Private Equity Investments in Microfinance in India

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Hugh Manahan*

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I. INTRODUCTION

A trail connects a skyscraper in Manhattan’s Financial District to a tiny food stand in a village in the southeast Indian state of Tamil Nadu. Initially wild and overgrown, the trail now resembles a well-developed road, cleared and shaped. The trail does not connect customers to call centers or raw materials to laborers; the path connects lenders seeking abnormal returns on their investments to borrowers living in poverty. This is the path of private equity investments in microfinance.

Microfinance is a powerful financial innovation that has changed personal finance in many parts of the world. While microfinance began as non-profit means of empowering low-income entrepreneurs, the promise of scale, high repayment rates, and underserved markets has made microfinance an increasingly attractive investment for profit-seeking investors. This observation is supported by an unprecedented level of private equity investment in microfinance enterprises. Microfinance’s promise as an investment opportunity is best exemplified in India, which offers a vast low-income population, low penetration of personal financial products, liberal regulatory policies, and cultural forces that support group liability structures.

This Note analyzes the investment potential of microfinance through the scope of Microfinance Institutions (MFIs) in India in four parts. Part II describes the MFI business model and explores how MFIs create contractual advantages and operational efficiencies in serving low-income borrowers. Part III explores how the Reserve Bank of India regulates MFIs and the incentive effects of these regulations on MFI behavior. Part IV attempts to quantify the extent of private equity investment in MFIs. Part V analyzes why private equity firms invest in MFIs and argues that two emerging trends may make MFIs less attractive investments in the future.

II. MICROFINANCE BUSINESS MODEL

A. Overview and History

Microfinance is defined as the large-scale provision of small loans and other financial services to low-income people by conveniently located commercial financial institutions. Microfinance is a broad term that en-
compasses multiple offerings, including loans, deposit services, insurance, and other personal financial products. From a personal finance perspective, microfinance enables low-income people to expand their entrepreneurial activities through access to capital, increase their income through lower interest rates, and improve self-confidence. From a macroeconomic perspective, microfinance reduces reliance on inefficient government subsidies and regulations, while also increasing the flow of capital into the formal financial sector to increase market liquidity. In other words, using the example discussed supra, microfinance allows the hypothetical Tamil food stand owner to borrow a small amount of money to buy vegetables for her food stand, pay a low enough interest rate to retain some of the stand’s profit, and empower herself by owning and operating a small business. When operating at a large scale, it empowers millions of similar small-business owners, reduces the need for certain government programs, and brings money out from under mattresses and into the financial system.

Microfinance generally follows two models: the poverty lending approach, which is donor- and government-funded, and the financial systems approach, which is operated by self-sufficient financial intermediaries. Under the poverty lending approach, either non-governmental organizations use donor funding to lend to poor populations or large financial institutions provide subsidized credit to poor populations in response to regulatory requirements. These methods suffer from obvious and well-publicized drawbacks, namely a limited ability to originate loans, corruption by the intermediary institutions that receive funds to originate loans, and losses caused by a mismatch between the interest earned from loans (revenue) and the cost to serve borrowers (cost). On the other hand, the financial systems approach operates through self-sufficient intermediaries that rely upon large-scale loan origination, cost-effective servicing models, and high repayment rates. The financial systems approach, which represents the private-sector formulation of microfinance, is the focus of this Note.

One of the original and most influential models under the financial systems approach is Muhammad Yunus’ Grameen Bank, which focuses on

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7. Robinson, supra note 1, at xxx.
8. Id.
11. Id. at 7.
13. Robinson, supra note 1, at 8.
the provision of microcredit, a subset of microfinance. In the Grameen Bank model, low-income individuals, 97% of whom are women, form small, mutually binding borrowing groups that co-guarantee loans in lieu of collateral. Borrowers then deploy capital to small-scale income-generating activities that vary depending on the community. Loan providers service these loans through ultra-local, semi-autonomous branch units that deploy mobile servicers to collect small installment payments from groups of borrowers. Under this model, Grameen Bank has maintained an average loan repayment rate of 95%. The Grameen Bank attributes such a high repayment rate to the powerful social pressure of its group lending model and its local loan servicing approach.

Largely following the Grameen Bank model, the microfinance industry expanded exponentially in the 1980s and 1990s across local communities, countries, and continents, maturing to comprise a group of sustainable financial intermediaries with notable successful models in Indonesia and Bolivia. By 2002, microfinance claimed more than 65 million customers across five continents using loan, deposit, and insurance products, which led the United Nations to declare 2005 the International Year of Microcredit. In 2008, the Microfinance Information Exchange estimated that between 1,000 and 2,500 microfinance institutions served more than 65 million customers in more than 100 countries. In India specifically, a Reserve Bank of India report estimated that MFIs accounted for 22% of all small borrower accounts, which is a larger share of accounts in the sector than the share held by large commercial banks. This rapid spread of microfinance is due in part to the advantages of the microfinance business model, which are explored in Part II.B infra.

14. Id. at xxxi.
16. Id.
18. Id.
20. Robinson, supra note 1, at xxxii.
21. Armendariz de Aghion & Morduch, supra note 6, at ix.
B. Business Model

The success of microfinance as a sustainable business model largely depends on scale, high repayment rates, and low transaction costs relative to traditional financial institutions. This section examines three main compositional elements of the microfinance business model through the scope of MFIs in India and explains how each aspect can help bestow a competitive advantage.

1. Target Population and Products

The first compositional element of the MFI business model is lending on a scale large enough to compensate for the small amount of each loan. MFIs offer small loans to a population of low-income potential customers, which, by any calculation, is vast in India. The McKinsey Global Institute recently estimated the population of Indians with an annual household income under $16,667 at 1.05 billion and the Unitus venture capital fund recently projected the bottom of the pyramid population in India at 997 million. Among this large low-income population, traditional financial institutions are not well established: an estimated 60% of rural and urban populations do not have a functional bank account and an estimated 90% of small businesses have no links to formal financial institutions. While India’s size as the seventh largest country in the world by land area implies that this large population segment may be dispersed and difficult to serve, India is in the midst of a decade-long wave of massive urbanization and has seen its urban population grow from 290 million in 2001 to 340 million in 2008. India’s 2011 census estimates an urban population of 377 million, which McKinsey estimates will grow to 590 million by 2030 and represent 67% of the total Indian population. Although MFIs are limited to serving populations in a certain income range as discussed in Part III infra and urban populations have higher average individ-

25. ROBINSON, supra note 1, at 121–22.


27. MOR ET AL., supra note 24, at 3.


30. SANKHE ET AL., supra note 26, at 8.
ual incomes than rural populations, the urban population within the income range that MFIs can serve under Indian law is still vast; adjusting for inflation at an assumed rate of 9%, an estimated 75% of the urban population, or 282 million people, falls within this income range.

MFIs offer this vast population segment a range of products that vary by size, term, and target population. A survey of the leading for-profit MFIs in India reveals a wide range of loan products for income-generating activities, including 2,000–12,000 rupees ($33–193) by SKS Microfinance, 2,000–30,000 rupees ($30–484) by Spandana, and 7,000–50,000 rupees ($113–808) by SHARE. MFIs also generally offer a number of different products with different loan sizes for microenterprises, vehicle finance, consumption, and farm equipment.

The result is tremendous potential scale for microfinance loan origination and one that is expected to grow considerably. The population of low-income borrowers as potential microfinance customers and the co-location of borrowers amidst Indian urbanization enables MFIs to scale lending in such a way to cover the fixed costs associated with ultra-local operations. As discussed in more depth in Part II.B.2 infra, many microfinance enterprises organize in joint liability groups in which members recruit other borrowers in the community. This organization increases penetration in low-income communities and the volume of loan origination. Government policies focused on the potential economic benefits of extending credit to the poor also allow microfinance institutions to secure cheap financing from large financial institutions and government lenders. In India, lending to MFIs counts toward large Indian commercial banks’ requirements for priority sector lending, which is a

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33. Estimate based on 2011 census data and urban income distribution estimates from a 2004 University of Maryland study. See Chandramouli, supra note 29; see Univ. of Md., supra note 31, at 12.
37. See, e.g., id.
38. Armendariz de Aghion & Morduch, supra note 6, at 12–13.
Reserve Bank of India program designed to promote inclusion of agricultural and small-scale industries in the financial system by requiring banks to allocate a proportion of total lending to borrowers in these sectors.\textsuperscript{41} Inclusion as a priority sector borrower enables MFIs to access capital from large commercial banks to fund expansion at relatively cheap interest rates of about 13\% to 14\%.\textsuperscript{42} As discussed in Part V.C infra, MFIs are also able to package and sell securitized microfinance loans to help large commercial banks meet priority sector lending requirements.\textsuperscript{43} In combination, priority sector lending and securitization allow MFIs to access capital and offload risk relatively quickly, thereby supporting the ability of MFIs to rapidly expand to meet India’s vast potential market of borrowers.

2. Joint Liability Groups

The second compositional element of the MFI business model is the use of joint liability groups as a means to secure loans. In this Grameen bank innovation, MFIs lend to small groups of borrowers rather than individual borrowers.\textsuperscript{44} Rather than each individual providing collateral, co-borrowers act as guarantors for one another.\textsuperscript{45} Groups are voluntarily formed, taking advantage of existing relationships within small, tight-knit communities.\textsuperscript{46} Many Indian MFIs, such as SKS Microfinance, form joint liability groups of five individuals that serve as guarantors for each other.\textsuperscript{47} Between three and ten of these groups comprise a local center where groups receive disbursements and make payments,\textsuperscript{48} although the number of members in a group and the number of groups in a center may vary.\textsuperscript{49} Members gather in a public forum to repay loans in weekly installments to a MFI loan officer,\textsuperscript{50} who records payments in a ledger or on a handheld device to capture collection data.\textsuperscript{51} If one group member defaults on a loan, the other members are responsible for the defaulting

\textsuperscript{41.} Reserve Bank of India, Master Circular – Priority Sector Lending – Targets and Classification, RBI/2013-14/107 (2013). For a contemporary perspective of priority sector lending requirements, see Gov’t of India Planning Comm’n, supra note 9, at 49–76.

\textsuperscript{42.} More et al., supra note 24, at 111.

\textsuperscript{43.} See id. at 98.


\textsuperscript{45.} Id.

\textsuperscript{46.} Id. (“An individual living below the poverty line, [sic] selects four people she knows and trusts to form a group.”).


\textsuperscript{48.} See id.

\textsuperscript{49.} See Armendariz de Aghion & Morduch, supra note 6, at 14 (citing groups of up to 21 members).

\textsuperscript{50.} Id. at 12–13.

member’s loan payments and all members of the group are deemed ineligible for subsequent loans.\textsuperscript{52}

Group lending and joint liability groups provide a number of economic advantages for MFIs. Intuitively, group lending reduces transaction costs associated with serving small borrowers by allowing a large number of borrowers to conduct multiple transactions with lenders in a regular group meeting.\textsuperscript{53} Group lending also provides a convenience benefit to borrowers because loan transactions are conducted within local communities, removing the need to travel.\textsuperscript{54} Perhaps less intuitively, group lending also solves many of the problems caused by informational asymmetries between borrowers and lenders, especially among poor borrowers and large traditional lenders.\textsuperscript{55} Armendariz de Aghion and Morduch argue that the liability structures in modern finance, revolving mainly around collateral and credit scores, are in place to mitigate informational symmetries between lenders and borrowers.\textsuperscript{56} In other words, collateral and credit scores serve as a reliable proxy to answer the question: will this borrower repay this loan? Without collateral or credit history, as is the case for many poor borrowers, traditional lenders are left with little information to assess the likelihood that borrowers will repay loans.\textsuperscript{57} Group lending mitigates this informational asymmetry in two ways. First, by forming groups, individuals seeking loans apply better, local information to assess the ability of others to repay loans and then form joint liability groups with individuals most likely to repay.\textsuperscript{58} In effect, co-borrowers can assess creditworthiness in their communities better than traditional lenders can, resulting in more reliable groups of borrowers. Second, loan amounts in the group lending model generally start small and increase in size and number as groups of borrowers prove their reliability. In essence, these initial loans generate valuable additional information for lenders about borrowers as the term of a loan continues.\textsuperscript{59}

In economic terms, group lending also mitigates the adverse selection and enforcement problems that large financial institutions often encounter in lending to the poor.\textsuperscript{60} Rational co-borrowers will not only refuse to join a group with a potential defaulting borrower, but also will help enforce repayment by fellow group members to ensure the group is not responsible for another borrower’s default. Group lending can also solve moral hazard problems by incentivizing borrowers to monitor how co-borrowers

\begin{itemize}
  \item \textsuperscript{52} Armendariz de Aghion & Morduch, supra note 6, at 13.
  \item \textsuperscript{53} Id. at 86.
  \item \textsuperscript{54} See id. at 147.
  \item \textsuperscript{55} Id. at 51–52.
  \item \textsuperscript{56} Id at 51.
  \item \textsuperscript{57} Id.
  \item \textsuperscript{58} Armendariz de Aghion and Morduch, supra note 6, at 88–89.
  \item \textsuperscript{59} Id.
  \item \textsuperscript{60} Id. at 86.
\end{itemize}
use funds. One intuitive formulation of this idea is that group borrowers exert pressure on one another to repay loans because the entire group is affected by non-payment. Armendariz de Aghion and Morduch take this idea further, arguing that the mere threat of sanctions by the group exerts pressure on borrowers not to shirk their repayment responsibilities.

Whatever the cause, microfinance has historically achieved extremely high repayment rates by using joint liability group lending: many Indian MFIs tout repayment rates as high as 98% and 99%. This well-publicized achievement of microfinance institutions is a significant improvement over repayment rates achieved by large financial institutions in low-income lending; for example, loan repayment rates in India reached only 60% during the Integrated Rural Development Program (IRDP), a government-sponsored financial inclusion initiative, and reached only 56% for Indian regional rural banks, which were established in the late 1990s to improve financial access for the poor.

3. Customer Acquisition and Loan Servicing

The third compositional aspect of the MFI business model is an innovative system of customer acquisition and loan servicing. In isolation, many of these tactics are not new, but in combination they fuse local community knowledge with technology to reduce costs in innovative ways.

MFIs generally acquire customers in a geographic-focused model. In a typical process, an MFI will identify a target neighborhood and pockets of potential customers through census data about income and occupation type, such as vegetable stand owner or flower seller. Sales officers then enter the identified neighborhood and make house-calls, asking for leads about potential customers who need loans for income generating activities or seek interest rates lower than those offered by unregulated local mon-
eylenders.69 Once a target borrower profile is identified, MFIs and initial potential customers seek other local community members in the same occupation or an occupation common among MFI borrowers.70 Thus, MFIs rely heavily on initial target customers when identifying and recruiting co-borrowers. In the case of a five-person joint liability group, a potential customer’s ability to borrow depends on finding four co-borrowers. This iterative process continues until a number of groups are identified in a single neighborhood to form a neighborhood center.71 Sales officers then meet with borrowers to guide them through loan applications, verify personal information, and gain basic information required for loan approval.72 For Equitas, a leading southeast Indian MFI, traditional loan criteria like income-to-expense ratios and household income are complemented with non-traditional loan criteria that verify ties to the local neighborhood, such as occupation type and length of residence in the neighborhood.73 Once loans are made, loan servicing occurs in the form of public meetings every fortnight, in which a loan servicing officer collects loan payments, records payments, and addresses any issues brought forth by customers.74 For many MFIs, modern technology provides additional operational advantages. For example, one MFI uses a network of local agents equipped with small, biometric devices to manage banking services, enabling ultra-local service and reliable customer identification.75

In effect, this customer acquisition process views each neighborhood as an individual market entry opportunity. Sales officers use the benefits of microfinance products, mainly lower interest rates than local lenders and

69. Id. Local, unregulated moneylenders remain a predominant lender to the poor population of India, despite interest rates that are often astronomical and exploitative. Gov’t of India Planning Comm’n, supra note 9, at 55; Gabreile Parussini, India’s Illicit Moneylenders Aren’t Going Away, Wall St. J. (Mar. 25, 2015 11:05 AM) http://www.wsj.com/articles/indias-bid-to-liberate-poor-from-illicit-moneylenders-yields-mixed-results-1427295915. For the lowest income quartile in India, local moneylenders, relatives, and friends provided more than 70% of loans in 2007. Gov’t of India Planning Comm’n, supra note 9, at 54. Armendariz De Aghion and Morduch review study results related to moneylenders that report effective interest rates between 60% and 160%. Armendariz De Aghion & Morduch, supra note 6, at 28. However, the role of the moneylender is more nuanced that simply being loan sharks; moneylenders may actually serve a purpose in certain economies by serving as the only source of credit available to certain populations. Id. at 28–29.

70. Id.

71. Id.

72. See Narayanan & Rangan, supra note 67.

73. Id.

74. Id.

convenience benefits, to attract one potential customer and then use this new source of neighborhood knowledge to penetrate the market. Borrowers use local knowledge to recruit co-borrowers, which bridges informational gaps between lenders and borrowers and creates a customer base with higher repayment potential. This method of customer acquisition not only allows MFIs to achieve scale benefits by spreading its customer base within a local community, but also allows MFIs to match its customer acquisition activities to its operating model. In other words, if one loan officer can serve five groups of borrowers, then a sales officer can tailor customer acquisition efforts to the number of customers that allows efficient loan servicing. The local servicing model also offers the operational advantage of lowering overhead associated with customer service. By centralizing loan servicing through a loan servicing officer equipped with modern technology linked to back office systems, MFIs can reduce or eliminate the costs of brick-and-mortar establishments and customer service channels. Recently, evidence indicates that large MFIs have continuously revised their service model in the last few years to lower operating costs, as explored in Part V.B.2 infra.

Overall, the large potential market size for microloans and the ability of MFIs to originate loans, bridge informational gaps, and create advantageous customer service models combine to make MFIs an attractive potential investment for private equity investors. In theory, each factor rebuts a reason why microfinance seems unprofitable: the scale of loan origination mitigates the effect of small loan sizes; joint liability groups mitigate the risk of default associated with low-income borrowers; and operational innovations mitigate the otherwise high overhead associated with servicing a geographically dispersed customer base. These factors also largely underlie the widespread opinion that MFIs are wildly profitable enterprises. Part V infra explores how these factors work in practice by assessing the investment potential of MFIs from the perspective of private equity investors.

III. REGULATION OF MFIs

The regulation of MFIs in India has evolved considerably in the last half century as the Indian government has pursued a number of initiatives aimed at increasing access to finance for poor and rural populations. After gaining independence in 1947, the Indian government nationalized the financial sector in 1968, India introduced priority sector lending within its

76. India’s 25 Leading MFIs, supra note 51, at 10.
78. Id.
credit policy, requiring commercial banks to direct a portion of their lending to sectors of the population that lack institutional financial support, known as the Priority Sector.79 By the mid-1970s, commercial banks were required to lend 40% of their credit to Priority Sector borrowers.80 In the 1970s and 1980s, the Indian government established regional rural banks to extend financial services to rural populations and the Self-Help Group model, which is explained further infra, to encourage commercial banks to lend to low-income borrowers.81 According to a Reserve Bank of India report, regional rural banks have not been profitable and have done little to allay reliance on local moneylenders.82 On the other hand, Self-Help Groups, which are autonomous collectives of low-income individuals who band together for financial services,83 have enjoyed more success but are limited in reach; in mid-2007, they comprised only about 47,000 borrowers.84 In the 1990s, economic liberalization in India opened the door for the private sector to serve poor borrowers, leading to the rise of for-profit microfinance enterprises that originated microfinance loans.85 These enterprises, termed Non-Bank Financial Companies (NBFCs), were supported by the government through the state-owned Small Industries Development Bank of India and by large commercial banks with the ability to buy securitized microfinance loans to meet priority sector lending requirements.86 Between the 1990s and early 2000s, for-profit MFIs rapidly emerged on the scene, capitalized increasingly through equity investments from specialized Microfinance Investment Vehicles (MIVs) and mainstream private equity funds.87

MFIs operated within the existing Indian financial regulatory framework until events in 2010 in the Indian state of Andhra Pradesh brought new regulatory scrutiny to MFIs. Beginning in the 1990s, Andhra Pradesh was the capital of microfinance and home to five of India’s largest MFIs that were also among the first MFIs to attract significant private equity

80. Id.
81. Id.
82. GOV’T OF INDIA PLANNING COMM’N, supra note 9, at 54.
84. GOV’T OF INDIA PLANNING COMM’N, supra note 9, at 57.
85. CGAP Focus Note, supra note 77, at 1.
86. Id. at 1–2.
87. Id. at 2.
and MIV investment. 88 MFIs grew rapidly within Andhra Pradesh, acquiring nearly 30 million customers and achieving an average outstanding debt per customer of 65,000 rupees ($1,050) in the state compared to an average of 7,700 rupees ($125) in the rest of India. 89 By the early 2000s, MFIs in the region began to develop a negative stereotype because they were earning high returns, awarding lavish executive compensation, and exhibiting little transparency. 90 Tensions rose in 2005 and 2006 when an Andhra Pradesh administrative district closed 50 MFI branches in response to allegations of unethical and illegal practices. 91 Tensions then boiled over in 2010 when the local Andhra Pradesh press linked a string of suicides to over-lending and unscrupulous lending by MFIs. The result was disastrous, crippling MFIs’ reputations and loan portfolios alike: politicians blamed MFIs and their harsh collection practices for 57 suicides in Andhra Pradesh, arrested field workers, 92 urged residents to default on loans, 93 and passed restrictive legislation at the state-level regarding MFI lending. 94 nearly 9.2 million customers, about one-third of Andhra Pradesh borrowers, defaulted and loan recovery rates fell from 95% to 10%. 95 In response to the crisis and the Andhra Pradesh state’s regulatory intrusion, the Reserve Bank of India in 2011 created a new regulatory framework for MFIs within the NBFC category. 96

A. Non-Banking Financial Companies (NBFCs)

MFIs in India are regulated as NBFCs, a category that includes many financial services companies such as loan companies, investment companies, and asset finance companies. 97 India had a total of 12,225 registered NBFCs as of March 31, 2013. 98 A Reserve Bank of India report notes that retail NBFCs generally outperform banks in terms of non-performing as-

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88. CGAP Focus Note, supra note 77, at 2.
90. Id. at 2.
91. CGAP Focus Note, supra note 77, at 3.
92. Discredited, ECONOMIST (Nov. 4, 2010), http://www.economist.com/node/17420202?
94. CGAP Focus Note, supra note 77, at 4.
97. MOR ET AL., supra note 24, at 106.
98. Id.
sets and the credit ratings of their loan portfolios. 99 While NBFCs are in many ways regulated like banks, with capital adequacy rules, non-performing asset norms, and a fair practice code, 100 the regulatory treatment of banks and NBFCs differs in a few important respects. First, NBFCs are subject to a 15% minimum capital adequacy requirement as opposed to a 9% requirement for banks 101 under the logic that as generally niche participants, NBFCs are much more likely to have a geographically concentrated asset profile relative to banks and therefore require higher capital adequacy. Second, regulatory classifications are more forgiving for NBFCs than banks in defining non-performing asset (non-payment for 180 days versus 90 days), sub-standard asset (non-performing asset for a period not exceeding 18 months versus 12 months), and doubtful asset (non-performing asset for a period not exceeding 18 months versus 12 months). 102 Third, NBFCs are subject to much lower entry capital requirements than banks (20 million rupees to 50 million rupees or $320,000 to $800,000, versus 5 billion rupees or $81 million). 103 Equity investments in NBFCs from foreign sources are also partially regulated through a tiered minimum capitalization requirement for entities with foreign ownership, which requires more capital for firms with higher levels of foreign investment. 104

B. Non-Banking Financial Companies – Microfinance Institutions (NBFC-MFIs)

In 2011 and 2012, MFIs were officially recognized in regulation as the seventh subset of NBFCs in response to the Andhra Pradesh Crisis described supra. 105 Under these regulations, NBFC-MFIs are prohibited from accepting deposits and are subject to four general categories of requirements under the new classification: (1) a minimum percentage of assets that meet the definition of qualified assets under the regulations; (2) interest rate caps applying to MFI-originated loans; (3) a net owned funds minimum; and (4) credit reporting and customer check requirements. 106 NBFC-MFIs not meeting these requirements are prohibited from extending loans to microfinance customers in excess of 10% of total assets,

99. Id.
100. Id.
101. Id. at 107–108
102. Mor et al., supra note 24, at 107–108
103. Id.
104. Id. at 110 (stating that minimum capitalization for NBFCs with foreign capital below 51% is $0.5 million USD, $5 million for those with foreign ownership below 76%, and $50 million for those with foreign ownership above 75%).
105. Id. at 111.
effectively requiring any previous NBFC focusing on microfinance to meet these requirements.\textsuperscript{107}

An MFI’s qualified assets must be at least 85\% or more of the MFIs’ net assets.\textsuperscript{108} The Reserve Bank of India defines net assets broadly as total assets other than cash, bank balances, and money market instruments.\textsuperscript{109} The qualified assets definition imposes restrictions on the type of borrower, loan size, loan tenure and loan use as follows:

Loan disbursed without collateral by an NBFC-MFI to a borrower with a household annual income not exceeding 60,000 [rupees] (rural) or 1,20,000 [rupees] (urban and semi-urban) and total indebtedness not exceeding Rs. 50,000 will be a qualifying asset provided:

(a) loan amount does not exceed 35,000 [rupees] in the first cycle and 50,000 [rupees] in subsequent cycles;
(b) tenure of the loan not to be less than 24 months for loan amount in excess of 15,000 [rupees] with prepayment without penalty;
(c) aggregate amount of loans, given for income generation, is not less than 70 per cent of the total loans given by the MFIs and
(d) loan is repayable on weekly, fortnightly or monthly installments at the choice of the borrower.\textsuperscript{110}

The effect of the new qualified asset provision is three-fold: first, it restricts the type of microfinance borrower based on income, debt, and location; second, it restricts the product offerings of MFIs in terms of loan amounts, duration, and repayment structure; and third, it limits the operations of MFIs in other types of business by requiring microfinance loans to comprise at least 85\% of a MFI’s net assets.

Interest margin caps also apply to MFI-originated loans.\textsuperscript{111} The new RBI regulations set the interest rates charged by NBFC-MFIs as the lower of: (a) cost of funds plus a 10\% margin for MFIs with asset sizes above 1 billion rupees and cost of funds plus a 12\% margin for MFIs with asset sizes below 1 billion rupees; and (b) the average base rate of the five largest commercial banks by assets, as reported quarterly by the RBI, multiplied by 2.75.\textsuperscript{112} Based on cost of funds and commercial bank average base rates, the interest rate cap is generally about 25\%; for example, in January 2014, cost of funds was between 13 and 14\%, producing an interest rate cap of about 26\% for small and mid-size MFIs.\textsuperscript{113}

\textsuperscript{107} Id.
\textsuperscript{108} Id.
\textsuperscript{109} Id.
\textsuperscript{110} Id.
\textsuperscript{111} Id.
\textsuperscript{112} Id.
\textsuperscript{113} Mor et al., supra note 24, at 111.
The minimum net owned funds requirement of 50 million rupees\(^{114}\) ($800,000) as opposed to 2 million rupees for other NBFCs\(^{115}\) works as a capital adequacy norm. Calculated generally as paid up equity capital and reserves minus certain investments and loans, the net owned funds minimum ensures only entities that are well capitalized, and therefore less likely to fail, qualify.\(^{116}\) The substantial increase in net owned funds under the new regulations has the effect not only of encouraging capital reserves and discouraging investments by MFIs in other MFIs, but also of putting a premium on higher levels of equity investments. Together with tiered foreign equity investment entry requirements, this requirement creates interesting incentives for MFIs: if an MFI raises too little equity capital, it may not meet the net owned funds requirement, thus incentivizing entities to raise capital from all available sources; but if capital is raised in too high of a proportion from foreign sources, MFIs are subject to higher entry requirements.

As these new regulations restrict the product offerings, target customer base, and diversification potential of MFIs, they also exert interesting influences on industry composition and MFI profitability. The minimum net owned funds requirement and restrictions on the number of MFIs serving a borrower serve as barriers to market entry, limiting internal competition.\(^{117}\) The requirement that MFIs originate loans for income generation purposes restricts MFIs’ ability to initiate consumption loans, which has the opposite of the intended effect by driving borrowers out of the formal financial sector to informal lenders.\(^{118}\) Finally, as discussed in Part V.C.1 infra, these requirements may adversely affect MFI profitability.

IV. Private Equity Investments in Microfinance

The spread of microfinance in India and the business model advantages that MFIs enjoy have attracted the attention and capital of private

\(^{114}\) See Exposure Norms for the Financial Institutions, Reserve Bank of India (Aug. 7, 2003), http://www.rbi.org.in/scripts/NotificationUser.aspx?Id=12966&Mode=0. (defining Net Owned Funds as “consisting of paid up equity capital, free reserves, balance in share premium account and capital reserves representing surplus arising out of sale proceeds of assets but not reserves created by revaluation of assets. From the aggregate of items will be deducted accumulated loss balance and book value of intangible assets, if any, to arrive at owned funds. Investments in shares of other NBFCs and in shares, debentures of subsidiaries and group companies in excess of ten percent of the owned fund mentioned above will be deducted to arrive at the Net Owned Fund. The NOF should be computed on the basis of last audited Balance Sheet and any capital raised after the Balance Sheet date should not be accounted for while computing NOF.”).

\(^{115}\) Mor et al., supra note 24, at 111.

\(^{116}\) See NBFC FAQ Release, supra note 106.

\(^{117}\) Mor, supra note 24, at 111–12.

\(^{118}\) Id. at 112.
equity investors. Given the many types of investors that fall under a broad definition of private equity, investments in microfinance by private equity investors are not new; however, investments in MFIs by profit-seeking private equity funds are a recent development in the last decade. From an investment perspective, the risk profile of microfinance in India has changed dramatically over the last decade. CARE Ratings, the second largest credit rating agency in India, classifies four major risk phases for the Indian microfinance sector: high growth from 2006 to 2010, high volatility from 2010 to 2011, consolidation from 2011 to 2013, and relative stability from 2013 to the present. Part IV analyzes the evolution of investments in Indian MFIs by for-profit private equity funds using these classifications.

A. Phase 1: High Growth 2006–2010

The modern microfinance sector in India spawned from government-initiated programs such as the Self-Help Group–bank linkage program in 1992, as described in Part III supra. Soon after, private sector participation in microfinance increased through growing numbers of MFIs, who initially accessed bulk funds from banks at discounted rates and subsequently lent these funds to microfinance borrowers. Following a period of relative stability, the MFI model began to grow quickly in 2006 through an increased level of debt and equity investments in MFIs. According to CARE, the overall loan portfolio of MFIs and Self-Help Groups increased nearly three-fold in three years, from 139.5 trillion rupees ($2.2 billion) on March 31, 2007, to 381.8 trillion rupees ($6.1 billion) on March 31, 2010.

While the vast majority of funding for MFIs continued to come from large Indian financial institutions as a way to meet their priority sector lending obligations, other sources of investment capital rapidly entered the microfinance sector during this period. Foreign investors and invest-


120. Margaret Brennan, Sequoia Invests $11.5 Million in Microfinance Fund, CNBC (Mar. 29, 2007 9:17 AM), http://www.cnbc.com/id/17844093#.


122. CARE RATINGS, supra note 96, at 1.

123. Id. at 3.

124. Id.

125. See Kantak, supra note 2, at 7–8.

126. CARE RATINGS, supra note 96, at 1.

ment funds increased investments in lockstep with or faster than loan portfolio growth: from 2007 to 2010, foreign investment in Indian microfinance increased more than five-fold, from 1.88 trillion rupees ($30.5 million) to 9.92 trillion rupees ($160.3 million) and investment fund investments increased between 2007 and 2010 from 2.36 trillion rupees ($38.2 million) to 8.27 trillion rupees ($133.6 million). This period of capital influx also saw a rise in the average number of investors in MFIs as new investors entered the microfinance sector; in the area of debt financing, for example, the average number of lenders per MFI in India grew from 8.23 in 2007 to 11.53 in 2010.

Amidst the growth in investment capital and the number of investors, foreign private equity investments also grew quickly. According to the Consultative Group to Assist the Poor (CGAP), foreign equity investments, which includes foreign private equity investors, in microfinance institutions worldwide grew at an annualized rate of 60% from 2006 to 2010 and accounted for 18% of total foreign investment. Among the growing number of investors, institutional investors, including private equity funds, international banks, pension funds, and insurance companies, were the fastest growing, estimated by CGAP to have grown from a $1.2 billion global investment in microfinance in 2006 to a $3.5 billion investment by 2010. One study of MFI ownership structures in 2010 found that international private commercial investors owned disproportionately large equity stakes in MFIs in South Asia, most of which were Indian MFIs. The study distinguished between international private social investors and international private commercial investors and found more private commercial investors in the South Asian region in both quantity and ownership stake than anywhere in the world.

This trend continued in the size of individual private equity investments as well; a CGAP survey based on a sample of private transactions reported thirty-seven private equity transactions in microfinance institutions globally in 2007, with an overall value of $60 million, compared to the same number of private equity transactions in 2010 with an overall value of $205 million. This period is also marked by a number of significant private equity investments in Indian MFIs: Sequoia Capital an-

128. Id.
129. Id.
131. Id. at 3.
132. KANTAK, supra note 2, at 17.
133. Id.
nounced an investment of 680 billion rupees ($11 million) in SKS Microfinance in 2006; 135 Dubai-based Legatum invested 1 trillion rupees ($16.2 million) in Share Microfin, a Hyderabad-based MFI, in 2007; and Ujjivan Financial Services raised a 1.21 trillion rupee ($19.6 million) equity round in November 2008 from existing private equity investors Unitus Equity Fund and Eletar Equity LLC and new private equity investors Sequoia Capital and Lok Capital.136

**B. Phases 2 and 3: 2010–2013: High Volatility and Consolidation**

The Andhra Pradesh crisis in 2010, discussed in Part III supra, created a significant roadblock for private equity investments in MFIs. With the politicization of microfinance during the crisis, MFIs in the region experienced high levels of delinquency, resulting in massive write-offs. Yet, even in the volatile investment environment created by the Andhra Pradesh crisis, private equity investments in microfinance persisted. Globally, the growth trend in private equity transactions continued, both in number and size: CGAP found that cross-border funding for microfinance amounted to over $25 billion in commitments in 2011, with private funders accounting for about $8 billion in commitments.138 More significantly, the study identified an average annualized growth rate in private funding of 12% (compared to 3% growth from public funders), most of which was driven by institutional and individual investors through specialized funds, MIVs, or holding company structures.139 In a similar period from 2008 to 2011, the equity share of total commitments increased from 9% to 13%, partly reflecting increased investment from private equity funds, while the debt share of total commitments during the same period decreased from 68% to 55%.140

In this period, a CGAP survey based on a sample of private transactions identified thirty-seven private equity deals worldwide worth $205 million in 2010 compared to sixty-eight private equity deals worth $292 million in 2011.141 In India specifically, CGAP’s sample included nineteen private equity transactions in 2011 worth $88.4 million despite the Andhra

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135. Brennan, supra note 120.
137. See discussion supra Part III.
141. Id.
Pradesh Crisis, compared to ten transactions worth $45 million in 2010.142 The impact of the Andhra Pradesh crisis was felt in the form of reduced valuations for MFIs, however, as the median and average price-to-book value ratios dropped between 2009 and 2011.143 In May 2011, CGAP also specifically noted the trend of private equity funds targeting India: “[s]ome of these funds, such as Sequoia and Legatum, have brought a more aggressive, commercial high-risk/high-return investment strategy to the industry. These investment models have helped spur the fast growth of MFIs in India. . . .”144

C. Phase 4: 2013–Present: Relative Stability

With a more stable regulatory environment following the RBI’s adoption of regulations governing NBFC-MFIs as described in Part III supra, private equity investments in microfinance have continued to grow, though at a pace that is difficult to assess. According to credit rating data, the share of foreign holdings in Indian MFIs exceeded 30% in 2014.145 This high share of foreign holdings reflects a mix of players: private equity funds like Sequoia, Caspian, Legatum, and Citi Venture Capital; international development funds like the International Finance Corporation; and private foundations like the Michael & Susan Dell Foundation.146

Private cross-border equity funding for MFIs in general has increased in this period to an estimated level of $7.5 billion in 2014147 and a number of record-setting private equity investments illustrate this trend. In January 2015, Ujjivan Financial Services raised 6 billion rupees ($111.1 million) from private equity investors and an international development fund, which is the largest single equity funding deal in the history of India’s microfinance sector.148 This deal closely followed the previous record-setting sale of a minority equity stake by Janalakshmi Financial Services to TPG Capital, a US-based private equity fund, for an estimated 6 billion rupees ($100 million) in November 2014.149 In November 2014, Equitas, a

142. Id. at 6.
143. Id. at 3.
144. Foreign Capital Investments in Microfinance, supra note 130, at 4.
146. Id.
leading MFI in South India, raised 3.25 billion rupees ($52.5 million) from a consortium of private impact and development finance investors, while Lok Capital, a venture capital fund focused on microfinance and social businesses in India, is reportedly in the process of raising a $100 million fund focused on MFIs.

Overall, private equity investments in Indian MFIs have increased substantially since 2006 amidst periods of strong growth and crisis. Having established the advantages of the MFI business model and the extent of private equity investments in MFIs, the question remains why private equity investors are targeting MFIs and whether this trend of increasing investment will continue.

V. Microfinance as Private Equity Investment Targets

The juxtaposition of private equity investors with the world’s poorest borrowers raises the question of why private equity funds invest in MFIs. Part V explores this question in three parts. First, Part V describes the criteria that private equity investors apply to potential investments in emerging markets. Second, it analyzes the extent to which Indian MFIs reflect these criteria. Third, it argues that two trends affecting microfinance in India will make MFIs less attractive potential investments for private equity investors in the future.

A. Private Equity Investment Criteria in Emerging Markets

This section aims to articulate the criteria that private equity investors apply to potential investments in emerging markets at both the market-level and firm-level to determine why private equity investors are investing in Indian MFIs.

In general, the goal of a private equity investor is to invest in portfolio companies with high growth potential or undervalued assets, work with management to improve performance of the business, and exit the investment to realize a significant gain. Investment strategies differ greatly within the category of private equity, most notably between different types of funds, fund sizes, target geographies, and target industries. But the general principles of risk, return, and value creation are similar. Private equity investments typically offer higher returns than other asset classes, but also embody greater risks and volatility; within this class, emerging markets private equity reflects an even higher risk and return profile.


Deal origination and screening are the key steps in which private equity funds identify and evaluate potential investments. In the context of emerging market private equity, which includes investments in microfinance, this deal origination stage requires that investors evaluate both the viability of the investment environment of an emerging market and the prospects of the firm in question.

1. Investment Environment

Private equity investors seek an investment environment with baseline protections and the ability to encourage growth at the firm-level. The building blocks of such an investment environment are geopolitical and economic stability, legal enforcement mechanisms, and human capital. Leeds defines these building blocks in more depth, including government policies that support the industry without impeding market forces, confidence-inducing legal frameworks, efficient financial markets, political and macroeconomic stability, acceptance of international business practices, and deep pools of skilled human capital. Investors, in other words, seek both the untapped opportunities offered in emerging markets and sufficient stability, contractual certainty, and human capital to execute an investment thesis.

Geopolitical and economic stability protects against the risk that radical changes in the investment environment will jeopardize investments. In the words of one expert, “[a] country’s macroeconomic profile and creditworthiness serves as one of the cornerstones for investor confidence and resides at the very foundation of the private equity ecosystem.” As illiquid investments with a long investment horizon, private equity investments are especially vulnerable to economic crises and currency crises, as illustrated by the major losses suffered by private equity portfolio companies in the Asian Financial Crisis of 1997. Basic legal enforcement mechanisms are another fundamental element to sustaining private equity investments. In general, the ability to rely on contracts and enforce contractual terms in a fair, efficient forum is vital for any investment. Because private equity investments in emerging markets often take the form of minority equity positions in high growth companies, minority shareholder protections are also of fundamental importance. Lastly, human

155. Id. at 32–33.
156. Id. at 32, 57.
157. Id. at 57; TALMOR & VASVARI, supra note 153, at 64–66.
158. LEEDS, supra note 152, at 57.
159. TALMOR & VASVARI, supra note 153, at 19.
160. LEEDS, supra note 152, at 72.
162. LEEDS, supra note 152, at 126.
163. Id. at 62.
164. LEEDS, supra note 152, at 56, 64.
capital presents an important prerequisite because investors are largely dependent on the business acumen and local knowledge of managers and operators.\textsuperscript{165} Without a deep pool of skilled workers to operate a portfolio company as it grows, portfolio companies are less likely to meet their growth potential.\textsuperscript{166}

While these factors provide strong guideposts, few investment environments fully reflect these elements, including the United States.\textsuperscript{167} Shortcomings in emerging markets in many of these areas create opportunities for private equity investors in the first place.\textsuperscript{168} The lack of access to medium- and long-term finance in developing countries, for example, is cited by a World Bank survey as the most frequently reported growth constraint for small- and medium-sized enterprises\textsuperscript{169} and provides private equity investors with investment opportunities that would not otherwise exist. Similarly, human capital deficiencies can offer investors value-creation opportunities in the form of installing competent managers and improving employee performance.\textsuperscript{170}

2. Firm Attributes

With a stable framework in which to invest, private equity investors evaluate the prospects of a specific firm to determine if the firm fits the fund’s investment criteria. Investment criteria vary among the large number of investors under the label of private equity and depend on a number of factors, including the maturity of the target company and the ownership percentage obtained.\textsuperscript{171} For example, a buyout fund seeking to purchase all or most of a mature company with a significant amount of debt will value robust and stable cash flows to support debt payments\textsuperscript{172}, while a venture capital fund investing in a young company will value growth potential and market size.\textsuperscript{173}

Private equity investments in emerging markets often take the form of minority equity investments due to heightened risk associated with investing in emerging markets.\textsuperscript{174} Likewise, private equity investments in microfinance generally take the form of minority equity investments in

\textsuperscript{165} Id. at 79.
\textsuperscript{166} Talmor & Vasvari, supra note 153, at 66, 68.
\textsuperscript{168} Talmor & Vasvari, supra note 153, at 57.
\textsuperscript{169} Leeds, supra note 152, at 21.
\textsuperscript{170} Id. at 79.
\textsuperscript{171} See generally Minority Investments: Overview, PLC Corp. & Secs. (2015), Westlaw.
\textsuperscript{172} Stowell, supra note 161, at 315, 317.
\textsuperscript{173} PLC Corporate & Securities, supra note 171.
\textsuperscript{174} Talmor & Vasvari, supra note 153, at 72.
young, high-growth microfinance companies, especially in India where foreign direct investment rules make acquiring MFIs outright difficult.\textsuperscript{175} While investment criteria and value creation opportunities still vary among funds, private equity investors taking minority equity positions will seek some common criteria when evaluating firms. These generalized criteria provide helpful guideposts for what constitutes an attractive investment, but ultimately the negotiated terms of each deal determines its attractiveness.

First, private equity investors seek companies with high growth potential and profitability potential.\textsuperscript{176} Growth and profitability are common factors across most forms of private equity investments,\textsuperscript{177} but are especially important in the context of minority equity investments in emerging markets due to increased geopolitical and economic risk.\textsuperscript{178} Second, private equity investors seek companies with strong management teams to apply new funds to execute a growth strategy.\textsuperscript{179} Whether by investing in a company with strong managers or inserting new management teams, competent management is a key factor across investment categories.\textsuperscript{180} Third, exit potential is a key criterion because investors need some degree of certainty that they can realize returns on their illiquid investments.\textsuperscript{181} Although simplified and generalized, these criteria cover the salient points that multiple private equity investors in this space identify in their investment theses. For example, Unitus Capital, a leading impact investor in India, identifies high growth, strong profits, and excellent management as key criteria supporting investment in Indian microfinance at all stages of maturity,\textsuperscript{182} while Emerging Capital Partners, a private equity firm focusing on Africa, invests in “high-growth companies with excellent manage-

\textsuperscript{175} Mor et al., supra note 24, at 110 (outlining the minimum foreign equity investment for NBFCs at different capitalization tiers: $0.05 million for those with foreign ownership below 51\%, $5 million for those with foreign ownership below 76\%, and $50 million for those with foreign ownership above 75\%); William Langer, The Role of Private Sector Investment in International Microfinance and the Implications of Domestic Regulatory Environments, 5 INT’L L. & MGMT. REV. 1, 63 (2008).


\textsuperscript{177} Talmor & Vasvari, supra note 153, at 359–65; Stowell, supra note 161, at 343.

\textsuperscript{178} Talmor & Vasvari, supra note 153, at 66–70.

\textsuperscript{179} See, e.g., Stowell, supra note 161, at 317–18; Doddy & Le Guennou, supra note 176.

\textsuperscript{180} Leeds, supra note 152, at 33. See also Talmor & Vasvari, supra note 153, at 68; Doddy & Le Guennou, supra note 176.

\textsuperscript{181} Talmor & Vasvari, supra note 153, at 72.

ment that can take advantage of the rise in consumer spending and increasing trade and regional integration.183

B. Presence of Private Equity Investment Criteria in Indian MFIs

This section evaluates the existence of private equity investment criteria in Indian MFIs to determine why private equity funds are investing in Indian MFIs. As explored infra, India and Indian MFIs meet many of the investment criteria that private equity investors seek in potential investments, but also reflect shortcomings in a few important areas.

1. Investment Environment in India

India provides both a stable investment environment for private equity activity and an opportunity for investors to earn strong returns. The initial impetus for private equity investors to seek investments in emerging markets derives in part from increased competition between private equity firms for deals.184 Global private equity fundraising hit all-time highs during the period of 2006 to 2008 and fundraising levels have rebounded to near record highs in 2013 and 2014.185 The result of high fundraising levels and buoyant capital market conditions has created “an environment of intense competition” for deals and lifted target valuations,186 which is causing private equity buyers to seek attractive targets in other markets; for example, in the Asia-Pacific region, buyout and growth funds increased 64% between 2008 and 2014 to a level of $84 billion.187 Even within the Asia-Pacific market, private equity investors faced stiff competition for deals, causing investors to search for new investments in the middle market and take on more risk in search for high returns.188 Together, these competitive dynamics have shifted the focus of many private equity investors to India and the Indian microfinance sector.

As an investment environment, India offers sufficient geopolitical stability, legal enforcement certainty, and human capital to encourage private equity activity. India is the world’s oldest democracy and its newly elected government has been viewed by creditors and market participants alike as stable and supportive of macroeconomic stability.189 India’s economy is

183. Doddy & Le Guennou, supra note 176.
185. Id. at 6–7.
186. Id. at 11.
187. Id. at 12.
188. Id. at 14.
also poised for growth; the World Bank projects annual Gross Domestic Product growth between 6% and 7% from 2015 to 2017.190 International measures of open markets and legal enforcement mechanisms also score India favorably relative to peer countries; in the World Bank’s 2014 Enterprise Surveys, which assess business environment conditions in emerging markets, India scored well in indicators of open, developed financial markets such as external financing and use of the financial markets compared to peer countries in South Asia and countries of a similar income profile.191 India also performed well in these surveys in measures of the rule of law, identifying courts as fair, impartial, and uncorrupted at a higher proportion than peer countries.192 Similarly, India outpaced South Asian and income profile peers in measures of human capital, including measures of firms’ use of internationally recognized quality certification, use of external auditors, and use of the internet.193

Despite these positive indicators relative to other developing countries, India also reflects some shortcomings as a stable investment environment. In the same 2014 World Bank surveys, India’s corruption scores indicated a higher corruption level than peer countries, which can serve as an impediment to growth.194 The Heritage Foundation’s 2014 Index of Economic Freedom highlights the shortcomings of the India legal system, including chronic corruption, an inefficient judiciary, and weak intellectual property rights.195 But with increasing competition within the private equity industry pushing firms to seek opportunities in new markets, India’s mix of opportunity and relative stability provides an attractive investment environment.

2. Firm Attributes of Indian MFIs

With a relatively stable environment in which to invest, private equity investors then evaluate whether potential investments meet the investment criteria for an emerging market, minority equity investment: growth and profitability potential, human capital, and exit certainty. Indian MFIs have sustained generally positive performance in these areas, giving potential investors reason for cautious optimism.

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192. Id. at 10.

193. Id. at 14.

194. Id. at 9.

a. Growth and Profitability Potential

Loan portfolio growth rates, measures of operational efficiency, and loan repayment rates provide empirical indicators of MFI growth and profitability potential. Because few MFIs are publicly traded, data to assess these measures of growth and profitability are limited to a few publicly traded MFIs and credit agency reports with select financial metrics. Nonetheless, this limited financial dataset provides insight into MFI scale, portfolio quality, and financial sustainability.

By any measure, the extent of recent MFI loan portfolio growth is remarkable. MFI loan assets grew at a 42% Compound Annual Growth Rate (CAGR) for the two-year period ending March 2014, which is a decrease from the loan asset growth rates of more than 100% that were prevalent before the Andhra Pradesh crisis in 2011. CRISIL, one of India’s major credit rating agencies, projects MFI loan assets to triple from 103 billion rupees ($1.91 billion) in 2010 to 350 crore ($6.4 billion) in March 2015. India Ratings & Research, another credit agency, recently estimated that the microfinance sector will grow at a CAGR of 24% between 2015 and 2019, driven by both increased disbursements to existing borrowers and doubling its borrower base. Within this environment of expansion, MFIs are still comfortably exceeding the capital adequacy regulatory requirement of 15% with many maintaining capital above 30%, which implies adequate capital to fuel continued growth.

Profitability metrics for Indian MFIs, on the other hand, lead to mixed conclusions, despite widespread belief that Indian MFIs are wildly lucrative. One study by the Council of Microfinance Equity funds estimates profit margins in Southern Asian MFIs, primarily though respondents in India, as the lowest of any region surveyed at 4.7% in 2005, 5.3% in 2007, and 6.4% in 2008. Table 1 below provides a more detailed view of MFI profitability by aggregating Return on Assets (ROA) metrics, calculated as net profit divided by average total assets, for India’s largest eleven MFIs from the Microfinance Information Exchange Market database.
which aggregates institutional data from MFIs across the world to broaden transparency and market insight.\footnote{203. \textit{Microfinance Institutions, Microfinance Info. Exchange Mkt.}, http://www.mixmarket.org/mfi (last visited May 26, 2015).}

<table>
<thead>
<tr>
<th>Return on Assets (ROA)</th>
<th>2011</th>
<th>2012</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Large MFIs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Bandhan Financial Services Pvt Ltd</td>
<td>6.4%</td>
<td>4.7%</td>
<td>5.0%</td>
</tr>
<tr>
<td>Equitas Micro Finance Pvt Ltd</td>
<td>2.3%</td>
<td>2.7%</td>
<td>3.7%</td>
</tr>
<tr>
<td>Janalakshmi Financial Services Pvt Ltd</td>
<td>0.5%</td>
<td>2.0%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Shree Kshetra Dharmasthala</td>
<td>1.6%</td>
<td>2.6%</td>
<td>2.2%</td>
</tr>
<tr>
<td>SKS Microfinance</td>
<td>-46.7%</td>
<td>-15.7%</td>
<td>2.9%</td>
</tr>
<tr>
<td>Ujjivan Financial Services Pvt Ltd</td>
<td>0.3%</td>
<td>3.4%</td>
<td>3.5%</td>
</tr>
<tr>
<td><strong>Average - Large MFIs</strong></td>
<td>-6.0%</td>
<td>-0.1%</td>
<td>3.4%</td>
</tr>
<tr>
<td><strong>Average (Adjusted for Andhra Pradesh Crisis)</strong></td>
<td>2.2%</td>
<td>3.1%</td>
<td>3.5%</td>
</tr>
<tr>
<td><strong>Medium MFIs</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cashpor Micro Credit</td>
<td>2.5%</td>
<td>3.6%</td>
<td>3.3%</td>
</tr>
<tr>
<td>ESAF Microfinance and Investments Pvt Ltd</td>
<td>0.6%</td>
<td>2.1%</td>
<td>2.0%</td>
</tr>
<tr>
<td>Grama Vidiyal Micro Finance Ltd</td>
<td>0.1%</td>
<td>0.6%</td>
<td>0.5%</td>
</tr>
<tr>
<td>Grameen Financial Services Pvt Ltd</td>
<td>0.2%</td>
<td>0.3%</td>
<td>1.3%</td>
</tr>
<tr>
<td>S.M.I.L.E. Microfinance Ltd</td>
<td>3.0%</td>
<td>1.0%</td>
<td>1.4%</td>
</tr>
<tr>
<td><strong>Medium MFI Average</strong></td>
<td>1.3%</td>
<td>1.5%</td>
<td>1.7%</td>
</tr>
<tr>
<td><strong>Combined Average (Adjusted)- Top 11 MFIs</strong></td>
<td>1.7%</td>
<td>2.3%</td>
<td>2.6%</td>
</tr>
<tr>
<td><strong>Scheduled Commercial Banks (Average)</strong></td>
<td>1.0%</td>
<td>1.1%</td>
<td>0.8%</td>
</tr>
</tbody>
</table>

Table 1: Profitability of 11 Largest Indian MFIs 2010-2013 (in Rs. crore).\footnote{204. All MFI data derived from \textit{MIX Market} dataset. \textit{Id.}}

While a general lack of uniform data beyond that published by Microfinance Information Exchange and credit rating agencies prevents analysis of additional metrics, the ROA figures in Table 1 show a generally positive profitability picture for India’s largest MFIs.\footnote{205. \textit{Id.} at 10.} Compared to other Indian financial institutions, the average ROA for India’s eleven largest MFIs of between 1.7% and 2.6% looks quite strong; by comparison, the Reserve Bank of India reported that the average ROA for India’s schedule commercial banks, a category that includes India’s largest banks, ranged from 1.0% in 2011 to 0.8% in 2013.\footnote{206. \textit{Reserve Bank of India, Financial Stability Report 14} (Dec. 2014), available at http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/FSR29122014_FL.pdf.} However, MFI access to the subsidies, grants, and loans at below-market interest rates may undermine the credibility of these strong ROA figures.\footnote{207. Richard Rosenberg, \textit{Measuring Results of Microfinance Institutions, Consultative Group to Assist the Poor} (June 2009), at 8–11, available at http://www.cgap.org/sites/}

A World Bank report advises investors and donors to adjust profitability metrics to account for...
borrowings below market interest rates, receipt of goods and services below market prices, and the effect of inflation. Given appropriate data, the resulting adjusted profitability metrics may provide a different, less rosy picture of MFI profitability.

Evidence also indicates that MFIs are coupling loan portfolio expansion to increase revenue with improved operational efficiencies to reduce costs. CRISIL estimates that the average number of borrowers per branch for MFIs has steadily increased from 2,500 in 2011 to 3,400 in 2013, with a corresponding decrease in average operating expense ratio from 8.6 in 2010–2011 to 6.5 in 2012–2013. The operating expense ratio compares an MFI’s portfolio yield with its personnel and administrative expenses, so this decrease implies that MFIs are servicing loans more efficiently as they continue to expand their loan portfolios. As shown in Table 2 below, among the largest six MFIs in India, operating expense ratios have decreased consistently since 2010. The same trend holds true for the next five largest Indian MFIs.

<table>
<thead>
<tr>
<th>MFI Name</th>
<th>Operating Expense Ratio</th>
</tr>
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<tbody>
<tr>
<td></td>
<td>2010-11</td>
</tr>
<tr>
<td>Bandhan Financial Services Pvt Ltd</td>
<td>5.1%</td>
</tr>
<tr>
<td>Equitas Micro Finance Pvt Ltd</td>
<td>7.8%</td>
</tr>
<tr>
<td>Janalakshmi Financial Services Pvt Ltd</td>
<td>21.5%</td>
</tr>
<tr>
<td>Shree Kshetra Dhamasthala</td>
<td>4.5%</td>
</tr>
<tr>
<td>SKS Microfinance</td>
<td>9.9%</td>
</tr>
<tr>
<td>Ujjivan Financial Services Pvt Ltd</td>
<td>15.3%</td>
</tr>
<tr>
<td>Average</td>
<td>10.7%</td>
</tr>
</tbody>
</table>

But like the profitability metrics described above, the improving trend in operating expense ratio may be less notable than it seems at first glance. First, MFIs are likely to improve operating efficiency as they grow and their staff, infrastructure, and overhead better match their loan servicing needs. In this sense, operating efficiency improvements by large MFIs are normal. Second, operating efficiency will improve as MFIs favor larger loans over smaller loans; as one World Bank report states, servicing


208. Id. at 9. The CGAP guide’s Subsidized Cost of Funds Adjustment compensates for the effect of soft loans to MFIs by inserting a market interest rate in lieu of the actual interest paid by the MFI. Id. The In-Kind Subsidy Adjustment quantifies the benefit of discounted goods and services by substituting the estimated market cost of goods and services for the actual cost. Id. The Inflation Adjustment reflects the loss in real value of an MFI’s net monetary assets due to inflation. Id.

209. India’s 25 Leading MFIs, supra note 51, at 9, 11.

210. Id.

211. Id. at 24–48.

212. Id. at 12.
six loans of $50 is more expensive than servicing one loan of $300. Therefore, this improvement could result from large MFIs shifting the focus of loan portfolios to wealthier borrowers within the microfinance-eligible segment.

Lastly, in combination with loan portfolio expansion and improved efficiencies, high repayment rates on MFI-originated loans bolster growth and profitability by preserving the spread between cost of funds and lending rates. Whether due to the advantages of joint liability group structures, the growing involvement of credit bureaus in assessing the borrowers, or the improved use of technology in collection, MFIs have enjoyed very low loan delinquency rates since 2010. Excluding MFIs based in Andhra Pradesh, MFI loans more than thirty days past due make up less than 1% of total loans by India’s twenty-five largest MFIs over the past five years and loans more than ninety days past due make up less than 0.5% of total loans for these MFIs in the same period. CRISIL reports that Indian MFI collection rates average over 99%, but even such a high collection rate may result in high loan loss rates depending on the average term of the loan. Regardless, high repayment rates are required for MFIs to be profitable and continue to grow their loan portfolios.

b. Human Capital

Indian MFIs face significant human capital challenges as they seek to scale operations and balance financial and social returns. Many MFI founders hail from the traditional banking sector, such as Janalakshmi’s Ramesh Ramananthan, former head of derivatives for Citibank in Europe, and Equitas’s PN Vasudevan, former head of retail banking at the Development Credit Bank. Recent high-profile hires also follow this trend, with MFIs recently hiring away the Managing Director and CEO of ICICI Prudential V Vaidyanathan and HSBC’s head of global banking and markets Tarun Kataria. This banking sector talent pipeline is responsible for building the popular sentiment expressed by the Indian Business Stan-

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213. Rosenberg, supra note 207, at 12.
214. See Armendariz de Aghion and Morduch, supra note 6, at 51–52.
215. India’s 25 Leading MFIs, supra note 51, at 9, 21.
216. Id. at 11.
219. Id.
dard that MFIs are “led by slick CEOs with Harvard degrees,” and it reflects the trend that MFI boards and investors favor strong finance and management backgrounds in the upper levels of management.

However, high-profile founders and executives aside, MFIs face significant human capital challenges at every level of their organizations as MFI growth has outpaced human capital capacity. In a 2008 study by the Centre for the Study of Financial Innovation, management quality was ranked as the top risk to MFI operations by more than 300 industry respondents from across the world. At the senior management level, MFIs face the inherent challenge of balancing financial and social missions, with pressure from investors and government pushing in opposite directions. In this sense, neither traditional banking nor traditional non-profit experience alone will suffice to meet the demands of leading a MFI.

The talent gap is most acute at the middle management level because of the decentralized nature of branch operations and the geographic dispersion of borrowers. A 2009 study led by the Grameen Foundation and ShoreCap Exchange found that MFI talent gaps were most acute in middle management. In the study, SKS Microfinance and BASIX, two large Indian MFIs, both acknowledged that rapid expansion posed unique challenges for middle managers in charge of branches in specific geographic areas. As one BASIX executive stated, “[e]ach branch manager is like a CEO.” As demand for these soft skills increases, MFIs are focused on developing training programs to build capacity within their organization to meet these needs. Thus, private equity investors likely view human capital challenges in Indian MFIs as both challenges and opportunities for value creation.

c. Exit Potential

Private equity investors in Indian MFIs have two primary methods to realize returns on their investments: selling equity positions directly to strategic and financial buyers and selling equity positions as a part of a


222. Id. at 4 (citations omitted).

223. Id. at 6.

224. Id.

225. Id. at 8.

226. Id. 8–9.

227. Id. at 11.
MFI IPO or acquisition. Overall, Indian MFIs reflect positive exit potential through the sale of equity interests to strategic and financial investors despite a lack of exit activity through traditional routes such as IPOs and mergers and acquisitions.

Private equity investors plan exits before making investments and the method of exit is determined by a number of factors, including the level of market development projected at the time of the exit, the size of the equity stake in question, and the maturity and ownership structure of the MFI.229 With the marked increase in investments in MFIs between 2006 and 2010, the current exit environment is active; MicroRate/Luminis reports that at least two microfinance-focused equity funds and six hybrid funds worth about $600 million are scheduled to mature between 2014 and 2016.230 While the specific terms of exits and the identities of buyers are often not revealed,231 several reports of successful exits from investments in Indian MFIs have emerged recently.

The direct sale of equity positions can take many forms and is often negotiated within initial investment contracts according to a specific time horizon.232 Generally, investors sell stakes to strategic buyers within the microfinance ecosystem, such as other shareholders or other MFIs, or to financial buyers outside of the microfinance ecosystem, such as regional banks and venture capital funds.233 For example, Kalpathi Investments, a Chennai-based investment firm, sold a 10% stake in Equitas Micro Finance to U.S.-based private equity fund Sequoia Capital in 2010234 and Lok Capital, a private equity firm, sold its stake in Delhi-based MFI Satin Creditcare to an equity fund backed by development-focused investors like the International Finance Corporation in 2013.235 Equity investors also negotiate exits within an investment contract at a designated time in

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229. Id. at 3.
230. Id. at 1.
231. See, e.g., A’kos Szebeni, Microcapital Brief: Lok Capital Sextuples Investment with Partial Exit from Indian “Socio-Commercial” Outsourcing Firm RuralShores, CREATION INVS. (May 9, 2014), http://www.microcapital.org/microcapital-brief-lok-capital-sextuples-investment-with-partial-exit-from-indian-socio-commercial-outsourcing-firm-ruralshores/ (“[T]he buyer and the terms of the sale were not disclosed . . . .”).
232. Rozas, supra note 228, at 2.
233. Id. at 4.
the future. For example, fixed-term investment vehicles build exit timing into the investment prospectus. In addition, MFIs can work with existing shareholders to create a liquid secondary market for MFI equity stakes and encourage participation in subsequent fundraising rounds; Ujjivan’s $19.6 million equity round in 2008 included such a feature, with Ujjivan and two existing investors offering to buy out part or all of the stakes of the round’s investors in the future.

Exits through company sales to strategic buyers and IPOs, although more common private equity exits in general, are less common exits for Indian MFIs. Strategic sales in the form of mergers and acquisitions are rare, but are beginning to take shape following the merger of Arohan Financial Services and Intellecash, which analysts speculate will signal consolidation among Indian MFIs. IPOs are also relatively rare among Indian MFIs and entail more controversy. Beginning with Rakyat Indonesia’s listing on multiple exchanges in South Asia, IPOs became a popular fundraising route for mature MFIs, culminating in the high-profile IPOs of Banco Compartamos in Mexico in 2007 and SKS Microfinance in India in 2010. The ability of these firms and others to engage in successful public offerings indicates increased liquidity of MFI shares and the rise of a broader base of private investors interested in microfinance. However, such public offerings have also drawn criticism from the microfinance community; as discussed in greater detail in Section V.C.3 infra, some of the most pointed criticism was leveled by the founder of modern microfinance Muhammad Yunus in his comments about the SKS Microfinance IPO.

C. Trends Affecting the Risk Profile of MFIs

While the Indian investment environment and the firm attributes of Indian MFIs meet many of the criteria that private equity investors seek, this Note argues that two main trends undermine the attractiveness of MFIs as investment targets in the future.

236. Rozas, supra note 228, at 2.
237. Id.
239. STOWELL, supra note 161, at 319.
241. Langer, supra note 175, at 14.
242. Id. at 15.
1. Effect of MFI Regulations and Risk of Deteriorating Lending Standards

New regulation of NBFC-MFIs by the Reserve Bank of India will have both direct and indirect effects on MFI profitability that will make MFIs less attractive investment targets.

As discussed in Part III supra, new Reserve Bank of India regulations impose interest margin caps on MFI-originated loans, a minimum qualified assets threshold, and credit reporting and customer check requirements.244 Interest margin caps of 10% for large MFIs will likely have a direct effect on MFI profitability because they lower revenue by narrowing the interest rate spread between the cost of funds and lending rates; CRISIL predicts a resulting decline in profitability of 0.3% to 0.4% each year for 2015 and 2016 due to the new regulations.245 With an average ROA for India’s eleven largest MFIs of 1.7% to 2.6%,246 as shown in Table 1 supra, such a decrease could have a significant effect on MFI profitability.

The indirect effects of new RBI regulations, however, may have a greater impact on MFI profitability. The qualified assets provision requires MFIs to dedicate 85% of their loan portfolios to microfinance loans; limits the population of borrowers based on annual income levels; and bans MFIs from collecting deposits.247 The cumulative effect of these requirements is to limit the potential market of borrowers and constrain MFIs’ potential to offer different products. In other words, these new regulations limit the ability of MFIs to seek alternative revenue sources outside of existing customer segments. For MFIs seeking growth, the most logical remaining choice is to optimize their current business by cutting operating costs and increasing the number of loans to existing customers with annual incomes below the regulatory threshold of 60,000 rupees for rural borrowers and 120,000 rupees for urban borrowers.248 As Tables 1 and 2 supra indicate, India’s large MFIs are already heading in this direction by steadily improving operating efficiency and increasing loan portfolio sizes in existing customer segments.249

But operating costs are necessarily linked to loan portfolio size and repayment rate; in other words, the extent to which MFIs can cut operating costs is limited by practical realities of loan servicing and origination. As MFIs pursue rapid portfolio growth and continue to lower operating costs, they also increase the number of borrowers and regions that MFI

244. NBFC FAQ Release, supra note 106.
245. India’s Leading MFIs, supra note 51, at 10.
247. NBFC FAQ Release, supra note 106.
248. Id. (limiting the population of borrowers based on annual income levels not exceeding 60,000 rupees ($970) for rural borrowers and 120,000 rupees ($1940) for urban borrowers, and total indebtedness not exceeding 50,000 rupees ($808)).
249. India’s 25 Leading MFIs, supra note 51, at 8, 12.
employees must cover, eroding the ability to service loans conveniently and maintain lending standards while increasing the risk of lower repayment rates and higher levels of delinquency. Faced with new regulatory requirements to conduct credit checks on borrowers and a decreasing number of branch employees per borrower, MFIs are also likely to rely more heavily on credit bureaus to assess the creditworthiness of customers, the same means of assessing creditworthiness of priority sector borrowers that has failed commercial banks in India for decades.\textsuperscript{250} Such a trend would in turn erode the foundational informational advantages associated with joint liability groups,\textsuperscript{251} namely ultra-local knowledge of co-borrowers and close community ties. While joint liability groups still mitigate adverse selection problems, limiting the informational advantages of joint liability groups will likely cause MFIs to choose less qualified borrowers and experience lower repayment rates as a result.

An emphasis on loan origination may also incentivize employees to approve loans that should otherwise not be approved. In other words, the combination of under-qualified, autonomous middle managers\textsuperscript{252} with incentives that emphasize loan volume growth could lead to a streak of imprudent loans. In combination, diminishing the advantages of joint liability groups and lending to less reliable borrowers could decrease collection rates from the incredibly high collection rates MFIs typically enjoy, which would have a devastating effect on MFI profitability. A CGAP study about MFI delinquency rates illustrates the enormous impact on profitability that small declines in collection rate can have: while an MFI with a 99% collection rate could lose between 1% and 12% of its average portfolio annually depending on loan cycles, an MFI with 95% collection rate could lose between 5% and 60% of its average loan portfolio annually.\textsuperscript{253} The experience of SKS Microfinance during the Andhra Pradesh crisis is an extreme but illustrative example; in 2011, repayment rates in Andhra Pradesh as a whole dropped to nearly 10%, causing SKS to experience a 396% increase in provisions and write-offs and a 1318.8% decrease in profit after tax, despite maintaining a 95.5% repayment rate outside of the region.\textsuperscript{254}

A deterioration of loan repayment rates also threatens to have a macro-level impact on the Indian economy. Microfinance loans are the second largest source of asset-backed securities in India comprising about 17% of the total Indian securitization market.\textsuperscript{255} In 2013 to 2014, 39 billion rupees ($722 million) of MFI loans were packaged and sold as asset-backed securities, mainly to bank customers seeking to meet priority sec-

\textsuperscript{250} GOV'T OF INDIA PLANNING COMM'N, supra note 9, at 49–50.
\textsuperscript{251} See ARMENDARIZ DE AGHION AND MORDUCH, supra note 6, at 88–89.
\textsuperscript{252} Ross et al., supra note 221, at 7–9.
\textsuperscript{253} Measuring Microcredit Delinquency, supra note 217, at 5.
\textsuperscript{255} India’s Leading MFIs, supra note 51, at 14.
tor lending obligations. Despite the fact that microfinance loans are generally unsecured, rating agencies like CRISIL tout 99% collection ratios on MFI loans and characterize securitized microfinance loans as offering a “high degree of safety to investors.” Thus, deteriorating loan standards could trigger higher default rates on individual loans, which would directly affect the purchasers (and potentially issuers) of these securitized loans.

2. Regulatory and Social Risk

Regulatory and social risks rooted in India’s microfinance history will also continue to threaten MFI profitability and the ability of private equity investors to exit investments in MFIs.

a. Regulatory Risk

Regulatory risk is prominent throughout the financial services sector, but is especially prominent in the context of financial services for very poor populations. Rating agencies point out that regulatory risk, though alleviated by RBI regulations after the Andhra Pradesh crisis, remains the biggest investment risk facing MFIs. Most immediately, the threat remains that state governments will intervene for reasons similar to the Andhra Pradesh crisis or for other politically expedient reasons. Government intervention at any level could trigger massive defaults, which would produce very unprofitable periods similar to SKS Microfinance’s 2011 performance. But regulatory risks run well beyond state government intervention. Because the primary source of MFI funds is commercial banks seeking to meet priority sector lending obligations through MFI-originated loans, any alteration to the priority sector classification of MFI loans could seriously threaten the MFI business model by limiting access to capital. It is not far-fetched to imagine a scenario in which publicity of unscrupulous lending could incite debate about MFIs, resulting in a change to priority sector lending regulations or existing regulatory classifications. Economic downturn could have a similar effect. Already, the fall of the rupee has caused delays in planned exits by private equity firms from their investments in MFIs. While India has enjoyed and is projected to continue to enjoy Gross Domestic Product growth in the near future, any macro-level economic downturn affecting India’s poor populations could endanger high collection rates, trigger defaults, and spur government intervention.

256. Id. at 9.
257. Id. at 18.
258. See CARE RATINGS, supra note 96, at 2.
259. See Microbanking Bulletin, supra note 127.
b. Social Risk

The ethical ambiguity of profit-seeking investors in microfinance also presents significant risk of social backlash, which this Note will refer to as social risk. As MFIIs attempt to balance financial returns and social mission, the ethical debate rages over the suitability of profit-seeking investors in microfinance.

For opponents of profit-seeking investors in microfinance, including Muhammad Yunus, microfinance is a social movement in which profit-seeking investors have only a limited role. For Yunus and his supporters, microfinance is a social business pursuing goals of financial inclusion and poverty reduction and any focus on profits is a diversion from the basic principles of microfinance. While social businesses in concept harness the discipline of the market to operate efficiently, social benefits are the ultimate goal and profits are reinvested in the business to increase the scale and, therefore, the social impact of the enterprise. Microfinance initiatives in the United States largely follow this social business model and investment statistics reflect the presence of development financial institutions and social investment funds in Indian microfinance.

Opponents of profit-seeking investments in microfinance present ethical and economic objections to the role of profit-seeking investors. In economic terms, they object to profit-seeking investors taking capital away from social businesses in the form of returns when that capital would otherwise be reinvested to provide additional credit for poor borrowers. Profit-seeking investors, in other words, limit the ability of social businesses to impact the lives of the poor when they exit. Yunus articulated this view following the IPO of SKS Microfinance, which was the first IPO by an Indian MFI: “Microcredit should not be presented as a money-making opportunity. It is an opportunity to make an impact on poor people’s lives. An IPO gives a wrong message.” In ethical terms, opponents of profit-seeking investors in microfinance argue that rich lenders exploit the socio-economic position of the poor to lend at high interest rates, thus reinforcing the socio-economic status quo. Most notably, Yunus him-


263. See generally MUHAMMAD YUNUS, CREATING A WORLD WITHOUT POVERTY (2007).


265. Foreign Capital Investments in Microfinance, supra note 130, at 8.

266. Bellman, supra note 243.

self has called profit-seeking MFIs “loan sharks” and urged such MFIs to refer to themselves as commercial lenders rather than as microfinance institutions.268

Proponents of profit-seeking investments in microfinance, including Carlos Danel and Carlos Labarthe, the founders of Mexico’s microfinance bank Compartamos, argue that profit-seeking investors expand the impact of microfinance by providing much-needed capital for businesses and funding more loans for poor entrepreneurs.269 In the view of the Compartamos co-founders, structuring microfinance as a profit-seeking business creates a mutually beneficial relationship between businesses and consumers that maximizes the impact of microfinance on the poor.270

We are great believers that, in order to reach scale, in order to serve people with better products and services, in this case financial services to the low-income sector, that a private sector approach, a commercial or business-minded approach, has a lot of virtues to it . . . having private capital benefit or profit from your operations drives performance to a different level.271

In this view, private sector investment provides the capital and operational discipline to maximize the impact of microfinance. Similarly, the management strategist and scholar C.K. Prahalad articulated a similar argument for profit-seeking businesses serving the world’s poor.

In short, the poorest populations raise a prodigious new managerial challenge for the world’s wealthiest companies: selling to the poor and helping them improve their lives by producing and distributing products and services in culturally sensitive, environmentally sustainable, and economically profitable ways.272

While Prahalad’s work focused on businesses across industries, his concepts are largely indicative of the economic argument in favor of profit-seeking investments in microfinance: effective development efforts are those that connect to the poor through entrepreneurship. MFIs promote entrepreneurship by providing loans to poor borrowers for income-generating projects, and the incentive effects of profits help spread entrepreneurship.273 Vikram Akula, the founder of SKS Microfinance, followed


269. Elisabeth Malkin, Microfinance’s Success Sets Off a Debate in Mexico, NY TIMES (Apr. 5, 2008), http://www.nytimes.com/2008/04/05/business/worldbusiness/05micro.html?pagewanted=all&_r=0.

270. Id.


the same reasoning as the Compartamos co-founders and Prahalad when SKS was gearing up for its IPO in 2010: “[t]he only place you can get the amount of money that is needed to help the poor is in the capital markets. That’s why we are doing this IPO.”

Proponents of profit-seeking investments in microfinance also rebut ethical objections by emphasizing relatively low interest rates, institutional limits on predatory lending, and the progress of consumer protection initiatives. By Indian standards, the average interest rate for MFI loans of 25% is cheap compared to the average interest rates of other institutions that lend to poor borrowers: studies estimate an average interest rate between 65% and 160% for moneylender borrowers. Recent RBI regulations imposing interest rate caps on lending and limits on the amount of credit extended to individual borrowers also directly address the risk of MFIs engaging in predatory lending. The MFI industry response to the Andhra Pradesh crisis led to the establishment of the Microfinance Institutions Network (MFIN), a self-regulatory body committed to increasing transparency and consumer protection in the microfinance industry.

In the view of the author, the benefits of increasing access to finance for poor entrepreneurs outweigh the risks of predatory lending. The recent Reserve Bank of India regulations provide fundamental protections against the risk of predatory lending and the net benefit of shifting borrowing from local moneylenders at average interest rates of 65% to MFIs at an average interest rate of 25% falls in large part to poor borrowers. From a macro-economic perspective, MFIs may also provide a partial answer to the age-old Indian problem of bringing a massive, poor, geographically dispersed population out of the shadows and into the formal financial sector, which could benefit the Indian economy as a whole and raise the standard of living across India. The most ominous risk, in the author’s view, is systemic; as MFIs chase portfolio growth and subsequently off-load the risk by securitizing loans, lending standards could deteriorate and increase the risk of massive default. This risk highlights the need for credit rating bureaus and self-regulatory agencies like the MFIN to effectively monitor MFIs and their borrowers. The debate over the suitability of profit-seeking investments in MFIs is far from resolved and will continue.

274. Bellman, supra note 243.
276. ARMENDARIZ DE AGHION & MORDUCH, supra note 6, at 28; MOR ET AL., supra note 24, at 37.
277. NBFC FAQ Release, supra note 106.
278. Id.
280. GOV’T OF INDIA PLANNING COMM’N, supra note 9, at 49–52.
to exist as long as social investors and profit-seeking investors invest side-by-side in the market. But for a profit-seeking investor, the suitability of an investment in microfinance is an essential part of the MFI risk profile, at the very least as the risk of social backlash and regulatory response.

VI. Conclusion

Overall, microfinance is a powerful innovation in personal finance that has the potential to affect the provision of credit to underserved populations across the world. India, in particular, provides fertile ground for microfinance to grow, evidenced by the rapid growth of MFIs since 2006. During this period, profit-seeking private equity investors have increasingly invested in Indian MFIs, seeking abnormal returns from the scale and operational efficiencies that MFIs offer. Indeed, many have successfully exited such investments, cashing in on periods of tremendous growth in loan origination.281 However, this Note argues that, based on available data, MFIs are unlikely to meet the investment criteria of private equity investors in the near future for two main reasons. First, new regulatory provisions are likely to have a negative impact on MFI profitability in the near future. Second, the debate still rages about whether profit-seeking investors are suitable investors for enterprises serving very poor populations, which presents significant political and public relations risks for private equity funds regardless the ethical issues involved.