

## Doing Bad by Doing Good?

### Theft and Abuse by Lenders in Inadequately-Regulated Microfinance Markets

Catherine S.M. Duggan  
Harvard Business School  
[cduggan@hbs.edu](mailto:cduggan@hbs.edu)

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**Abstract:** This paper argues that micro-credit transactions in developing countries put borrowers at more risk than previously recognized. The private enforcement of loan contracts creates opportunities for unscrupulous lenders to steal from their clients, collecting collateral from borrowers in good standing and seizing property from those who have not yet borrowed. Evidence from the Ugandan microfinance sector illustrates these problems. Microfinance's extremely positive image, coupled with inadequate restrictions on the use of the term 'microfinance,' has created a population of borrowers ripe for abuse. This evidence suggests that the largest-ever experiment in developmental lending may be premised on an incomplete lending model – and that commonly-accepted policy prescriptions to increase competition and decrease regulation in the sector may be unintentionally harmful to the very people these loans are intended to help.

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Do microfinance loans expose poor borrowers to harm?<sup>1</sup> The literature, for the most part, says that they do not. Extant models suggest that where formal institutions are inadequate it is lenders who overwhelmingly bear the risks associated with lending. While borrowers can break lending agreements by defaulting, lenders have little recourse beyond refusing to lend in the first place.

Modern microfinance is based on this premise. Insofar as credit rationing explains low levels of lending in many developing countries, then mitigating the risks which lenders face, and encouraging competition among lenders, ought to make credit cheaper and more widely available. At best, borrowers should have a number of increasingly affordable sources of credit. At worst they will still be unable to obtain loans, having suffered no net loss.

In contrast to this conventional wisdom, this paper argues that borrowers can be – and have been – abused by microfinance institutions. These abuses go well beyond frequently-voiced complaints about high interest rates, an inappropriate emphasis on credit over savings, inflexible and onerous procedures, and a loss of focus on the poorest of the poor. Rather, the microfinance sector's reluctance to go to court to enforce contracts, coupled with its increased dependence on collateral, has allowed microfinance lenders to profit by cheating their clients. Malicious micro-lenders may steal from their clients, collecting more than they are owed, collecting after payment has been made, or even taking collateral from would-be borrowers without ever making a loan. Worse, the well-publicized success of the 'microfinance revolution' may be inducing borrowers to make themselves vulnerable to malicious institutions. While strangers promising loans on easy terms might once have raised suspicions, such promises are now associated with a Nobel-prize-winning idea

I argue that some of the most basic assumptions that undergird microfinance models have

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<sup>1</sup> The definition of microfinance is complex and controversial. Rather than using a definition which relies on the lenders' genuine motives (poverty alleviation, etc.) I include any type of small loan made by an institution or person claiming to be engaged in 'microfinance.' This broad definition is consistent with borrowers' experiences, and reflects what are often lax restrictions on the use of the word 'microfinance.'

blinded researchers and policymakers to these abuses. At root, microfinance models rely on three assumptions: (1) that microfinance loans are wholly uncollateralized, (2) that community ties provide accurate information, and (3) that microfinance lenders are benevolent by definition. Using the Ugandan market as an example, I show that each of these assumptions is too strong to be universally applicable, and that systematically relaxing them reveals a fuller picture of the myriad risks microfinance borrowers face.

This argument has implications for both theory and policy. It suggests that extant models of lending do not adequately capture the risks of lending, nor fully acknowledge the protections provided by formal institutions in developed countries. It also indicates that measuring performance simply in terms of repayment rates and returns may create noxious incentives for lenders, that the metrics for identifying successful microfinance institutions (MFIs) should be expanded to capture adherence to non-abusive ‘best practices,’ and that we must do more to help borrowers distinguish between genuinely development-minded institutions and what are essentially scams. Finally, it suggests that policies touting increased competition and decreased regulation may be inappropriate, and that large unrestricted donations and investments in microfinance may, in fact, allow harm to come to the very people whom these loans are intended to help.

The evidence in this paper is suggestive, rather than conclusive. It does not provide a full sense of the scope or scale at which these abuses occur. It does, however, buttress the conclusion that stakeholders in the industry must pay more attention to problems of borrower-abuse, and that previously-ignored risks of microfinance are likely to be a fruitful avenue for future research.

This paper consists of four main parts. The first briefly outlines traditional microfinance models and the microfinance industry, and describes the Ugandan microfinance sector in some detail. The second discusses the widespread practice use of collateral in microfinance loans and the risks created by private collection in Uganda. The third explores problems of deceit, uncertainty,

and unreliable information in lending disputes, and the difficulties of relying on reputational solutions to these problems of abuse. The fourth explores the problems of asymmetric information that microfinance borrowers face, and problem of loan avoidance by would-be borrowers. The conclusion discusses the generalizability of these problems, explores possible solutions, and strikes notes of warning for recent trends toward providing savings products and micro-insurance in these markets.

## **Background**

A number of economists have explored the risks associated with uncollateralized lending where formal institutions such as courts are absent or inadequate, and lenders cannot rely on iterated transactions. Under these circumstances, lending is often modeled as a simple trust game (figure 1), in which a lender can best protect himself from strategic default by refusing to lend.<sup>2</sup> Even where some borrowers may be less risky than others, lenders may still ration credit as long as problems of asymmetric information prevent them from reliably distinguishing good risks from bad.<sup>3</sup>

Microfinance models are designed to overcome this problem of credit rationing by mitigating default risks at relatively low cost. Classical microfinance uses joint liability loans to outsource screening, monitoring, and collection activities to co-borrowers. Traditionally, loans are disbursed to groups, and MFIs will refuse to make additional loans to any members of the group until all members have repaid.<sup>4</sup> By tapping into deep local knowledge, peer pressure, and community ties, MFIs can mitigate problems of asymmetric information and moral hazard, and achieve extraordinary repayment rates at relatively low cost.

Nearly all microfinance models rely on three key assumptions. The most fundamental is that

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<sup>2</sup> See, e.g. Greif (2006), and Wydick (2008) for extensive discussions of these dynamics.

<sup>3</sup> Stiglitz and Weiss (1981).

<sup>4</sup> This generalization captures the fundamental elements of these loans, though there is substantial variation among MFIs in the particulars of group-formation, payment sequence, and precise requirements.

microfinance loans are not collateralized – indeed, that they *could not* be collateralized because the poor lack property that could secure a loan. In his autobiography, Muhammed Yunus, the Nobel prizewinning founder of the Grameen Bank, recounts his first description of the bank, as “a special bank for the poor. It requires no collateral, and no credit check.”<sup>5</sup> Academic work, practitioner guides, and popular articles routinely describe microfinance as an effort to provide affordable, uncollateralized loans.<sup>6</sup>

A second key assumption is that information available to borrowers in these markets is uniformly true. While lending institutions may not have access to local information about individuals’ reputations, most models assume that co-borrowers and other members of the community have some amount of information. While this information may not be complete, it is generally assumed to be accurate. Although many scholars acknowledge the difficulties of disseminating information, to my knowledge none of the microfinance literature incorporates the possibility of strategic deception. In other words, that a borrower, lender, or competing institution might attempt to gain an advantage by lying or spreading false information through gossip networks.

Third, both policymakers and researchers have tended to assume that the term ‘microfinance’ includes only institutions with some sort of social interest. Microfinance institutions are often identified by this ideology more than precise lending methodology, interest rate, market segment, or loan size. An allied assumption is that most microfinance institutions are large and international, with valuable relationships and reputations to safeguard. This picture of the industry has been reinforced by alliances between researchers and large, pro-bono institutions, as well as by the audited data provided by the largest global institutions.<sup>7</sup> Since much of what we know about

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<sup>5</sup> Yunus, 1998 (2007). p. 179.

<sup>6</sup> See Ghatak and Guinnane (1999), Armendariz and Morduch (2005), Karlan and Valdivia (2009), Matthäus-Maier, and Von Pischke (2006),

<sup>7</sup> See, for example, the institutions which supply audited financial data reported to the Consultative Group to Assist the Poor’s MIXmarket project: [www.mixmarket.org](http://www.mixmarket.org).

microfinance is drawn from studies of the best institutions in the business, it is tempting to extrapolate this picture to the entire industry.

Indeed, at first glance these lending models appear to work well – at least insofar as they generate low default rates and relatively good returns. In 2006 the largest microfinance institutions reported a mean delinquency rate of 2.3%, and wrote-off only half a percent of their loans.<sup>8</sup> For several years donors have stressed profitability – or at least “sustainability” – as a goal for MFIs, and large-scale institutional investors and hedge funds have begun to look to microfinance as a profitable investment. Default rates and rates of return have become one of the main metrics for judging an MFI’s success.

As these MFIs have become increasingly expert at reducing defaults, donors, governments and other stakeholders have turned their attention to increasing competition and outreach. Advocates of competition suggest that it will drive down interest rates, encourage MFIs to improve their products and customer service. The proliferation of lending institutions may increase geographic outreach to new borrowers and create incentives for institutions to redouble their focus on the poorest of the poor<sup>9</sup>

To this end, many countries have minimized their supervision of, and involvement in, microfinance markets. They have kept barriers to entry and supervision to a minimum, and made it relatively easy for MFIs to recover debts outside court. Quantitative evidence has suggested that regulation creates a drag on outreach and profitability for MFIs, and both scholars and practitioners have advocated minimizing government involvement in the sector as much as possible, often by restricting regulation to MFIs that intermediate deposits.<sup>10</sup> One practitioner report noted that

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<sup>8</sup> Calculated from 2006 data, using data from the 55 largest MFIs which report financial data to Mixmarket.org. These institutions represent 38.5 million active borrowers in 2006.

<sup>9</sup> Cull et al. (2009).

<sup>10</sup> Cull et al. (2009, 2008) examine the implications of regulation for outreach and profitability, and discuss the trade-offs associated with regulation in the sector.

“Prudential regulation is needed only when there are depositors to protect, so it is not appropriate for credit-only MFIs that fund themselves from donors or commercial loans.”<sup>11</sup>

Microfinance in Uganda is a particularly good example of this type of laissez-faire policy. The Ugandan government has taken an unusually market-friendly approach to microfinance, encouraging outreach, allowing free-entry to the sector, and minimizing red tape. As a result, Uganda has one of the most open and competitive microfinance sectors in Africa, and it provides an excellent illustration of the pitfalls of an almost entirely free microfinance market.

### *Microfinance in Uganda*

In its naissance in the early 1990s, Ugandan microfinance was dominated by donor-funded NGOs, many of which were branches of international microfinance organizations. These NGOs were local monopolists uniformly subsidized by grant money and primarily focused on outreach.<sup>12</sup> A decade later, donors and the government were pushing MFIs toward sustainability, if not outright profitability.<sup>13</sup> As one government publication put it, profitability in the microfinance sector was “an important step in making sure that the population is aware that there is no free money from government or donors.”<sup>14</sup>

By 2006 the Ugandan microcredit market had become enormously competitive. The best available figures suggest that there were just over 800 institutions and just over 1,200 outlets (including branches) providing small loans to a population of approximately 25 million people, mostly in urban and peri-urban areas.<sup>15</sup> In the same year, nearly three-quarters of all of the

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<sup>11</sup> Consultative Group to Assist the Poor, Donor Brief 12, May 2003. “Regulation and Supervision of Microfinance.”

<sup>12</sup> In the late 1990s, MFIs would rarely find themselves operating in close proximity to one another; when they did, they would enter into ‘gentleman’s agreements’ to divide the area geographically. See J. Beijuka, Peter Mukwana and Earnest Kaffu, *Use of Financial Services over Time in Uganda* (Nairobi, Kenya: MicroSave, 2003).

<sup>13</sup> See FSDU “Consolidation Challenge” project materials, [www.fsdug.or.ug](http://www.fsdug.or.ug) (accessed 6/10/07); Obara, Andrew, “Challenges of Commercialising and Transforming Microfinance” in *The Microfinance Banker* (an AMFIU publication) Vol 4, Issue 2, 2004.

<sup>14</sup> Government of Uganda “Microfinance Outreach Plan” pamphlet, no date.

<sup>15</sup> “Report of a Census of Financial Institutions in Uganda,” p.5.

microfinance institutions in the country said that they were in direct competition for clients with at least one other institution.<sup>16</sup> A third of the districts in the country are home to more than 30 different institutions, and the capital city has more than 80 registered institutions operating within and just beyond the city limits.<sup>17</sup>

Most significantly, the vast majority of MFIs operating in Uganda are essentially unregulated. The Micro Deposit-taking Institutions Act of 2003 made provision for regulating the four largest institutions (now called MDIs), though this regulated group represented less than 1% of the institutions providing microfinance in 2007.<sup>18</sup> The Act explicitly did not regulate the remainder of the institutions in the sector, which are classified as “Tier 4” institutions and prohibited from on-lending savings.<sup>19</sup> All told, these unregulated institutions comprise 97% of *all* of the financial institutions operating in the country, and were the fastest-growing segment of the market in 2005.<sup>20</sup>

Although unregulated Tier 4 MFIs are required to register with the government, they may do so under a number of different guises. A few (2%) register with local magistrate courts as moneylenders under the Moneylenders Act of 1952, while 13% license themselves as limited liability companies under the Companies Act. A surprisingly small number (6%) register as non-governmental organizations (NGOs) with NGO Board of the Ministry of Internal Affairs. These NGOs receive little supervision through this office, which suffers from a lack of resources and personnel, a largely manual record-keeping system, a severe shortage of space, and frequent staff

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<sup>16</sup> Calculated from the Tier 4 Census data.

<sup>17</sup> Calculated from the Tier 4 Census.

<sup>18</sup> As many as ten MFIs – the largest in terms of clients and operating budgets – may end up being regulated by this bill, when the “transformation” process is complete.

<sup>19</sup> The Ugandan financial services sector is currently classified in four Tiers: (1) Commercial Banks (there are 15, most of which do not provide microfinance); (2) Formal credit institutions (7, most of which do not provide microfinance), (3) Micro Deposit-taking institutions, a category newly-created by the 2003 Act (4, all of which provide microfinance, and (4) unregulated institutions (792, all of which provide microfinance).

<sup>20</sup> The most recent year that data are available. These Tier 4 institutions are not the largest loan providers by the number or volume of loans; they are, however, the fastest-growing, with a 64% increase in clients between 2004-2005 (an addition of nearly 200,000 clients). In comparison, commercial banks (the next fastest-growing group of financial institutions) added just under 50,000 new clients (a 16% increase). This trend is likely to continue: most of the two-thirds of the population which is currently ‘unbanked’ is ineligible for loans from banks.

turnover.<sup>21</sup> The vast majority of Tier 4 institutions (82%) are registered with the Ministry of Tourism, Trade, and Industry as Savings and Credit Cooperatives (SACCOs). One donor report noted that this ministry was “widely recognized” not to have the capacity to adequately monitor them, a supervisory gap that is particularly disturbing in light of the fact that SACCO registration allows these institutions to intermediate their members’ savings through on-lending to other members.<sup>22</sup> They are essentially wholly-unsupervised credit unions.

Nor do these supervisory institutions explicitly cooperate with one another. There is no centralized registration system for lenders who might be called ‘microfinance’ institutions, no mechanism for the government agencies which register them to share information, no formal check to ensure that institutions that call themselves MFIs are registered at all, and no supervision of registered institutions. Licensing costs are, in practice, extremely small, and the government has welcomed new lenders – anecdotal evidence suggests few barriers to registration.<sup>23</sup>

The near-total lack of government supervision over Tier 4 MFIs was dramatically illustrated during the 2006 census of these institutions. The census had an apparently modest goal: sending teams to survey and gather locational data from all of the registered Tier 4 microfinance institutions in the country. This proved to be easier said than done. No one had any idea how many of the duly registered institutions were actually operating – let alone where they were.

The first step of the project involved estimating the number of MFIs from the data on hand. The sponsors of the census collected registration information from disparate agencies, as well as information from donors, industry groups, and local governments. This process yielded an estimate

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<sup>21</sup> For instance, one official in an outlying district told me that he had duly collected letters of complaint about COWE and other MFIs in their districts, and forwarded them to the NGO Board, per the Board’s instructions. The head officer at the NGO Board, who was relatively new at the time, appeared to have no idea that such things existed – though she was quite excited to hear about the files, and exhorted me to let her know if I tracked any down. Unfortunately, I was not able to find any. MFIs, moreover, represent an extremely small fraction of the total organizations for which the Board is responsible: the Tier 4 MFIs registered as NGOs constitute about 2% of the total registered NGOs.

<sup>22</sup> AMFIU (2006).

<sup>23</sup> Author interviews, Uganda, 2005.

of 3,360 Tier 4 (unregulated) MFIs in the country.

Teams of professional surveyors were sent out to canvass the country and find as many of the identified institutions as possible. This survey found that only 779 of these institutions were operating – despite the fact that the Savings and Credit Cooperative office alone reported 1,274 institutions with active registrations. A subsequent study was mounted in an attempt to find these ‘missing’ institutions; among other strategies, the lead researcher himself systematically scoured the areas where these MFIs were supposed to be. In the end, about a third of the missing institutions were found. The balance – more than 300 registered institutions – appeared to be non-operational. Interviews with officers from a sample of these collapsed institutions indicated that they had most frequently failed because of “poor governance, fraud, and mismanagement of institutional funds,” as well as high rates of default.<sup>24</sup>

The census revealed that the vast majority of Ugandan MFIs were small and locally-operated by an entirely Ugandan staff, with no formal oversight by international organizations. The median loan disbursement among reporting institutions was 18 million shillings in 2005 (approximately \$9,000); the median number of loans awarded in the same year was 70.<sup>25</sup> Most institutions had single branches and four or fewer employees. The vast majority of these institutions (81%) kept accounts by hand, 57% reported that their accounts were audited by officers of the organization, and 25% reported that they did not have their accounts audited at all.<sup>26</sup> Nearly two-thirds of the directors of these institutions had fewer than five years of experience in microfinance, and nearly a quarter reported that they had only a secondary school education (or less). While the census did not

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<sup>24</sup> The other reasons cited in the study were: (1) organizational restructuring, (2) “failure to balance between social and commercial missions”, (3) inadequate loan capital, and (4) “lack of member sensitization.” See “Where have all the SACCOs gone: findings of the study on the status of the missing SACCOs” AMFIU and FSDU (2006).

<sup>25</sup> 2005, the year prior to the census, is the most recent year for which institutions reported these data. The largest reported disbursement was approximately \$90,000 in 2005, while the largest number of loans was nearly 28,000.

<sup>26</sup> Calculated from Tier 4 census. Questions were: “Which kind of accounting system does this MFI have?” (Manual/Computerized/Both/None of the Above) ; “Does this institution have audited accounts?” (Y/N); “Who conducted the most recent Audit?” (Cooperative Officers/Auditing Firm/Other)

ask for the educational attainment of loan officers, it did show that 91% of loan officers had less than a year in the industry. Finally, 16% of all of the registered MFIs in the country reported that the institution did business *out of the director's house*.<sup>27</sup>

Delinquencies in the sector were enormously high, even among the institutions that were still operating at the time of the census. Overall, Tier 4 institutions reported that they had made 354,000 loans in 2005 – and had 273,000 loans outstanding at the end of the year.<sup>28</sup> My own audits of a small number of Tier 4 institutions buttress these figures: it is not uncommon to find page after page of monthly reports on which there are only one or two borrowers in good standing.<sup>29</sup>

In the face of these risks, collateralized microfinance lending has become extremely popular. While the literature tends to assume that microfinance loans are uncollateralized by definition, in reality microfinance is often explicitly collateralized on the borrower's property, or implicitly collateralized on property to which the borrower has access. In areas with inadequate institutions, the private collection of collateral poses serious and unexplored problems.

### **Collateral, Private Collection, and Theft**

Like many other microfinance markets, in Uganda collateralized individual microfinance loans have become the norm. While individual loans were once almost unheard-of, in 2006 93% of institutions offered individual loans, and more than a third of Ugandan MFIs relied exclusively on this lending model.<sup>30</sup> In the same year, about 85% of clients borrowing from MFIs reported that

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<sup>27</sup> 84% operated out of a single branch; 75% had four or fewer employees. The survey question about the institution's operating premises was self-reported: "Are the offices in which the MFI Outlet is currently operating different from the residence of the owners/promoters?" (Y/N) All calculated from the Tier 4 Census data.

<sup>28</sup> This calculation is slightly difficult, as the relationship between disbursed loans and outstanding loans is vague. Since few of these loans are likely to be for much more than 12 months, however, we can draw at least some conclusions about the magnitude of delinquencies. For comparison, the regulated MFIs reported 32% of their loans outstanding, based on the same calculation.

<sup>29</sup> Author data collected in 2005-2006.

<sup>30</sup> Tier 4 Census, 2006.

they had individual loans.<sup>31</sup>

In many respects, collateralized microfinance loans mirror secured debts in the developed world. If the borrower repays, then she retains the collateral; if she defaults, then the lender sells the collateral and reimburses himself with the proceeds.<sup>32</sup> Not only does the threat of collection mitigate strategic default, but it allows the lender to be confident that he will be repaid whether or not the borrower's investment scheme is successful. As long as a lender can ensure that the value of the collateral is sufficient and is confident in his ability to collect, collateralization should be able to induce lending (figure 2).

Yet unlike lenders in the developed world, Ugandan MFIs typically collect collateral themselves, without going through a court or other third party. Private collection not only reduces the cost and uncertainty associated with seizing collateral, but it allows lenders to take as much as they need to reimburse themselves. By requiring specific types of collateral, the institution can reduce the costs and uncertainty of collection almost to zero.

Microfinance loans are typically collateralized on three categories of property: chattel, money, and titled collateral. Chattel is perhaps the most familiar. In microfinance, this moveable, untitled property includes household furniture and small appliances (radios, etc.), business stock, livestock, and even the materials of the borrower's house, such as corrugated metal roofing sheets. Nearly 60% of the Tier 4 MFIs reported that they accepted chattel collateral for loans, and survey of borrowers found that half of those who had taken micro-loans had assigned some form of chattel as security, including household goods, livestock, bicycles, and business stock.<sup>33</sup>

Ugandan MFIs usually send their loan officers with a truck to collect chattels, which are

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<sup>31</sup> Calculated from FinScope data, 2006. (N = 2,959)

<sup>32</sup> This description assumes that the availability of collateral is unrelated to the success of the project for which the borrower took the loan. This assumption differs from Stiglitz and Weiss (1981), who assume that the value of the borrower's collateral cannot be greater than the loan itself – and is, in fact, dependent on the success of his venture.

<sup>33</sup> Calculated Tier 4 census data and from the FinScope data (collected in 2006). (N = 2,959)

stored at the institution before being sold. One Ugandan court broker noted that MFIs essentially never used his services, and that they did not bother getting a court order to collect property. When asked why, he responded that they did not need to effect collections through the court because they use contracts and “have a company lawyer.” MFIs, he noted, “can go *direct* and take property.”<sup>34</sup>

Microfinance institutions also collateralize loans against deposits, which even unregulated MFIs may accept as long as these deposits are not on-lent or counted as part of a savings product. One of the most common models involves what is called ‘forced savings.’ As a condition of the loan, the borrower deposits a percentage of the principal into a non-interest-bearing escrow account at the lending institution. If she pays in full, she will gain access to her money. If she defaults, then the institution will use this money to reimburse itself.

Beyond this simple forced savings model, MFIs use several types of deposit-collateral. Loans guaranteed on directly-deposited salaries are increasingly common; in case of default the MFI can reimburse itself before the borrower has access to her salary. Some microfinance models marry forced savings with the group liability model. Each member of the group deposits money with the MFI, and the institution automatically makes withdrawals from all group members’ accounts if one member fails to make a payment. The other group members must turn to the defaulter to compensate them for their loss.

In Uganda forced savings requirements have become at least as common as chattel as a way to secure loans. In 2006, 60% of Tier 4 MFIs reported that they used forced savings as collateral. In a 2003 survey, 83% of respondents who had taken a microfinance loan reported that they had been required to make such a deposit.<sup>35</sup>

Finally, titled property may be used to secure a microfinance loan. Despite the conventional wisdom that the poor cannot secure loans on property, this is not the case in Uganda, where 65% of

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<sup>34</sup> Author Interview, Uganda, 2005.

<sup>35</sup> Wright and Rippey, 2003. (n=1795).

Tier 4 lending institutions reported that they accept land titles as collateral, 69% report that they will secure loans on untitled land, and 77% will make loans secured against other types of titled property, such as vehicles and motorbikes. In each of these cases the procedure is similar: the borrower signs the title over to the MFI, which will keep the title for the duration of the loan. If the borrower repays, the institution will sign over and return the title; if she defaults, the institution will evict her or seize the vehicle – sometimes with the aid of the police, who help in evicting the ‘squatter’ or recovering the ‘stolen’ vehicle.

Not all collateral is explicitly assigned in the loan contract. Lenders may count on being able to seize property that the borrower has not assigned as security – and which the borrower may not even own, but to which she might have access under duress. I term this ‘implicit’ collateral.

Traditional group loans use a form of implicit collateralization. If one member defaults, co-borrowers will often voluntarily make-up the difference in order to ensure future loans. They will then compensate themselves by seizing the defaulter’s belongings, money, or future earnings. If none of these sources are sufficient, the group may be able to put enough social pressure on the borrower to force her to ask her family for help or take additional debt from other lenders.

Borrowers need not necessarily go even that far afield for emergency assistance: they may have money secreted away which they will only be willing to access under duress. Slightly more than 50% of Ugandan survey respondents reported that they save money in a secret hiding place, such as a tin buried in the ground or stuck in the roof of a house.<sup>36</sup> Even household goods and livestock that were not formally assigned to a loan can serve as implicit collateral, and there is anecdotal evidence that co-borrowers and MFI loan officers often survey this other property as part of the

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<sup>36</sup> FinScope Report (2007). (N=2,959). Of the total, 2,134 reported that they were currently saving; 71% of these savers reported that they were saving in a “secret hiding place.” Informal groups such as Rotating Savings and Credit Cooperatives were the next most popular place to save, with 27% of savers using this strategy.

screening process.<sup>37</sup>

Implicit collateral can have noxious implications. Informal moneylenders have long used threats in an effort to access implicit collateral.<sup>38</sup> Violence, shaming, and other strong pressure may persuade borrowers to surrender secret reserves or plead for help from others. Lenders may also be able to avoid losing collateral to competing lenders by making themselves the person on whom a borrower *least* wants to default. At its nastiest, the borrower's body or the bodies of her family-members may serve as implicit collateral on the loan.<sup>39</sup> It is, perhaps, wishful thinking to imagine that poor, vulnerable women can literally have nothing of value to an unsupervised lender or collection agent.

Ugandan microfinance does not seem to be immune to coercion. Anecdotal evidence suggests that loan officers and co-borrowers sometimes put pressure on a female borrower by notifying her husband or male relatives. Where domestic violence is the norm, this type of notification may lead to a beating. Even where women are not beaten, co-borrowers and loan officers may be able to apply crushing amounts of social pressure, humiliating defaulters in ways that have long been illegal in the United States.<sup>40</sup>

### *The risks of collateral*

Even if we lay aside the possibility of physical or sexual harassment, collateralization can distort lenders' incentives. Extant work notes the problem of 'predatory lending,' in which lenders seek borrowers who will default so that they can seize their property.<sup>41</sup> In some cases, malicious lenders may accomplish this by leveraging their informational advantage about the probability that

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<sup>37</sup> Author interviews, 2003-2006.

<sup>38</sup> See *e.g.* Rea (1984), and Gambetta (1993).

<sup>39</sup> Sexual labor and the debt bondage of children may provide implicit collateral for black market loans.

<sup>40</sup> See the U.S. Fair Debt Collection Practices Act (FDCPA), 15 U.S.C. §§ 1692-1692pp.

<sup>41</sup> Bell and Clemenz (2006)

the borrower's scheme will be successful.<sup>42</sup> In others, they may fool borrowers into believing that the contract has better terms than it actually does.<sup>43</sup>

Yet even this literature on the risks of collateralized loans assumes that a borrower's liability is limited to the amount of collateral that she has assigned to the loan, and that the collateral is collected by some third party, typically a court. In fact, where lenders pursue privately and without supervision, collateralization can expose borrowers to extortion and outright theft.

### *Overcollection*

The most straightforward type of theft is overcollection, in which the lender takes more than he is entitled to, and more than what is required for him to reimburse himself for his lost money. Once a lender has his foot in the door he may collect all of the chattels in the house; a lender with access to a borrower's deposits or salary may take money far in excess of the amount that the borrower has failed to pay.

Although this problem is extremely hard to measure, we can glean some evidence from the amounts of chattel that some debt collectors report taking. While chattel requirements for microfinance loans in Uganda are typically 150-200% of the principal, borrowers have reported recoveries of property in excess of 1000%.<sup>44</sup> A 2003 report based on a series of focus groups of microfinance borrowers noted their fear of this type of abuse, and concluded that:

where the institution insists on securing very high value [of chattel collateral], a simple written undertaking attached to the client's loan file and shown to the client, that the institution will only dispose of assets that equate the balance outstanding in the event of a default, would go a long way in giving clients confidence in the institution.<sup>45</sup>

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<sup>42</sup> Bond *et al.* (2005)

<sup>43</sup> Richardson (2003)

<sup>44</sup> Graham A.M Wright and Paul Rippey, The Competitive Environment in Uganda: Implications for Microfinance Institutions and Their Clients (Kampala, Uganda: MicroSave-Africa, FSDU, Imp-Act, 2003).

<sup>45</sup> Mukwana, and Sebageni, (2003). This study ran 63 sessions with a total of 251 respondents, using focus groups, individual interviews, and other guided group discussions.

### *Pursuit after payment*

Pursuit-after-payment is an even more problematic type of theft. Where collection occurs privately and borrowers cannot expect to obtain redress through the institutions of the state, then the costs that the lender pays to collect (and the probability that he will be successful) may be the same whether the borrower has paid or not.<sup>46</sup> If this is the case, then a lender who is able to credibly threaten to collect the borrower's property after a default will often be unable to credibly promise *not* to pursue if she pays as agreed (figure 3).<sup>47</sup> As long as the lender expects to see a net gain from the collection, he will always have incentives to seize the borrower's property – whether or not the borrower has repaid the loan. Rather than credit rationing by the lender, it is now the borrower who is likely to avoid loans.

Notably, we do find examples of collection from borrowers in good standing in the Ugandan microfinance sector. As I discuss below, Ugandan borrowers have appeared to be more trusting of microfinance institutions than they might have been of other types of lenders. As a result, they have allowed themselves to be vulnerable to this type of pursuit.

There is some evidence that borrowers' collateral deposits have long been at risk in Ugandan MFIs. Wright *et al.* note one instance in which an MFI closed an under-performing branch fairly suddenly, and simply seized savings from borrowers in good standing to cover loans which had not been repaid at the time of the closure. This action, the authors note, "left behind a fair degree of chaos and bad feeling."<sup>48</sup> Even borrowers' voluntary savings – in other words, savings beyond the required collateral for their loan – have not been secure. The same study found "several" instances in which borrowers had been denied access to the voluntary portion of their savings by "over-

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<sup>46</sup> Why would the costs of collection be the same in both cases? A lender certainly cannot bank on the idea that the borrower will willingly surrender his property under either circumstance; he will only make loans if he is reasonably confident that he will be able to collect – even over the borrower's protests.

<sup>47</sup> In other work I demonstrate that efficient lending can occur under these circumstances if the lender collects the retained principal of the loan when he pursues after default, and only if the costs of pursuit are appropriately bounded. Duggan (2008).

<sup>48</sup> Wright *et al.* (1998). p. 13.

zealous credit officers” seeking to “protect the quality of their loan portfolio.”<sup>49</sup>

One of woman described the vulnerability of collateral deposits particularly succinctly. Microfinance institutions, she stated, were “stealing” from poor Ugandans. When asked why victims of this abuse did not attempt to bring malicious lenders to justice, she answered by asking how a small-business person could fight an MFI, given how much money these lenders have. “Lawyers,” she concluded, “are corrupt.”<sup>50</sup>

More recently, fear of this type of lender malfeasance precipitated a crisis in the sector. At the end of 2007, newspapers reported that several MFIs in the capital had given their clients “the run-around” and refused to give them access to savings deposits. Other clients complained that they had been given far less money than they had originally deposited, and were told that their deposits had been fully refunded.<sup>51</sup> These reports created a panic which led to a series of bank-runs on MFIs and the destruction of property outside their offices.<sup>52</sup>

In response, the Bank of Uganda distanced itself from all but the four institutions that it formally regulates. A leading newspaper parsed the Bank’s statement as “anyone who loses money to any of the [Tier 4 MFIs]...has no recourse for compensation because [the Bank of Uganda] can’t intervene on behalf of any such person.”<sup>53</sup> The paper went on to point out that “This effectively implies that the hundreds of MFIs that operate throughout the country can literally disappear with depositors’ money with little worry of punitive action from anyone.”<sup>54</sup> Indeed, in this single move the Bank of Uganda effectively disavowed nearly 800 lending institutions – or 97% of all of the

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<sup>49</sup> Wright et al. (1998) p.7, note 8.

<sup>50</sup> Author Interview, Uganda 2005.

<sup>51</sup> Abola, James “Microfinance Bodies Should be Watched Closely” *Monitor* (Uganda), September 29, 2007.

<sup>52</sup> Olanyo, Jospeh. “Bank of Uganda disowns microfinance institutions amid customer protests” *Daily Monitor* (Uganda), December 24, 2007.

<sup>53</sup> The new Micro-Deposit-taking Institutions Act explicitly prohibits Tier 4 institutions from on-lending deposits, or taking savings deposits from individuals who are not borrowers or members. The Act does not appear to prohibit these Tier 4 institutions from collecting forced savings as loan collateral, though this interpretation is obviously in flux.

<sup>54</sup> Biryabarema, Elias & Walter Wafula. “Deposit cash in micro-finance at own risk – BOU” *Daily Monitor* (Uganda), November 28, 2007.

financial institutions operating in the country.

*Pursuit without lending*

In an even more noxious form of theft, ‘lenders’ may steal collateral from borrowers without even making a loan. If a borrower must reveal her property to a lender to apply for a loan, then under certain circumstances the lender will have incentives to steal it without lending first. Thieves posing as lenders can gain information and access that they would not otherwise have had.

There is, in fact, evidence that Ugandan institutions billing themselves as MFIs have stolen borrowers’ collateral without ever lending to them. The highest-profile case of this type involved an organization called *Caring for Orphans, Widows, and the Elderly* (COWE), a registered NGO working in microfinance and health insurance in rural Uganda. As the name implies, the organization was targeted at marginalized and extremely poor clients. The institution’s lending procedures were not unusual, requiring borrowers to deposit ‘forced savings’ into an account at a COWE branch before they could take a loan.<sup>55</sup> Its employees worked through local officials and community leaders, and by 2002, a year after it first registered as an NGO, local papers were reporting that it would provide grants “through micro-finance institutions will enable the beneficiaries to engage in productive work and reduce poverty.”<sup>56</sup>

The following year members began to complain that COWE branches were closing – sometimes literally in the middle of the night – without making any loans and without refunding any deposits. Elderly women began staging demonstrations in town centers. One 75-year old woman pleaded to a local paper “they either kill us or they bring back our money. I sold all my six pigs and gave the money to the officials of COWE who promised to give me a big loan and free medical

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<sup>55</sup> In this case, would-be borrowers were told that they had to pay a membership fee of 13,500 Ugandan Shillings (\$6.75), and deposit 50,000 Uganda Shillings (\$25) in order to be eligible to receive a loan.

<sup>56</sup> “COWE helps orphans, elderly” *The New Vision*, 4/1/2002

service but I have got nothing since. They have closed all their offices.”<sup>57</sup> After a string of closures, officials estimated that more than 5 billion Ugandan Shillings (\$2.5 million) had been lost, with more than 700 million Shillings (\$350,000) taken from widows and orphans in one district alone.<sup>58</sup>

Notably, COWE appears to have run the same scam over and over throughout the country, despite national media attention. The institution continued to attract deposits from would-be borrowers – and continued to disappear with them – even after the story of their initial fraud gained national media attention.<sup>59</sup> In fact, the institution was still doing business four years after borrowers had demonstrated against it. In 2007, the largest newspaper in the country described the organization as “a charity that supports orphans and the elderly,” without additional comment.<sup>60</sup>

Unfortunately, the COWE case is not unique. In the first quarter of 2007, two other MFIs in an outlying district were closed after being accused of exactly the same type of fraud. Their activities had been centered in an upcountry district that had lost substantial money to COWE just a few years earlier.<sup>61</sup>

In 2005 I interviewed a man who had run a smaller-scale version of the same scam in a different upcountry district, opening a “microfinance institution” that was actually a pyramid scheme. In a particularly notable move, he brought a minister into the scheme as a front-man, to ensure that “people found the thing trustworthy.” He and his partner targeted unsophisticated individuals in villages and had these borrowers pay “seed money” into a pool from which they were supposed to receive much larger individual loans. By his own admission, no loans were ever made. Microfinance, he confided in a private interview, is “a money-spinning wheel.”<sup>62</sup>

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<sup>57</sup> “Tororo residents conned of sh300m, petition government” *The New Vision* (Uganda) November 26, 2003.

<sup>58</sup> Magara, Darius. “NGOs closed over fleecing residents” *The New Vision* (Uganda), March 16, 2007.

<sup>59</sup> Kiwanuka, Frederick. “NGO cons Luweero residents of money” October 7, 2003.

<sup>60</sup> Twinamasiko, Onesimus. “COWE gives items worth sh40m” *New Vision* (Uganda). August 12, 2007.

<sup>61</sup> Magara, Darius. “NGOs closed over fleecing residents” *New Vision* (Uganda), March 16, 2007. This fraud almost certainly helped to precipitate the bank run and crisis at the end of the year.

<sup>62</sup> Author interview. A local politician claimed that thousands of people had been involved in the fraud. While I doubt the veracity of this claim, it was clearly a significant event: three of my (town-dwelling) survey subjects mentioned the

## Deception, Reputation, and Inadequate Informal Institutions

One might imagine that informal institutions could mitigate these types of abuse. MFIs could garner reputations for being honest (or malicious), and neighbors might intervene to prevent illicit collection. Yet both of these possibilities are insufficient as long as both borrower and lender can lie in an attempt to take advantage of the other party, and as long as third parties cannot easily determine who is telling the truth.

In Uganda, collection efforts often draw a crowd of neighbors who could put a stop to it. The MFI officer often defends the collection by brandishing a loan document and claiming that the it is justified in light of the borrower's default. The borrower, for her part, may plead with her neighbors to intervene, claiming that she has paid, or that the lender is taking far too much of her property. These impromptu judges may know that there was an underlying loan, and that one party is now lying, but it is extremely difficult for them to know who is in the right. Each party is making the expected claim, and witnesses may be suspect, particularly as crowds may be poor at divining the truth based on statements of rumor and hearsay.<sup>63</sup> Under these circumstances a receipt may be the difference between theft and contract enforcement – and documents can be forged, lost, misplaced, or never given.

Relying on lenders' incentives to garner honest reputations is not an adequate solution. If one party is caught in a lie, he or she can evade reputational harm by claiming to have made an honest error. Divining a pattern of malfeasance across multiple collection efforts would require a series of fair judgments by different crowds, as well as excellent information-sharing from area to

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episode without prompting, and all noted that it was worse in the villages. Nonetheless, it does not seem to have garnered any media attention, and appears to have quickly lost the attention of local politicians.

<sup>63</sup> Reputation and hearsay have been disallowed as evidence since Roman times. See McNair (1999). Since a lie may not be caught, doing business with a person who is well-known for being 'honest' – but who is actually dishonest – might decrease one's chances of winning the sympathy of the crowd.

area.<sup>64</sup> Either party could also attempt to gain advantage by lying preemptively, spreading malicious gossip to lay the groundwork for success in an informal appeal. Competing lenders might use similar strategies, attempting to sully the reputation of another lender to gain a competitive advantage, or in an attempt to induce neighbors to refuse to allow other lenders to collect a borrower's collateral. Lenders may even attempt to capture rents by spreading word that reliable payers are habitual defaulters in order to lock-in valuable clients.

Although testing the extent of these problems poses obvious challenges, the COWE case discussed above hints at some of the problems of verifying the veracity of claims of abuse. After the institution lost its NGO license in the wake of allegations that it was stealing from borrowers, the COWE directors protested that this action had been taken without a hearing, based on allegations leveled by competing microfinance institutions and a former director who had been refused a large loan.<sup>65</sup> After an in-depth hearing, a court reinstated COWE's license – only to have new rumors about borrower abuse surface in the papers several months later.

In Uganda these informational problems are exacerbated by turnover in the microfinance market. Many MFIs leave the market in the same year that they receive their licenses. In 2006, nearly half of the Savings and Credit Cooperatives (SACCOs) which had registered in the previous year were no longer operating. Among the institutions that were operating, nearly two-thirds had opened in the previous five years, and 17% (146 institutions) had been open for a year or less. Where new microfinance institutions come and go at this rate it is likely to be difficult for borrowers to know which institutions to trust.

Indeed, Ugandan borrowers overwhelmingly report that they choose lending institutions based on the direct experiences of friends and family, rather than according to interest rates or general reputation. In 2002, only 1% of respondents who had taken a loan in the past said that they

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<sup>64</sup> Hoff and Stiglitz (1997) describe the difficulties of relying on shared information in areas with inadequate institutions.

<sup>65</sup> *Ibid*; "COWE woes" July 31, 2002

had chosen the institution because it offered the best interest rate, and only 7% said that they had chosen the institution because it had a “stable/secure” image. In contrast, 58% of respondents said that they had made the choice based on a recommendation by a family member or friend.<sup>66</sup> While this may be a reasonable stop-gap, encouraging borrowers to rely exclusively on a single well-recommended or well-established lender is far from ideal, since lenders in such a position can extract rents from these locked-in clients.

### **Asymmetric Information, Vulnerability, and Loan Avoidance**

Under most conditions we would not expect to see borrowers make themselves vulnerable to these types of abuse. Lenders who lack access to borrower’s collateral may be unwilling to lend; borrowers ought to be reticent about borrowing from lenders who have easy access to their property. Microfinance, however, introduces new problems of asymmetric information. If borrowers believe that all MFIs are good, then they are far more likely to make themselves vulnerable to these institutions. If borrowers know that some MFIs are abusive, but cannot tell good institutions from malicious ones, then they may avoid ‘microfinance’ loans altogether.

At first glance, there seems to be good reason for borrowers to trust microfinance institutions. Donors, governments, and researchers have tended to assume that MFIs will be bound by their developmental goals, internal codes of behavior, and a desire to protect their international reputations. It is quite natural to think borrowers would similarly assume that MFIs are constrained by their association with government and international donors, as well as by their internal values.

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<sup>66</sup> Wright and Rippey, 2003. (n=1794). Why aren’t interest rates more important? One reason may be that the actual interest rate on the loan is extremely difficult to calculate. MFIs charge a large number of explicit fees (including ‘membership’ fees, fees for buying forms, fees for submitting loan applications, etc.), as well as less obvious fees (late fees, etc.) and hidden costs (including the opportunity costs associated with inaccessible ‘forced savings’ on which no interest is being paid). An American working for a donor agency quipped that *he* could barely figure out the effective interest rates after a lifetime of working in microfinance. He had little hope that most microfinance borrowers could work out how much they were actually paying for their loans. As a woman running a small clothes-shop in Jinja complained, MFIs “have used our ignorance because we don't know how to calculate percentages.” Author Interview, Uganda, 2005.

Yet in Uganda virtually anyone can be a microfinance institution. There are no restrictions on who can call themselves an MFI, no test of intent, and no supervision of lenders' behavior. It is certainly possible to register and operate as an MFI, and even possible to receive external assistance and grant funding, with little more than a statement that one intends to help the poor and encourage high repayment rates.

The earlier examples of borrower-abuse in Uganda underscore the problem of allowing anyone to operate under a trusted banner. In one instance, COWE took advantage of its NGO status, benevolent name, and self-categorization as a "microfinance" institution. In another, a con-artist married good feelings toward microfinance with people's trust in a preacher to induce them to give him money. Each of these cases is particularly striking if we compare them to an almost universal wariness of informal moneylenders in Uganda. One cannot imagine a known moneylender collecting the vast amounts of money that Ugandans have given to con-men dressed as MFIs – particularly without making any loans in return.

### *Loan avoidance*

There is some evidence that Ugandan borrowers avoid taking microfinance loans for fear of abuse. A 2003 focus-group study of Ugandan borrowers noted that respondents "were generally very scared of micro finance institutions' procedures on default," and that many avoided microfinance borrowing as a result.<sup>67</sup> Survey evidence also suggests that some small-business owners are avoiding microfinance out of fear. Of the 1,794 adult respondents to a randomized 2002 survey, nearly half reported that they had heard negative things about microfinance institutions.<sup>68</sup> The most common 'bad things' were that individuals had lost money to closure/liquidation, and that

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<sup>67</sup> Mukwana, and Sebageni, (2003).

<sup>68</sup> Hudson (2003). The survey was conducted in 2002, on a randomly-selected group of 'economically active' adult Ugandans.

MFI's engaged in "harsh recovery methods," including the confiscation of property.<sup>69</sup>

Indeed, some of the very people who might be ideal candidates for microfinance appear to avoid it. In a 2006 survey, 87% of respondents agreed with the statements "small loans help people get out of poverty," and "I would like to start my own business but I can't get enough money." Yet of the respondents who agreed with both statements, 65% also said that they "try to avoid taking loans as much as possible."<sup>70</sup> At the very least, the argument that there is simply not enough microfinance to accommodate demand may not be capturing the entire story.

## **Conclusion**

This paper's main contention is that the foundational assumptions of microfinance models are not applicable in all developing markets, and that ignoring this fact may allow harm to come to microfinance borrowers. The literature has tended to assume that loans are uncollateralized, gossip is true, and MFIs are benevolent, all of which are justifiable assumptions to improve the parsimony of lending models. These assumptions do not, however, correspond to the reality of lending in places like Uganda, and borrowers have fallen through the cracks between this reality and these incomplete models. In fact, the full range of risks that microfinance borrowers are exposed to ought to give pause to policy prescriptions to increase competition and avoid regulating 'credit only' institutions.

### *Generalizability*

To what extent do we see these problems outside Uganda? Certainly, Uganda's highly competitive and lightly-regulated sector appears to provide the ideal circumstances. Nonetheless, reports from other countries do suggest that these types of abuses might be more commonplace

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<sup>69</sup> Notably, this survey pre-dates reporting of the COWE incident, so these responses are not driven by the national media attention to this series of closures.

<sup>70</sup> Calculated from FinScope data (N = 2,959).

than we might imagine.

The sexual harassment of female microfinance borrowers has been a problem in parts of South Asia. Press reports in the Indian State of Andhra Pradesh alleged that a wave of women's suicides was the result of microfinance institutions using "barbaric" recovery methods, including the physical and sexual harassment of the MFI's female clients by hired youths.<sup>71</sup> On-going work in Bangladesh has found that local residents "reported that it was not uncommon for field officers — who are in charge of granting and collecting weekly payments or 'installments' — to resort to violence in collecting on loans. Physical and sexual abuse were common."<sup>72</sup>

The parallels with Uganda are striking. In Bangladesh, too, "Unauthorized repossession of assets, including the very roofs off of recipients' houses, was not infrequent."<sup>73</sup> In Nigeria borrowers have also lost money in pyramid schemes calling themselves banks and promising loans.

The South African government has explicitly prohibited MFIs from collecting forms of collateral, like ATM cards, that make it easy for lenders to abuse borrowers, as well as practices like charging penalties for early repayment which are not outlined in the loan contract. Nonetheless, enforcement has long been a problem. Censuses of lenders have suggested that unregistered lenders and abuses remain prevalent, and the South African regulators have been unable to either induce or force universal regulation. While an on-line (and call-in) database currently allows borrowers to check the status and reputation of a lender, this system has seen mixed success — and is out of reach of countries like Uganda which lack the requisite infrastructure.

Even the nascent Grameen Bank may have, perhaps unwittingly, used implicit threats of violence to encourage repayment. In his autobiography Muhammad Yunus notes that many of the

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<sup>71</sup> When the state government temporarily shut down the microfinance sector, the large MFIs in the area claimed that the abuses were the work of small, fly-by-night 'microfinance' operations. These large operators were allowed to reopen after they promised to be vigilant about monitoring for abuses. "Microfinance: Cure worse than disease" *Hindustan Times*, 7/9/2006. Kumar, S. Nagesh. *The makings of a debt trap in Andhra Pradesh*. *The Hindu*, 4/20/2006. See also Sudhirendar Sharma, "Death by microcredit" *The Times of India*, 9/16/2006.

<sup>72</sup> Cons and Paprocki (2008), p. 2.

<sup>73</sup> Cons and Paprocki (2008), p. 2.

Bank's early loan officers were decommissioned rebel fighters. These soldiers "had wanted to liberate the country with guns and revolution," he writes, "and now they were walking around *those same villages* extending micro-loans to the destitute."<sup>74</sup>

Nor are borrowers in the United States immune from abuse. In a study of 1,768 mortgage claims filed in US courts, Porter (2007) found that creditors neglected to attach the promissory note – the "instrument establishing the existence and terms of the debt" – more than 40% of the time. More worryingly, in 70% of her sample, creditors claimed they were owed more than debtors claimed they owed. She calculates that these discrepancies might translate into as much as a billion dollars across all US mortgage claims, and suggests that at least a small portion of them may be the result of creditors "overreaching in their claims."<sup>75</sup>

In an even more egregious example of abuse, in 2008 Citibank settled a class action lawsuit with the state of California for the illegitimate seizure of borrower's money. The firm acknowledged that it had engaged in an illegal "sweeping" program, removing positive balances from customers' accounts without their knowledge. The California Attorney General noted that the lender "knowingly stole from its customers, mostly poor people and the recently deceased, when it designed and implemented the sweeps."<sup>76</sup> In a piece of internal communication describing the program, one bank executive wrote that "Stealing from our customers is a business decision, not a legal decision."<sup>77</sup>

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<sup>74</sup> Yunus, 1998 (2007) p. 90, italics mine. Yunus is very positive about employing these former rebels, noting that they were young and hard-working, and that "Provided they gave up their guns, we were happy to hire them as bank workers." Earlier, however, Yunus notes that "These guerrillas killed with little compunction. They simply pointed a gun and fired. In every village we came across dead bodies lying in the middle of the road, hanging from trees, or shot by a wall." (p.89) He does not discuss the degree to which these officers' previous vocation influenced repayment, though it is hard to believe that these early, poor – and largely female – borrowers were able to completely discount it.

<sup>75</sup> Porter (2007) p. 32.

<sup>76</sup> "Atty. General Brown Forces Settlement with Citibank: Investigation Reveals Bank Was Stealing From Its Customers" *Office of the Attorney General News Release*, August 26, 2008.

<sup>77</sup> Ibid.

### *New policy directions*

How, then, might we begin to solve these problems, particularly in developing countries most in need of microfinance? In other work I have argued that the systematic reduction of these types of abuse was key in the historical development of credit markets in the West.<sup>78</sup> Borrowers in 19<sup>th</sup> century England faced many of these dangers, including moneylenders free-riding on the good reputation of banks, lenders who illegitimately seized capital – and had borrowers imprisoned for false debts – and malicious lenders who moved around to evade the consequences of their malfeasance. In response, the *Moneylender's Act of 1900* limited private pursuit, defined who was (and was not) a ‘moneylender,’ required all moneylenders to conduct business in a fixed location, and explicitly forbade moneylenders from using the term ‘bank’ anywhere in their name or literature. Similar legislation in the United States led to the formation of self-regulating groups of lenders.

We may be able to appropriate the best elements of these historical solutions to supervise microfinance markets in the modern world. A first step ought to give borrowers a way to tell the difference between ‘good’ MFIs and malicious lenders. Restricting the use of the word ‘microfinance’ – or, perhaps, creating an alternate identifier – is an obvious place to start.

Ironically, the lessons of microfinance may suggest solutions for its regulation. Grouping MFIs and holding them liable for the behavior of other group members may create a certain degree of supervision at relatively low cost. Such a step would also give group members incentives to identify illegal lenders. While the government would still have to investigate and punish this type of behavior, such a step would enormously increase the number of ‘eyes on the ground’ looking out for unregistered lenders passing themselves off as ‘microfinance’ institutions.

A second step must involve some sort of supervision by donors and commercial lenders. Currently, microfinance institutions are assessed almost entirely on the basis of variables such as

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<sup>78</sup> See Duggan (2008)

outreach (the number and type of clients served), repayment rates, and returns on assets and equity.<sup>79</sup> Future loans, grants, and other support is often contingent on MFIs achieving high repayment rates while reaching as many borrowers as possible. Yet there has been very little attention paid to ensuring that MFIs are not engaging in abusive behavior. An MFI's success in a donor or pro-bono investor's eyes should take both its repayment rates and collection de facto collection policies into account, particularly as relationships with international donors and organizations provide something of a 'seal of approval' for borrowers. This is especially true for international organizations which use local partners to administer their loans, and often have relatively little idea about their partners' policies on collection.

Third, researchers and governments must take a more comprehensive view of what constitutes the microfinance market. It may be tempting for researchers and policymakers to ignore malicious lenders because they are not true 'microfinance' lenders. Yet evaluating only 'real' microfinance lenders biases our ability to evaluate the market that borrowers actually experience. Well-run international MFIs may leave borrowers better-off.<sup>80</sup> The modal MFI, however, may generate far less desirable outcomes – and the worst institutions operating under microfinance shingles may actually leave borrowers poorer.

In the end, it may be overly-optimistic to imagine that microfinance can scale-up without government involvement. Simple calls for increased outreach and competition may have noxious consequences, particularly if supervision remains low. By treating microfinance as a market which will right itself without regulation, we may be unintentionally complicit in allowing predation on some of the world's poorest and most vulnerable. More, we may be inadvertently allowing scam-artists to undercut the reputation of a tool which, when used appropriately, may genuinely be an effective way to reduce poverty.

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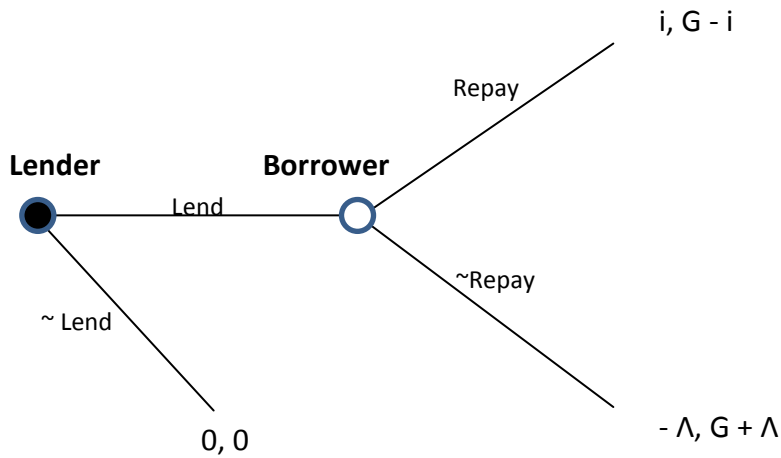
<sup>79</sup> See, for instance, CGAP's "Good Practice Guidelines for Funders of Microfinance." (2006).

<sup>80</sup> See Banerjee *et al.* (2009) on the mixed effects of microfinance lending by a large, well-run institution on borrowers.

These unacknowledged problems in micro-credit are particularly worrisome as microfinance institutions branch into savings and insurance. While the risks to savings are serious, many countries limit financial intermediation to regulated MFIs; the challenge is in the implementation and enforcement of these laws, rather than in demonstrating the problem. The risks of micro-insurance, on the other hand, have drawn far less attention. In the developed world insurance has long offered the opportunity for theft, and insurance sectors are highly regulated. At the very least, it is clear that the supervision of micro-insurance is not keeping up with innovations in this sector.

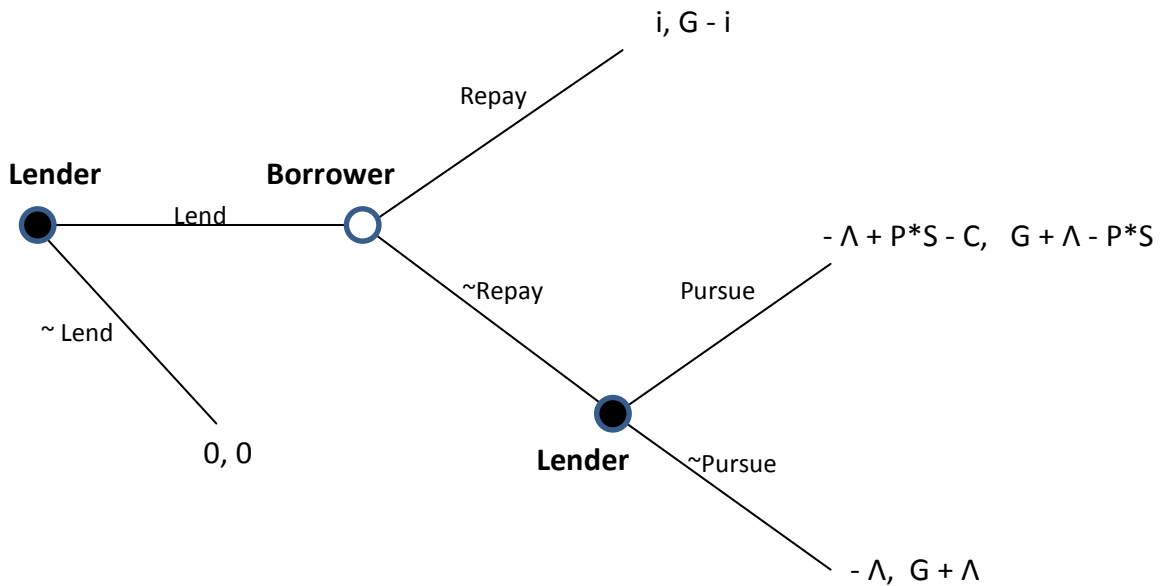
This paper is by no means a condemnation of the microfinance enterprise. Rather, it suggests that the next step for microfinance policy ought to be to strengthen the regulation of the sector, and do more to allow borrowers to differentiate ‘real’ microfinance institutions from pretenders. At the very least, it suggests that we must think more carefully about the implementation of a model that calls for competitive, unregulated, profit-driven lenders to systematically target some of the most vulnerable members of society – especially under the banner of a Nobel Prize-winning concept.

Figure 1: Lending as a trust game



All payoffs indicate the net expected change. The principal on the loan is  $\Lambda$ , the interest payment is  $i$ , and the borrower's return on her investment is  $G$ .

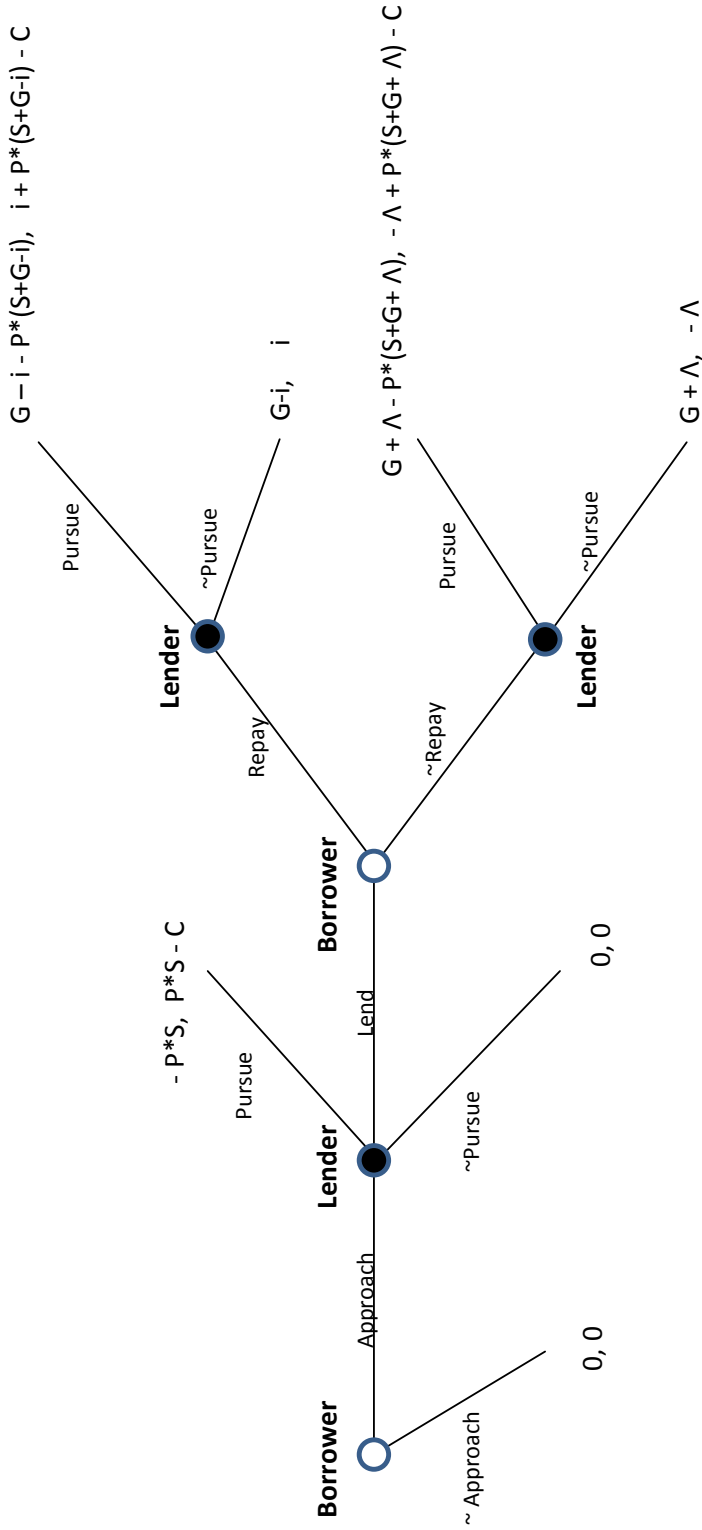
Figure 2: Lending with collateral



All payoffs indicate the net expected change. The principal on the loan is  $\Lambda$ , the interest payment is  $i$ , and the borrower's return on her investment is  $G$ . The borrower's security is  $S$ , the probability that pursuit will be successful is  $P$ , and the lender's costs of pursuit are  $C$ .

NB: Here payoffs are **Borrower, Lender**

Figure 3: Lending with unconstrained pursuit



All payoffs indicate the net expected change. The principal on the loan is  $\Lambda$ , the interest payment is  $i$ , and the borrower's return on her investment is  $G$ . The borrower's security is  $S$ , the probability that pursuit will be successful is  $P$ , and the lender's costs of pursuit are  $C$ .

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