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Dedicated to my mother, Dipl. Ing. Monika Leipold (1952 – 2006)
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INTRODUCTION

Traditional microfinance institutions (MFIs) are usually NGOs which work in a donor fund and subsidy based environment. They also tend to combine their actual microlending agenda with other, so-called “credit plus” services, such as business training, product development and marketing assistance. These organizations are therefore not merely financial institutions, but “social advancement agencies” that deal with a variety of issues in order to improve their clients’ economic situation.

Since many MFIs operate on a non-profit basis, their respective outreach and operational capacity is generally limited to the aforementioned donor funds and grants by other organizations and governments. In order to fulfill their mission to alleviate poverty, however, these organizations find themselves constantly faced with the need to expand their operations, in order to extend their outreach either horizontally (i.e. into new regions / markets) or vertically (i.e. to more clients in their existing market).

As the ability to do so using only the aforementioned sources of funds is viewed as limited by many researchers, there is increased discussion in literature as to how to maximize MFI outreach and thus maximize welfare for the poor.

Many authors argue that commercialization of the microfinance industry is an essential step towards this goal. In order to define the term for the rest of this paper, I will adhere to Christen’s definition of commercialization, which states that commercialization has three essential elements: profitability, competition and regulation.¹

In essence, this definition results in the imperative for MFIs to conduct business on a for-profit, rather than a non-profit basis and also calls for alterations of the legal, political and industrial framework in which these organizations operate, ultimately leading up to their full integration into the existing financial industry.

Other authors question whether financial self-sufficiency is in fact necessary, as the better part of the microfinance industry has always been and is still dependent on subsidies and donor funds have so far not shown significant decreases over time. Even if donor agencies should back out and corporate funding of MFI operations subside, governments are still likely to continue funding such projects if they have

¹ [CGAP02], p. 2
proved successful in the past and continue to do so. Moreover, as subsidized microcredit programs until this day have proven to be feasible social investments, empirical evidence suggests that subsidized operations can indeed be very successful.²

Issues that arise in conjunction with increasing commercialization of the microfinance industry, such as possible “mission drift” (i.e. the trade-off between the original objective of poverty alleviation and profit orientation), possible social and economic benefits and repercussions and the general question of whether or not it is advisable to transfer poverty alleviation from governments to private organizations on a large scale, will be discussed in this paper, both theoretically and empirically.

Also, the important question of regulation in the microfinance industry will be explored, as there is to this day, no consistent regulatory framework to govern MFI operations. Although literature abounds with numerous suggestions on the subject, the organic nature of the microfinance industry and the different organizational structure and product range of many practitioners has sparked a diversified debate as to what, if any, regulatory system would be appropriate and financially feasible for introduction into the microfinance industry.

In this paper I will try to summarize some of the major approaches to, arguments against and models for a possible further commercialization of the microfinance market and compare theoretical assumptions as well as empirical data on the subject.

² e.g. [MORD01] or [WOLL01]
THE HISTORY OF MICROFINANCE

With the mass media hype that microfinance has seen since Muhammad Yunus was awarded the Nobel Peace Prize in 2006, one might be tempted to believe that the concept of commercial microcredit was only created in the 1970ies, when in fact it dates back as far as the 18th and 19th century in Europe and even farther in India. Interesting examples of such early attempts at microfinance in order to alleviate poverty are the Irish loan funds, the first of which were established in 1720 and the German “Sparkassen” and Raiffeisen’s rural “Darlehnsvereine” (which later evolved into the “Raiffeisenbanken”), as well as the Schulze-Delitzsch’s urban savings and credit cooperatives (which evolved into the “Volksbanken” later on).

The Irish loan funds also used the same system Yunus’ Grameen Bank is employing today – peer monitoring to ensure repayment of the granted loans. While at first the loans were free of interest and only based on donated resources, the enactment of a new law in 1823 enabled the credit providers to charge interest for their loans and also made them official financial intermediaries. The second factor contributing to this system’s initial success was the formation of the Loan Fund Board in 1836, providing supervision and regulation, which led to the creation of roughly 300 funds by 1840 with an outreach of around 20% of all Irish households.

In order to mobilize more capital, these funds were also allowed to collect interest-bearing deposits and they were able to pay interest rates that sometimes amounted to three times those of commercial banks. This fact obviously enraged commercial bankers since the loan funds were effectively cutting into their business, which ultimately resulted in increased pressure on the government on the part of commercial banks and the enactment of a cap on interest rates. With this cap in effect, the loan funds soon lost their competitive advantage and gradually declined until they ultimately disappeared in the 1950ies.³

In Germany, the microfinance movement was based on three initiatives, the “Sparkassen” (communal savings banks), Raiffeisen’s rural “Darlehnsvereine” (loan associations) and Schulze-Delitzsch’s urban savings and credit cooperatives (now “Volksbanken” or people’s banks). All of these were created in the 19th century. While the “Sparkassen” date back to 1801, Raiffeisen’s involvement was triggered by the

³ [SEIB01], p. 2
famine of 1846/47, because of which he formed a rural charity association with the help of wealthy contributors to transport grain from the better-off Eastern parts of Germany to the West. Schulze-Delitzsch followed his example in 1850, focusing on urban areas and basing his concept strictly on self-help (as opposed to charity). In 1864, upon realizing that charity was generally not sustainable, Raiffeisen then founded the first rural credit association which no longer had a charitable but a self-help connotation. Growth was slow until 1889, when both, the urban and rural associations, were subjected to the new Cooperative Act of the German Reich, which imposed a regulatory framework for these microfinance institutions. At the same time, joint liability was replaced by limited liability, which had been an inhibitor for further growth in the past, resulting in an astonishing increase from 245 rural cooperatives (1880ies) to around 15,000 (1914).

Today, the German financial sector is effectively dominated by these former MFIs, which have long become regular commercial banks while still retaining a focus on smaller customers, both private and business. As of 2002, both rural and urban banks combined, were made up of 29,500 branches, thus making up 93% of all bank branches in Germany and accounting for 53% of all individual loans and 57% of all small business loans in the country. With a pre-tax return on equity of 8 to 9 percent, as opposed to -3.1 percent for other commercial banks, the other players in the German financial sector have begun to take action with the EU similar to the pressure exercised by commercial bankers in Ireland, to revoke community guarantees to savings banks.

Utilizing these two examples, Seibel outlines two important factors in the successful evolution of microfinance institutions:

- Regulation through an appropriate legal framework, with amends over time
- Effective supervision, delegated because of their large number to apex organizations of MFI networks, which in turn are supervised by the national financial authorities.⁴

This concurs with the widely held view that a legal framework and rigid supervision is crucial for further commercialization of the microfinance industry in today’s...
developing and semi-developed countries\textsuperscript{5}, which will be presented and analyzed in greater detail later on.

On the Indian subcontinent, microfinance has an even longer tradition, its origins dating back as far as the first millennium BC. The three primary pillars of indigenous finance found in India are traditional moneylending, rotating credit funds (also known as “chit” funds) and merchant banking.

Attempts to reach the rural poor have been diverse throughout the past centuries and millennia and by far not always benevolent in nature. India has seen heavy state-sanctioned discrimination against its rural population in medieval times which in effect even led to a land reform “in reverse”, turning many peasants into serfs and slaves. British occupation had a tremendous impact on the Indian economy as a whole, with trade restrictions imposed by Britain effectively destroying its ancient commercial structure and killing industries like textile manufacturing.

On the other hand, British rule also brought British laws to India, giving rise to new opportunities for moneylenders, who could now pursue claims to money and property of defaulting borrowers in court. While rural indebtedness increased over the first half of the 20th century, moneylending, usury and tenancy legislation was imposed to keep it from spiraling out of control. India’s banking caste adopted western-style business models, pooling resources and buying shares of banks, while indigenous-style banking continued in the small to medium business sphere.

None of these developments tackled the problem of rural poverty however. After gaining its independence from Britain, India’s government was faced with an economically bizarre situation. With 80\% of the population living in rural areas and 40\% of the GDP going into agriculture, only 2.2\% of total credit went into this industrial sector. Commercial banks which would actually have been supposed to provide such credit were effectively absent from rural areas, while informal credit accounted for 90\% (in 1951) and subsequently 70\% (in 1971) of rural indebtedness.

In order to combat this situation, India’s government took several steps in an effort to aid the country’s struggling farmers: At first through the nationalization of previously private banks, later through the establishment of Regional Rural Banks, designed specifically for this purpose. Both initiatives ultimately failed to alleviate the problem, as the demographic they were

\textsuperscript{5} see [CHAR01] and [CHAR02] and [CHAR03] for example
aimed at was effectively not affected by them – all banks catered mainly to farmers and not to the hard core poor migrating laborers and illiterate women in the Indian countryside.

The All-India Debt and Investment Survey, published in 1983 by the Reserve Bank of India, showed that despite tremendous efforts worth billions of dollars had been made to get credit to the poor, 39% of rural indebtedness was still rooted in informal credit and 250 million people still lacked access to formal finance.

This situation led to the creation of NABARD, the National Bank for Agriculture and Rural development, which has ever since been at the forefront of the microfinance movement in India. Not only is NABARD responsible for all the rural outlets of commercial banks, numbering around 160,000 in total, but it is also responsible for orchestrating NGO activity in the microfinance sector in India. Today NABARD is mainly focused on linking the formal banking sector with NGO-led self-help groups to assist the poor, while trying to reform the rural banking sector which has so far succeeded neither in becoming profitable as a whole nor reaching those it was initially created to reach.

The conclusion was reached, that savings were an integral part of any microfinance operation, as they would also enable the poor to capitalize on funds they did not require for immediate spending and thus, with support from RBI, a new project was born.

After a pilot phase, during which possible linkages between self-help groups (SHGs) with NGO ties and commercial banks were evaluated in the early 1990s, NABARD’s evaluation showed significant positive trends for all indicators, including increased amounts of savings and decreasing transaction costs over time as well as close to 100% repayment rates.

With the support of the government, mainstreaming of the project began soon after and as of 2005, 1.6 million SHGs had been credit-linked to over 35,000 bank branches, thus covering a total population of roughly 120 million.⁶

In the 2006-2007 financial year, NABARD generated profits of roughly 256 million USD⁷ through its operations, while its continuous growth shows no signs of slowing down, making NABARD’s initiative the fastest growing microfinance program in the developing world.

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⁶ [SEIB01], p. 6 ff
⁷ NABARD annual report 2006-2007
The situation in India can be compared to Indonesia, where the dominant microfinance program is Bank Rakyat Indonesia’s “unit desa” project. While, contrary to India’s NABARD, BRI requires its borrowers to present some form of physical collateral, this program is also financially self-sufficient and profitable.

The most prominent microfinance program though, is Muhammad Yunus’ Grameen Bank in Bangladesh, which was founded in 1983, after a series of pilot projects in the late 1970s. Yunus, who also received the Nobel Peace Prize in 2006 for his work, originally an economics professor at Chittatong University, was startled by the contradiction of the economic theories he taught in class and their seeming invalidity in regard to the poor farmers and laborers living in the villages around the university campus. He therefore decided, at first, to lend money to some poor families out of his own pocket in 1976 to enable them to buy production materials for their stool making trade.

As this project proved to be highly successful, both in terms of repayment rates and social impact, it was extended to more villages in the Tangail district in 1977. Subsequently, with the help of the Bangladesh Central Bank, numerous other commercial banks and – perhaps most importantly – special legislation passed by the government of the country, Yunus was able to transform his microloan program into what is known today as the Grameen Bank. Therefore, whenever Grameen Bank is cited as an incredible success story, one should not forget that this was and is only made possible by its special status, as it required specialized legislation to officially become a bank – an advantage no other microfinance NGO in the world shares. Also, upon the official creation of Grameen as a bank in 1983, 60% of its shares were owned by the government – an aspect that was crucial for the aforementioned legislation to be passed by Bangladesh’s cabinet at the time. Although it is almost fully owned by its borrowers today, Grameen was definitely not a NGO in the beginning, and even today Bangladesh’s government still owns around 10% of its shares. In addition, none of Bangladesh’s cabinets since 1983 has shown an interest or trend towards establishing a similar legal status for any other MFI in the country, further cementing the Grameen Bank’s preferential position among its peers.

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8 [YUN01], p. 45 ff
Despite its one-of-a-kind status, the program’s model of lending, both with its focus on women and the group-based approach to loan distribution has functioned as a role model for countless microfinance programs across the globe.
THE ROLE MODEL IN DETAIL – HOW GRAMEEN WORKS

Before delving deeper into the academic discussion surrounding the area of microfinance, I will further examine Grameen’s practices and operations, as they have been used as a blueprint for so many other organizations of its kind. Grameen Bank relies heavily on borrowers’ identification with the organization – not only is it owned by them, but as the only collateral that borrowers can contribute is social in nature (i.e. peer pressure towards repayment, a feeling of guilt if they default and the like), this process of identification with the bank as an “extended family” is very much necessary to ensure stability.

For this reason, new members of the Grameen Bank are expected to pledge their will to follow what the bank calls its “16 decisions”, a code of conduct that all borrowers are expected to adhere to:

1) We shall follow and advance the four principles of Grameen Bank – Discipline, Unity, Courage and Hard Work – in all walks of our lives.
2) Prosperity we shall bring to our families.
3) We shall not live in dilapidated houses. We shall repair our houses and work towards constructing new houses at the earliest.
4) We shall grow vegetables all year round. We shall eat plenty of them and sell the surplus.
5) During the plantation seasons, we shall plant as many seedlings as possible.
6) We shall plan to keep our families small. We shall minimize our expenditures. We shall look after our health.
7) We shall educate our children and ensure that they can earn to pay for their education.
8) We shall always keep our children and the environment clean.
9) We shall build and use pit-latrines.
10) We shall drink water from tube wells. If it is not available, we shall boil water or use alum.
11) We shall not take any dowry at our sons’ weddings, neither shall we give any dowry at our daughters’ weddings. We shall keep our centre free from the curse of dowry. We shall not practice child marriage.
12) We shall not inflict any injustice on anyone, neither shall we allow anyone to do so.
13) We shall collectively undertake bigger investments for higher incomes.
14) We shall always be ready to help each other. If anyone is in difficulty, we shall help him or her.
15) If we come to know of any breach of discipline in any centre, we shall go there and help restore discipline.
16) We shall take part in all social activities collectively.⁹

While many of these guidelines may not seem to be directly connected with Grameen Bank’s financial services, they are in fact the pillars of the entire microfinance industry. Physical health – as will also be explained in greater detail below – is a borrower’s main asset. Without it, the borrower cannot continue to generate income and merely incur expenses to recuperate and thus end up losing larger amounts of money in the medium to long term – and obviously end up unable to repay his loan. In addition, education, as is widely agreed, constitutes the primary weapon against poverty across the globe and finally, cohesion within loan groups is the most important prerequisite for the bank to ensure timely and full repayment of the loans disbursed.

Despite the aforementioned rules for borrowers, Grameen also employs a set of ten indicators to assess whether a borrower’s family has managed to permanently escape poverty. They include non-monetary factors like the condition of the family’s house, the education of the family’s children over six years of age, but also the borrower’s annual average savings balance with the bank and the average weekly installments on the borrower’s current loan.

Grameen loan groups consist of five persons, selected by the members themselves from their peers. This works primarily as a screening and monitoring system (under the assumption that the villagers themselves will know best who is reliable and who isn’t in terms repaying loans) and as the group as a whole is held reliable for repayment can be considered “social collateral” as peer pressure from group

⁹ Source: [GRAM01]: “Methodology” – “16 Decisions”
members will usually suffice to induce repayment from group members who might otherwise default.

Loans are first given to the first two group members, then – upon successful repayment of that loan for at least six weeks – to the next two and so forth. Should any part of the group fail to repay their loan, the entire group runs the risk of future loan requests being denied by the bank. Obviously Grameen takes precautions for this situation not to arise and does its best to aid borrowers who are encountering difficulties repaying their outstanding balance.

Loan groups are further federated into so-called “centres” in which eight groups, i.e. 40 members, hold weekly meetings at which transactions take place and progress as well as any difficulties are discussed with a field worker from Grameen.

Grameen’s lending and repayment strategy in the bank’s own words is defined as follows:

i) very small loans given without any collateral
ii) loans repayable in weekly instalments spread over a year
iii) eligibility for a subsequent loan depends upon repayment of first loan
iv) individual, self chosen, quick income generating activities which employ the skills that borrowers already posses
v) close supervision of credit by the group as well as the bank staff
vi) stress on credit discipline and collective borrower responsibility or peer pressure
vii) special safegaurds through compulsory and voluntary savings to minimise the risks that the poor confront
viii) transparency in all bank transactions most of which take place at centre meetings.

In addition to loans, Grameen tries to provide communities with social advancement programs in order to raise the loan groups’ social and political consciousness and to encourage groups in villages to build and maintain basic infrastructure such as tube wells, housing and sanitary facilities, thus aiding borrowers to adhere to the “sixteen decisions” they have vowed to follow.10

10 [GRAM01]: “Methodology” – “Credit Delivery System”
Ever since it was officially established as a bank in 1983, Grameen Bank has grown at a phenomenal rate and continues to do so today. Over the past ten years, the number of villages in which Grameen is present, as well as the number of Grameen centers – which can essentially be equated with branch offices of regular banks – has more than doubled.

![Diagram 1: Grameen Bank presence 1997-2007](image)

Over the same period the number of active Grameen members, i.e. borrowers and depositors, has grown from around 2.3 million in 1997 to a staggering 7.4 million in 2007 and thus more than tripled. Coincidentally, the amount of bad debt that Grameen Bank faced over these 11 years, also rose substantially – from a mere 0.42 million USD in 1997 to 10.78 million USD in 2007 (peaking at 30.4 million in 2005). Grameen’s efforts at debt recovery however enabled the bank to recover a large portion of these outstanding loans which would have had to be written off as losses otherwise.

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11 Source: [GRAM01]
As the current academic debate, which will be reviewed in depth below, focuses to some extent on whether or not microfinance NGOs should be allowed to accept public deposits (and if so on what terms), a look at Grameen’s savings statistic seems in order. Grameen Bank accepts savings both from members and the general public – members, one the one hand, are obligated to have a savings account to accompany their loan, but they are also free to open a voluntary savings account any time.

Grameen’s deposits balance shows an increase of close to 700% between 1997 and 2007, from 0.11 billion to 0.76 billion USD, while its loan balance increased from 0.31 billion to 0.53 billion USD over that period. At the same time, the bank’s borrowings from other financial institutions declined steadily from 0.25 billion to 0.03 billion USD. 13

As the data shows, savings are becoming increasingly important in proportion to the organization’s other sources of capital and will likely continue to do so as this trend shows no signs of subsiding.

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12 Source: [GRAM01]
13 [GRAM01]: “Data & Reports” – “Past 11 Years”
GRAMEEN’S ACCOUNTING CONTROVERSY

Grameen Bank has always reported a steadily increasing loan portfolio and phenomenal loan repayment rates ever since its inception. Also, according to its own annual reports it appears to be making healthy profits almost every year. This, however, is mainly due to Grameen’s somewhat non-standard accounting procedures and its unique calculation methods for certain performance indicators. The overdue loan ratio, i.e. the percentage of loans which have not been repaid for over one year, is calculated as

\[
\text{Value of loans overdue for more than one year} \div \text{Value of current portfolio}
\]

While this may appear correct at first glance, one should consider the fact that Grameen’s loan portfolio is constantly expanding and has in fact multiplied many times since the bank was established. Therefore, in order to get an accurate percentage, one would need to adjust the denominator to match the loan portfolio’s value at the time of disbursement of said overdue loans. The same goes for Grameen’s standard write off procedure for losses. Using its own overdue rates, Grameen writes off about 3.5% of its portfolio every year – a rate

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14 Source: [GRAM01]
substantially lower than its adjusted 7.8% overdue rate. If one were to use the adjusted percentage instead of the official one, Grameen would have incurred 17.8 million USD worth of losses on average between 1985 and 1996 instead of the reported average of 1.5 million USD in profits.

In addition donor grants were also added on the income side of the bank’s profit and loss statement, which further distorts the picture.\footnote{\cite{KHAW01}, p. 11f}

Grameen Bank is however trying hard to implement standard accounting procedures in its operations and – since 2004 – has been audited on an annual basis by chartered accountant firms.

This can also be considered to be a move towards the establishment of general standards within the microfinance industry in Bangladesh, as Grameen remains the biggest player in this sector and its business decisions usually have trendsetting effects throughout the country and beyond. Regulation of the microfinance industry in general will be discussed in greater detail below.
MICROFINANCE IN RESEARCH AND THE MEDIA

On the whole, microfinance has only been brought into the global spotlight over the past 40 to 50 years, mainly caused by the trend to try and formalize the provision of financial service to the poor on an international scale. Even with thousands of MFIs worldwide serving a clientele of about 100-200 million people, microfinance has yet to permeate the area of financial journalism. Although the idea of “doing well by doing good” has triggered an increasing interest by commercial financial institutions, most of the reporting on the subject is still done in scientific circles while it remains virtually ignored by finance journals and, except for heavy reporting on Muhammad Yunus receiving the Nobel Peace Prize in 2006, mass newspapers.

To illustrate this lapse of mainstream reporting, one can look to a paper by Brau and Woller from 2004: Among over 350 peer reviewed articles examined, not a single one had been published in a mainstream or entrepreneurial finance journal.\footnote{BRAU01, p. 4f} Although there is only the occasional hiccup in terms of reporting in the mass media, the discussion in academic circles is becoming increasingly intense as case studies and empirical data from the field is still scarce compared to the industry’s growth rate which remains unmatched by most sectors of “traditional” economy.
“[The role of group lending] has been exaggerated: group lending is not the only mechanism that differentiates microfinance contracts from standard loan contracts. The programs described […] also use dynamic incentives, regular repayment schedules and collateral substitutes to help maintain high repayment rates.”¹⁷

Despite sometimes big differences among programs, all microcredit programs have several things in common:

- loans sizes increase over time to successful clients (“progressive” lending)
- the terms offered are better than alternative credit sources (e.g. local moneylenders)
- borrowers in default are cut off

Morduch demonstrates that under a group lending scheme, “risky” investors (i.e. individuals with a lower probability to succeed but a higher return on successful investment) will voluntarily group with other risky investors, while “safe” investors (i.e. individuals with a higher probability to succeed but a lower return on successful investment) will voluntarily group with other safe investors. This is due to the fact, that while safe types would logically be preferred as partners as they have a lower probability of failure, the expected gains to risky types are always smaller than the expected losses to safe types in case they teamed up. Therefore it is not possible to create a mutually beneficial way for risky and safe types to group together.

In consequence, with interest rates and liability payments set at the right levels, both risky and safe investors will stay in or enter the market, while banks are enabled to price discriminate between the two groups, creating a more financially efficient environment for themselves. On the whole, this increase in efficiency will cause repayment rates to rise, making it possible for the banks to lower their interest rates while not losing money.

Also, with the joint liability payment set at a high enough level, banks can provide an incentive for borrower groups, which they have to rely on to ultimately enforce the loan contract, to choose a safe over a potentially risky activity. While saddling the

¹⁷ [MORD01], p. 1579
borrowers with extra risk (through higher joint liability payments), the bank can once again lower its interest rate, knowing that borrowers are more likely to choose safer investments, at the same time offsetting the burden of higher risk for the borrowers, raising expected utility and expected repayment rates.

Incentives like progressive lending and the credible threat to cut off borrowers in default can be used to overcome information problems and raise efficiency in both individual and group lending scenarios. While effective competition is currently scarce, an increase will diminish the effect of dynamic incentives against moral hazard, an effect already partially felt by BancoSol and Bank Rakyat Indonesia. Due to lower mobility, dynamic incentives usually tend to work better in rural than in urban areas, as borrowers in an urban setting are harder to get a hold of for lenders if they default and move, even if it is just to another part of town. In addition, as with any finite repeated game, the incentive to default in the last period is extremely high for borrowers, as the threat of being cut off is no longer credible. By logic, lenders would most likely to refuse to lend in that period, which would however would only shift the moral hazard to the penultimate one and so forth. The only way to overcome this obstacle is to create substantial uncertainty about the end date of the game, or a well-established system of graduation from one program to the next.

Another, positive, aspect of dynamic incentives which should not be overlooked, is the ability to test borrowers with small loans at the beginning, also enabling lenders to establish relationships with clients over time and to evaluate the worst prospects before a loan scale expansion.

Focus on women was not a priority in both BRAC and Grameen from the beginning. In fact, the concentration on female borrowers only occurred over time and has certain advantages for lenders. Women tend to be less mobile, which limits the possibility that they will just take out a loan and “disappear” while dynamic incentives are more appealing in situations where women have lower access to alternative sources of funds than men. This fact of course stands in stark contrast to the officially declared mission of numerous MFIs, namely to generally increase economic access of women.

Regular repayment schedules, which are a feature that definitely sets most microloan systems apart from traditional banking, are one of the key aspects which make most of these programs so successful. As opposed to a normal loan, repayment usually starts very shortly after disbursement in small installments, which yields numerous
advantages. Undisciplined borrowers are screened out, peer group members and loan officers are alerted early to emerging problems and they also give banks control over cash flows before they are consumed or diverted.

As repayment begins so early, namely before any investments made with the loan can turn any profit, MFIs also lend against a households stream of income and not just the potentially risky investment project. This however also poses problems in terms of market penetration in areas that have a largely seasonal economy (e.g. rainfed agriculture), which are among the poorest in South Asia and Africa.

In spite of the fact, that most MFIs do not require any form of collateral, some, like Grameen, require mandatory savings. In Grameen’s case, 0.5 of every unit borrowed beyond a given scale is a required contribution to what the bank calls its “emergency fund”, which provides insurance in the case of default, death, disability, etc. Grameen also takes out 5 percent of every loan as a “group tax”, up to half of which can be used by group members (with unanimous consent). These mandatory savings serve as partial collateral to the bank and also grant a certain amount of safety to group members.

In cases, like BRI’s, where collateral is explicitly required, it is hardly ever collected. This lends support to the theory of the importance of dynamic incentives – just the threat of collateral collection may be enough to ensure timely repayment.\[MORD01\], p. 1580ff
MICROSAVINGS – ARE THE POOR RICH ENOUGH TO SAVE?

“In fact […] the need to save is not so much a function of surplus funds as of insecurity. In a household where even one day’s sickness can lead to immediate hunger, or where daily earnings depend on the weather or the whims of a local landowner, it is vital to have some means of saving.”19

Savings have always been an important part of the financial framework across all parts of the world. Deposits against interest make up a large amount of any commercial bank’s portfolio, some of which is being lent on to private or commercial borrowers at (even higher) interest and thus constitute a profitable source of income for all parties involved. For a long time, also during the period of misguided subsidized credit endeavors in the Third World, the poor were not regarded as capable of saving money. It was assumed that all the money they had, borrowed or earned otherwise, would be used up entirely and thus savings mobilization on the part of government or NGO programs was never a priority. This, however, proves to have been a severe misconception, widely held as it may have been for a long time, as numerous MFIs that actually offer their clients the option of opening savings accounts are reporting great successes. In fact, savings constitute many poor households’ first line of defense when it comes to coping with external shocks, emergencies and life-cycle events while at the same time providing them with the option to profit from productive investment opportunities – and therefore also a huge market. A market which appears to exceed that for enterprise related microcredit several times in size. Exemplary evidence from Latin America shows that while banks opened millions of small savings accounts over a period of two to three years, MFIs only managed to gain just below 200,000 customers in the same region.20

Savings are of course risky, in the sense that they require a lot of trust on the part of the depositors and reliability on the part of the bank or organization holding the savings. In most countries, legislation allows only for certified commercial banks to offer savings accounts, mainly as a means to protect the potential customer from

19 [HARP01], p. 18
20 [BRAU01], p. 13f
fraudsters, as banks are subject to an extremely rigid regulatory framework. Despite the legal difficulties in implementation, both institutionists and welfarists – although at times for different reasons – appear to be in support of increased savings mobilization through MFIs.

Three factors contribute to the beneficial role of savings to all parties involved:

- MFIs gain a relatively cheap source of capital which can be lent on
- Depositors may turn into borrowers at a later date and thus augment the client base of the MFI
- Households are able to build their own assets through savings, in the long run enabling them to invest their own funds rather than taking up another loan\textsuperscript{21}

Institutionists naturally put a lot of emphasis on the first criterion – the possibility to gain potentially large amounts of capital at low interest. If MFIs manage to acquire deposits at a large enough scale, they should eventually become independent of other sources of funding and thus achieve complete financial sustainability.

Welfarists naturally attribute greater relevance to the third factor listed above, as the ultimate goal of microfinance is the alleviation of poverty. Therefore, the more people are able to break free from the loan cycle and manage to make a living off of assets they have built and income they continue to generate, the better.

The second argument in favor of microsavings would logically appeal to advocates of both schools of thought. An enlarged client base will only add to an institution’s breadth (and hopefully its depth) of outreach, which after all can only be beneficial to all parties involved.

According to the MicroBanking Bulletin, the growth both in the number of depositors as in the overall volume of deposits from 2004 through 2006 was quite impressive on a global scale.

\textsuperscript{21} see [WRIGH01]
Table 2: Global microfinance trend (2004-2006)

<table>
<thead>
<tr>
<th>Data (in millions)</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
<th>Growth (total)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loan Portfolio (USD)</td>
<td>7,501</td>
<td>9,783</td>
<td>13,524</td>
<td>6,023</td>
</tr>
<tr>
<td>Borrowers</td>
<td>19.9</td>
<td>24.7</td>
<td>30.1</td>
<td>10.2</td>
</tr>
<tr>
<td>Deposits (USD)</td>
<td>6,406</td>
<td>7,469</td>
<td>9,803</td>
<td>3,397</td>
</tr>
<tr>
<td>Depositors</td>
<td>41.0</td>
<td>45.0</td>
<td>46.7</td>
<td>5.7</td>
</tr>
</tbody>
</table>

The data in this statistic was collected from a sample of 340 MFIs from all parts of the world and therefore provides a fairly balanced picture of the current situation – and the figures are impressive. As can be seen in the table above, savings play an extremely important role in the microfinance industry.

The number of depositors exceeded the number of active borrowers by more than 200% in 2004 with the total amount of deposits totaling at 85% of all outstanding loans on a global scale. The average deposit in 2004 (calculated as the mean value of the sum of deposits divided by the number of depositors) was 156.24 USD versus an average outstanding loan size of 376.94 USD. Therefore just over 40% of every outstanding loan was backed up by savings.

While the number of borrowers skyrocketed from 2004 to 2006, growing about 50% to be exact, the number of depositors only rose by 13% over the same period. The total amount of savings grew a great deal stronger though (about 53%), which resulted in the average deposit rising to almost 210 USD.

In 2006, about 47% of every loan was therefore backed up by client deposits and, judging from the trend so far, this number will likely increase in the future. The question that remains – and which will have a tremendous impact on the overall growth of the microfinance industry – is of course at what pace this increase will occur.

Both camps, institutionists and welfarists, in effect agree that savings are beneficial to all parties involved. Thus, both sides will likely also agree, that increasing the total amount of savings and also the savings-to-loans ratio will yield improvements in the medium to long term.

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Source: [MIX01]
With a larger amount of client deposits at their disposal, all MFIs – whether sustainable or not – would be able to extend their operations and be less dependent on donor money or government grants and soft loans.

As most MFIs are run as NGOs however, the topic of savings must be worked out with considerable caution. Organizations other than commercial banks are not allowed to take deposits on a large scale in most countries, as they are not subject to the same strict regulations. As corresponding legislation’s primary objective is client protection, the first and foremost problem in the microfinance sector is a lack of such legislation on a global or at least regional scale.
THE WELFARIST VERSUS THE INSTITUTIONIST PARADIGM

“[…] It is not clear why the starting point for so many is the belief that, as a matter of course, funding will be pulled away from programs, even those able to demonstrate sustained social effectiveness. Moreover, there has never been a general presumption that the most effective poverty alleviation programs can be – or should be – self-financing.”23

As almost all microfinance providers are aiming to extend their operations to reach more prospective clients, the topic of sustainability (which, in literature, is usually equated with financial self-sufficiency) is becoming ever more prominent. The two opposing forces in scientific discussion are the “institutionist” paradigm, suggesting that financial self-sufficiency is key to an increase in operational breadth and that for-profit operation is in fact a necessity for growth, and the “welfarist” paradigm, stating that investors with social motives do not necessarily expect monetary returns on their investment in social programs but that the investment itself has an intrinsic value for them. The welfarist paradigm also focuses more on depth rather than breadth of outreach.

One of the main issues of this debate is the question of whether financially self-sufficient MFIs will try to realize economies of scale by increasingly extending their lending operations to marginally poor or non-poor clients. While there is still no conclusion on the matter in literature, what little evidence exists, suggests that if such an increase in operational scale (and thus sustainability) is desired, those in most dire need for credit will ultimately be left out and once again be considered “unbankable”. 24

Advocates of the institutionist paradigm argue, that by ultimately breaking free of donor funding and operating profitably, MFIs will be able to grow independently and eventually reach ever more people while at least covering their costs if not turning a continuous profit. This point of view, however, is far from being empirically proven. As there are hardly any comparative studies or indicators to actually compare microfinance programs on a global or even crosscountry scale, as most of them differ in client occupations, client loan uses and loan sizes, aswell as the organization’s

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23 [MORD02], p. 619
24 [BRAU01], p. 6ff
age, one always runs the risk of comparing apples with pears when examining different MFIs.

While some institutions, like Bolivia’s BancoSol can charge their clients real interest rates close to 50% over a loan duration of 3-4 months because their clients mainly run high margin businesses and need the loans to make quick turnaround investments, MFIs in rural areas often serve a clientele that has no other option but to take up longer term loans for moderate return investments – which are mainly agriculture related – and is thus unable to bear such high interest rates.\textsuperscript{25}

While institutionists mainly call for the establishment of and general adherence to a set of “best practices” for microfinance providers on an international scale\textsuperscript{26}, the issue of who is being served has effectively been ignored in the debate – much to the dismay of many socially oriented practitioners who feel that the demographic of their clientele is not necessarily compatible with abstract best practices established by think tanks like CGAP and other major donors.

Despite the dispute over whether financial self-sufficiency is a necessary prerequisite for successful MFI operation or not, institutionists and welfarists alike are very much determined to avoid the well documented mistakes of the past. State-subsidized credit programs have failed disastrously over the past couple of decades, mainly because there was no way to circumvent the problem of nonexistent collateral on the part of borrowers – in consequence default rates skyrocketed and government accounts were constantly drained. Another factor which was crucial in these programs’ failures was the fact that despite losing money on the lending side, most of these credit programs were still generously capitalized by their respective administrations and thus had no incentive to try and mobilize savings – especially because re-lending those savings would have just led to more losses. In conjunction with a substantial amount of political nepotism in regard to loan disbursement, most of these programs ended up with very little benefit for the poor they were actually supposed to serve at extremely high costs.\textsuperscript{27}

While group-lending and dynamic incentives as described in more detail below, have dramatically improved repayment rates to above 90% for the majority of microfinance

\textsuperscript{25} [MORD02], p. 617ff
\textsuperscript{26} see [CHAR01], [CHAR02] and [CHAR03]
\textsuperscript{27} see [ADAM01]
programs today, there is a general consensus among institutionists, that subsidization, inefficiency and limited scale effectively go hand in hand, that government involvement in MFI operations is never beneficial and that savings mobilization in conjunction with subsidized credit is a practical impossibility. From this rather neoliberal stance on past experience and current policy, institutionists offer a rather simple yet prosperous win-win scenario towards which the microfinance industry should strive: complete independence of donor funding, resulting in growth which will make the realization of large economies of scale possible and thus create the ability for MFIs to reach ever more clients – and ultimately provide MFIs with access to commercial sources of credit enabling them to expand operations even further. While this idea may sound extremely convincing at first, some of the theories and assumptions which are at its foundations do not necessarily withstand confrontation with empirical evidence and practitioners’ field experience.
THE WIN-WIN PROPOSITION UNDER SCRUTINY

The aforementioned scenario, envisioned by advocates of the institutionist (among them such important institutions as the World Bank, CGAP and others) approach to microfinance, rests on a series of assumptions, the most important of which is that households require access to credit, not necessarily cheap credit. This argument is supported by several claims, the most important ones of which are:
- Raising the costs of financial services does not diminish demand.
- Financially sustainable programs can achieve the greatest impact on poverty due to their scale.
- Financially sustainable programs will be granted access to commercial financial markets.
- Subsidized programs are always inefficient and thus bound to fail.

CLAIM 1: CREDIT DEMAND IS INTEREST-INSENSITIVE

When it comes to credit demand, one important factor that needs to be considered when examining lending to the poor, is the way the poor use the money they borrow. The commonly used distinction between “production” and “consumption” does not necessarily capture the full spectrum of credit use, as food, clothing and medicine can also be viewed as means of production, since a person is not able to work without them. Another investment which is usually regarded as belonging to the “consumption” category, is children’s education. While there is no direct return on investment in this case, at least not in the short or medium term, education remains one of the foremost weapons in the fight against poverty.28

Data taken from a paper published by CGAP in 1996 was split up into the categories listed in the following table:

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28 [HARP01], p. 13f
<table>
<thead>
<tr>
<th>Loan Use per USD 100 borrowed</th>
<th>Household Income Category</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Below 80% of poverty line</td>
</tr>
<tr>
<td>Consumption</td>
<td>68%</td>
</tr>
<tr>
<td>Purchase of working capital</td>
<td>14%</td>
</tr>
<tr>
<td>Hiring of labor outside the household</td>
<td>4%</td>
</tr>
<tr>
<td>Purchase of fixed capital (no new technology)</td>
<td>9%</td>
</tr>
<tr>
<td>Purchase of fixed capital (new technology)</td>
<td>5%</td>
</tr>
<tr>
<td>Average loan size (USD)</td>
<td>59</td>
</tr>
</tbody>
</table>

Table 1: Loan use categories for poorer and less poor borrowers

Although the figures across all categories should sum up to 100 as indicated, they somehow add up to 105 for the “Below 80% of poverty line” column. I have therefore subtracted one percentage point from the original values in each spending category in order to make up for this error.

If one decides to agree with Harper and his criticism of the split into “consumption” and “production” uses of loans, the values in this table need do be recalculated. Let us assume that 80 percent of what is listed as “consumption” spending actually goes into basic needs like food, clothing, medicine and the like, thus guaranteeing the poor person’s ability to work and generate an income on a regular basis. Obviously poorer clients will use a higher percentage of their loans for these needs, while less poor households will be able to cover such basic requirements from other sources of income rather than microloans for which they have to pay interest.

We will therefore assume, that the aforementioned 80 percent only hold for households below 80 percent of the poverty line, while less poor households spend most (i.e. 75 percent) of what is listed in the “consumption” category of the above table on things like home improvement and the like, i.e. expenses which are not basic requirements for mere survival.

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29 [CGAP01], p. 3
Revised in this way the table above now looks like this:

<table>
<thead>
<tr>
<th>Loan Use per USD 100 borrowed</th>
<th>Household Income Category</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Below 80% of poverty line</td>
</tr>
<tr>
<td>Consumption</td>
<td>13,6%</td>
</tr>
<tr>
<td>Purchase of working capital</td>
<td>68,8%</td>
</tr>
<tr>
<td>Hiring of labor outside the household</td>
<td>4%</td>
</tr>
<tr>
<td>Purchase of fixed capital (no new technology)</td>
<td>9%</td>
</tr>
<tr>
<td>Purchase of fixed capital (new technology)</td>
<td>5%</td>
</tr>
<tr>
<td>Average loan size (USD)</td>
<td>59</td>
</tr>
</tbody>
</table>

Table 2: Adjusted values for loan usage

The weights introduced above cause a substantial shift within the first two spending categories for the poorer borrowers in the table. This shift seems realistic when considering that oftentimes the only real working capital poorer borrowers have is their bare hands and some basic tools like seeds or raw materials from which to produce some kind of product they can in turn sell at a profit. Better off borrowers are rarely part of the (rural) hard core poor – they are usually petty traders or craftsmen of some sort. These professions obviously require more “working capital” in the traditional sense as investments tend to be higher, but as I pointed out above, hard core poor people’s main piece of working capital is their own physical self and thus most of what would be viewed as “consumption” in the traditional sense is merely an investment in their own ability to continue to work and generate an income for themselves.

As for the insensitivity of credit demand towards interest when it comes to commercial investments, one cannot simply examine the aggregated demand across a country’s or region’s entire population. It may of course be true, that overall demand will hardly fall, even if interest rates rise significantly, but as the primary objective of microfinance on a global scale is the alleviation of poverty, priority must be given to the different social layers that make up the clientele of microfinance institutions. They include people ranging from what
Yunus refers to as the “hard core poor” up to individuals who might be just below or at the poverty line.

How much any person is willing and able to pay for credit will depend on the return on investment they can generate with it over the duration of the loan and beyond. While this return may be comparatively high for petty traders and craftsmen who are able to generate high turnarounds in a short period of time, people working in agriculture (who are also the majority of borrowers in many parts of the world) often have to wait significantly longer before their investments – sometimes literally – begin to bear fruit.

If one ignores these important differences and merely looks at the aggregated demand across a society, microfinance programs (and on a larger scale the entire microfinance industry) run the risk of deviating from their original social objective in favor of higher profits, which will ultimately lead to the denial of access to microcredit for certain groups of the poor – mainly those who are at the very bottom rung of the poverty ladder and therefore lack the ability to realize higher returns in a sufficiently short period of time.

Also, as loan size is generally treated as the only reliable and available indicator of the poverty level of clients, a look at recent empirical data reveals the following:

<table>
<thead>
<tr>
<th>Average loan balance per borrower (in USD)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
</tr>
<tr>
<td>For-profit MFIs</td>
</tr>
<tr>
<td>2004</td>
</tr>
<tr>
<td>530</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
</tr>
<tr>
<td>406</td>
</tr>
</tbody>
</table>

Table 3: Average loan balance per borrower, 2004 through 2006

As for-profit MFIs will generally tend to charge cost-covering – and therefore higher – interest rates, the large difference in average loan sizes from their non-profit counterparts can most likely be attributed to the fact that their clients are less poor than those of non-profit organizations. Higher loan size and higher interest rates logically result in higher periodic payments and thus the consumption of a bigger part

\[30\] [MIX01], p. 34
of household income for the repayment of the loan. It can therefore hardly be argued, that both, for- and non-profit MFIs serve a clientele at the same poverty level.

It seems appropriate to suggest, that the question of how to set interest rates for microcredit can only be answered empirically and with a strong emphasis on regional specificity, taking into account the occupations of borrowers, as well as their social standing and other factors which will determine their return on investment and thus their ability to repay their respective loans.31

CLAIM 2: GREATER ECONOMIES OF SCALE CAN BE REALIZED BY SUSTAINABLE PROGRAMS

Charitonenko et al cite, among others, the success of Bank Rakyat Indonesia’s “unit desa” program in at extending their outreach from 2.5 million to 2.9 million borrowers in the period of 1998 to 2001 to support this claim, also pointing out that the average loan size has remained the same and thus, they assume, the social standing of BRI’s average borrower must have remained the same.32

One needs to consider, however, that BRI requires its borrowers to present collateral to begin with. Therefore, its borrowers can not be compared to the hard core poor borrowers of other institutions which do not require any form of physical collateral and rely solely on peer monitoring and other means to ensure timely repayment of loans.

Still, this claim may seem strikingly convincing at first glance, however the institutionists’ main concern is to reduce the absolute number of people below the poverty line, not taking into account the oftentimes important distinctions between groups within the working poor social layer.

The point is, that subsidized programs tend to serve poorer borrowers than programs which are financially sustainable. Therefore only decreasing the number of those below the poverty line while calling for a move towards financial sustainability, also yields the risk of excluding those borrowers whose need for credit is the most critical, once again the poorest in any given society.

31 see [HARP01] and [MORD02]
32 [CHAR03], p. 37f
Numerous poverty indexes support this theory in the sense that they show how much greater the impact of a small increase in income is for a poorer borrower when compared to a less poor one. The Watts measure, for example, shows a leverage effect of 1.8 per dollar in the poor versus less poor comparison, while indicators like the “squared poverty gap” or “cubed poverty gap” yield results of 5:1 and 25:1 respectively. This also puts client numbers in perspective, when judging impact in regard to the actual dent in poverty made.

For ease of calculation, Morduch assumes that the typical client of a subsidized program has an average income of 50% of the poverty line and that the income of a client of a sustainable program lies somewhere around 90% of that same measure. Therefore a sustainable program with 75,000 members will have roughly the same impact as a subsidized program with 42,000 members (after the Watts measure) and merely 15,000 and 3,000 members if one uses the other two indexes holding all else constant.\(^3\)

All such calculations obviously hinge on the question of which poverty index best captures the actual impact of poverty reduction in a given society. On the whole, generalizations, also in this respect, are hard to make and will rarely hold up to empirical tests on a global scale, as region specific differences tend to have a huge impact on the actual effect of any program.

CLAIM 3: FINANCIALLY SUSTAINABLE MIFs CAN TAP COMMERCIAL CAPITAL MARKETS TO INCREASE THEIR OUTREACH

Even studies commissioned by the Asian Development Bank admit that MFIs, whether fully sustainable or not, have so far not managed to attract substantial amounts of private risk capital. The failure to do so is attributed to a lack of transparency in MFI operations and the absence of independent ratings for microfinance providers. Also, subsidized credit, particularly in Asian countries like Bangladesh and Sri Lanka, is cited as a possible reason for this situation.\(^4\)

Despite the current obvious inability, even of very successful MFIs, to gain access to commercial capital at market rates, institutions like CGAP and the World Bank still view a foray into the private equity sector as a long term goal.

\(^3\) [MORD02], p. 622
\(^4\) [CHAR03], p. 44
Looking at the status quo from another angle, one could compare the situation of MFIs in the commercial finance market to the situation of their borrowers when trying to secure loans from commercial banks. Just like single borrowers generally cannot provide collateral to back up a loan and thus remain unserved by commercial banks, microfinance institutions have the exact same problem, only on a larger scale. They simply lack the collateral to back up their portfolio and the mere prospect of positive financial returns is hardly enough to secure commercial credit.

On the other hand, Grameen Bank – heavily subsidized as it may be – has already successfully sold bonds, guaranteed by Bangladesh’s government. It seems, thus, that the main obstacle in the way of tapping commercial finance markets is not subsidization in itself but MFIs’ ability to limit perceived riskiness towards potential commercial lenders.35

While, even for-profit, MFIs have had considerable trouble acquiring commercial credit on a large scale, the system of self-help groups (SHGs) stands proof that such a foray into the commercial finance sector is indeed possible and lucrative. In India, where the national government has and continues to vigorously support this system, roughly 235,000 SHGs totaling at about 4 million members have already managed to secure loans from 41 commercial banks, 166 regional rural banks and 111 cooperative banks. Despite the fact that this model is neither part of the traditional microfinance approach its obvious advantages are its integration into the formal financial system, its ability to scale-up fast if need be and its high flexibility. The model’s major downside so far, appears to be that it has been unable to reach the very poor social layer, which obviously makes it less appealing to those adhering to a welfarist point of view. Institutionists on the other hand may find the prospects of tapping into commercial finance appealing, while the fact that SHGs are not necessarily part of a larger framework (i.e. an NGO of some kind or any larger organization) makes them ever harder to regulate and control, which obviously stands in contrast to the institutionist agenda of establishing general standards and best practices in the microfinance industry.36

35 [MORD02], p. 622f
36 [WOLL01], p. 17
CLAIM 4: SUBSIDIZED PROGRAMS ARE INEFFICIENT AND BOUND TO FAIL

This claim is obviously based on the – oftentimes disastrous – failures of subsidized credit programs of the past. As mentioned above, funds from these programs, all across the Third World had a tendency to either get channeled into influential people’s pockets or vanished because borrowers had no real incentive to pay back the loan and subsequently did not repay at all.

As microfinance programs generally differ fundamentally from the unsuccessful subsidized credit programs of the past in two ways – namely their structure as NGOs and their lending mechanisms – and in the face of highly successful examples like the Grameen Bank or BRAC to name but two, this claim appears to be hard to substantiate.

The supporting claim generally brought forward by institutionists in this respect, is that donor funding will dry up over time and that cost covering interest rates are the most important prerequisite for efficiency in microlending.37

So far, however, the interest of governments and other organizations in poverty alleviation shows no signs of subsiding. It also seems reasonable to expect that the fight against poverty will remain a top priority of most governments and other donors and of the programs they subsidize and support, as long as said programs continue their efforts at cost containment and increasing their outreach.

In addition, measures other than profits can be employed as an incentive for managers, also in nonprofit organizations. One such system is the use of socially determined transfer prices, which is being used very successfully in BRI’s “unit desa” program. Although BRI is financially sustainable, transfer pricing in the form of “shadow prices” can also be adapted for use in a subsidized project. In a subsidized setting, such shadow prices are adjusted so that they show the social benefit gained from lending, which can guarantee efficiency if compensation is tied to performance based on the achieved shadow profits.38

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37 see [CHAR01], [CHAR02] and [CHAR03]
38 [MORD02], p. 624
PUTTING THE DEBATE IN PERSPECTIVE

From the aforementioned arguments and disputed points of view, it may seem that the debate between institutionists and welfarists is solely rooted in the quest for the right methods to be employed in order to best serve the poor of the world. On a broader scale though, the debate becomes a lot more philosophical and deviates from its supposedly methodological origins.

In effect, scholars and practitioners on either side of the divide agree on the fact that poverty alleviation is the ultimate goal and should occur as widespread as somehow possible – every other question currently being discussed is thus a reflection of the philosophical disposition of the parties involved.

If one were to view the entire “outreach versus sustainability” debate as a purely mathematical one, the logical function one would end up with is a double maximization problem. However, as with all maximization problems, the only way to fully maximize one function is to regard the other as a constraint. Therefore one always ends up with a tradeoff between the two target functions if both are to be maximized as far as possible – that is, if one has managed to reach the frontier up to which both functions can be increased without putting a strain on each other.

If this allegory is applied to the microfinance schism, the one question that arises is whether or not the frontier where an actual tradeoff between sustainability and outreach actually occurs has already been reached – or put in a less theoretical way: Whether or not the poorest are still able to afford the cost of the services offered.

This train of thought, considering the ongoing debate over whether or not MFI interest rates should rather be “cost covering” (institutionists) or “affordable” (welfarists), ultimately leads to the conclusion that the actual discourse can easily be brought down to the question of whether or not subsidized interest rates are necessary in order to serve the poorest.

And exactly therein lies the source of the strong philosophical divide. History has shown on numerous occasions, that as soon as people gain more power (which in this particular case can be seen as synonymous with escaping poverty to some extent), they tend to divert available resources towards themselves, thus excluding their former peers.
While, for this reason and others, welfarists eagerly demand that all measures be taken to insure permanent inclusion of the poorest in any and all programs available, institutionists generally try to de-emphasize morality issues and politics, while approaching the matter from a purely economic and quantitative angle. It therefore appears that the microfinance sector just mirrors the general divide among today’s economists when it comes to economic policy. Advocates of neoliberal thinking argue that the free market is the only efficient force in any economy (just like institutionists would like to see government intervention in microfinance phased out over the coming years and NGOs take over completely), the political left has always leaned towards state intervention in favor of social justice and as a balancing factor to deal with the effects of external shocks and the like – demands which are in fact identical with those adhering to the welfarist agenda. The list of similarities in both debates could of course be extended, but the most striking one of all appears to be this (just replace “poverty alleviation” with “social justice” if you will):

Most participants in the discussion appear to focus more on details, i.e. trying to establish best practices suited for one purpose or another and the like and all of that within an either institutionist or welfarist mindset, rather than the big picture of a most effective system for poverty alleviation – which in essence may contain elements from both schools of thought. Efficiency, one of the primary concerns among institutionists, and depth of outreach, which is among the main objectives of welfarists are, as explained above, not necessarily contradictory objectives but can indeed complement each other to attain an efficient yet socially balanced formula.

In addition to the already disputed points, one should not ignore the harsh criticism coming from some authors as regards the current incarnation of microfinance. The ongoing hype about microcredit, spectacular figures in MFIs’ reports both in terms of repayment and expansion of operations and the highly energized discussion about mere details within the microfinance superstructure could lead to the belief that – except for some glitches that still need fixing – the provisioning of credit to the poor is an effective cure for poverty.

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39 [RHYN01]
There are, however, numerous instances of anecdotal evidence which show that microdebt is not necessarily the answer that many of the poor are looking for. People working in low-return professions where markets are saturated and who are faced with a high likelihood of external shocks such as droughts and disease (conditions encountered in many simple trades in developing countries) will quite likely encounter difficulties trying to repay their loans. Difficulties which, especially in countries with a poorly developed judicial system and oftentimes powerless authorities, may easily lead to repercussions for the debtors that can range from incarceration over the seizure of what little assets those borrowers may have to physical violence.40

Just as not all people in developed countries are cut out to be entrepreneurs, not all of the poor will do well as heads of “micro enterprises”. Therefore, the most important focus for MFIs should be to also cater to those among the poor that belong to the non-entrepreneurial category and provide them with flexible savings products and lines of credit which may suit their needs better.

In addition, those who are usually referred to as “the poorest of the poor” — and who would obviously need the most attention in order to escape poverty — are still being ignored by the vast majority of MFIs. The homeless and truly destitute are not likely to start micro enterprises but will require money to pay for their food and medical needs above everything else. Grameen Bank’s “Struggling Members” program constitutes a noteworthy exception to this rule as it actually focuses solely on beggars and tries to encourage them to take up some income generating activity in addition to begging (while not forcing them to stop begging), but even 25 years into the microfinance boom remains just that — an exception.

It therefore seems appropriate to suggest that the debate about the provisioning of microcredit be shifted towards a debate about the provisioning of a richer array of financial (and non-financial) services to the poor and to encourage a more holistic approach on the part of all participants in order to keep it from getting stuck on the fine print before the big picture starts to take shape.

40 [HULM01], p. 26f
Institutions like the World Bank, CGAP and others, which could for the most part be considered part of the institutionist camp, have long been calling for a regulatory framework and the development of sets of “best practices” for use in the microfinance industry. These calls however, have not yet led to such a system actually being put in place, but rather to an ongoing discussion about the advantages and shortcomings of the systems proposed, and the debate is currently not showing any signs of subsiding.

Imposing globally applicable rules and regulations on an industry which is largely based on regional specificity and as such has a structure as diverse as can be, is obviously a mission close to impossible to accomplish.

At the same time, one of the main problems in the microfinance industry, which is being dominated by NGOs which oftentimes lack field experience or education in matters of finance, is the inconsistency in accounting procedures and planning which then results in inefficient use of funds that could otherwise be employed to greater effect.

In the face of a trend towards commercialization though, microfinance providers cannot and should not ignore the need to increase the level of control that they have over their own activities. Effective control, undisputedly a crucial ingredient for long-term competitiveness, can best be exercised through accurate accounting information – information which in turn can be used for planning, product costing, pricing and resource allocation.

Even if a microfinance organization is not specifically designed to be profitable, taking steps like these will greatly increase their financial efficiency and thus ensure the most effective use of donor funds, help maintain or reach financial self-sufficiency (if not actual profitability) or – in case of an MFI already operating on a for-profit basis – likely boost its net income.

Literature distinguishes between three types of financial institutions, namely formal, semi-formal and informal. Formal institutions are those to which the banking laws of a
given country apply, i.e. regular commercial banks. The informal category contains everything from local moneylenders over traders, rotating savings associations and pawn brokers, which used to be the only sources of credit for the poor in the pre-microfinance era.

Finally, semi-formal institutions are defined as being NGOs or banks with a special charter like the Grameen Bank and therefore also the center of attention in the ongoing discussion about regulation.

The general consensus is, that regulators have four basic options when designing any kind of guidelines and regulations:

- no regulation (i.e. the status quo with no national or international laws in place)
- self-regulation (i.e. reliance on market forces and trendsetters within the MFI community)
- existing banking regulation
- special regulation (e.g. the special legislation in Bangladesh which allowed for the creation of the Grameen Bank)

With increasing anecdotal evidence of poor people’s desire to not just gain access to credit but to a wider range of services, the question of regulation of course increases heavily in priority. Some authors also claim that MFIs need to realize that their focus on microenterprises needs to shift towards the provision of microfinancial services which include things like insurance and savings.41

One of the stumbling blocks in the effort to create effective, yet practical, forms of regulation for the microfinance industry is that there is no historical precedent for such laws or guidelines. In the era of subsidized agricultural credit, the legislation which facilitated the creation of the credit programs was always separate from the existing banking laws and the programs were left with little to no supervision after they had been put in pace.

Similarly, today’s MFIs are – for the most part – NGOs which are not required to report to a country’s central bank or other organization. As mentioned before, this situation led to a tremendous variety of organization styles, accounting systems and common practices among MFIs which is ultimately very hard to fit into a corset of regulations.

41 see [WRIGH02]
ENTRY REGULATIONS AND SUPERVISION

One of the most important regulatory instances in the formal banking sector are the market entry regulations for commercial banks. While those laws are generally extremely rigid, microfinance laws, where they exist at all, hardly contain any criteria comparable to the strict requirements for banks in when it comes to capital requirements, the existence of fully developed business plan or the management qualifications of their respective boards.

The desire for such regulation, however, is not restricted to the governments of countries with a large microfinance economy. MFIs themselves, looking to fund themselves, may very well be interested in such standards to be put in place as they will legally enable them to access public deposits or credit lines from donors. In addition central banks will likely welcome any such regulations as giving out licenses will allow them to protect depositors with MFIs who are already taking deposits despite the current lack of regulation.

However, the number of MFIs in many Third World countries is already too great to possibly be supervised by any form of central body (either the country’s central bank or another organization), as such institutions only have a limited capacity for supervisory tasks themselves.

Although there is a broad consensus throughout literature that regulation is necessary, there are hardly any concrete suggestions as to what benchmarks and thresholds to use for entry regulation and ongoing supervision.

MONITORING AND BEST PRACTICES

Monitoring, i.e. the process of ongoing supervision of microfinance institutions, is very likely the most time and resource consuming aspect of any future microfinance legislation. While there is a broad consensus that credit-only MFIs do not require strict supervision as their activity rarely poses a risk to clients, if any, literature is also consistent in demanding that deposit taking MFIs be supervised, as they acquire part of their operating capital from the public.

Authors also agree that the traditional forms of audit, e.g. the checking of single client files for standards compliance and the like, will likely be cost-ineffective and
inefficient with the extremely large amount of clients and the miniscule size of loans in the microfinance industry. Thus, new audit concepts will have to be developed to fit the specific needs of that sector.

While a consensus exists in those two areas, the question of what kind of regulation (out of the four types mentioned above) would be best suited for the microfinance industry remains disputed:

- Those in favor of the no regulation approach argue that designing a regulatory framework specifically for microfinance institutions will be too costly compared to the benefits that can be reaped from the implementation of such a system. In addition, MFI operations are viewed as too small to actually pose a threat to the stability to the global financial system, even if they remain unregulated. Opponents of this theory argue that the risk profile of MFIs necessitates some kind of regulation, especially considering the industry’s high rate of growth.

- Self regulation obviously gets more complicated as the diversity of the microfinance industry increases. Since there are already huge differences in size, scale, objectives and resources across the MFI spectrum, self-regulation is not necessarily a feasible regulatory option.

- Extending existing banking regulations to also include the provision of microfinancial services on the other hand, may cause substantial expenses on the part of MFIs in order to achieve compliance with these regulations and in turn considerably increase their operating costs, ultimately resulting in higher interest rates for loans and a generally undesirable situation.

- Fourth, many practitioners of microfinance favor the development of special regulations, as such a system would allow them to maintain their unique characteristics while providing a limited range of financial services (compared to those of regular banks) with a lower capital requirement. Opponents of this approach argue, that such regulation will cause an imbalance among deposit taking financial institutions and that the development of any such specialized system would currently be ahead of the industry’s development process as a whole and therefore premature.42

42 [KIRK01], p.294 ff.
Although discussion in recent literature focuses to great extent on the right approach to regulation, practical suggestions as to how to actually design such regulation are scarce. The following suggestions for the adaptation of traditional banking regulations are taken from a 1997 paper by Berenbach and Churchill:

“**Lower capital requirements.** Minimum capital requirements should be low enough to attract new entrants into microfinance, but high enough to ensure the creation of a sound financial intermediary.

**Risk weighting of assets for unsecured loans.** The type of lending (unsecured or secured and, if secured, by what type of collateral) a bank engages in affects its risk weighting of assets, capital adequacy, and provisioning. Regulators should assess the level of risk of an MFI based on overall portfolio quality and repayment history rather than on the value of traditional guarantees. Historical performances of portfolios, statistical sampling of arrears, the adequacy of management information systems and the MFI’s own policies for dealing with arrears should also be taken into account.

**Higher capital adequacy ratios.** A weighted capital adequacy ratio of 8% of risk-weighted assets is currently recommended by the Basle Accord. Because of their generally lower ability to diversify their risks, MFIs should be subject to even higher capital adequacy ratios as a means to safeguard investor funds. Consideration should be given to application of initial MFI capital adequacy ratios approaching 20%, with potential lowering to the range of 12-15%, based on good performance over time.

**Stricter provisioning.** Provisioning requirements should be based on the average loan maturity of the portfolio. MFI portfolios tend to have shorter average maturities and, therefore, require more aggressive provisioning. Base Accord requirements suggest that banks be subject to loan provisioning requirements of 25% for substandard loans, 50% for nonperforming loans, and 100% for loss loans. Stricter provision loan loss requirements for MFIs should be at least:

- 10% of the unpaid balance 0-30 days in arrears
- 25% of the unpaid balance 31-90 days in arrears
50% of the unpaid balance 91-180 days in arrears; and
100% of the unpaid balance in arrears more than 180 days

**Higher operational costs allowed.** MFIs manage small loans and deposits; thus, they tend to have higher operational costs than traditional banks. Allowing MFIs to offer incentive-based payments to staff; to have flexible hours of operation convenient for clients; and to engage in mobile banking, permitting them to disburse funds and collect payments outside branches, can help MFIs to minimize their operational costs. Permitting incentive-based payments to staff can help MFIs reduce portfolio risk. Regulators should not penalize MFIs for higher operating costs if they can demonstrate a reasonable average return on assets.

**Customized reporting requirements.** Not all the reporting requirements of traditional banks are applicable to MFIs and microentrepreneurs usually cannot produce the same level of documentation as required of traditional lending. Portfolio reporting formats should take into account the volume, loan size, and term of microfinance loans."

If one believes that clients will ultimately know best what microfinance provider to entrust their savings to or which institution to deal with on general principle, an approach proposed by Stuart Rutherford may yield great benefits at moderate costs. Although designed with focus on Bangladesh, this system could likely be applied to other countries as well:

"The scheme centres around a voluntary register, backed by law that works as follows:

(i) An institution (in Bangladesh the Credit and Development Forum, the MFI’s trade association, is proposed) would open a register of MFIs wishing to mobilize deposits. However, the institution would have absolutely no say in whether or not any particular MFI is allowed to register, and absolutely no say whatsoever in what the MFI chooses to include in its registration document.

43 [BEREN01] cited in [CHAR02]
(ii) The registration document will give details about the MFI, its name, its address, the names of its owners and backers, its area of operations, and its resources, financial products and so on.

(iii) It will also have to state on what basis aggrieved parties could make a case against it in the eventuality that it failed to honour deposits that it had accepted. For example, it might give the name and address of some immovable property that it would be willing to have confiscated.

(iv) The MFI would then be obliged to hand out a copy of its registration document, in easy local language, to everyone of its clients. It would also be obliged to distribute copies of the document to any member of the public who wanted one. There would also be copies displayed at the local government offices.

(v) In this way, clients would be able to compare one MFI with another, and to estimate the balance of risk and benefit represented by ‘their’ MFI. Unregistered MFIs would, it is hoped, lose business.

As Rutherford notes, to be effective and useful, the voluntary register must be accurate, up-to-date, simple, clear and accessible.\textsuperscript{44}

Due to the continuous growth of the microfinance industry, especially at its current pace, the need for regulation, especially for client protection purposes, is pressing. Academics and practitioners of all ideological colors seem to agree, that if the industry is to maintain its present rate of expansion, sets of rules to control it need to be put in place.

There are, however, hardly any suggestions as to how such rules should be modeled and the current debate about regulation appears to be controlled by ideological skirmishes over which aspects need to be considered in regulatory efforts, while the actual process of establishing any form of effective regulation has yet to begin.

As with many other issues pertaining to microfinance, it appears that due to the high regional specificity of many programs, a globally (or even nationally applicable) set of regulations may be too inflexible to accommodate the diversity of programs currently in operation. Therefore, organizations pushing for regulation such as CGAP and the World Bank, should focus on working with the central banks and other superintendencies of countries with a high density of microfinance projects, in order

\footnote{\textsuperscript{44} [WRIGH02] cited in [KIRK01]}
to maintain the highest possible degree of “locality” when designing and implementing any regulatory legislation.
REGULATION VERSUS FLEXIBILITY – CLIENT OVERLAP ISSUES

One may view the commercialization of microfinance from whatever ideological perspective that one chooses – the trend towards it, however, cannot be ignored. As ever more microfinance providers emerge on the market each year, and with the already established organizations trying to expand their portfolios, the currently largely unregulated industry holds risks not just for borrowers but for institutions as well.

In Bangladesh for example, the growth of the industry has been tremendous over the past 15 years and studies on the subject have even had trouble finding “control” groups of villages with no MFI presence whatsoever.

While a wider variety of microfinance providers should generally be beneficial to clients, as the competing organizations will have to adopt demand driven strategies in order to maintain or expand their scale of operations, there may also be repercussions for practitioners in such a densely populated market. Currently, MFIs do not have any formal information sharing system, through which they could exchange information on delinquent clients and other relevant business data.

At the same time, clients have the option of acting strategically, since the traditional incentives (i.e. “social collateral” and future loan prospects as described above) lose much of their power in this setting. Moral hazard on the part of “buyers” in a situation with many competing “sellers” is one of the standard problems in game theory and can of course also be applied here, as the incentive to take up numerous loans and run increases in proportion to the amount of MFIs competing for business and thus the likelihood of actually getting away with such conduct.

As a 2002 study by Chaudhurin and Matin on the situation in Bangladesh shows, poorer households are more likely to compensate for loan repayment difficulties either by decreasing expenses or by acquiring additional funds from other MFIs, while also having only a 39% probability of being able to pay loan installments on time. On the whole though, households face about the same likelihood of being members of multiple MFIs, regardless of their poverty level. The reasons for multiple memberships, however, oftentimes differ substantially from poorer to less poor households.
While better off households will mostly use the additional capital gained from multiple membership to seize economic opportunities, such as business expansion or starting up a new enterprise, poorer households are likely to use it for distress management in times of economic hardship.

Some authors\textsuperscript{45} view the problem of client overlap merely as a threat to providers and as a result of opportunistic behavior on the part of borrowers and are therefore calling for the establishment of credit bureau types of organizations to facilitate information exchange among microfinance NGOs, but Chaudhurin and Matin point to the importance of the cause for multiple lending especially among the poorest.

The lending system of most MFIs is not equipped to supply borrowers with quick lump sum payments, as repayment schedules are designed for extended periods of time. In addition, full repayment usually is the primary prerequisite for the provisioning of future loans, so multiple membership effectively becomes the only alternative in order to deal with external shocks. While this strategy may work out in some cases, it can hardly be considered safe for both clients and lending institutions, as more loans mean more interest payments for borrowers and ultimately also higher risks for providers. In the worst case, a borrower’s reputation with one or more MFIs will be ruined because he failed to repay his loans, the providers will have lost money and the borrower subsequently be unable to get further loans in times of emergency.

The study showed, however, that while repayments may easily become irregular in times of crisis, the tendency to actually default on a loan remains limited. In the long term, overdue repayment rates are low which further strengthens the view of multiple loans as distress management tools and indicates that multi-borrowing is not just a strategy used by the poor to avoid repayment of loans taken.\textsuperscript{46}

In light of the aforementioned findings, it appears that although a credit bureau type institution in countries with high MFI density will likely help fight default on the part of borrowers, microfinance providers also need to rethink their strategy when it comes to product design.

\textsuperscript{45} e.g. [CHAR01], [CHAR02] and [CHAR03]
\textsuperscript{46} [CHAU01], p. 46 ff
Poorer households, by definition, are more vulnerable to external shocks than those who are better off. Therefore, in order to ameliorate their situation, they will also need access to emergency credit in hard times – a service that most MFIs are not yet equipped to provide, as the vast majority of their products is geared towards long-term usage and repayment and not towards emergency intervention.
HARD DATA – FOR-PROFIT VERSUS NON-PROFIT MICROFINANCE PROVIDERS

Aggregated empirical data in the microfinance industry usually proves to be hard to come by, as there are no national authorities for MFI regulation that could collect such data, but the MicroBanking Bulletin compiles voluntarily submitted figures by participating MFIs.

Therefore, I will use the latest issue of this periodic publication for the following comparisons, focusing on the differences and similarities between for-profit and non-profit MFIs in regard to key indicators.

Over the three year period covered in the latest issue of the MicroBanking Bulletin, the number of for-profit and non-profit MFIs has remained almost constant in proportion to each other which should guarantee high comparability of the reported figures.

<table>
<thead>
<tr>
<th>Number of reporting MFIs</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>101</td>
<td>108</td>
<td>104</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>239</td>
<td>232</td>
<td>236</td>
</tr>
</tbody>
</table>

Table 4: Number of reporting MFIs, 2004 through 2006

TOTAL ASSETS

Over the three years observed, for-profit MFIs have seen an increase in total assets of close to 300%, while the total assets of non-profit MFIs just fell short of doubling. While the fact that the assets of for-profit microfinance providers would rise faster than those of non-profit organizations can hardly be considered surprising, the rate of increase for for-profit microfinance institutions, however, is quite startling.

In addition, the proportion of total assets (non-profit to for-profit) fell from around 1:2 in 2004 to almost 1:4 in 2006.

47 Source: [MIX01]
**Total Assets (in USD)**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>10,102,842</td>
<td>15,885,710</td>
<td>29,049,552</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>4,196,413</td>
<td>6,036,700</td>
<td>7,970,208</td>
</tr>
</tbody>
</table>

Table 5: Total assets comparison, for-profit vs. non-profit MFIs

**DEBT / EQUITY RATIO**

As the debt / equity ratio represents a company’s financing strategy, namely the relationship between shareholders’ equity and thus constitutes an indicator of the likely future volatility of earnings, it should not be ignored in this comparison.

While this ratio has increased slightly from 2004 through 2006 for non-profit MFIs, it has remained virtually constant (and substantially higher) for for-profit organizations.

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>4.0</td>
<td>4.4</td>
<td>4.2</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>1.3</td>
<td>1.7</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Table 6: Debt / Equity ratio comparison, for-profit vs. non-profit MFIs

This also puts the growth in total assets in perspective. For-profit MFIs appear to be financing a large proportion of their assets through debt, which of course enables them to grow faster but on the other hand might put their future earnings at risk if the debt / equity ratio should also increase in the future and the tremendous rise in total assets continues at its current pace.

Non-profit MFIs also seem to have developed a taste for financing their operations through debt over the past years which also indicates a growing interest on their part to aggressively expand their operations.

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48 Source: [MIX01]
49 Source: [MIX01]
GROSS LOAN PORTFOLIO

The gross loan portfolio constitutes a good indicator of the overall scale of operations of a microfinance institution. From 2004 through 2006, both non-profit and for-profit MFIs have expanded their operations substantially, as can be seen when comparing GLP sizes for this period. While for-profit organizations’ GLP grew more than 300%, non-profit organizations also saw an increase to almost twice their size over those three years.

<table>
<thead>
<tr>
<th>Gross loan portfolio (in USD)</th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>6,818,887</td>
<td>10,425,950</td>
<td>20,527,922</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>3,474,434</td>
<td>4,755,789</td>
<td>6,082,881</td>
</tr>
</tbody>
</table>

Table 7: Gross loan portfolio comparison, for-profit vs. non-profit MFIs

This also stands proof of the fact, that regardless of profit status, all MFIs surveyed have been making successful efforts at increasing their outreach at an increasingly fast pace and that profit-orientation is not necessarily a prerequisite to do so.

AVERAGE LOAN BALANCE / GNI PER CAPITA

In order to determine the average poverty level of clients of any particular MFI, the ratio of the average loan balance to the country of operation’s GNI per capita can be used for approximation. As for-profit MFIs will generally charge higher interest rates (and some even require collateral) their clients generally tend to be less poor than those of non-profit institutions, which also results in a higher average loan balance as less poor borrowers will usually undertake more capital intensive endeavors with the loans they procure, thus producing a higher value for this indicator.

Source: [MIX01]

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50 Source: [MIX01]
The big difference in this aspect between for-profit and non-profit MFIs can hardly be considered surprising. The substantial increase in this ratio for non-profit MFIs though – namely by 27% relative to its 2004 value – should be of some interest to researchers. Whether this rise was triggered by mission drift and a shift towards less poor clients or by successful operations and thus an increase in the well-being of existing clients and higher follow-up loans cannot be ascertained from these figures alone.

As non-profit MFIs have also expanded their operations on a substantial level over the three years under observation though, this development is likely due to a mix of these two factors.

OVERALL FINANCIAL PERFORMANCE

As a final note, I want to compare two indicators of financial performance which may be of some interest in the current discussion about financial sustainability of MFIs. The rate of return on assets, as well as the rate of financial self-sufficiency is a good indicator of operational efficiency and performance for any financial institution as the former represents the “interest” on assets generated through operation and the latter puts adjusted revenue in perspective with adjusted expenses and losses.

One would expect for-profit MFIs to outperform non-profit institutions by a substantial margin in both categories – however the data collected for the MicroBanking Bulletin shows the situation to be quite different from this assumption.

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51 Source: [MiX01]
### Return on assets

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>1.5 %</td>
<td>1.2 %</td>
<td>1.3 %</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>2.1 %</td>
<td>2.1 %</td>
<td>2.9 %</td>
</tr>
</tbody>
</table>

### Financial self-sufficiency

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>2006</th>
</tr>
</thead>
<tbody>
<tr>
<td>For-profit MFIs</td>
<td>110 %</td>
<td>108 %</td>
<td>111 %</td>
</tr>
<tr>
<td>Non-profit MFIs</td>
<td>109 %</td>
<td>109 %</td>
<td>112 %</td>
</tr>
</tbody>
</table>

Table 9: Efficiency indicators, for-profit vs. non-profit MFIs\(^{52}\)

The rate of return on assets is defined as the adjusted net operating income after taxes divided by the institution’s total assets and thus represents the ratio of effective profits in proportion to the assets used for “production”.

The rate of financial self-sufficiency is defined as the adjusted financial revenue divided by the adjusted financial expense including loan impairment losses and operating expense and therefore measures an organization’s operational efficiency and profits in relation to its expenses.

Interestingly, the return on assets was substantially higher for non-profit MFIs in all three years, which indicates a high degree of operational efficiency on their part and even more importantly, non-profit MFIs were able to match the degree of financial self-sufficiency their profitable counterparts over the entirety of the period.

Although these higher values may have been due to cheaper subsidized sources of capital made available to non-profit MFIs, the result still casts substantial amount of doubt on institutionists’ claims in regard to the inefficiency of non-profitable microfinance providers as at least those surveyed in the MicroBanking Bulletin appear to be measuring up to – if not outperforming – their for-profit peers in this respect.

\(^{52}\) Source: [MIX01]
CONCLUSIONS

The microfinance industry is today one of the primary means of poverty alleviation on the planet. It has seen an expansion of tremendous scale over the past decades and grown from single projects like Muhammad Yunus’ Grameen Bank into a veritable “sub-culture” of traditional finance.

While its merits remain undisputed and its successes at providing the world’s poor with means to help themselves are indeed astounding, there is growing concern as to its future development – concern, which sparked a vivid academic debate in respect to possible paths along which this development could and should occur.

The institutionist (i.e. neoliberal) push, headed by the World Bank, CGAP and other organizations, towards total “privatization” of the poverty alleviation agenda and towards establishing a solely profit-oriented paradigm in the microfinance community has met and continues to meet resistance from scholars of different ideological dispositions.

While some of the claims set forth by institutionists can be refuted with relative ease based on empirical data and anecdotal evidence, the fact that some form of regulation of the microfinance industry will not only be beneficial but indeed necessary cannot and should not be ignored if one wishes for the current positive development to continue.

The current discourse on the subject of regulation, however, appears to be stuck on theoretical differences, and as academics from both sides of the ideological divide are lobbying for support of their point of view rather than trying to find practical solutions, effective sets of rules (let alone their actual implementation) have yet to be developed.

As for the methodological structure of microfinance, the traditional system of Grameen style group lending and its many variations in use across MFIs all over the world have yielded spectacular results in outreach and were long regarded as the ultimate cure for poverty on a global scale. Recent experience shows, however, that in order to extend the provisioning of microfinancial services to those among the poor who currently remain unserved by the traditional approach, practitioners will need to design new, more flexible products, and also shift their focus away from solely
providing loans and towards services like microsavings, microinsurance and lines of credit.

It appears that, despite institutionist claims to the contrary, profit orientation is not necessarily a prerequisite for the efficient operation of MFIs. As the data presented in the last chapter of this paper shows, non-profit organizations are indeed able – if structured appropriately – to conduct business in an economically efficient way. The non-profit sector has also grown substantially over the period in question and has indeed shown potential to outperform their profitable peers in some key measures of efficiency.

Although it may be argued that non-profit MFIs were only able to do so because of subsidized sources of capital that they were granted access to by governments and donors, the institutionist demand to phase out government or donor support for microfinance on grounds of lacking efficiency remains unsubstantiated. As (democratic) governments are the elected representatives of their people, the fight against poverty in any given country should – or indeed, must – involve its current administration. Total privatization of services for the general public in the past have usually led to higher costs for clients while service quality did not necessarily improve but indeed decline in many cases – a fact to which the public health and transportation sectors, among others, in many countries of the northern hemisphere stand testament today.

Advocates of a neoliberal agenda have always had trouble to substantiate their assumptions on different aspects of policy when reality did not evolve the way they predicted – and the microfinance industry seems to be no exception to this rule. Donor funds have not been and are not showing any signs of decreasing and governments in Third World countries continue to have an understandable interest in poverty alleviation, if only for the sake of social stability. While the institutionist calls for regulation and efficiency are points that should indeed be put on the agenda of all trendsetting organizations involved in the microfinance industry worldwide, it does not seem illogical to assume that both, profitable and subsidized microfinance providers will be able to adopt any such industry wide
standards once they are established and to further coexist in the future like they have for the past several decades.
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ZUSAMMENFASSUNG (GERMAN ABSTRACT)

Die vorliegende Arbeit behandelt die vor allem in wissenschaftlichen Kreisen viel diskutierte Frage danach, ob eine Kommerzialisierung, sprich Profitorientierung, in der Mikrofinanzindustrie von Nutzen sowohl für Anbieter wie auch Konsumenten von Mikrofinanz-Dienstleistungen sei.


Einer der Hauptkritikpunkte der Welfarists liegt darin, daß eine Profitorientierung von Mikrofinanzanbietern de facto automatisch zu höheren Kosten für die Leistungsempfänger führen würde, womit tendentiell ärmere Schichten überhaupt von diesen Leistungen ausgeschlossen werden könnten, da sie für diese schlicht nicht mehr erschwinglich wären.

In dieser Arbeit werden sowohl theoretische Standpunkte der beiden ideologischen Lager einander gegenübergestellt, sowie empirisch erhobene Daten verglichen und es wird versucht, ein möglichst objektives Bild der aktuellen Situation zu bieten.

Weiters werden Ansätze zur Regulierung des rasant wachsenden Mikrofinanz-Marktes vorgestellt, über deren Notwendigkeit sich, zumindest in Grundzügen, beide Denkschulen einig sind.
CURRICULUM VITAE (ENGLISH)

Martin Leipold, born in Vienna, Austria, in 1982, attended Rainergasse High School where he attained his high school diploma with distinction in 2000.

He then enrolled in the International Business program at the University of Vienna, specializing in Business IT and Organization and HR Management.

After several part time positions (mainly in the fields of marketing and promotion) he started a freelance career in the music industry as a concert promoter both locally in Vienna and throughout all of Austria in 2003. In 2004 he changed into the field of artist management and tour booking which led to an international expansion of business throughout all of Western Europe and North America. In addition, Mr. Leipold is a freelance graphics and web designer, as well as an active musician.

Martin Leipold currently lives and works in Vienna, Austria, and Toronto, Canada.
CURRICULUM VITAE (GERMAN)


Er begann danach sein Studium der Internationalen Betriebswirtschaft an der Universität Wien, mit einer Spezialisierung auf die Kernfachkombinationen Wirtschaftsinformatik sowie Organisation- und Personalmanagement.

Nach einigen Teilzeit-Anstellungen (vorwiegend im Marketing- und Promotionbereich) begann er 2003 selbständig in der Musikindustrie zu arbeiten, zunächst als Konzertveranstalter, sowohl regional in Wien als auch im gesamten Bundesgebiet und wechselte 2004 in den Bereich Artist Management und Tour Booking, was zu einer internationalen Tätigkeit in ganz Westeuropa und Nordamerika führte.
Ebenso ist er in den Bereichen Grafik- und Webdesign, sowie als Musiker tätig.

Martin Leipold lebt und arbeitet derzeit in Wien, sowie in Toronto, Kanada.