

# Corruption and financial crime – an issue in microfinance?

**responsAbility's Discussion Papers**  
 responsAbility publishes Discussion Papers on a regular basis. They are aimed at providing state-of-the-art information on actual topics relevant to microfinance and to our clients. Their aim is to support the ongoing discussion with our partners, clients and stakeholders with the ultimate objective of developing a common understanding of key issues in the field.

**Many microfinance institutions (MFIs) operate in 'difficult' countries with a weak rule of law, open and latent conflicts, and corruption affecting everyday life. Social and private investors who finance MFIs may therefore be concerned about the benefits of their engagement and the sustainability and profitability of their investments. Obviously, there is no corruption-free world. Corruption may occur in an MFI as it may in any other type of company, organisation or government institution. Empirical experience, together with the theoretical line of reasoning, however, provide good reasons to assume that corruption in MFIs is not a big issue. This paper aims to clarify some of the questions addressed by investors and interested stakeholders. How**

**are MFIs affected by corruption (and money laundering)? How do they deal with this situation? And what is the appropriate benchmark to evaluate the outcome?**

## **Corruption and money laundering - Definitions**

Corruption is commonly defined as the abuse of official power for private gain or, more generally, the misuse of a position of trust (within administration, private and public companies or politics) for a dishonest personal benefit. The main forms of corruption involve bribery, embezzlement, fraud and extortion. Depending on the focus, corruption may also take very subtle forms, such as attending unnecessary seminars or conferences implying higher inefficiency within the company or institution. Sometimes corruption is even understood in a very broad context as "something against law".

Money laundering refers to the act of concealing the origin (source and identity) of funds, either because funds have been generated by illegal means or because they are subject to reporting requirements that involve paying taxes and other duties. Money launderers may operate through financial systems or fictive companies and transactions. In particular since

9/11 concerns about terror financing have gained a lot of attention.

## **There are different levels where corruption may affect MFIs directly and indirectly**

The most probable type of corruption and financial crime that might occur at MFIs is fraud. Although fraud occurs in all business sectors, institutions dealing with finance are specifically exposed to it. Loan officers and managers may make fictitious loans, transfer funds into their personal accounts, receive bribes or simply steal cash (see Box 2).

Corruption-related concern may also be linked to the ownership structure of an MFI. Non-governmental organizations (NGOs), for instance, tend to be more focused on social benefits rather than financial outcomes and profitability. As majority shareholders in MFIs they may on average demand less stringent internal controls than private, profit-maximizing owners and thereby unintentionally open doors for fraudulent behaviour. By contrast, other people argue that NGOs often have a social and church-related background bringing in higher moral standards and therefore less corruption. Last but not least,

corruption may originate from activities of MFI owners themselves, abusing MFI lending for their own mission or political agendas, for instance, granting loans to buy votes. This type of political corruption has not been a big issue but has occurred in some cases where governments have been direct or indirect owners of MFIs.

### Box 2: Areas for Microfinance fraud, money laundering and financial crime

- Grant fictitious loans or grant loans to ghost borrowers (transferring funds into personal accounts)
- Make loans to family, friends and close associates (loans not being repaid thereafter)
- Receive kick-backs from clients (clients paying bribes to get a loan, collusion with client to approve bogus loans and subsequent sharing of loan proceeds)
- Manipulate financial data: misstating, misrepresenting (not recording incoming payments or recording non-existing payments of interest and principal of ghost loans)
- Steal cash
- Provide micro credit to finance illegal activities
- Use the proceeds of businesses supported by MFI loans to finance illegal activities.

Corruption may also be related to MFIs indirectly, i.e. MFIs may offer credits or accept deposits from clients

that pursue corrupt businesses and money-laundering activities. There are, however, good reasons to assume that this is not a major problem. On the one hand, many MFIs, above all MFIs linked with international donors and NGOs, explicitly apply exclusion criteria on the type of business activities they support and they know the identity of their customers very well. On the other hand, even though money launders may operate through fictive companies, casinos, jewellery stores or import-export activities, they do not tend to choose MFIs where a deposit of \$50'000 would immediately draw attention to them. They rather prefer larger financial institutions with international relations. It is within these institutions that bankers have to watch out for major or unexpected transactions. MFIs, by contrast, typically operate in segments of poor people where the micro-entrepreneurs' business activity does not provide many options to be corrupt. Corruption, if it occurs, mostly takes the form of petty corruption often driven by some type of extortion, i.e. micro-entrepreneurs bribing civil servants for due (and legitimate) services.

Besides corruption, associated with the MFI's main business activities (lending to clients and taking deposits), MFIs are also exposed to corruption in their interaction with the government bureaucracy. Setting up an MFI or opening a new branch, for

instance, may involve insurmountable procedural and administrative barriers. Bureaucratic hazards and delays may be particularly strong with obtaining approvals and licenses or site development (construction and utilities). Managers may then be inclined to bribe to speed up processes or to obtain services they are legitimately due. This type of corruption is indeed a real threat in countries with a predatory and inefficient bureaucracy. Yet, for the cases where international donors, NGOs and MFI networks with strict governance and checks and balances have been directly involved in the start-up, the problem does not appear to be severe as many have a longer stamina in trying to set up processes and activities with a zero-corruption approach. ProCredit Congo is a case in point. It started its operations in Congo in the 1990s and managed to launch its MFI without paying any bribes, even though Congo has been rated as one of the most difficult countries in the world to do business.

**Above all MFIs with international relations have become strong in controlling and preventing corruption. The issue is, however, also a matter of finding a balance between conflicting goals.**

MFIs are very heterogeneous and range from ad hoc and entirely free operating NGOs to sophisticated and tightly supervised financial institutions. The potential risk for fraudulent

behaviour, money laundering and other corrupt practices varies equally. Preventing fraud starts with the type of products offered by an MFI and the simplicity of its operations. In general, the more standardised the terms and the less complex the organisation, the fewer opportunities for fraudulent behaviour. By contrast, non-standardised and easily negotiable terms of products increase potential benefits of corrupt deals. Loan approvals should involve at least two persons and loan officers should be forced to immediately stop lending if their portfolio at risk surpasses a certain percentage. A higher level of accountability and transparency can be obtained with a detailed, decentralised accounting system (each lending unit being treated as a separate profit centre) and small sizes of units in terms of staff and products. Adequate and simple running audits for cash, new loans and delinquencies, as well as frequent internal audits (including direct field visits with customers) make it harder to undertake and hide corruption. Finally, equally important is a clear message from the MFI leadership that fraud is taken seriously.

Potential costs and benefits of corrupt activities within MFIs are also influenced by the surrounding regulatory framework. Particularly problematic are maximum interest rate regulations at far below market rates, which usually lead to a further rationing of formal credits, i.e. credits

are cheap but not available. Very low maximum interest rates not only make it impossible for MFIs to provide tiny loans on a cost-effective basis, they also increase benefits of corrupt deals. Loan officers can demand bribes while borrowers still earn extra profits (as compared to the more expensive loans obtained from non-regulated informal sources). If interest rates are kept very low, some clients in collusion with loan officers may even receive cheap but rationed MFI loans and on-lend them at higher rates in the parallel market.

Depending on the country and the MFI type, MFIs are also subject to more or less complex financial regulations. If efficiently enforced, financial regulations limit risks in MFIs and to some extent fraud and other corrupt activities. Virtually all regulated MFIs, for instance, have to follow certain procedures to control money-laundering activities, among others, crosschecking the identity of clients with a black list. If regulations require MFIs to have guards and vaults, simple cash theft will be more difficult. And limitations in ownership (minimum number of shareholders, nature of permissible shareholders, etc.) may enforce a more close internal supervision, thereby curbing corruption.

Yet, having said that, the elimination of corruption is obviously not an absolute value overruling all other considerations. Some rules and

regulations that lower risk can also lower poor people's access to financial services, i.e. under specific conditions small MFIs may not be viable if they are subject to complex and costly regulations. Poor people would prefer to keep their savings in weakly-regulated MFIs rather than being forced to use less efficient and riskier means (keeping cash under mattresses or converting it in livestock and building materials). The same argument of balancing goals holds for internal regulations. Being 100% sure that corruption is not possible in an MFI would require extremely restrictive procedures and heavy control and supervision costs, which effectively undermines the MFI's profitability and long-term viability. The goal should therefore be to try to prevent and control fraud, i.e. to keep fraud within tolerable bounds in terms of costs, risk to assets and reputation.

### **Conclusion**

There is no corruption-free world. Corruption may occur in an MFI as it does in any other type of company, organisation or government institution. Empirical experience, together with the theoretical line of reasoning, however, provide good reasons to assume that corruption in MFIs is not a big issue. Beside the fact that most MFIs have high quality lending portfolios, relatively few cases of corruption have been reported. A lot of this finding has to do with the type of activities MFIs are doing, i.e.

taking deposits and providing small loans for poor people. In this business model there is not much room for corrupt activities. Even the high borrowing rates are not suitable to attract corruption, as they reflect high costs of handling micro loans. There is simply no fast money to be earned in microfinance.

Having all these arguments in mind, it can be concluded that at least on average, MFIs tend to be more sheltered against corrupt practices and some MFIs may even, in collaboration with international partners, become a driving force in disseminating non-corrupt standards and business ethics within their regions .

Yet, even though corruption does not appear to be a major issue, it does not mean it should be ignored. In particular fraud may occur in MFIs, and MFIs have to safeguard against it. responsAbility is aware of the risks and addresses them in its investment analysis. This includes an in depth due diligence of investment partners and a detailed operational risk assessment of MFIs, which comprises issues like governance, information systems, risk management and controlling. Finally, responsAbility also has a process in place to address the integrity of business behaviour of the MFIs it has invested in (responsAbility Exclusion Policy).

#### Sources and further readings

Rober Peck Christen, Timothy R. Lyman and Richard Rosenberg. Microfinance Consensus Guidelines. Guiding Principles on Regulation and Supervision of Microfinance. [www.cgap.org/docs/Guideline\\_RegSup.pdf](http://www.cgap.org/docs/Guideline_RegSup.pdf)

Richard Hook. Controlling Fraud in Microfinance Programs. [http://www.microlinks.org/ev\\_en.php?ID=3239\\_201&ID2=DO\\_TOPIC](http://www.microlinks.org/ev_en.php?ID=3239_201&ID2=DO_TOPIC)

responsAbility Guiding Principles and Exclusion Policy (available at [www.responsAbility.com](http://www.responsAbility.com))

Interview with Rochus Mommartz, consultant on financial sector development

Applying high business standards not only increases the accountability towards investors, it also encourages MFIs to keep the prevention and control over corruption as a priority in their agendas — in fact, those depending on international funding can just not afford to do something else.