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Indian Commercialisation of Microfinance: A Study of the Emperor's Apparel

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Introduction

Long been discussed as an innovation to address poverty issues, microfinance is now being viewed as the next big investment opportunity. The language of microfinance has undergone a fundamental change in the two decades of its evolution. As some large microfinance institutions (MFIs) hit the capital market, we examine the origins of these MFIs, their transformation processes, and the overall trajectory of the governance processes.

ISSN-2230-7540

When we look at the two decades of MFI presence in India, we fi nd three distinct waves. The first wave was when the development sector discovered the methodology of reaching loans to the poor through a scalable model, which was mastered by the Grameen Bank. The second wave was when these MFIs reached scale and sought methods to morph into commercial organisations. The third wave was when mainstream institutions like L&T finance and Equitas took to microfinance as a business. Most high growth MFIs have adopted and improvised upon the Grameen methodology. This methodology has the following elements:

(1) Identify customers using a poverty index thereby ensuring homogeneity in borrowers.

(2) Organise them into groups. Groups address the issue of information asymmetry and lack of collateral by transferring an individual liability into a group liability and hold the group morally responsible for repayment.

(3) Have standardised products and systems, enforce discipline, and ensure that the exceptions (non-attendance in meetings, non-payment of dues, etc) are dealt with severely.

This template could be applied irrespective of local/cultural issues. The small loan amount did not threaten the vested interests of local moneylenders; it did not affect the basic fabric of the local economy. The amount was sufficient for the borrowers to go through the process of group meetings. It was also attractive for the MFIs because they could keep track of their work through client numbers, portfolio quality, amount loaned and recovery. While it was possible for the mainstream to look at this business from the bottom-of-the-pyramid paradigm, the idea was not yet attractive for the commercial world.

ISSN-2230-7540

The first wave players had limited personal means. The donor community saw a market-based model for helping the poor to get financial services. It was a good combination of a market waiting to be tapped and funding coming from soft sources. In a few years, MFIs started facing challenges in keeping pace with the growth. By the year 2002, most of the first wave MFIs were talking the language of transformation.

In an earlier paper we had listed the imperatives for movement to a for-profi t format for the MFIs and the challenges in "transformation". One of these imperatives was size. With MFIs operating more than acceptable levels of commercial activities in a non-profit format, it was difficult for them to explain their form to the commercial world. Donor funds stopped as their operations became profitable, and maintaining capital adequacy became a challenge. For a while, this problem was addressed by a product innovation of the ICICI Bank. The Bank first offered a securitisation product in 2003, where it bought the portfolio of MFIs in return for an agreement for collection of the loans. Every time a portfolio was bought, the MFI would get the ability to lend, borrow more, and expand. ICICI Bank followed this up with a partnership model which converted the MFIs into agents of the Bank. With this innovation, ICICI lent the strength of its balance sheet to the MFIs, making capital adequacy of MFIs an irrelevant number. This helped the MFIs to grow from fi rst wave to second wave at a pace faster than they would have naturally grown. However, MFIs were keenly aware that they could not put all their eggs in one basket. If anything were to happen in the product offering of ICICI, they would be greatly constrained not only in their growth, but also in maintaining their current portfolio. Therefore, the imperative for entering mainstream became even greater. Most MFIs also used the product offering of ICICI Bank as an opportunity for transformation, which we shall discuss a little later.

ISSN-2230-7540

Logic of Public-Purpose Institutions

Unlike the for-profits, the not-for-profit organisations operate as "public purpose" organisations. The difference is not in their operating methodology – for instance, there is little difference in how Grameen Bank and Swayam Krishi Sangam (SKS) Micro finance operate, but there is a significant difference in what these organisations are. The "public purpose" organisations are structured so that there are no residual claims on current income or on the liquidation proceeds. If a not-for-profit liquidates and there are resources left after settling the liabilities, this residue has to go to another public purpose organisation or to the State. If the organisation is working on philanthropic resources, which could be taxpayer money or potential taxpayer money, or even resources which philanthropists put into the public arena, these should necessarily be used for a public cause than for generating private profits. Therefore, such funds should remain in the public domain.

The MFIs in the first wave were started as organisations with a "public purpose" with donor money. When microfinance scaled up and became attractive for the mainstream market there was no longer a need for MFIs to continue making a point. They should have declared "mission accomplished", and moved on to other social problems. However, the success of microfinance was too attractive for anybody to give this up. The need to prove it at scale and make it successful elsewhere was great.

Thus, there was a natural push for MFIs to become commercial even in their incorporation. The move was not simple. The options available in the commercial space were either to set up a local area bank or form a non-banking finance company (NBFC). We do not discuss cooperatives as a

ISSN-2230-7540

format here, because the logic of cooperatives and community-owned institutions are fundamentally different.

Each option had its barriers from the perspective of the first wave MFIs. Setting up a local area bank was difficult. The Reserve Bank of India (RBI) was careful in granting licences, the area of operations were restricted to three districts and the capitalisation required was Rs 5 crore, a steep hurdle for the players operating at that time. The regulations also prescribed dilution of equity and diversification of ownership in a specific time frame. There was also a cap on voting rights irrespective of investments. All these did not make the prospect attractive for anybody to pursue.

The other option was to incorporate a NBFC. Following a scam in the NBFC space in 1996-97, the RBI tightened the regulations for NBFCs. The initial capital requirement for new NBFCs was set at Rs 2 crore and a licence from the RBI was made mandatory. The promoters of the first wave MFIs were not able to bring in this capital through their personal resources to morph into second wave MFIs. Most MFIs had adequate surpluses to promote a NBFC, but funds from not-for-profits could not be invested in NBFCs.

Internationally, this was not much of a problem. In our discussion on BancoSol and Banco Compartamos (BC), we shall discuss the specific experiences of non-profits moving to for-profits. In India, in the spirit of what public purpose organisations ought to do, the law prohibited equity investments by not-for-profits.

ISSN-2230-7540

International Experiences in 'Transformation'

While there are several examples of organisations "transforming" from not-for-profi t to commercial institutions we discuss two celebrated cases here.

BancoSol: BancoSolodario (BancoSol) of Bolivia was the fi rst celebrated experiment that moved from starting as a donor-based not for-profit entity to a full-fl edged bank that listed its instruments on Wall Street. A not-for-profit institution called Prodem carried out the initial activities of microfinance. The Bolivian law permitted Prodem to take an equity position in the new entity, when BancoSol was set up. Prodem transferred its existing portfolio to BancoSol in consideration of equity in the bank. BancoSol also attracted other investors to contribute to the equity. Prodem continued to fund newer clients and transfer the stable clients to BancoSol.

Over a period of time, there were tensions between Prodem and BancoSol on the orientation of the latter, with differences on excessive commercialisation. BancoSol was accused of drifting away from small clients towards the larger ones. The ownership structure of BancoSol underwent a fundamental change with the original promoters fully moving out, Prodem reducing its stake and giving up its board seat. However, there is no data on "enrichment" of either Prodem or any of the individual promoters. The holdings in BancoSol were largely with institutions, and individuals had less than 2.5% shares. The controversy of BancoSol was around mission drift and strategic focus, and not about public resources going into private hands. This could have been because Prodem – the original MFI actually continued to serve the poorer clients and held on to its work and its mission, and even questioned the mission drift in BancoSol. From this it appears that the criticism actually came from within and not from outside.

ISSN-2230-7540

Banco Compartamos: The case of Banco Compartamos (BC) of Mexico was controversial. BC was established as a nongovernmental organisation (NGO) in 1990. It received funding in the form of direct grants and grant like soft loans to the extent of 4.3 million (Rosenberg 2007). It did not stir up controversy when it moved its portfolio to a new finance company in 2000 or when it received a banking licence in 2006. The debate opened up when BC decided to make a public offering of shares in the year 2007. The debate was on issues of undue enrichment of people running the institution in comparison to the "poor clients" who contributed to the overall profitability of the institutions. BC was much simpler to analyse. When they set up the fi nance company, the NGO itself became a shareholder (similar to Prodem) thus ensuring that the money from charitable purposes continued to remain within the NGO; and any appreciation of the contribution would eventually accrue to the NGO. Thus it kept profits in the public domain.

In BC the issue that started a debate was the investment made at the time of transformation by the promoters, aid institutions and investors including the directors and managers of the NGO/company. Rosenberg (2007) indicates that the original investment of 6 million had grown to a book value of around 126 million and these were in the public offering fetching a valuation of 12 times the book. The initial investors sold 30% of their holding in the public offering. In BC, 41% of the net worth value was represented by accumulated profits – directly attributable to the interest paid by poor borrowers. To BC's credit, it was one of the most efficient institutions in the market segment for the poor, and at 86% per annum interest it was also the cheapest provider of finance compared to its peers. However, this rate was significantly higher than what credit unions charged.

ISSN-2230-7540

The major debate around the public issue of BC was threefold:

(1) Its own business practices – particularly on the interest charged to the poor;

(2) Use of grant money in the investment in BC and the resultant enrichment of directors, managers and institutional investors like the International Monetary Fund (IMF) and Accion;

(3) The appropriateness of offering for sale the shares of the existing shareholders without an expansion of the capital at the time of the public offering.

Surprisingly, the debate was led by no less than Dale Adams of the Ohio University, on the development finance network listserve. Adams and the Ohio school have advocated a financial sector approach to microfinance – questioning subsidies and advocating market-based solutions. They argued that the grants given by donors were in the spirit of benefitting the common good through various mechanisms, and not meant for individual enrichment. Dale Adams appropriately raised the issue on whether the aid money was indeed spread out in an equitable manner to benefit a larger community. The difference between BancoSol and BC was that most of BancoSol's shares were held by institutions. In case of BC, the directors and managers had shares to the extent of 23.7%, and other private investors had a share of 8.5% of the total capital. Rosenberg's defence of the BC issue was strong. The original investors were putting on sale only 30% of their holding and with the proceeds of 450 million unlocked, he argued, this would help in pushing the resources into the hands of the public purpose institutions.

This amount would go back into further development work and advance the cause of microfinance. The NGO held 39.2% of the shares and even this return (at a compounded internal

ISSN-2230-7540

rate of return of 100% per annum) would have meant substantial resources for carrying out charitable activities. However, Rosenberg did not discuss the enrichment of the managers and directors. His larger argument was that there was a market for loans at such interest rates and the borrowers would have been worse off, had BC not existed. Further, he argued that the profitability of BC would encourage more players to come into the business and the resulting competition would be good for the poor.

The Indian Situation

For discussing the situation in India,3 we have chosen to examine four of the largest MFIs based on the Microfinance Information Exchange (MIX)4 data. Each of these four institutions serve more than 8,00,000 customers, have a loan portfolio of more than 100 million and an asset size of more than 170 million each by the year end 2009. These institutions are Share Microfin Limited, Asmitha Microfin Limited, Spandana Spoorthy Financials Limited and SKS Microfinance.

The issues raised in the BC case resonate with those of the four MFIs. In addition, there are issues pertaining to legal mechanisms and ethical questions in the process of transformation. With the impending public offerings of some MFIs, the time is appropriate for a public scrutiny of their practices. Our discussion will focus on issues pertaining to the nature and type of capital infusion, and its implication on the governance standards. Three of the four MFIs, had similar organisational incorporation and a similar conversion to a commercial format. The issues with reference to Spandana were discussed in detail in an earlier paper. In this paper we carry the arguments further.

ISSN-2230-7540

The Indian MFIs could not replicate the processes followed by the international counterparts in the process of moving mainstream because the law did not permit NGOs to take equity position in any company. At the time of transformation, the promoters of each of these MFIs possibly did not have personal resources to meet the capitalisation requirements of Rs 2 crore. The portfolio of the NGO could not be acquired in consideration of equity and had to be done by providing the consideration in cash. The MFI promoters had to examine mechanisms of utilising the investments made in the non-profits in a meaningful manner. In terms of a legal (and not moral/ethical) mechanism to overcome the hurdle there were two options:

(1) Ensure the residual claims are low, by skimming resources above the line. This could be done by paying the promoter high salary/incentives to generate personal wealth legally and use these resources to invest in the next wave of the business. The compensation structure at that time indicates that this was not opted for. The composition of the boards also shows that they were populated with professionals from the development sector rather than from the commercial world.

(2) The second option for these entities was to look at ways of distributing the un-distributable – the residual claims itself.

Of the four MFIs, three resorted to the option of using the grant funding sought in the NGO to capitalise the NBFCs. This was possibly done with a benign intention. Literature of that time indicates that they were trying to involve the community members (who were also borrowers) in the capital structure of the NBFCs –largely termed as a process of “transformation”.

ISSN-2230-7540

The process meant transferring all the operations from the NGO to an NBFC, while winding down of the operations of the former. Thus, for every inflow in the NBFC, there had to be a matching outflow in the NGO. Unlike Compartamos and BancoSol where they allotted shares to the NGOs in return for the portfolio, in India the NGOs had to give a grant to their individual borrowers, who, in turn, would then invest these grants as shares in the NBFC. The grant to individual borrowers was justified in law as having provided financial support to the poor. With the donor community, this was justified as integrating the poor in the investment opportunity in their own financial institution, operating on market principles.

However in order to cut out the transaction intensity of dealing with a large number of individual donees, the transactions were aggregated into mutual benefit trusts (MBTs). The grants from the NGO would be made to MBTs and the MBT would contribute to the equity of the NBFC. The MBTs had two advantages – the NBFCs would deal with blocks of shareholders (MBTs) instead of individuals. The trust deed would ensure that an employee of the NBFC would chair the MBTs and participate in the general body of the NBFC as a representative – thereby ensuring complete control

over community investment in the NBFC. The process needed enough liquidity in the system because the NGOs needed an amount equal to the capital to be invested in the

NBFC in cash to be handed over to the MBTs. Two products helped this process:

(1) The Small Industries Development Bank of India (SIDBI) launched a product called "transformation loan". These loans came at low rates of interest, provided NGOs the liquidity to

ISSN-2230-7540

give grants to MBTs who, in turn, invested in the NBFC; the NBFC in turn bought the portfolio of the NGO for cash and this cash inflow into the NGO was used to repay the transformation loan.

(2) ICICI Bank's securitisation/partnership products also helped the NGOs to get rid of their portfolio for cash and pass it on to the MBTs and build the portfolio afresh in the NBFC. This plan was encouraged – in good faith – even by institutions like SIDBI. However, when we look back at the effects of the process of transformation after a few years, we have larger questions that remain unanswered. In examining the process, we extend the argument that public purpose funds were used to leverage personal wealth.

Case 1: Share Microfin Limited

The first in the series to be incorporated as a company in 1999 was Share Microfin Limited (SML). Unlike the later entrants SML was a pioneer and went through a process of canvassing small amounts from individuals to be invested in the NBFC. While details are not fully available in the public domain, literature of that time indicates that the Share group operated four entities – SML the NBFC, SHARE the society where microfinance activities were carried out, and two mutually aided cooperative societies (MACS). The MACS collected savings from a set of people who were borrowers of SML.

The cooperatives in turn actually lent to SML the NBFC. While there were indications that the savings of the members of the MACS were in turn used to invest in the capitalisation of SML, it is also said that a grant from the Consultative Group to Assist the Poor (CGAP) provided liquidity for capitalising the NBFC. In the fi rst year of operations, SML claimed that it had equity from

ISSN-2230-7540

around 4,000 individuals who belonged to the community and had a capitalisation of Rs 4 crore. In the annual returns of 2003-045 fi led by SML with the Registrar of Companies (RoC), only 2% of the shareholdings were listed under promoterdirectors and relatives, while the others were listed separately. In the annual returns of 2005 the promoter shareholding actually was 1%6 with a reported increase in share capital. The board of SML in both the years had people from the development world and at least two women who represented the borrower community. In the annual returns filed in 2006,7 the total capital increased by Rs 1 crore – a substantial increase in equity shares, and there was a redemption of Rs 4 crore of preference shares. The list of shareholders8 showed a little less than 3,000 shareholders. While the annual returns do not have a declaration of the holdings by the promoter and his family, a perusal of the list of shareholders indicates that the family had increased its shareholding from 1% to roughly 13%, and the MBTs held around 20% of the holdings.

In 2006-07,9 the list of shareholders filed by SML as a part of the annual returns showed a dramatic fall in the number of share holders. From a 44 page document that had around 3,000 shareholders in 2006, it dropped to a two page document with just 68 shareholders in 2007.10 The total amount of share capital remained stable at around Rs 22 crore. As per the annual returns cited above, the shareholding of the promoter who had 75,010 shares in 2006 went up to 24.25 lakh shares in 2007. Those of his family members went up from around 13% of the total shareholding to 57%,11 and these were held in individual names. Another 40% of the shares were held by an investment company, which in turn was substantially owned by the promoter's family. The representatives of the community and development sector were no

longer on the board of SML.

ISSN-2230-7540

Post 2007, other investors like Legatum Ventures and Aavishkar Goodwell purchased equity from SML at a premium. With the expanded capital and divesting of equity by the promoter and the investment company, SML became a subsidiary of Legatum Ventures. The promoter's family and the investment company continued to have around 30% shareholding. The other individuals had less than 1% in the company.

Case 2: Asmitha Microfin Limited

Asmitha Microfi Limited (Asmitha) was set up in 2001 and is promoted by the same family that promoted SML. In 2003-04, Asmitha had equity of over Rs 2 crore, invested by five shareholders – all from the family.14 Unlike SML, Asmitha did not have community participation. There were no inter-corporate transactions between SML and Asmitha. The latter was a purely family-owned

entity in the first few years – the equity moved from Rs 2 crore to about Rs 4.91 crore in 2004-0515 and remained at that level with 59 shareholders, of which 49 shareholders were either directors or their relatives. In 2007-08, something peculiar happened – the number suddenly moved up to 324 shareholders. While the shareholders from the family and the investment firm Jacinth (numbering 24 in all) held a significant part of the shares, a nother 300 shareholders came in with a monotonous holding of 1000 shares each, amounting to an equity contribution of Rs 30 lakh. Of these, 270 shareholders disappeared in 2008-09. Of the other 30, only 14 shareholders were common, with 16 shareholders transferring their shares to others. The shares of the disappearing shareholders were transferred to two shareholders, who suddenly increased their joint holding from 12,000 shares to 2.82 lakh shares. While these transactions do not seem to follow any particular logic, they do seem to have a pattern.

ISSN-2230-7540

When we look at the governance of Asmitha, we find that the board largely consisted of members of the family with a few outsiders. There were no representatives of the financial institutions. However by 2008-09, with investments from Blue Orchard (an equity fund), we find a representative of that investor on the board. Even as of 2008-09,20 the family and the investment firm owned a substantial part of the company. Only about 2.91% of the shareholding of the company was held by individuals outside the family and by the institutional investors. There was a distinction between SML and Asmitha, the latter being a for-profit NBFC. While there is no reason to believe that the funds that came into the SML system could have been diverted to Asmitha, the unusual movement of capital during the period in which Aavishkar Goodwell and Legatum invested in SML is uncanny.

In both the NBFCs, there are similarities in ownership and in the manner in which family ties were fostered. What is intriguing and important is not just the fact that the family acquired significant holding in SML through an irregular mechanism, but also how above-the-line skimming took place systematically. The remuneration of the managing director of SML in 2007-08 was Rs 2.29 crore (including sweat equity of Rs 88 lakh, valued at a notional price of Rs 34.67 per share but against a nil payment).21 In 2008-09 it was Rs 8.08 crore (including sweat equity of Rs 2.69 crore). The remuneration paid to the managing d irector was around 7% of the total personnel cost of SML in 2007-08 and shot up to 15% of the personnel cost in 2008-09. Similarly, in Asmitha Microfi n, the managing director obtained a salary of Rs 34 lakh in 2006-07, which was proposed to be hiked to around Rs 60 lakh in 2007-08. In 2008-09, she was paid a salary of Rs 1.58 crore (including incentives) and allotted sweat equity of Rs 1.94 crore taking the total

ISSN-2230-7540

remuneration to above Rs 3.5 crore. In addition to this, their daughter, a wholetime director in the company, was paid a remuneration of Rs 24 lakh (pro-rated for six months, while the annual salary was around Rs 50 lakh). The remuneration of the managing director moved up from around 3.1% of the personnel costs to more than 11% of the personnel costs. During the same period, Asmitha had appointed a joint managing director at a salary of Rs 45,000 per month (Rs 5.4 lakh per annum). The disconnect between the salaries of the family and others is clearly visible.

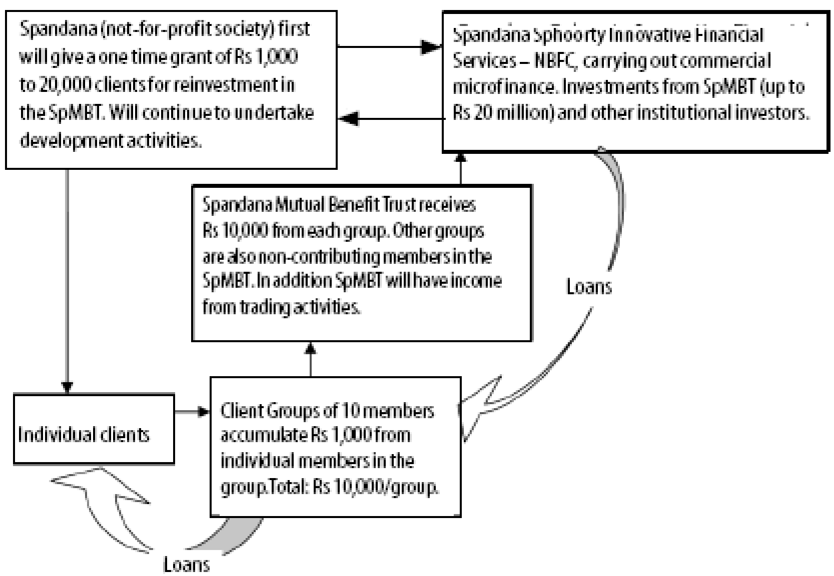
In case of SML, it is significant that the general body passed a resolution of providing the managing director a salary of Rs 80 lakh per annum and "a discretionary performance bonus…decided by the board" (and such incentives were in the order of several crores). In both the cases the overall salary provided to the chief executives was above the maximum managerial remuneration payable as per the Companies Act, for which they would have sought special permission. When we examine these aspects we fi nd that there is disproportionate payment to the promoters of the fi rm. This happens while the boards of these organisations have representatives

of not only the international investors, but also stateowned financial institutions such as the SIDBI. Banks and financial institutions have a large exposure to both the institutions. As lenders, with one of them (SIDBI) having a board position, it is unclear what stand they have taken in the overall governance of SML.

Case 3: Spandana Spoorthy Financials Limited

ISSN-2230-7540

Spandana Spoorthy Financial Services (Spandana) was incorporated in 2003. The process of transformation from a not-for-profit to a for-profit is explained in detail in an earlier paper (Sriram 2005a). We had represented this in the accompanying diagram. Unlike SML where the funds were aggregated into multiple MBTs, after experimentation with individuals in Spandana, the aggregation was into a single MBT for all the existing members.



Over three years the holdings of the MBTs were gradually wound down, with the promoter's family picking up the shares of MBTs. The annual returns for 2003-04 show the MBTs holding shares worth Rs 2 crore. The returns of 2004-05 indicate a reduction in the holding of MBTs to Rs 1.72 crore with an increase in the holding of the promoters' family to more than 26% of the Rs 2.46 crore share capital of the company. These shares were picked up at par or at a nominal premium from the MBT. By 2005-06 the share capital increased to Rs 8.6 crore. The holding of the MBTs fell to Rs 38 lakh while the promoters' holding increased to Rs 7.4 crore representing

ISSN-2230-7540

nearly 86% of the equity of the company. By 2007-08 the share capital increased by Rs 1 crore infused by JM Financials, the shares of the MBT were fully eliminated, and the promoter holding went up marginally by an amount slightly less than what was divested by the MBTs. By 2008-09, the total share capital of the company was about Rs 13.39 crore, of which the promoters owned 59%. It is indeed intriguing how the promoter's family continued to increase their stake till 2008, despite not having the resources to initially infuse capital into the NBFC.

Unlike SML, we did not find sweat equity or any other forms of non-cash allotment of shares to the promoters. While there was a stake sale, this was largely to expand the capital base of the company rather than to significantly dilute the shares of the promoters. The first round of investors – JM Financials and Lok Capital came at a smaller premium of Rs 155 per share; the later investors like Valiant were sold shares at a premium of Rs 650 per share. The number of shareholders remained stable with minor movements. When we look at how Spandana has managed the funds above the line, we fi nd that the managerial remuneration was moderate at Rs 36 lakh in 2007, Rs 33 lakh in 200834 and went up to Rs 82 lakh in 2009. While in 2007 the remuneration was 2.5% of the personnel expenses, in the years that followed, the managerial remuneration was at 1.4% of the total personnel expenses. From the annual reports we find that the MBTs continue to exist, as some transactions are reported under the related party transactions. While in the earlier scheme of events, the promoter had planned to wind up the MBTs (Sriram 2005a), it appears that some funds continue to be held by the trusts. However there are no details on how they are managed and to what purposes these funds are being applied.

ISSN-2230-7540

Case 4: SKS Microfinance Limited

SKS is the most high profile MFI in the country. Unlike other companies discussed in this paper, the data for SKS is available in a consolidated format in the draft red herring prospectus (DRHP) filed for a potential public offering of shares. The original shareholders of SKS were five mutual benefit trusts apart from a nominal holding by some individuals who were signatories to the memorandum. These MBTs held the initial share capital of Rs 2.05 crore. The offer document states that the MBTs received funds donated by the SKS Society (the non-profit entity in which the operations were carried out from 1997 to 2005). The transition of SKS from a non-profit to a for-profit format took a fairly long time when compared to SML and Spandana. Unlike SML and Spandana, there was little holding by the founder right from the beginning. However it is important to look at the details of the transactions that have taken place after the company was incorporated. Unlike the three organisations discussed above, SKS appeared professional right from the beginning. It had set in place some systems of a modern corporate. This included hiring high profile legal consultants as well as being audited by one of the big audit firms (Ernst and Young, Batliboi). SKS and its promoter were o ften prominently featured in the print and visual media. While Spandana and SML maintained a relatively low profile and acquired the shares allotted to the MBT over a period of time, converting the shares into their personal holding, this did not happen in SKS. In this context, the issues in SKS come closest to those in the case of BC.

It is important to note that while the grants that were meant for the community remained in the MBTs, the promoter's holding did go up and down over a period. Unlike SML and Asmitha which discovered the power of a high salary for the chief executive officer (CEO) somewhat later in life,

ISSN-2230-7540

the salaries of SKS were the highest in the industry. There was a stock option plan, which was not only available for the CEO, but also for others in the hierarchy. The board was packed with high profile persons, who were rewarded adequately.

The community funds came in to SKS in December 200339 but SKS received the NBFC licence only in 2005. The commercial operations of SKS started in 2006. Between the time the company was incorporated and the time they started operations, there were no personal finances of the founder locked up in the entity; it was fully funded by the MBTs. In 2005 when it got the NBFC l icence, SKS purchased the readymade portfolio of the NGO amounting to Rs 48 crore at a premium of Rs 3.97 crore.

Investment with a 'Cause' to Personal Enrichment

SKS was growing fast and needed capital. The first infusion of capital other than the MBTs happened around March of 2006 in three tranches. The MBTs invested more capital (the source of their funding is not clear from the documents available, but considering the timing, it may be fair to assume that it was possibly the premium paid on the acquisition of the portfolio from SKS that came back as equity), SIDBI Foundation took stakes. It is important to flag the point that these two organisations had also supported the NGO before the transformation. We assume both these amounts came in from developmental sources.

ISSN-2230-7540

In addition, two other investors –Unitus Equity Fund – took positions in the company. It is possible that all the investors were still looking at this as an investment with a cause. All the investors were allotted shares at par. Till this time we do not come across the personal finances of the founder (apart from a nominal amount of Rs 5,000 that was invested as a part of the subscription to the memorandum and that was transferred in eight months for a consideration that did not fetch profits). It is possible that the founder saw himself purely as a professional who was acting in trust – being a good intermediary between people who viewed this as a developmental cause with a commercial approach. He was being paid a professional salary for the work. Till 2007 the transactions between the founder and SKS were largely transactional – salary and travel and other small perquisites.

In 2007, the founder was allotted shares worth Rs 1.6 crore at par; all other employees together were allotted shares worth Rs 81.8 lakhs (about half of what the founder received) in an e mployee share purchase scheme (ESPS). On the same day other investors, including the investors of the first tranche paid Rs 49.77 per share. Assuming that the founder was getting a professional salary for his work and also given the fact that the original capital came in from developmental funds, this allotment looks peculiar. From a governance point of view, what appears even more unusual is the fact that SKS Microfinance lent him an interest-free loan of Rs 1.6 crore. It does not take too many dots to connect this loan to the purchase shares in the same company.

In the same year, apart from a salary, SKS also rented out the property from the founder's father. This allotment of shares was outside of the ESPS – a special allotment. If we were to monetise the amount, the founder got a one shot notional gain of Rs 6.5 crore, if valued at the price paid

ISSN-2230-7540

by the other investors on the same day. In 18 months from getting this allotment, he sold them out for a price of Rs 103.91 – a gain of Rs 15 crore on an investment (financed by an interest-free loan) of Rs 1.6 crore. While it can be argued that for our analysis, we should be considering the period from the date the options were allotted (vesting date) to the date of sale, it is important to note that there is no explicit intent to purchase the shares on the vesting date. This intent or demonstration on the side of the option holder (employee) is explicit only on the date of exercise of options (when the cash is actually paid). Therefore it is appropriate that we consider the exercise date and the date of sale as an

appropriate period for the analysis of gains.

This is followed by a stock option allotted under the employee stock option plan (ESOP) of 2007 exercised in the month of December 2009 and sold in February 2010 (in the run up to the fi ling of the DRHP). The exercise of options was at a price of Rs 49.77 per share, while the sale to Treeline Asia Master Fund was at a price of around Rs 636 per share indicating a profit of around Rs 55 crore in about three months. Currently as the company approaches the market, the founder holds nil equity, and options that are to be exercised, which he has subjected to a lock-in.

As of the date of fi ling the prospectus, the founder held the position of a non-executive chairman of the company.48 The annual general meeting held in 2009 however had an agenda of appointing him to manage the liason office in the United States for a s alary of Rs 1.1 crore (to be paid in dollars) with bonus and perquisites, thereby proposing to convert his position to an executive one.49

ISSN-2230-7540

Cashing in on the Public Issue

The current CEO was appointed in December 2008. He was granted a one-time bonus of Rs 1 crore in April 2009 and earns a salary of Rs 1.5 crore per annum, along with a performance bonus of another Rs 1.5 crore and stock options. In the run up to the public offering, the CEO who had exercised his option to purchase 2,25,000 shares at a price of Rs 300 on 23 March 2010 a lready had an agreement with Treeline dated 27 January 2010 to sell his shares for a consideration for Rs 14.32 crore51 – a profit of Rs 7.5 crore. The senior management comprising the chief operating officer, the chief fi nancial offi cer, and other employees have cashed out in the run-up to the public issue, selling all their allotments under both the stock option and stock purchase plans at a significant premium through a common agreement with Treeline.

While there is nothing legally wrong in the encashment process, it does raise a larger question about the signalling of commitment on the eve of a public issue which needs to be considered. The argument that the unexercised portion has been locked in for the future is unconvincing, as the option not to exercise the "option" exists with the management, thereby offering only the upside and protecting them from the downside of the market vagaries. As the company is asking newer investors (including retail investors) to invest in the company, all the senior executives are encashing their own stakes indicating – as investors – that this is a good price to exit from the company.

The SKS issue keeps two important questions open. One is pertaining to the governance of an MBT and the other to the governance of the company itself. Unlike SML and Spandana the MBTs continue to hold a significant stake in the NBFC. Not only do the MBTs hold shares, they have

ISSN-2230-7540

also been allotted shares twice in the last few years for which they have subscribed. We were able to postulate how the MBTs subscribed to the first allotment of shares. However, the second allotment to the MBT which was at a premium is intriguing.

Given that MBTs have no business of their own and are shell organisations, one wonders how the share purchase of the MBTs was funded. It is clear that the MBTs were able to source enough funds to further invest in the shares of SKS at a premium. This happened at a stage when SKS was in a position to attract commercial capital and was possibly not in need of any more philanthropic funds. The thinking could have possibly been that MBTs being institutions working for the benefit of the borrowers of the company, the donors should bolster their corpus so that they can work with renewed vigour to help the poor.

Given that the MBTs own around 16% of the pre-issue capital at 1.04 crore shares, and assuming they would fetch a price of Rs 636, which was the last price paid by Treeline, they are worth around Rs 650 crore. This is a large amount of corpus to be controlled. The question is, how would this amount – that came in as a small amount to kick-start a development oriented MFI – be used or ring-fenced? If it were similar to SML or Spandana, this would possibly have been converted into promoter equity, and would have gone unnoticed, but in the case of SKS that has not happened.

Similar to the case of Compartamos where the share of the NGO remained intact and could have been put to a larger developmental use, even in case of SKS it is possible for us to argue that these developmental funds be used for the larger common good. Given the nature of the fund and the purpose to which it can be put, the sudden changes in the governance of MBTs need to

ISSN-2230-7540

be examined. Each MBT had five trustees comprising three employees and two beneficiary members from the regions. In November 2009, SKS Trust Advisors was designated as the sole trustee of each SKS MBT. From broad-based governance (which included having women beneficiaries) to a concentrated control of two persons is a development that needs to be viewed carefully. First, the funds technically belong to the five MBTs. Second, it is not clear if the larger community was informed of the impending public issue, explained the implications of not only expanding the benefits of the MBTs from the original five regions to all the clients of SKS but also that a fair amount of the investments made in the name of the poor would actually be locked in for another three years.

Not only is this development of "taking charge" of the MBTs worrying, but also the pattern of changes in the board of SKS Trust Advisers is a matter of concern from the perspective of governance of public purpose funds.

The DRHP states that the governance of SKS Trust Advisors is expected to be broad-based. However the quick turn of events and the churn in the board seems to indicate the narrowing down of control from a broad base. The speed at which some fundamental changes have taken place in the governance structure of the MBT funds have not been articulated clearly anywhere.

Issues of Compensation and Governance

ISSN-2230-7540

In case of governance of the company itself, two recent incidents are important to note. The company has an ESOP 2008 (ID) scheme – a stock option plan for independent directors. The stated purpose of the plan is to attract, retain and remunerate independent directors.

While independent directors are to be compensated, offering them stock options and setting their incentives on par with the management of the company is actually taking away their independence and aligning rewards to the performance of the company in the stock market and not on fundamentals. This instrument, which seems to provide an unlimited upside but a zero down side, is to be questioned – not only in case of SKS, but as a general practice.

Added to this, one of the independent directors59 has been allotted shares worth 50,000 on a preferential basis in August 2009 at a price of Rs 300 per share. Such general preferential allotment (outside of the ESOP-ID) made to board members, or amounts lent by the company to its directors in order to purchase shares in the same company in the case of a listed company, would be seen as serious breach of governance. While those regulations may not apply to private companies, the conceptual similarity of these transactions is to be noted. Governance that is laced with conflict of interest of this nature – a reward system that puts the independence at stake, does not appear suitable for a company, particularly for one with a lofty mission statement.

Apart from the above, Catamaran Management Services has been preferentially allotted shares in SKS on 19 January 2010 at a price of Rs 300 per share. This was done through a hurriedly convened extraordinary general meeting (EGM) with a five day notice62 issued on 13 January. Around 27 January, Treeline was willing to buy the shares of the employees at Rs 636 per share.

ISSN-2230-7540

Why would Catamaran want a share in SKS? We suppose the fund has a spirit of nurturing entrepreneurship and promoting innovation – and possibly that is why Catamaran was set up with Murthy's personal resources. SKS is neither innovative nor an untested idea. Catamaran has notionally doubled the value of its holdings in less than a week and might even see a greater value unlock at the end of its lock-in period. While doubling or tripling of the investment in a short period could be a good enough reason for any investor, does the same hold for Murthy who has carefully nurtured his image as an ethical, non-greedy, professional? Of course, it makes perfect sense for SKS to sell shares to Murthy at whatever price; that is an investment they make in a brand ambassador for the public issue. SKS gets credibility – something that is most needed when one is doing a business with the poor. As a part of this deal Murthy will head an advisory board. In the process SKS gets the upside of the association with Murthy, while Murthy himself would not have the responsibility of a full board member – no civil or criminal liabilities attendant with a proper director of a company. While from the perspective of SKS this arrangement is understandable, from Murthy's perspective it is intriguing.

This aspect is well explained by an executive of one of the large private equity investors in SKS who did not want to be identified. According to him, "This (lower price) was a way of compensating him for being part of the board".

ISSN-2230-7540

Implications and Need for Introspection

Microfi nance sector has emerged out of development paradigm. Over time it has tasted success, because it was addressing a need for financial services for a particular segment. This ensured that there were sufficient rents to be sought – because of the inelasticity in interest rates at the client end.

Our argument in this paper is about the ethical fabric on which these MFIs are built. Each one of the promoters came in with a developmental objective – wanting to promote institutions that helped the community. Each tried to have a community share

holding and give some parts of the profit back. No commercial outfit would have thought of such a structure. They moved to mainstream due to the requirements of capital and the pace of growth. That was why institutions like SIDBI proactively designed products and became a part of this process. However, in the process of getting the mainstream players into the poverty market, there was a drift. Whether they were pushed into a corner because of pressure from the new investors, or they thought that their job was done, is not known. However, the incidents in the history of

these organisations do not make a very good reading, particularly with organisations that started out with resources from the society.

The founders never invested risk capital, and borrowed the ideas and models from elsewhere. This is not a strong moral fabric to build a business on, when the goal is that of eradicating poverty. It is also true that the bottom-of-the-pyramid argument should apply to this business. In

ISSN-2230-7540

the case of a fast-moving consumer goods company which looks at the bottom-of-the-pyramid and tries to design products that attract the poor, it is difficult for anybody to trace the profits of the company specifi cally to the poor clients. In any case, they do not claim to eradicate poverty. However, in case of MFIs it is possible to trace the profits to the poor. The contrast between the client who is supposed to benefit and the promoter who is actually benefited is stark. In such a business it is better to be moderate. It would be in the long-term interest of these businessmen to consider this because the backlash in case of undue enrichment from the poor is going to be much larger and harsher.

One category of institutions that are definitely going to be hit if the microfinance market falls are the banks who have aggressively lent to the MFIs and allowed them to leverage public funds (in the form of loans) for generating private profits.

Examining this from the perspective of valuations, let us assume that these organisations continue to get the valuations that they are getting now. Are these realistic? If they are, what are the assumptions under which they are? The valuations indicate that these institutions are expected to earn either as much profit, or more, that the historical trend. We need to worry about whether this indication is indeed well founded. If it is, the implication is that the poverty market is here to stay, for more entrepreneurs to enter it and capitalise on the high returns. It is thus time that the MFI sector took a pause and introspected.

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