Both developments detract from what has, so far, made microfinance unique.

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### **Notes**

1. Recent estimates point to a borrowing base in the region of 91 million worldwide, with Indian and Bangladeshi borrowers accounting for half this number: <https://www.themix.org/mixmarket/countries-regions/south-asia>. See V. Bajaj, “In India Microcredit Has Suffered a Black Eye,” *New York Times* (January 5, 2011): B3.
2. Formerly the Bangladesh Rural Advancement Committee, then Building Resources Across Communities; see <http://www.brac.net/>.

3. See, on the organization of rural lending, K. Hoff and J.E. Stiglitz, "Imperfect Information and Rural Credit Markets: Puzzles and Policy Perspectives," in Perspectives," *World Bank Economic Review* 4 (no. 3) (1990): 235–50.
4. Somewhat ironically, SKS Microfinance recently changed its name to Bharat Financial Inclusion Limited. For reasons of consistency, however, we will refer to it as SKS Microfinance throughout the article.
5. See L. Polgreen and V. Bajaj. "India Microcredit Faces Collapse from Defaults," *New York Times* (November 17, 2010): A5.
6. Although one of the first authors to use the term "social capital" was J.S. Coleman, "Social Capital in the Creation of Human Capital," *American Journal of Sociology* 94 (1988): S95–S120, it has been popularized by R. Putnam, R. Leonardi, and R.Y. Nanetti, *Making Democracy Work: Civic Traditions in Modern Italy* (Princeton, NJ: Princeton University Press, 1993); R. Putnam, *Bowling Alone: The Collapse and Revival of American Community* (New York: Simon & Schuster, 2000); and especially M. Woolcock, "Social Capital and Economic Development: Toward a Theoretical Synthesis and Policy Framework," *Theory & Society* 27, no. 2 (1998): 151–208. Despite the how widely the concept is used, it is difficult to find an authoritative definition in the development literature. Putnam defines it as follows: "By analogy with notions of physical and human capital—tools and training that enhance individual productivity—'social capital' refers to features of social organization such as networks, norms and social trust that facilitate coordination and cooperation for mutual benefit." R. Putnam, "Tuning In, Tuning Out: The Strange Disappearance of Social Capital in America," *Political Science & Politics* 28, no. 4 (1995): 664. Its benefits, he argues, include fostering norms of reciprocity and social trust, facilitating coordination, cooperation and communication, amplifying reputations, facilitating the resolution of collective action dilemmas, reducing incentives for opportunism, widening the templates of cultural collaboration and, finally, increasing the "taste" for collective benefits. Coleman does not provide a definition of social capital, but, instead, describes it as an intangible resource that pertains to relations among persons: "Just as physical capital and human capital facilitate productive activity, social capital does as well. For example a group within which there is extensive trustworthiness and extensive trust is able to accomplish much more than a comparable group without that trustworthiness and trust"; Coleman, "Social Capital," 101. Coleman distinguishes between three forms of social capital: obligations, expectations, and trustworthiness of structures; information channels; and norms and effective sanctions. Thus "social capital" and "trust" although closely related—may be distinguished from each other; trust may be seen as a subset of the concept of social capital. For the purposes of this article, however, the two terms will be used more or less interchangeably.
7. The literature on the role of social capital in microfinance began with T. Besley and S. Coate, "Group Lending, Repayment Incentives and Social Collateral," *Journal of Development Economics* 46, no. 1 (1995): 1–18. However, there has been a recent resurgence of roughly contemporaneous research on the topic. We first presented these ideas in A. Haldar and J.E. Stiglitz, "Undue Credit: Is Formal Law Essential for Development?" (paper presented at the Initiative for Policy Dialogue China Task Force Meeting, Manchester, 2008), and in A. Haldar and J.E. Stiglitz, "Analyzing Legal Formality and Informality: Evidence from Land-Titling and Microfinance Programs," in D. Kennedy and J.E. Stiglitz, eds., *Law and Economics with Chinese Characteristics: Institutions for the Twenty-first Century* (Oxford: Oxford University Press, 2013). For a number of excellent recent papers empirically demonstrating the importance of social capital in microfinance, see D.S. Karlan, "Social Connections and Group Banking," *Economic Journal*

- 117, no. 517 (2007): F52–F84; A. Cassar, L. Crowley, and B. Wydick, “The Effect of Social Capital on Group Loan Repayment: Evidence from Field Experiments,” *Economic Journal* 117, no. 517 (2007): F85–F106; A. Cassar and B. Wydick, “Does Social Capital Matter? Evidence from a Five-Country Group Lending Experiment,” *Oxford Economic Papers* 62, no. 4 (2010): 715–39; and B. Feigenberg, E.M. Field, and R. Pande, *Building Social Capital through Microfinance* (unpublished paper, Harvard Kennedy School, 2010). The discussion in the text highlights important differences among these authors in usage of the term “social capital” and the mechanisms through which it operated.
8. For a history of the Grameen Bank through the Yunus’s eyes, see M. Yunus, *Banker to the Poor* (London: Aurum Press, 1998). See also <http://www.grameen-info.org/>.
  9. See <http://www.asa.org.bd>.
  10. M. Yunus, *Grameen Bank at a Glance* (Dhaka: Grameen Bank, 2008).
  11. As shown by M.S. Emran, A.K.M. Morshed, and J.E. Stiglitz, *Microfinance and Missing Markets* (working paper, March 2007; online at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1001309](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1001309)), one of the consequences (given imperfections of labor markets) was that rural labor was vastly underemployed.
  12. The exact figure is disputed, but it is broadly accepted that repayment rates in the micro-finance industry have traditionally been extremely high, especially when compared with conventional banks. See, for an early estimate of Grameen repayment rates, M. Hossain, *Credit for Alleviation of Rural Poverty: The Grameen Bank in Bangladesh*, International Food Policy Research Institute Report no. 65 (Washington, DC: IFPRI, 1998).
  13. The factors that sustained these repayment rates are discussed at length in the text. For a detailed analysis of the merits of an informal contract over a formal one, see A. Haldar and J.E. Stiglitz, “Analyzing Legal Formality and Informality.”
  14. M. Yunus, *Grameen Bank at a Glance*, 2.
  15. See, for a bank worker’s account, A. Dowla and D. Barua, *The Poor Always Pay Back: The Grameen II Story* (Bloomfield, CT: Kumarian, 2006).
  16. The United Nations, e.g., declared 2005 the Year of Microcredit, and the World Bank was the biggest funder of microfinance worldwide; see <https://openknowledge.worldbank.org/bitstream/handle/10986/12383/18771.pdf>.
  17. See [https://www.nobelprize.org/nobel\\_prizes/peace/laureates/2006/yunus-lecture-en.html](https://www.nobelprize.org/nobel_prizes/peace/laureates/2006/yunus-lecture-en.html).
  18. For instance, S.R. Khandker, “Microfinance and Poverty: Evidence Using Panel Data from Bangladesh,” *World Bank Economic Review* 19, no. 2 (2005): 263–86, estimates that microfinance in Bangladesh has reduced poverty in Bangladesh only by 1 percent per year. Still, that means that over the thirty years since the beginning of Grameen, the poverty rate has been reduced significantly: this is reflected in a newer study, S.R. Khandker and H.A. Samad, “Dynamic Effects of Microcredit in Bangladesh,” World Bank Policy Research Working Papers, March 2014. Any discussion of the impact of microfinance programs is, however, mired in the methodological controversies of the Pitt-Morduch debate. Using the same dataset, Morduch arrived at a very different (and more negative) set of conclusions about the impact of microfinance from Pitt and Khandker. See J. Morduch, “Does Microfinance Really Help the Poor? New Evidence from Flagship Programs in Bangladesh” (working paper, Hoover Institution, June 7, 1998); M.M. Pitt and S.R. Khandker, “The Impact of Group Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?” *Journal of Political Economy* 106, no. 5 (1998): 958–96. Morduch explicitly challenged their findings, mainly on a number of methodological flaws (e.g., Pitt and Khandker’s calculation of land ownership by beneficiary households, village fixed effects). Pitt responded with a defense of the original methodology: M. Pitt, “Reply to Johathan Morduch’s ‘Does Microfinance Really

- Help the Poor? New Evidence from Flagship Programs in Bangladesh” (working paper, Department of Economics, Brown University, 1999). The exchange illustrates the difficulties that underlie “impact assessments” of development programs in general, including large-scale quantitative studies based on substantial datasets and rigorous econometric analysis—and the consequent difficulty of arriving at a definitive pronouncement on the success or failure of a program. The ongoing nature of this debate is illustrated by the differences in the findings of Khandker and the more pessimistic ones based on “randomized control trials,” see, e.g. Crepon et al., “Estimating the Impact of Microcredit on Those Who Take it Up: Evidence From a Randomized Experiment in Morocco,” 2014; online at [economics.mit.edu/files/6659](http://economics.mit.edu/files/6659).
19. One very obvious manifestation, repeatedly reported in interviews, was an observable increase in female mobility, or women being seen outside the home. For other instances see M.M. Pitt, S.R. Khandker, and J. Cartwright, “Empowering Women with Micro Finance: Evidence from Bangladesh,” *Economic Development & Cultural Change* 54, no. 4 (2006): 791–831; S.R. Schuler, S. Hashemi, and A. Riley, “The Influence of Women’s Changing Roles and Status in Bangladesh’s Fertility and Contraceptive Use,” *World Development* 31, no. 3 (1996): 513–34.
  20. See A. Haldar, “Rethinking Law and Development: Evidence from Land Titling and Microfinance Programmes” (PhD thesis, University of Cambridge, 2011), Chap. 3. These developments were paid relatively little attention by the academic community, but the crisis in India would have come as less of a surprise if the warning signals in Bangladesh had been heeded.
  21. The former governor of the Reserve Bank of India explicitly makes this comparison: see G. Nayak, “Microfinance in India Is Like Subprime Lending: YV Reddy,” *Economic Times* (November 23, 2010).
  22. Ibid.
  23. A. Ballem, D. George, G. Mohammed, R. Kapoor, S. Chakraborty, and N. Venkata, “What Are Clients Doing post the Andhra Pradesh MFI Crisis,” Microsave Research Report (2011); online at [http://www.microsave.net/files/pdf/What\\_are\\_Clients\\_doing\\_Post\\_the\\_Andhra\\_Pradesh\\_MFI\\_Crisis.pdf](http://www.microsave.net/files/pdf/What_are_Clients_doing_Post_the_Andhra_Pradesh_MFI_Crisis.pdf).
  24. V. Bajaj, “Amid Scandal, Chairman of Troubled Lender Will Quit,” *New York Times* (November 24, 2011): B3. This accords with estimates provided by Vikram Akula in an interview with NDTV that repayment rates in the immediate aftermath of the crisis had dropped to 43 percent, but fell further to 10 percent (NDTV, May 13, 2011); online at <http://www.ndtv.com/video/shows/ndtv-special-ndtv-profit/no-question-of-insolvency-sks-microfinance-chief-199488>.
  25. See L. Polgreen and V. Bajaj, “India Microcredit Faces Collapse from Defaults,” *New York Times* (November 17, 2010): A5.
  26. The October 14 Ordinance, now the Andhra Pradesh Microfinance Institutions Act, 2010.
  27. CGAP, “Andhra Pradesh 2010: Global Implications of the Crisis in Indian Microfinance,” CGAP Focus Note 67 (Washington, DC: CGAP, November 2010); online at <http://www.cgap.org/sites/default/files/CGAP-Focus-Note-Andhra-Pradesh-2010-Global-Implications-of-the-Crisis-in-Indian-Microfinance-Nov-2010.pdf>.
  28. N. Srinivasan, *Microfinance State of the Sector in India* (New Delhi: Sage Publications, 2010).
  29. D. Johnson and S. Meka, “Access to Finance in Andhra Pradesh” (Chennai: IFMR Research 2010); online at <http://ifmrlead.org/access-to-finance-in-andhra-pradesh/>.
  30. “Status of Micro Finance in India—2008–09” (Mumbai: National Bank for Agriculture and Rural Development, March 2010); online at <https://www.nabard.org/Publication/>

- SMFI%202008-09.pdf. This dramatic increase in commercial lending to MFIs was partially the result of a government requirement to apportion a certain percentage of credit to “priority sectors”—further strengthening the analogies with the US subprime mortgage crisis.
31. Limiting competition has two effects: First, it reduces the problem of overlap noted earlier; and second, it increases the franchise value (the ongoing value of an enterprise), which provides enhanced incentives for “good behavior,” e.g., not engaging in excessive risk taking, or bad or fraudulent lending practices. See T. Hellman, K. Murdoch, and Joseph E. Stiglitz, “Liberalization, Moral Hazard in Banking and Prudential Regulation: Are Capital Requirements Enough?,” *American Economic Review* 90, no. 1 (2000): 147–65.
  32. See further “Report of the Sub-Committee of the Central Board of Directors of Reserve Bank of India to Study Issues and Concerns in the MFI Sector” (Mumbai: Reserve Bank of India, January 2011), online at <https://rbidocs.rbi.org.in/rdocs/PublicationReport/Pdfs/YHMR190111.pdf>.
  33. The legislation—The Microfinance Institutions (Development and Regulation) Bill 2012—is still being debated. See M. Jogota, “India Government Introduces Bill to Regulate Microfinance,” *Wall Street Journal* (May 22, 2012).
  34. SKS reacted initially by retracting substantially from the original microfinance model—and shifting an increasing part of its lending portfolio to collateralized lending, namely, issuing business loans against gold as collateral. V. Bajaj, “Luster Dims for Microlender,” *New York Times* (May 11, 2011): B1. It has, since, trimmed operations and largely withdrawn from Andhra Pradesh and its agenda of poverty alleviation—thereby restoring profitability.
  35. S. Chakraborty and P. Sokhi, “At 9.3 Million, a Third of MFI Borrowers and Defaulters,” *Business Standard* (March 22, 2012): A1.
  36. To provide a few examples: In Mexico, there are reports of microfinance institutions charging interest rates in the region of 125 percent; see N. MacFarquhar, “Making Big Profits from Tiny Loans,” *New York Times* (April 14, 2010). In Nicaragua, “*movimiento no pago*”—the no-pay movement—was started by farmers who could not pay their debts, and supported by the president. V. Bajaj, “In India Microcredit Has Suffered a Black Eye,” *New York Times* (January 5, 2011): B3.”
  37. For an influential critique of how microfinance distracts from more determined efforts at structural change see M. Bateman and H.J. Chang. “Microfinance and the Illusion of Development: From Hubris to Nemesis in Thirty Years,” *World Economic Review* 1 (2012): 13–36.
  38. See D. Rodrik, “Institutions for High Quality Growth: What They Are and How to Acquire Them,” *Studies in Comparative International Development* 35, no. 3 (2000): 3–31. This distinction is far from absolute: microfinance has always been a hybrid institution. Indeed, although it is accurate to classify the Grameen Bank as substantially informal in its relationship with borrowers—especially since there exists no formal contract between bank and borrower, and default on the part of the borrower is not regulated by formal legal sanction—the Grameen itself is not an entirely “informal” institution. As described above, it started as a series of experiments in various Bangladeshi villages—but consolidating those experiments into what is now the Grameen Bank required formal law, i.e., the Grameen Bank Ordinance Act 1983. Thus, despite the fact that the Grameen is able to maintain contractual relations with so many million borrowers without needing to resort to formal law, the institution operates within the framework of a more formal legal system in Bangladesh.

39. Personal interview, Grameen Bank headquarters, Dhaka, April 20, 2009.
40. Personal interview, Grameen Bank headquarters, Dhaka, March 19, 2009.
41. Aminur Rahman, *Women and Microcredit in Rural Bangladesh: Anthropological Study of the Rhetoric and Realities of Grameen Bank Lending* (Boulder, CO: Westview Press 1999).
42. Eric Van Tassel, "Household Bargaining and Microfinance," *Journal of Development Economics* 74, no. 2 (2004): 449–68; Ethan Ligon, "Dynamic Bargaining in Households (with an Application to Bangladesh)," Giannini Foundation Working Paper (Berkeley: University of California, 2002).
43. L.N.K. Osmani, "Impact of Credit on the Relative Well-Being of Women: Evidence from the Grameen Bank," *IDS Bulletin* 29, no. 4 (1998): 31–88; S.R. Schuler and S.M. Hashemi, "Credit Programs, Women's Empowerment, and Contraceptive Use in Rural Bangladesh," *Studies in Family Planning* 25, no. 2 (1994): 65–76; S.R. Schuler, S. Hashemi, and A. Riley, "The Influence of Women's Changing Roles and Status in Bangladesh's Fertility and Contraceptive Use," *World Development* 31, no. 3 (1996): 513–34; Pitt, Khandker, and Cartwright, "Empowering Women with Micro Finance: Evidence from Bangladesh," *Economic Development & Cultural Change* 54, no. 4 (2006): 791–831.
44. Schuler, Hashemi, and Riley, "The Influence of Women's Changing Roles"; S.R. Schuler, S.M. Hashemi and S. Huda Badal, "Men's Violence against Women in Bangladesh: Undermined or Exacerbated by Microcredit Programmes?," *Development in Practice* 8, no. 2 (1998): 148–57.
45. P. Sanyal, "From Credit to Collective Action: The Role of Microfinance in Promoting Women's Social Capital and Normative Influence," *American Sociological Review* 74 (2009): 529–50.
46. Pitt and Khandker find that annual household consumption expenditure increases by Tk 18 for every additional Taka borrowed by women from these credit programs, compared with Tk 11 for men. M.M. Pitt and S.R. Khandker, "The Impact of Group-Based Credit Programs on Poor Households in Bangladesh: Does the Gender of Participants Matter?," *Journal of Political Economy* 106, no. 5 (1998): 958–96.
47. See Greg Chen, Stephen Rasmussen, Xavier Reille, and Daniel Rozas, "Indian Microfinance Goes Public: The SKS Initial Public Offering," CGAP Focus Note 65 (Washington, DC: September 2010), 1; available online at <https://www.cgap.org/sites/default/files/CGAP-Focus-Note-Indian-Microfinance-Goes-Public-The-SKS-Initial-Public-Offering-Sep-2010.pdf>.
48. *Time Magazine* (May 8, 2006).
49. See Akula's profile on the Echoing Green website: <http://www.echoinggreen.org/fellows/vikram-akula>.
50. Bharat Financial Inclusion Limited (formerly known as SKS Microfinance Limited), 2009; online at <http://www.bfil.co.in/how-we-do/>. See also Chen et al., "Indian Microfinance Goes Public," 3.
51. See S. Strom and V. Bajaj, "Rich I.P.O. Brings Controversy to SKS Microfinance," *New York Times* (July 30, 2010): B1.
52. See M. Yunus, "Sacrificing Microfinance for Megaprofits," *New York Times* (January 15, 2011): A23.
53. See E. Malkin, "Microfinance's Success Sets Off Debate in Mexico" *New York Times* (April 6, 2008): C1.
54. T. Bhandopadhyay and D. Unnikrishnan, "SKS Microfinance: The Inside Story," *Live Mint* (February 7, 2013).

55. A recent theoretical paper argues that a for-profit lender can exploit social capital to design more efficient contracts: J. De Quidt, T. Fetzer, and M. Ghatak, "Microfinance, Social Capital and For-Profit Lending" (unpublished paper, London School of Economics, 2012) But although social capital can improve the functioning of markets, and under perfect competition the gains from social capital will accrue to borrowers, in most real world settings, the shift to for-profit lending will (and did, in the case of SKS) erode social capital. R. Arnott and Joseph E. Stiglitz, "Moral Hazard and Nonmarket Institutions: Dysfunctional Crowding Out of Peer Monitoring?," *American Economic Review* 81, no. 1 (1991): 179–90.
56. Ballem et al., "What Are Clients Doing?"
57. Sandel provides the example of a daycare center in Israel where defections (in the sense of parents arriving late to pick their children up) rose as a result of monetizing bad behavior—the parents were happy to pay the fine and be spared the moral responsibility they felt earlier. M. Sandel, *What Money Can't Buy: The Moral Limits of Markets* (New York: Farrar, Straus & Giroux, 2012). It is, of course, also true that the consequences of non-repayment are reduced, since an individual might be able to borrow from another MFI. See also R. Titmus, *The Gift Relationship: From Human Blood to Social Policy* (London: LSE Books, 1970).
58. Including, notably, in Bangladesh, where Sheikh Hasina launched a movement to oust Yunus from Grameen on the basis of a technicality. See Z. Mahmood and M. Magnier, "Nobel Laureate Economist Yunus May Be a Victim of Petty Jealousy," *Los Angeles Times* (March 6, 2011); R. Nolan, "Did 'Hingsha' Do In a Nobel Prize Winner?" *New York Times Magazine* (March 22, 2011).
59. For a critical perspective on government intervention in India, see A. Kazmin, "Microfinance: India Considers Rate Cap on Loans to the Poor," *Financial Times* (November 17, 2010). In the Andhra Pradesh case there are also specific insinuations that MFIs were stepping on the toes of the government-funded SHGs.
60. Sheikh Hasina, e.g., famously referred to Yunus as "*shoudkhor*"—a highly derogatory Bengali term for moneylender. Personal interview with a senior journalist at Bangladesh's leading English language daily, *Daily Star*, May 5, 2009. The shifts in practice by SKS—e.g., increasingly lending against collateral—provide alarming evidence of a reversion to traditional moneylending.
61. "Akula Steps Down at SKS," *Business Standard* (November 24, 2011).
62. T. Bandopadhyay and D. Unnikrishnan, "SKS Microfinance: The Inside Story" *Live Mint* (February 7, 2013).
63. For an overview of the literature, see B. Armendriz de Aghion and J. Morduch, *The Economics of Microfinance* (Cambridge, MA: MIT Press, 2010).
64. Another theory, popular in the early days of microfinance, argued that they were not really successful, but survived on subsidies, largely from donors. (The benefit of high repayment rates was partially offset by the high transactions costs inevitable in dealing with very small loans.)
65. Joseph E. Stiglitz, "Peer Monitoring and Credit Markets," *World Bank Economic Review* 4, no. 3 (1990): 351–66; see also H. Varian, "Monitoring Agents with Other Agents," *Journal of Institutional & Theoretical Economics* 146, no. 1 (1990): 153–17; M. Ghatak, "Group Lending, Local Information and Peer Selection," *Journal of Development Economics* 60, no. 1 (1999): 27–50; M. Ghatak and T. Guinnane, "The Economics of Lending with Joint Liability: Theory and Practice," *Journal of Development Economics* 60, no. 1 (1999): 195–228; and Beatriz Armendariz De Aghion "On the Design of a Credit Agreement with Peer Monitoring," *Journal of Development Economics* 60, no. 1 (1999): 79–104.

66. Timothy Besley and Stephen Coate, "Group Lending, Repayment Incentives and Social Collateral," *Journal of Development Economics* 46, no. 1 (1995): 1–18.
67. This may be especially important since the borrowers are largely women who find themselves in unfamiliar positions, both as active economic agents and in breaking out of their traditional social roles.
68. In an excellent review article, Fehr and Fischbacher explain that the concept of "strong reciprocity" extends beyond reciprocal altruism and reputation-based cooperation:

Strong reciprocity is a combination of altruistic rewarding, which is a predisposition to reward others for cooperative, norm abiding behaviours, and altruistic punishment, which is a propensity to impose sanctions on others for norm violations. Strong reciprocators bear the cost of rewarding or punishing even if they gain absolutely no economic benefit whatsoever from their acts. Strong reciprocity thus constitutes a powerful incentive for cooperation even in non-repeated interactions and when reputation gains are absent, because strong reciprocators will reward those who cooperate and punish those who defect.

- E. Fehr and U. Fischbacher, "The Nature of Human Altruism," *Nature* 425 (2003): 85–86. They further argue that "the interaction between selfish and strongly reciprocal individuals is essential for understanding human cooperation . . . identify[ing] conditions under which selfish individuals trigger the breakdown of cooperation, and conditions under which strongly reciprocal individuals have the power to ensure widespread cooperation." E. Fehr, U. Fischbacher, and S. Gächter, "Strong Reciprocity, Human Cooperation and Enforcement of Social Norms," *Human Nature: An Interdisciplinary Biosocial Perspective* 13, no. 1 (2002): 1–25.
69. Intensive field research was conducted in Bangladesh (January–June 2009). The results are more fully reported in Haldar, "Rethinking Law and Development." The qualitative data, mostly from in-depth interviews—are presented as supporting evidence largely in the endnotes rather than the main text.
  70. Mark Granovetter, "Economic Action and Social Structure: The Problem of Embeddedness," *American Journal of Sociology* 91, no. 3 (1985): 481–510.
  71. If individuals do not interact repeatedly, then, of course, repeated games do not provide an effective enforcement mechanism. When they interact across a wider area, there is a broader range of sanctions that can be imposed for noncooperative behavior. See J.E. Stiglitz, "Formal and Informal Institutions," in P. Dasgupta and I. Serageldin, eds., *Social Capital: A Multifaceted Perspective* (Washington, DC: World Bank, 2000).
  72. A major development in the theoretical work questioning the centrality of the "external enforcement model" is Ostrom's work on common pool resources. See, e.g., E. Ostrom, J. Walker, and R. Gardner, "Covenants with and without a Sword: Self-Governance Is Possible," *American Political Science Review* 86, no. 2 (1992): 404–17.
  73. It is a matter of some controversy whether a legal obligation—and hence a contract—between bank and borrower exists in law or not. There is certainly no written contract between bank and borrower, and the bank neither intends that a contract exist nor takes legal action against borrowers in a court of law, but it may be that the law, nonetheless, imputes a contract contrary to the intentions of the bank. Since no legal action has in fact been taken by the bank against a borrower, this remains a point of academic debate.
  74. Implicit contracts (repeated games) can be enforced even without joint liability.

75. Of course, much lending in advanced industrial countries is also not collateral-based, but there are effective enforcement of credit contracts through the courts, making the wealth of the corporation or the individual (that has not otherwise been put up for collateral) act effectively as collateral. It is interesting that the growing use of collateralized obligations by banks and other financial institutions may be crowding out noncollateralized lending in some advanced industrial countries. The economic consequences of this are the subject of ongoing research.
76. See further A. Haldar, "Rethinking Law and Development," and Haldar and Stiglitz, "Analyzing Legal Formality and Informality."
77. As he put it: "The key lesson for conventional banks is that collateral is not so important, especially given how difficult it is to claim through the judicial process. Another lesson that conventional banks can learn is the importance of monitoring—especially a careful review of the lender profile." Personal interview at his residence in Baridhara, Dhaka, April 21, 2009. He adds an interesting insight: it may be possible to introduce some elements of "peer monitoring" or "peer pressure" into commercial lending by getting chambers of commerce and other such organizations to exclude defaulters from their activities.
78. According to a well-known human rights activist, although the MFIs claim not to hold collateral, in effect, various categories of forced contributions amount to an insurance fund for the MFI. Personal interview at the headquarters of prominent Bangladeshi NGO *Nijera Kori*, Dhaka, April 24, 2009.) But such collateral typically offsets only a small part of the potential loss.
79. Personal interview with a Grameen Bank "center manager" on a field trip to Tangail, March 21, 2009.
80. A senior lawyer-developmental, for instance, argued that these forced savings were part of the explanation for the high repayment rates of MFIs. Personal interview, Center for Governance Studies, BRAC University, March 24, 2009.
81. Of course, in principle, a formal contract can build in flexibility, with automatic contingency clauses or broader clauses providing for renegotiation under certain circumstances. This is a context in which there may be an important difference between (formal or informal) contracts between borrowers and for-profit lenders and not-for-profit lenders. Especially in times of crisis, the borrower will not have access to alternative suppliers of credit, and so he is likely to be in a very disadvantageous bargaining position, and there may be a (rational) fear that a for-profit lender may take advantage of the unfortunate borrower in these circumstances. One might have hoped that "lender reputation" would mitigate these risks, but even in the best of circumstances (and poor developing countries do not provide the best of circumstances) it may take a long time for creditors to establish such good reputations. In advanced countries, loan flexibility provides an important advantage of institutional provision of credit (that is, through banks, engaged in a long-term relationship, rather than through capital markets). See B.C.N. Greenwald and J.E. Stiglitz, "Information, Finance and Markets: The Architecture of Allocative Mechanisms," *Industrial & Corporate Change* 1, no. 1 (1992): 37–63.
82. Typically, however, even within a formal system there is scope for renegotiation, subject to the concerns raised in the previous note. There are special problems posed by a natural disaster: whereas the necessity of renegotiating large numbers of contracts may make such a strategy infeasible, the problems of moral hazard are somewhat mitigated. Note too that concerns about agency problems by mortgage service providers led, in the United States, to lenders' restricting the possibility of renegotiation in debt contracts.

83. Redrawing of repayment schedules allowed a significant recovery of losses. See further Dowla and Barua, *The Poor Always Pay Back*. See also N. Nayar and E.M. Hasan Faisal, "Microfinance Survives Bangladesh Floods" *Economic & Political Weekly* 34, no. 14 (1999): 801–3.
84. Coleman distinguishes between "internalized" and "shared" norms. Breach of internalized norms leads to feelings such as anxiety, guilt, and a lowered self-worth. "Shared" norms involve sanctioning for nonconformity by others of the same group who exhibit social displeasure if the norm is breached. Shared norms are frequently internalized; and when this happens, the costs of a breach are both social and psychic. The greater the scope for reinforcing shared norms, the stronger they are. Tipping in the United States is an example of a norm that is "internalized" and further reinforced by "sharing." J.S. Coleman, "Social Capital."
85. This factor was anticipated in the theoretical literature by Joseph E. Stiglitz, "Peer Monitoring and Credit Markets," *World Bank Economic Review* 4, no. 3 (1990): 351–66, as well as by Besley and Coate, "Group Lending, Repayment Incentives and Social Collateral," and was stressed by several interviewees in the field. A prominent legal expert in Bangladesh explained:

The threat of social and financial sanction on which microfinance organizations operate is far more real than the formal sanction of law courts. Even in the absence of an explicit contract, local forces are used to make sure that people comply. A lot of contractual relations in Bangladesh don't work because the threat of being taken to court is meaningless. The sense of impunity is quite high and there is very little sense of redress.

Personal interview, Office of the Institute of Governance Studies, Dhaka, March 24, 2009.

86. See Stiglitz, "Peer Monitoring and Credit Markets," which followed on A. Braverman and Joseph E. Stiglitz, "Sharecropping and the Interlinking of Agrarian Markets," *American Economic Review* 72, no. 4 (1982): 695–715; see also T. Besley, "Nonmarket Institutions for Credit and Risk Sharing in Low-Income Countries," *Journal of Economic Perspectives* 9, no. 3 (1995): 115–27. One extremely eminent development economists interviewed stressed this factor, in particular: "The MFIs are a great boon to the poor in their struggle for survival—they realize that if they don't repay, their access will be cut off." Personal interview, Bangladesh Institute of Development Studies Office, Dhaka, April 18, 2009.
87. Notice this incentive was at the heart of work by J. Eaton and M. Gersovitz, "LDC Participation in International Financial Markets: Debt and Reserves," *Journal of Development Economics* 7 (1980): 3–21, and by J. Eaton, M. Gersovitz, and Joseph E. Stiglitz, "The Pure Theory of Country Risk," *European Economic Review* 30, no. 3 (1986): 481–514, analyzing sovereign debt, in which the same issue arises: Why do sovereigns repay, in the absence of a credible legal enforcement mechanism? Joseph E. Stiglitz and A. Weiss, "Incentive Effects of Termination: Applications to the Credit and Labor Markets," *American Economic Review* 73, no. 5 (1983): 912–27, show the threat of termination of credit can be an effective incentive device even within a competitive credit market.
88. Hoff and Stiglitz emphasize the importance of interlinking markets. K.R. Hoff and J.E. Stiglitz, "Imperfect Information and Rural Credit Markets: Puzzles and Policy

- Perspectives,” *World Bank Economic Review* 4, no. 3 (1990): 235–50. Grameen enterprises include Grameen Shakti (energy), Grameen Phone, Grameen Telecom, Grameen Cybernet, Grameen Communications, Grameen Solutions Ltd., Grameen IT Park, Grameen Information Highways Ltd., Grameen Trust, Grameen Fund, Grameen Shikkha (education), Grameen Star Education Ltd., Grameen Knitwear, Gonoshastaya Grameen Textile Mills Ltd, Grameen Bitek Ltd, Grameen Uddog (enterprise), Grameen Shamogree (products), Grameen Capital Management Ltd, Grameen Byabosa Bikash (business promotion), Grameen Health Care Trust, Grameen Healthcare Services Ltd, Grameen Veolia Water Ltd., and, the world’s first “social-business enterprise,” Grameen Danone Food Ltd. It is notable that Grameen Bank does not own shares in these companies. They are independent companies bound by the usual tax and other obligations. See, further, M. Yunus, *Creating a World without Poverty: Social Business and the Future of Capitalism* (New York: Public Affairs, 2007).
89. Thus, not only may a person be a Grameen borrower, but Grameen may, at the same time, be her employer, bank, source of infrastructural facilities, or provider of goods and services and may run her daughter’s school. The omnipresence of Grameen and some other leading Bangladeshi NGOs has led to speculation about their having become para-governmental organizations.
  90. P. Dasgupta, “Social Capital and Economic Performance: Analytics,” in E. Ostrom and T.K. Ahn, eds., *Critical Writings in Economic Institutions: The Foundations of Social Capital* (Cheltenham: Edward Elgar, 2003); online at <http://citeseerx.ist.psu.edu/viewdoc/download?doi=10.1.1.127.8067&rep=rep1&type=pdf>.
  91. Typically a “lower” standard, i.e., many observable breaches may not be easily verifiable by an independent court, especially when courts are circumscribed in the kinds of evidence that are admissible, and borrowers know this.
  92. This is a technical term used in the economic literature to describe the difference between a person insulated from risk and another fully exposed to risk in a particular situation. On the advantages of the microfinance model in avoiding this problem, see R. Arnott and Joseph E. Stiglitz, “Moral Hazard and Nonmarket Institutions: Dysfunctional Crowding Out of Peer Monitoring?,” *American Economic Review* 81, no. 1 (1991): 179–90.
  93. This economic term refers to “bad” results in market processes that arise from buyers and sellers having asymmetric information. On the benefits of the microfinance model in dealing with this problem, see M. Ghatak, “Group Lending, Local Information.”
  94. B. Wydick, “Can Social Cohesion Be Harnessed to Repair Market Failures? Evidence from Group Lending in Guatemala,” *Economic Journal* 109, no. 457 (1999): 463–75, finds evidence of this insurance dimension of group lending.
  95. See, e.g., A. Jain, “Managing Credit for the Rural Poor: Lessons from Grameen Bank,” *World Development* 24, no. 1 (1996): 79–89). We have, however, already noted that, even in the absence of joint and several liability, cooperative behavior can also be induced by making access to future credit dependent on group repayment.
  96. Haldar and Stiglitz, “Undue Credit” and, “Analyzing Legal Formality and Informality.”
  97. It should be emphasized that socially desirable behavior can be so enforced, but so too can less desirable forms of behavior, such as caste, race, and gender discrimination. See, e.g., F. Fukuyama, “Social Capital” in L.E. Harrison and S.P. Huntington, eds., *Culture Matters: How Values Shape Human Progress* (New York: Basic Books, 2001).
  98. See, e.g., Putnam, *Bowling Alone*; J.E. Stiglitz, A.K. Sen, and J.P. Fitoussi, *Mismeasuring Our Lives: Why GDP Doesn’t Add Up* (New York: New Press, 2010).

99. See, e.g., E.O. Wilson, *Sociobiology: The New Synthesis* (Cambridge, MA: Harvard University Press, 1975), which popularized a field that attempts to explain social behavior of animals in terms of genetics, evolution, and natural selection. There is hefty debate as to the exact evolutionary drive behind eusocial behaviors such as cooperation and altruism, but it is agreed that eusocial and prosocial behavior evolved over years of natural selection, and that these behaviors are inherent in our genes. See M.A. Nowak, "Five Rules for the Evolution of Cooperation," *Science* 314 (2006): 1560–63.
100. A study of "ethics and compliance" initiatives in the corporate world, T. Tyler, J. Dienhart, and T. Thomas, "The Ethical Commitment to Compliance: Building Value Based Cultures," *California Management Review* 50, no. 2, (2008): 31–51, found that the "values and integrity" approach to promoting compliance was far more effective than the traditional "command-and-control" approach. See also L.S. Paine, "Managing for Organizational Integrity," *Harvard Business Review* 72, no. 2 (1994): 106–17; L.K. Trevino, G.R. Weaver, D.G. Gibson, and B.L. Toffler, "Managing Ethics and Legal Compliance: What Works and What Hurts," *California Management Review* 41, no. 2 (1999): 131–51.
101. A senior associate at BRAC emphasized the aspects of the group mechanism that promote loan repayment:

The fact that groups are homogenized and lending is mostly to poor women is important. In the early 1970s, with nonhomogenous groups, the system didn't work. Mixed groups of men and women were highly ineffective. Money entered the picture much later, when members of the group already knew each other. The social function of the selection of women as borrowers is crucial since the sense of responsibility of women, their commitment to the household and children and their traditional role as custodians of "family honor" lend themselves well to the functioning of the mechanism.

Personal interview, BRAC Institute of Governance, Dhaka, March 24, 2009.

102. Personal interview, Power and Participation Research Centre Office, Dhaka, March 29, 2009.
103. This factor was alluded to by an internationally renowned economist and microfinance researcher interviewed. Personal interview at the office of the BRAC Institute of Development Studies, Dhaka, April 17, 2009.
104. Personal interview with the former Chairman of the Palli Karma Shohayok Foundation the Institute of Microfinance at his Motijheel residence, April 1, 2009.
105. This allegation was made in the academic literature early on by Rahman and Mallick, and such claims have since become more widespread. Rahman, *Women and Microcredit in Bangladesh*; R. Mallick, "Implementing and Evaluating Microcredit in Bangladesh," *Development in Practice* 12, no. 2 (2002): 153–63.
106. Personal interview with a prominent Bangladeshi international lawyer at his Gulshan residence, Dhaka, April 3, 2009.
107. Personal interview with a well-known Bangladeshi economist (formerly at Dhaka University and now founder of his own think tank on development) at the *Unnayan Parishad* office, April 27, 2009.
108. Personal interview with an extremely high-profile lawyer with close ties to the Hasina administration at the Sonar Bangla Hotel, Dhaka, April 3, 2009.
109. This is specifically the allegation that Sheikh Hasina, the Bangladeshi prime minister, makes against Yunus.

110. According to one human rights activist interviewed, the use of force—both violent and in the form of psychological pressure—is common practice: “These are situations in which the MFI is forcing people to repay who can’t. For the ground staff, everything—from their salary to their prospects of promotion—depends on their being able to collect repayment.” Personal interview, *Nijera Kori* office, April 24, 2009. Another well-known economist put it as follows: “The purpose of the MFIs is to collect money; they will use any means available” Personal interview, Bangladesh *Unnayan Parishad* office, April 27, 2009.
111. Personal interview with a prominent human rights activist at the *Nijera Kori* Office, April 24, 2009.
112. One senior advocate at the Supreme Court and veteran politician, was especially emphatic, arguing that the mode of recovery adopted by the Grameen amounted to legal “molestation.” Personal interview, Sonar Bangla Hotel, Dhaka, April 3, 2009. Despite the fact that the functioning of the bank is authorized by the Grameen Bank Ordinance Act 1983, he argued that its operations were “unlawful.” He pointed out that under the Usurious Loans Act (1918), the Money Lenders Act (1933) and the Money Lenders Act (1940) two features emerged—the regulation of the quantum of interest and the modalities of recovery—by which the Grameen ought to be bound. Under this body of law, the creditor has certain facilities for pursuing the debtor. For instance, the loan officer has the powers to act as a certificate officer and is allowed to make a determination, in writing, as to whether there was a failure to pay. Further, since 1940, if recovery was not elicited through written notice, this would be called “molestation.” Not only, he argues, does the Grameen Bank never issue written notice, but all the devices they use would, according to him, fall into the category of molestation.
113. A well-known Dhaka University professor emphasized that internal coercion can be very problematic as well:

Since 90 percent of the time the person using the credit is the husband, and the person repaying the loan is the wife, the women spend many sleepless nights. In fact, polygamy is re-emerging as a function of microfinance since the more wives a man has, the more credit he can access. This, combined with the fact that there are many different MFIs providing loans means that there is a lot of credit in circulation, leading to borrowers being caught in a debt-trap. This makes ensuring repayment even harder for the MFIs and leads to the further use of force, higher interest rates and so on. It also results in greater domestic violence and heightened social unrest.

Telephone interview, May 2, 2009.

114. This factor was stressed by one extremely prominent long-time microfinance researcher in particular—attributing the problem of the use of coercion to the growing competition in the microfinance sector in Bangladesh and to what he calls “management failure”:

The average loan size for an MFI is very small, Tk 5000–6000. Therefore there has not been much growth in the size of loans. The problem of “overlapping” is occurring because MFIs are being risk averse in not increasing the size of loans, and the current size of individual loans does not satisfy demand. As a result of “overlapping,” however, the “weakest lender” gets paid off last. This is the main inducement to use force. The increase in coercion is essentially a function of the fact that there are too many players. The smaller MFIs are the biggest problem

. . . There are bound to be some lapses, especially since credit officers are under pressure to both disburse and collect loans, as is necessary for MFIs to run. But in most cases, the use of coercion is a function of management failure. For instance, there are many instances of one group member taking loans from everyone else in the group. But a good manager would have formed the groups better. The manager is cheating and trying to make his life easier by allowing members with a greater credit absorption capacity into the group.

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

115. Yunus put it as follows: "Even if we could use force in Bangladesh, could we do that in New York, or in the many other countries in which we operate? It is not true that our borrowers have no 'voice.' Even if they are not educated, their children are. Do you think that they would stay silent?" Personal interview, Grameen Bank headquarters, April 20, 2009.
116. According to a senior associate at BRAC, the use of coercion is sporadic rather than a trend: "If pressure, extortion and intimidation were the norm, the whole scheme would have failed. To what extent can you intimidate, and how would the NGOs have achieved this?" He reiterated that without cooperation at a very high level, the scheme would not have worked, and that lapses are very much the exception or aberration to a scheme supported by a very high measure of consensus. He emphasized that maintaining discipline is essential, training borrowers to understand, observe and enforce rules, but that some NGO workers may "miss the wood for the trees" and take things too literally. This, according to him, is the main source of the lapses. In addition, microfinance projects tend to be very labor intensive, and for them to be sustainable, it is important that a business-like perspective be adopted, especially since a large majority of MFIs are now striving to be self-sustaining. Personal interview, BRAC Institute of Governance headquarters, March 24, 2009.
117. Dasgupta "Social Capital and Economic Performance."
118. It should be clear that social sanctions are, for the most part, still individually applied; i.e., there is no group decision to impose sanctions, simply a set of incentives (associated with repeated interactions), including sanctions imposed against those that do not impose sanctions. See D. Abreu, D. Pearce, and E. Stachetti, "Toward a Theory of Discounted Repeated Games with Imperfect Monitoring," *Econometrica* 58, no. 5 (1990): 1041–63.
119. C.R. Sukumar, "10 Million Rural Borrowers in AP May Soon Be Labelled Defaulters," *Economic Times* (December 28, 2011).
120. This comment was made at the Social Enterprise Conference at Harvard: N. Thirani, "A Conversation with: Muhammad Yunus," *New York Times* (February 22, 2012). Amid much pressure, Akula resigned as chairman of SKS in late 2010. For Yunus's version, see Bajaj, "Amid Scandal, Chairman of Troubled Lender Will Quit."

## Author Biographies

**Antara Haldar** (ah447@cam.ac.uk) is associate professor and deputy director of graduate programs at the Faculty of Law, and a senior research associate at the Judge Business School at the University of Cambridge. She teaches law and economics and Cambridge's first-ever course on law and development—and her research lies at the intersection of these areas. She was invited to serve on the scholarly committee of the American Bar Association's inaugural World Justice Project and has been a consultant to the United Nations on "inclusive finance." She previously taught at Columbia University and the European University Institute in Florence. Her award-winning research has been published in leading law, economics, and business journals including *Law & Society Review* and the *International Journal of Law in Context*.

**Joseph E. Stiglitz** (jes322@gsb.columbia.edu) is university professor at Columbia University, where he teaches at the Graduate School of Arts and Sciences, the Business School and School for International and Public Affairs. He is also the co-president and founder of the Columbia's Initiative for Policy Dialogue. He was the chief economic adviser to the Clinton administration between 1995 and 1997, and the chief economist of the World Bank between 1997 and 2000. He has taught at Yale, Princeton, Stanford, MIT, and Oxford. He is the author of a number of bestselling books (including *Globalization and Its Discontents*) and innumerable scholarly articles. He is the winner of the John Bates Clarke Medal (1979) and the Nobel Prize in Economics (2001).

