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Are Profits and Poverty Reduction Compatible Goals for MFIs?

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Abstract

Microfinance has been touted by many as a miraculous tool in the fight against poverty. Proponents of microfinance say that it helps to alleviate poverty and at the same time can be profitable. Critics of microfinance argue that the benefits of microfinance are over-exaggerated or misrepresented, while others argue that MFIs are charging borrowers interest rates that are too high and keep debtors in a cycle of indebtedness. Critiques of microfinance institutions (MFIs), come from both the left and right, with the largest point of contention being the commercialization of MFIs. MFIs are becoming more commercialized and this is particularly true in Latin America. The goal of this paper is to weigh the pros and cons of MFIs and to determine whether they are beneficial to development and how their benefits could be maximized.

Table of Contents

Introduction 4

Background 7

MFI Structures 9

Compartamos 11

Theoretical Framework 14

Neo-liberalism 15

The Neoliberal case for MFIs' success in achieving its goals 17

The Post-Keynesian case against MFI's ability to achieve its goals 19

Critical Analysis 24

Policy recommendations 28

Conclusion 32

Bibliography 35

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Introduction

Since the commercialization of Microfinance Institutions (MFIs), most notably that of Compartamos in 2007, the development community has been faced with examining whether profits and poverty reduction are compatible objectives. Ostensibly, the goal of microfinance, the way its most prominent proponent, Muhammed Yunus, has stated, is poverty reduction, (Yunus, 1999). As a tool for eradicating poverty, it must not only work towards poverty reduction, but also, the inextricably intertwined other seven Millennium Development Goals: education, gender equality, child health, maternal health, infectious diseases, environmental sustainability, and global partnership. With microfinance institutions (MFIs) increasingly becoming privatized banking institutions, a trend known as the 'new wave' of microfinance, which is embodied by "commercial banking entrants into the sector," (Berger, Goldmark, & Miller-Sanabria, 2006) the question of whether profits and poverty reduction are mutually exclusive or compatible becomes more central to development issues.

It is imperative that microfinance works in conjunction with the MDGs because without reaching these MDGs, such as universal primary education, combatting diseases, and developing a global partnership. These MDGs directly impact the success of micro-enterprises through a complex series of relationships. For example, education has an impact on borrowers' abilities to understand the terms of a loan, and to create a business plan; combatting diseases is important because without medical insurance and with little to no savings, the poor are deeply affected by diseases and other health concerns since poor health is expensive and can mean an end to income; and developing a global partnership, or more specifically, increasing telecommunications, can give borrowers access to expanded markets.

One way to determine if microfinance is successful is to compare the advancement of the Millennium Development Goals (MDGs) in countries which have thriving microfinance sectors to the advancement of MDGs in countries which have less fecund microfinance sectors. The most visible goal of microfinance is ending poverty and hunger, however, all of the MDGs are supported through microfinance, specifically gender equality, universal education, and healthcare as they are part of the microfinance agenda. MFIs address these MDGs by historically focusing on loans to women borrowers, offering health insurance, and providing incentives such as scholarships and raffle prizes for the school-aged children of their clients. While there are a myriad of goals of microfinance, there is an overarching theme which resonates amongst the institutions, “The microfinance equation is straightforward: to alleviate poverty and promote development, MFIs provide funds at a relatively low cost to poor communities and populations that previously were excluded from credit,” (Olsen, 2010).

What is microfinance? Microfinance has been an international development response to poverty, with microfinance receiving much support from the United Nations, which named 2005 the year of microcredit. It is important to note that although microfinance and microcredit are referred to interchangeably, they do have different denotations: microfinance refers to a broader concept of offering scaled-down financial services, while microloans refer specifically to small loans for the poor to invest in entrepreuneurial activities. MFIs are the actual firms which are responsible for microloans, and the broader range of microfinancial services, which include offering savings, insurance, and remittance handling services. One author offers the following analogy: “Microfinance is more similar to retail than to corporate banking and, therefore, should have a structure that facilitates a decentralised client service model, taking advantage of branch infrastructure,” (Young, et al., 2005). In short, microfinance is a service which should be available to every segment of the population, no matter what the size of the loan is. As one might purchase a case of water bottles at a wholesale club, one would also expect to similarly be able to purchase a single water bottle at a local convenience store, which is to say that there is no need too small to be met. Although microfinance started off as a charitable endeavor relying on philanthropic donations for capital, it has increasingly become privatized and has emerged “from its protected status inside international development into the mainstream financial sector,” (Rhyne, 27 January 2010).

Within the past decade there has been a trend towards privatized, commercialized MFIs which charge high interest rates which are ostensibly for the purpose of proliferation so that the organizations will have more money to loan to the poor. However, with commercialized MFIs, profits are not only be channeled towards the poor, but also to private investors. Although high interest rates are not uncommon in the microfinance industry, what sets the commercialized MFIs apart from the non-profit organizations is that the commercialized MFIs are charging the poor high interest rates and then using those profits to pay investors and high salaries for their executives. Thus, the question that is raised is, '*Are profits and poverty reduction compatible goals for MFIs?*' By examining the MDGs in Latin America this paper attempts to answer that question. Latin America is the most relevant region to this question because the commercialization of microfinance is most predominant in Latin America in comparison to other regions such as Asia, Eastern Europe, and Africa, (Berger, Goldmark, & Miller-Sanabria, 2006). According to Olsen, the commercialization of MFIs in Latin America is manifested in the form of "many formal institutions (primarily banks) are entering into the microfinance sector while NGOs are "professionalizing" to become formal lending organizations," (2010).

In answering this question, further subquestions are raised, such as "Is microfinance successful*,"* and "How is the success of microfinance measured?" Since microfinance was initially conceived by Muhammad Yunus as a way to alleviate poverty, the greatest factor in determining microfinance's success will be in its ability to alleviate poverty, followed by its ability to help countries achieve overall development. Furthermore, the ethics of commercialized MFIs is questionable, and will be further explored in the policy recommendations section.

Background

The most prominent figure in the microfinance landscape is Muhammad Yunus, founder of Grameen Bank. Both he and the bank have won numerous awards through the years, not the least of which was the Nobel Peace Prize in 2006. What has the international development community buzzing is the idea of sustainable human development that is completely self-sufficient. The idea of microfinance is that it requires very little startup capital, and that through the collection of interest rates it can actually proliferate itself, meaning that it the only funding it requires throughout its lifetime is the initial startup capital. With the accumulation of interest rates the MFIs can pay for the actual costs of dispersing the loans and have money left over to create more loans, thus becoming a self-perpetuating cycle of collecting interest and distributing loans. While this premise alone is unobjectionable, ethical questions arise when the MFIs seek their own self-interest too aggressively, or even worse, start to turn profits for private share-holders. How MFIs act often depends on how they are organized: the four primary types of MFIs are commercial banks, credit unions, non-governmental organizations (NGOs) and non-banking financial institutions (NBFIs), (Olsen, 2010).

The organization of the MFI not only affects their legal status, but also the goals of the MFI itself and the services the MFI is able and willing to offer its clients. NGOs lead the pack in terms of altruistic goals: they offer different social programs, most notably educational programs for their clients, in conjunction with offering financial services and do not seek to profit from their transactions. In contrast, commercial banks offer the least amount of social services for their clients and do seek to profit from the business of lending to the poor. The more formal a MFI is, the greater the financial services they can offer their clients, such as remittances transactions, savings, and insurance services.

MFI Structures

Since MFIs originated as non-profit NGOs, the emergence of privately owned for-profit MFIs on the microfinance landscape has caused a stir within the development community as the legitimacy of these organizations is being questioned. Turning microfinance into a profit-driven industry has become a point of contention as officials in Andhra Pradesh, a state in India, have found aggressive debt collection from SKS (an Indian MFI) accountable for the suicides of more than fifty people, (Discredited, 2010), (Polgreen & Bajaj, 2011). Aggressive debt collection entails publically shaming the debtors and threatening to cut off their life line – access to microloans and has been widely coumented, (Discredited, 2010), (Polgreen & Bajaj, 2011), (Heinemann, 2010). To avoid being cut off from future loans, a debtor might take loans from another MFI to repay the first loan, or even go to a local money-lender which may falsely give the impression of high repayment rates amongst the borrowers despite their inability to generate enough profits to legitimately pay off their debts, which is also problematic as it leads to over-indebtedness.

Over-indebtedness is a problem as there is a growing concern that microloans are not really helping the poor. High interest rates and quick repayment periods are cited as reasons why the poor are becoming over-indebted. Another leading cause of over-indebtedness is the lack of transparency in some MFIs where clients are charged hidden fees such as processing fees which are not factored into the APR and are difficult for iliterate and ilnumerate customers, (Brix & McKee, 2010).

An incalcitrant reaction to the questionable practices employed is the *Movimiento No Pago* or *No-pay Movement*, in Nicaragua, which encourages debtors to default on loans. The significance of this movement is that, "The No Pago movement in Nicaragua has protested against the high interest rates of micro-finance loans, arguing that such high interest rates are unfair, especially for loans intended for the poor," (Srinivas, 2010). There are three vulnerabilities in the microfinance sector which lead to the repayment crises, such as the one in Nicaragua: lending concentration and multiple borrowing; overstretched MFI capacity; and a loss of MFI credit discipline, (Chen, Rasmussen, & Reille, 2010).

The sources of funding of MFIs in Latin America are varied. As previously stated, there are four main types of MFIs, which are: private banks, credit unions, NGOs and (NBFIs). Funding may come from inter-governmental organizations, such as the UN; non-profit, non-governmental organizations such as ACCION International, Grameen Bank; philanthropists; or private investors. According to one source, "a large and growing proportion of NGO finance comes, directly or indirectly, either from donor governments and multilateral banks or, in developing countries, from their own governments. The World Bank's recently announced Consultative Group to Assist the Poorest will provide $ 200 million or more from bilateral and multilateral donors to NGO microfinance programs in the South," (Streeten, 1997). In the beginning of microfinance movement, funding was mainly available through NGOs, such as ACCION. Over time, MFIs have become attractive investment opportunities to private investors, since an average interest rate for a microloan is approximately 82% (Partida, 2008).

One reason that microloans are such an attractive investment opportunity for the private sector is their astonishingly high repayment rates. One study found that less than .5% of a particular Mexican microfinance portfolio had outstanding loans, which is to say, loans that# were 90 days or more over due, (Wollini, 2001). Given the successful rate of repayment for microloans, which means little to no risk for investors, it is then no wonder that "socially responsible investors are already pouring in. And even the purely profit-minded have begun to open their wallets. According to a study of 200 microlenders by MIX, which collects data on the microfinance industry, commercial funding grew to $7.3 billion in 2005, from $4.9 billion two years before," (Economics focus | Small loans and big ambitions., 2007). In fact, MFIs have become such attractive investment opportunities, TIAA-CREF purchased $ 43 million of stock in a global microfinance fund in September 2006, (Roepcke, 2008).

Compartamos

The MFI which sparked the debate in the microfinance community over the ethics of charging clients high interest rates in order to create a profit for private investors is Compartamos, a Mexican bank. Compartamos currently boasts the largest number of active borrowers of all MFIs in Mexico, with 1,503,006 clients, however, does not have the largest gross loan portfolio in the country, which means that Compartamos serves smaller loans – on average $384, (Microfinance Information eXchange, 2009). Compartamos had its humble origins as a charitable non-profit NGO and later became a privately-held, profit-turning corporation. According to the New York Times:

> In the past several years, Citigroup and its subsidiary Banamex raised seventy million dollars in the capital markets for the Acción affiliate Compartamos…. This June, Compartamos became a fully regulated bank. "The only way to have massive impact is to do it profitably," Compartamos's co-C.E.O. Carlos Labarthe declared. "As an N.G.O., getting donations, we were not able to grow. But when you are able to go to the market, then the sky's the limit." Labarthe said that Compartamos now has access to two hundred million dollars in the market. In five years, he predicted, eighty to ninety per cent of all microfinance institutions will be for-profit institutions. (Bruck, 2006).

The case of Compartamos is indicative of a growing trend in microfinance, which is the shift from a charitable NGO to a private organization which has share-holders to answer to. With this change in financing and organizational structure comes an inherent change in the objective of these MFIs. Moving from being people-oriented to being profit-driven, the privatization and commercialization of NGO MFIs means that development goals will take a back seat profit goals. Ostensibly, it is in the NGO’s best interest to become a for-profit corporation, in order to secure more funds to distribute via loans to the poor, however, it remains to be seen if a for-profit corporation can exist while simultaneously advancing sustainable human development and profit-driven goals.

Compartamos has become a profitable MFI in Mexico, and originated through a pilot project of Gente Nueva, a large Mexican NGO, in 1990, (Wollini, 2001). By 2000, the transfer of Compartamos from an NGO subsidiary to a fully commercialized financial institution had occurred, and the newly formed financial institution was the product of an initial investment pool of $6 million, “generated from International Finance Corporation (IFC is a public finance institution associated with the World Bank), ACCION, a large American network of NGOs, Gateway fund, Profund, the Compartamos NGO itself and other private

Mexican investors," (Aitken, 2010). This transformation from a non-profit to for profit organization in 2000 allowed Compartamos to obtain commercial funds since non-profit organizations in Mexico are not permitted to access commercial sources of funding, (Wollini, 2001). Ostensibly, Compartamos is now able to provide better and more extensive financial services, which is, theoretically, the best possible outcome for the economically disadvantaged people who have come to rely on Compartamos. However, this is not necessarily the case as we will see later.

The coup de grâce of Compartamos' non-profit NGO origins occurred in the spring of 2007, when Compartamos completed an IPO which put a 30 per cent stake of its operations on the Mexican stock exchange. When Compartamos' stock was put on the market, it became an overwhelming success. To put it in perspective, consider:

> …Even Compartamos's managing directors were surprised when the IPO was more than 13 times oversubscribed, resulting in the share price jumping by 32.2 percent on the first day and raising capital of US$458 million. The positive market reaction was based on Compartamos's exceptional 2006–07 financial performance: the company reported a return on equity of 38.4 percent, a return on assets of 17.2 percent, nonperforming loans of only 1.4 percent of the portfolio, and profits of $80 million, and had seen its loan portfolio grow at a double-digit rate for several years. For comparison, in 2007 most private commercial Mexican banks averaged a return on equity of 15 percent, and self-sufficient Mexican financial organizations averaged a return on assets of 5.5 percent. To achieve its superior results, Compartamos's leadership had pursued a policy of high interest rates on its lending (annualized rates averaged 90 percent) coupled with high profit retention. (Campion, Ekka, & Wenner, 2010)

In short, between the high interest rates Compartamos charges its clients, combined with the high rates of repayment, Compartamos' stock is extremely attractive to investors.

Currently, Compartamos has lent US$ 316 million in microloans to some 765,000 clients, which is comprised mostly of poor women, (Aitken, 2010).

Today, the main product offered by Compartamos is the Income Generator Loan (IGL), which charges approximately eighty-two percent interest, and targets the working capital needs of microbusiness owners (mostly women), (Partida, 2008). The typical Compartamos borrower has no credit history, the loan balance is small, with an average of US $41.3 transaction costs are high and the default rates are low, (Partida, 2008).

Theoretical Framework

Microfinance has been touted as a solution to underdevelopment by neo-liberals because it fits nicely with the neo-liberal world view; it advocates self-sufficiency and free-market capitalism. It has been a predominantly neo-liberal response to underdevelopment in so far as the microfinance sector remains largely unregulated and it is argued that government intervention of any kind will hurt the industry, (Campion, Ekka, & Wenner, 2010). According to Campion, Ekka, & Wenner, under the auspices of the Inter-American Development Bank, in their interviews of MFI managers they found that "competition was often the largest factor in determining the interest rates they charged." However, this has not proven to be true as MFIs in Mexico reported that only three out of thirty-four MFIs had operating expenses equal to fifteen percent of their portfolio or less, while the majority of MFIs reported operating expenses equal to thirty percent or more, with some even reporting operating expenses as high as one hundred and thirty-four percent of their loan portfolio, (Microfinance Information eXchange, 2009). Government regulations such as the

Nicaraguan government's intervention as called for by the No Pago Movimiento, interest caps, and transparency requirements have been widely critiqued, fostering a laissez faire environment desirable to neo-liberal economics.

Neo-liberalism

According to Chang, "Liberal economists of the 18th and 19th centuries believed that unlimited competition in the free market was the best way… because it forces everyone to perform with maximum efficiency," and "Neo-liberal economists support things that the old liberals did not – most notably certain forms of monopolies (such as patents or the central bank's monopoly over the issue of bank notes)," (Chang, 2007). Furthermore, he writes, "Unleashing more market forces through deregulation, as the neo-liberal orthodoxy constantly pushes for, may worsen the situation," (Chang, 2007). This post-Keynesian assessment of neo-liberalism provides a reason as to why microfinance may not be an appropriate response to underdevelopment. Another criticism of neo-liberalism that is offered is that neo-liberalism is, "An ideology premised on the infallibility of self-regulated financial markets, private ownership and unrestrained individual self-interest collapsed in late 2008 just as spectacularly as the Berlin Wall and communism fell at the end of 1989," (Bateman, 2010). Part of the neo-liberal myth of microfinance is that, "microfinance helps start or expand an income-generating microenterprise," (Bateman, 2010) which is why microfinance looks like a positive tool in fighting poverty and working towards the MDGs. However, the most recent research suggests that microfinance is not being used to invest in microenterprises, but instead are largely used for consumption smoothing, (Banerjeey, Duflo, Glennerster, & Kinnan, 2009), (Bateman & Chang, The Microfinance Illusion, 2009), (Dichter, 2010).

As Bateman and Chang explain, microfinance is steeped in ideology, and:

> "microfinance is actually almost perfectly in tune with the core doctrines of neoliberalism, the reigning ideology of our time: that is, the need to vector all economic activity through private individual initiative; the need to avoid any aspect of planning or conscious guidance of the market mechanism; the need for all institutions to attempt to 'earn their keep on the market'; and, the need to ensure that all economic organizations are also as much as possible owned and controlled by the private sector," (2009).

This is a paradox of neo-liberal economic approach to a social and political problem embraced by liberals which is difficult to untangle since both sides are highly invested in their respective angles of microfinance.

Criticisms of Muhammed Yunus, the man most readily associated with microfinance, come from both the left and right of the political spectrum: "Those to the left would argue that the economist is selling "free market" neo-liberalism in the guise of liberal do-gooderism. Right-wing libertarians, in contrast, contend that he is peddling communitarian snake oil in a business-friendly container," (Engler, 2009).). A particularly poignant criticism of Yunus which has considerably tarnished his reputation in the development community comes from a documentary released in 2010, "Caught in Micro Debt." This documentary shows documents in which Yunus asked for assistance from the Norwegian aid agency, Norad, in transferring assets from Grameen Bank to a sister company, Grameen Kaylan, and most notably, interviews with clients from Bangladesh who revealed that the overwhelming majority of them had not been helped by Grameen Bank, but may even be worse off because of the loans. As a result of this documentary being released, the Bangladesh government has called for Yunus to step down from his position at Grameen Bank, although it remains unclear whether the movement to oust him from his position was politically motivated[1] or not, (US and France lament exit of Grameen's Muhammad Yunus, 2011).

The Neoliberal case for MFIs' success in achieving its goals

There is a case for MFIs as positive tools in attaining some of the MDGs. While the primary economic benchmarks of success of MFIs are quantifiable aspects, such as increased household consumption, increased GDP, etc., proponents of microfinance would point to the secondary indicators of the success of microfinance, such as increasing the educational attainment of children, enfranchising the poor, providing better access to healthcare, and women's empowerment.

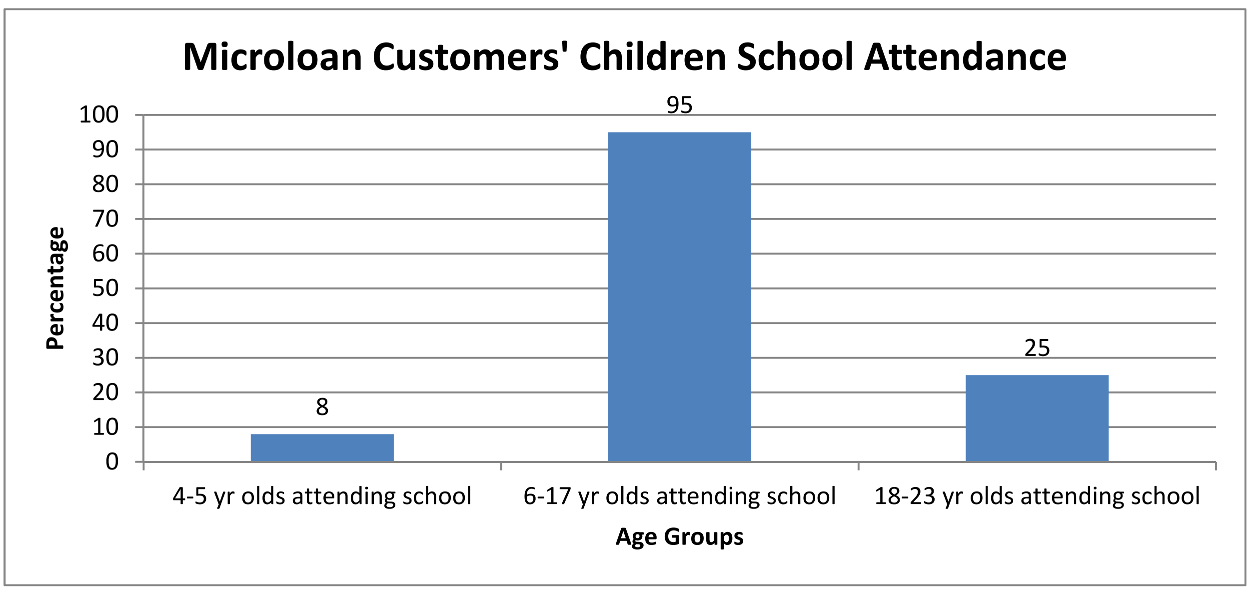
Women's empowerment has been a cornerstone of microfinance from its inception. It is believed that women's societal roles as caretakers make them more apt to reinvest their money in their families, meaning that wealth is more evenly distributed amongst family members, (Yunus, Banker to the Poor, 1999). Specifically, "A finding of many studies of women's vs. men's decisions is that women spend more on child health and education," (Banerjeey, Duflo, Glennerster, & Kinnan, 2009). As such, women are the largest recipients of microloans – in Nicaragua, small convenience stores, known as pulperias, which are

[1] Yunus is said to have lost favor with "Bangladesh's Prime Minister Sheikh Hasina after trying to launch his own political party in 2007," (US and France lament exit of Grameen's Muhammad Yunus, 2011).

iconic small, income-generating enterprises in the Latin American landscape, are roughly seventy-percent female owned, (Pisani & Yoskowitz, 2010). In the case of Nicaragua, approximately sixty-one percent of microloans in 2009 went to women borrowers, (Microfinance Information eXchange, 2009), which has given women economic opportunities they previously would not have had.

Although there is not substantial quantitative data to suggest that microfinance negatively effects educational attainment, it is worth noting that there is evidence that it can and has, (Holland & Wang, 2011).

Figure 1. Microloan Customers' Children School Attendance.



Source: (Holland & Wang, 2011)

From a neo-liberal perspective, it is argued that "the 'success' of microfinance was overwhelmingly judged on the basis of the financial sustainability of the MFI itself: that microfinance made a positive development and poverty reduction impact within the local community was assumed as given," (Bateman & Chang, 2009). This belief that the success of MFIs is defined by its ability to proliferate is misguided and represents the mission drift problem that microfinance faces. Since microfinance was conceived as a response to poverty (Yunus, 1999), the success of microfinance cannot be measured in terms of its own ability to proliferate, but must be defined in terms relative to poverty. Results are reflected in reflected in absolute values, such as the number of people living under $1 per day in purchasing power parity, or the literacy rate in a country, to name a few examples.

Furthermore, this neo-liberal perspective of microfinance is inherently flawed in that capitalism and the free market assume that the poor are poor for a reason. Capitalism echoes sentiments of social Darwinism which would imply that those who are less economically secure are so because they are not as resourceful as those who are more economically secure. As Morduch and Haley point out, "Microfinance is not for everyone. Most importantly, entrepreneurial skills and ability are necessary to run a successful microenterprise and not all potential customers are equally able to take on debt," (2002). What the neo-liberal perspective of microfinance fails to consider that not all people have entrepreneurial talents. As such, it is unrealistic to assume that microfinance can be a solution to poverty for everyone.

The Post-Keynesian case against MFI's ability to achieve its goals

According to the neo-liberal narrative of microfinance, microloans are used by the poor make their entrepreneurial endeavors come to fruition, and provide borrowers with more economical interest rates than that of the local usurious money-lenders. However, there is research indicating that much of the microloans borrowers receive are used in consumption-smoothing, (Bateman, 2010) (Dichter, 2010) (Littlefield & Morduch, 2003). Consumption-smoothing is the process by which microloans are used to make ends meet, and although critical for survival -- is not sustainable, (Dichter, 2010). More importantly, consumption-smoothing is not a profit-generating activity and in fact borrows against future income.

Another argument against the success of microfinance is that household consumption is not necessarily indicative of an overall increase or decrease in household income, (Dichter, 2010). It has been theorized that microloans largely serve as a last resort because they are used for “"consumption smoothing"—the use of loans to iron out the bumps that occur when a poor family needs cash for an emergency, or their use for a social event perceived as obligatory (weddings, funerals, etc.),” (Dichter, 2010). Banerjee *et al*. posits:

> “…It is possible that in the longer run these people who are currently cutting back consumption to enable greater investment will become significantly richer and increase their consumption. On the other hand, the segment of the population that increased its consumption when it got the loan without starting a business may eventually become poorer because it is borrowing against is future, though it is also possible that they are just enjoying the "income effect" of having paid down their debt to the money-lender (in which case they are richer now and perhaps will continue to be richer in the future),” (Banerjeey, Duflo, Glennerster, & Kinnan, 2009)

The scenarios offered here are plausible and question the validity of studies which have shown that microfinance has had a positive overall effect on household consumption. While household consumption may have increased, it is not necessarily correlated to a higher quality of life for poor households.

Even if microloans are successfully used in cultivating entrepreneurship amongst the poor, this may not necessarily produce desirable outcomes. One study by Maldonado and Gonzalez-Vega found that:

> "In particular, for some ranges of household income and some types of borrowers, access to MFIs may have conflicting impacts on schooling gaps. On the one hand, microfinance may increase the demand for education as a result of income, risk-management, gender, and information effects. On the other hand, credit-constrained households that cultivate land may discover new demands for child labor for farming (or perhaps taking care of siblings while the mothers operate a new or expanded business). Significant program and policy consequences are derived from these paradoxical results," (Maldonado & Gonzalez-Vega, 2008)

Accordingly, the success of any small business owner with a microloan could have the unintended consequence of creating more work for the children of a family.

Overall, the case that microfinance is not working as a tool for reducing poverty and increasing development is stronger than that for microfinance's success. According to Bateman and Chang, "Many of the supposed positive impacts we find to be quite illusory or, at the very least, hugely exaggerated," (Bateman & Chang, The Microfinance Illusion, 2009). Another critique of microfinance's long-term success is:

> …It is possible that in the longer run these people who are currently cutting back consumption to enable greater investment will become significantly richer and increase their consumption. On the other hand, the segment of the population that increased its consumption when it got the loan without starting a business may eventually become poorer because it is borrowing against is future, though it is also possible that they are just enjoying the "income effect" of having paid down their debt to the money-lender (in which case they are richer now and perhaps will continue to be richer in the future), (Banerjeey, Duflo, Glennerster, & Kinnan, 2009)

What this means for proponents of microfinance is that the studies which use increased household consumption as an indicator of microfinance's success may be too quick to link an effect (increased household income) to a causation (the efficacy of microfinance). Furthermore, Banerjeey, *et al.*, found that women in an area where MFIs had become available were women in treatment areas were "no more likely to be make decisions about household spending, investment, savings, or education…. spend no more on medical and sanitation (e.g. soap)…. [and are] not more likely to have children in school," (2009).

While proponents of microfinance may argue that poverty reduction may not be an immediate result of successful MFIs, the secondary characteristics of efficacy are not strong enough to make the case for the efficacy of microfinance. The neo-liberal approach to microfinance has been to maximize profits for the sake of maximizing the most people that can be reached by microfinance, however, this approach simply touts microfinance for the sake of microfinance. With only the goal of sustainability and proliferation of itself, microfinance from this neo-liberal approach fails to meet its incipient goal which is to alleviate poverty. According to the neo-liberal approach, the microfinance industry merely has to be self-sufficient and thriving, and the rest will fall into place, (Bateman & Chang, 2009). However, even by these standards, it would seem that the commercialization of microfinance is counter-productive to its purported goal of proliferation as profits diverted to investors are profits which cannot be reinvested into more loans for the poor.

These two goals of microfinance, that of proliferation of microfinance as a means to the end of poverty, and that of end of poverty in itself are divergent. Although both claim to ultimately be after the same ends (poverty reduction) the former tends to emphasize its existence as an end in itself so much so that it has become separated from the original goal of poverty reduction. When MFIs are focused on maximizing profits so they can remain operation and expand their presence, they start to lose sight of the original goal which was poverty reduction. Although neo-liberals make a good argument that helping the largest amount of people serves the greater good, they mistakenly assume that all microloans are beneficial, and that is simply not the case. A loan which comes with a one-hundred and twenty percent APR does not benefit the poor, even if those profits are directly reinvested in reaching more people through microfinance. Instead, what this does is create a proliferation of debt amongst the poor who are already struggling to eke out an existence. Furthermore, "the commercialization of microfinance has got into its stride over the last ten years or so, its own practitioners agree that the average commercialized MFI has begun to veer significantly off course," (Bateman, 2010).

Even when MFIs are charging interest rates as much as eighty-six percent a year, and yielding returns on equity above fifty percent per year, (Consultative Group to Assist the Poor, 2007) neo-liberal policies are still reticent to react to the reality of usurious interest rates. In reflecting on the mission drift of Compartamos, the Consultative Group to Assist the Poor (CGAP) released a statement writing:

> Our 1996 grant of US$2 million to the Compartamos NGO included no covenants about future interest rates or profit levels. Such covenants would probably have been inappropriate or impractical for a number of reasons, but in truth we never gave much consideration to the possibility that Compartamos would be charging such interest rates, and generating such profits, ten years later, after private investors had been brought into the picture. We thought the motivations of the early leaders, or at least eventual competition, would keep things in reasonable bounds. We still hope--indeed expect--that competition will reduce rates and profits in the sector, as discussed above. But it is taking a long time, (Consultative Group to Assist the Poor, 2007).

What is worth noting in this statement is that although they acknowledge that the current system is not operating as they anticipated, they are still unwilling to adopt a new strategy to fix the problem of high-interest rates and fat profit margins at the expense of the poor who they are supposed to serve. Instead, CGAP takes a wait-and-see approach.

Although various arguments could be made that household consumption, the amount of microloans in circulation, etc. are indicators of the success of microfinance, the goal of microfinance, and MFIs has always been to help the poor by giving them the opportunity to have income-generating enterprises. As such, the success of the MDGs in Latin America is a useful determinant.

Critical Analysis

Of the twenty countries in the Latin American region, four have been chosen here for the diversity they represent: the Dominican Republic, Nicaragua, Mexico, and Peru have progressively larger microfinance sectors respectively. To put this in perspective, the Dominican Republic has a gross loan portfolio of 224.2 million; Nicaragua has a gross loan portfolio of 472.3 million; Mexico has a gross loan portfolio of 2.7 billion; and Peru has a gross loan portfolio of 5.4 billion, as of 2009, (Microfinance Information eXchange). The development of these countries also shows a high level of variance: Mexico is ranked 56 on the United Nations Human Development Index (UN HDI); Peru is ranked 63; Dominican Republic 88; and Nicaragua 115, (United Nations, 2010). The variance amongst these countries is representative of the region as a whole, which is why this paper will focus on the Dominican Republic, Mexico, Nicaragua, and Peru.

One indicator of how successful microfinance has been in achieving the MDGs is the Proportion of population below $1 (PPP) per day. Specifically, we will look at the proportion of population living below one dollar (PPP) per day in four Latin American countries with diverse microfinance backgrounds.

Figure 2. Proportion of population living below $1 (PPP) per day.

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008
Dominican Republic			4.6%				5.9%	6.7%			4.4%			6.1%		5 %	4 %	4.4%	
Mexico			4.5%		3.3%		7 %		8 %		4.8%		3.7%		2.8%		2 %		4 %
Nicaragua				32.5%					21.8%			19.4%				15.8%			
Peru	2%				5.7%		8.6%					15.1%	12.6%			8.2%	7.9%	7.7%	

Source: UN MDG -- http://mdgs.un.org/unsd/mdg/Data.aspx

As evidenced in Figure 2, only one of the four countries examined showed an overall trend towards poverty reduction. That country, Nicaragua, started at an unusually high percentage of people living below one dollar a day, and as last recorded in 2005, has almost sixteen percent of its population living below one dollar a day, which is higher than any other countries' from 1990-2008. As previously noted, Nicaragua still remains one of the least developed nation in the region aside from Haiti. The data suggests that there is no visible trend towards poverty reduction in these countries which have thriving microfinance sectors.

Furthermore, when looking at the Average Cost Per Borrower (ACPB), defined as “Operating Expense/ Number of Active Borrowers, average,” (Microfinance Information eXchange, 2009) in our four sample countries over a ten year period, an interesting dichotomy emerges. First, you will note that the absolute value of the ACPB decreases over time except in the case of Peru, the country which represents a highly regulated microfinance industry. This finding runs contrary to the anticipated outcome: that a highly regulated microfinance industry would lower borrowing costs when fees are not being surreptitiously added to unsuspecting consumers and MFIs are being disbarred from charging usurious interest rates. However, when the ACPB is viewed as a percentage of the Average Loan Balance Per Borrower (ALBPB), defined as “Loan Portfolio, Gross / Number of Active Borrowers,” (Microfinance Information eXchange) a different picture emerges – one in which Mexico, representative of a commercialized microfinance industry, has an increase in the percent of ALBPB of ACPB. Although a cursory glance at Figure 3 would suggest that the ACPB has decreased over time in Mexico because Mexico’s free market is able to regulate the ACPB, the Percent of the ACPB of the ALBPB has actually increased over time in Mexico, while it has decreased over the ten year period in Peru, the country representative of a highly regulated microfinance industry.

Figure 3. Costs of Microloans Over Ten Year Period.

	Dominican Republic '99	Dominican Republic '09	Mexico '99	Mexico '09	Peru '99	Peru '09	Nicaragua '99	Nicaragua '09
Average Loan Balance Per Borrower	$529	$716	$709	$499	$997	$1,562	$529	$1,046
Average Cost Per Borrower	$245	$206	$248	$193	$168	$211	$245	$159
Percent of Average Cost Per Borrower of Average Loan Balance	46%	29%	35%	39%	28%	14%	46%	15%

Source: Microfinance Information eXchange – http://www.mixmarket.org/mfi/country/

In determining the fairness of high interest rates, Hudon writes that there are four approaches: deontological arguments; examining the question through the marginal impact on the client's financial situation; market-based and focusing on the demand for credit; and suggest a procedural definition of fair interest rates based on the fair wage literature, (Hudon, 2007). Of the four approaches, the one which is most useful is the second, which "addresses the fairness issue by assessing the amelioration or worsening of the client's situation," (Hudon, 2007). This is the most relevant approach because it directly focuses on the financial situation of the micro-borrower for whom the benefit of microfinance should be.

The third approach, the market-based approach, is inherently flawed because it assumes that the proliferation of microloans is a sign that the interest rates are fair: "It uses high repayment rates and repetitive loans as instrumental proxies of fairness," (Hudon, 2007). This assumption that repeat business correlates to fairness is inaccurate because it does not take into account how destitute the poor are, and is a neo-liberal perspective because it believes in that the clients, like the economy as a whole, will only support fair options, *e.g.* the market will regulate itself. Although many MFIs seek to expand their market in rural areas, there is no guarantee that rural areas are covered by multiple MFIs which would allow for competition. Unfortunately, this market-based approach is one that is most often used to justify high interest rates.

Policy recommendations

While neo-liberal economic theory argues that the rates of interest charged on microloans will regulate itself, the poor are often not in a position to seek out better services, and they cannot indefinitely hope to for the market to regulate itself. As many micro-borrowers are located in rural areas, they are hindered by a lack of physical mobility and may be illiterate or poorly literate, which may be a contributing factor to why neo-liberal economic theory does not work in this instance. Another issue which may arise from taking a neo-liberal approach to microfinance is an issue of oversaturation. Specifically the practice of giving out loans, often with little to no risk assessment, may oversaturate the microfinance market. The neo-liberal approach to microfinance would call for as many loans to be created as possible for the sake of proliferating loans, and sustaining the MFIs. However, this practice could become too successful in that clients will become over-indebted as MFIs race to create as many microloans as possible, without regard for the feasibility of paying loans back and generating profits for the clients. As such, these obstacles can lead to a very niche market in which a few institutions do not allow for a free market to prevail.

There are several issues which need to be addressed in the microfinance industry. If microfinance is to be used as a development tool, it needs to be regulated in a way that will allow for microfinance to serve as the best possible tool it can be. For this to happen, microfinance needs to be streamlined, meaning that for profit MFIs with bloated interest rates and fees that are accommodating shareholders must be eliminated. Even MFIs that are non-profit, but generate profits for the purposes of proliferation need to be re-examined since the goal of microfinance is not to create more MFIs, or to create the most loans, but to create the biggest positive impact on development.

One of the biggest issues in microfinance is the transparency of the terms of loans: consumers cannot make informed decisions about loans without this transparency. This is particularly important since microloans are aimed towards the poor, and with poverty, lack of education go hand-in-hand. Since borrowers are the poorest of the poor, they have not had a robust access to education, and may be illiterate or poorly literate. Borrowers need to be able to understand the terms of their loans so that they can maximize their profits by picking the lowest cost loans available to them. According to a study done by Campion, *et al.*, "The interviews show that clients have a limited understanding of interest rates and focus more on their monthly payment schedules," (Campion, Ekka, & Wenner, 2010). This shows that there is a need not only for more sophisticated educations amongst the interviewees, but also a need to protect these consumers because of their lack of understanding, most likely due to their lack of education.

In fact, one of the most often cited critiques of microloans is the lack of transparency they have, even in heavily regulated markets, such as Peru and Bolivia. Even though interest rate caps may be applicable within a state, MFIs can find ways around this by creating various processing fees for loans. A survey of clients of two MFIs in India found that the majority of respondents could not identify the interest rates on their loans due to their lack of education and the lack of transparency in their loans, (Tiwari, Khandelwal, & Ramji, 2008).

To further protect these consumers, who may be easily exploited due to their lack of understanding/education of loans, government regulations are needed to protect this vulnerable group, and should be created to cap interest rates. It is unacceptable for commercialized banks like Compartamos to charge the poor high interest rates and then turn around to pay investors profits which are the ill-conceived fruits generated from outrageous interest rates. The rationalization for charging high interest rates, that MFIs need to generate profits in order to have the funds available to loan out even more money, grossly misses the point of microfinance and microloans as made popular by Mohammed Yunus, which is to alleviate poverty. In order to alleviate poverty, the entrepreneurial poor who are taking out microloans to fund their businesses need to be able to keep as much of their profits as possible. Paying high interest rates directly cuts into a borrower's profits, and is inexcusable given that the poor are struggling to eke out an existence.

While having the funds to loan even more poor people life-saving microloans sounds good in theory, it is not a realistic approach to poverty reduction. Charging high interest rates in order to create a surplus of capital for the sake of creating more loans is an inane cycle that will not alleviate poverty because everyone will be paying high interest rates. Administering microloans with high interest rates will only lead to indebtedness which is a step in the opposite direction of where microfinance should be going – helping people out of poverty.

One suggestion for microfinance reform from the Inter-American Development Bank is that regulations in the microfinance industry are necessary, and "should be guided by three principles: flexibility, simplicity, and automaticity—flexibility in interest rates, collateral and internal credit processes; simplicity in client documentation, loan delinquency and recuperation of collateral; and automaticity in portfolio classification, loan loss provisions and write-offs," (2002). These more moderate regulations, it is argued, "provide room for innovation, lower the regulatory costs of compliance and subject microlending to a strict recognition of revenues, expenses and risks," (Jansson, 2002). Whether a more moderate or aggressive reform approach is taken, reforms are undeniably necessary.

While the aforementioned reforms to the microfinance aimed at streamlining microfinance as a development tool may make microfinance a better poverty alleviation tool, microfinance is still not meant to be seen as a unilateral approach to development. That is to say, resources still need to be allocated towards development programs, and most importantly towards education. Microfinance does not occur in a vacuum, and if microfinance is to succeed in poverty alleviation, the right climate for microfinance needs to be created. Micro-entrepreneurs cannot be expected to sell all of their services in in their local villages and as such need access to larger markets. Accessing larger markets is achieved through investing in infrastructure, such as roads and telecommunications. Needs for infrastructure and education cannot be met through microfinance alone, which intergovernmental organizations like the World Bank, and the Inter-American Development Bank should take into consideration when allocating funds.

Conclusion

With the advent of the commercialization of microfinance, the most serious issue the microfinance industry faces today is mission drift. According to Milford Bateman in his book *Why Microfinance Doesn't Work*, "converting MFIs into straightforward profit-seeking businesses inevitably means that there is always a loss, often a complete loss, of the original social mission," (2010). Because the original mission statement of MFIs was to help alleviate poverty through sustainable loans for entrepreneurial activities, profiting from microfinance services is problematic in that profits are generated through higher interest rates and service charges which could be lowered in order to put that money directly back where it is most needed: in the hands of the poor. While a certain amount of profit is necessary for MFIs to proliferate and sustain themselves, turning profits for private investors creates a huge mission drift in the original intention of the microfinance industry.

In Yunus' book, *Creating a World Without Poverty*, he addresses the rationalizations for charging high interest rates, such as the believe that profits are needed to proliferate microloans, and that both investors and borrowers can benefit from loans which charge interest rates that are high enough to generate profits, (Yunus & Weber, 2007). In the book, he writes, "I have serious problems when people try to justify high interest rates (30 percent real interest and above) and even very high interest rates (over 70 percent) on loans given to the poor…. Microcredit was created to protect the people from moneylenders, not to create more moneylenders," (2007). These are very real concerns that the microfinance industry faces today.

In order for microloans to have a positive impact in the lives of the poor, it has to be given the best chance to work, which means interest rates need to be minimized so that borrowers can maximize their profits. Making microloans accessible to more people is useless if microloans come with unbearably high interest rates which drain profits from the poor. Similarly, microloans which charge high interest rates for the purpose of creating profits for private investors is an abomination, and is predatory since many micro-borrowers are uneducated or poorly educated.

As with any industry, regulations are needed, but in the case of microfinance, regulations are particularly imperative because vulnerable populations are at risk. Since Muhammed Yunus' originally envisioned microfinance as a way out from under the thumb of usurious local money lenders, it then stands to reason that usurious international money lenders are to be avoided as well. To keep interest rates reasonable, regulations are needed since the market has failed to regulate itself.

Furthermore, as previously indicated, it is unrealistic to expect that every person living in poverty has the skills required to be entrepreneurial and economically successful. Those living in poverty face more challenges than those who are not living in poverty, such as limited access to education, limited access to the global economy, and are often more sensitive to economic setbacks, such as costs associated with funerals, weddings, natural disasters, etc. As such, the viability of these microfinance programs needs to be re-examined. It remains unseen if microfinance in its originally intended form, that as a tool of poverty reduction, can really work. Unfortunately, at the present time, the pressure to privatize and become commercialized has forced many MFIs into a serious mission drift dilemma in which the needs of the poor are overlooked in favor of the needs of private investors.

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