EVALUATING EFFICACY: FROM COMMERCIALIZATION FORWARD, UNDERSTANDING MICROFINANCE INSTITUTIONS IN EVOLVING CENTRAL AMERICAN MARKETS

By

DANIELLE CHRISTINE DESANTIS

A Thesis Submitted to The Honors College

In Partial Fulfillment of the Bachelors degree
With Honors in

Interdisciplinary International Studies

THE UNIVERSITY OF ARIZONA

May 2 0 1 0

Approved by:

Dr. Wayne Decker
International Studies

The University of Arizona Electronic Theses and Dissertations Reproduction and Distribution Rights Form

Name (Last, First, Middle) DeSantis, Danielle, Christine

Degree title (eg BA, BS, BSE, BSB, BFA): BA

Honors area (eg Molecular and Cellular Biology, English, Studio Art): International Studies

Date thesis submitted to Honors College: May 4, 2010

Title of Honors thesis:

Evaluating Efficacy: From Commercialization Forward, Understanding Microfinance Institutions in Evolving Central American Markets

:The University of Arizona Library Release	I hereby grant to the University of Arizona Library the nonexclusive worldwide right to reproduce and distribute my dissertation or thesis and abstract (herein, the "licensed materials"), in whole or in part, in any and all media of distribution and in any format in existence now or developed in the future. I represent and warrant to the University of Arizona that the licensed materials are my original work, that I am the sole owner of all rights in and to the licensed materials, and that none of the licensed materials infringe or violate the rights of others. I further represent that I have obtained all necessary rights to permit the University of Arizona Library to reproduce and distribute any nonpublic third party software necessary to access, display, run or print my dissertation or thesis. I acknowledge that University of Arizona Library may elect not to distribute my dissertation or thesis in digital format if, in its reasonable judgment, it believes all such rights have not been secured. . Signed: Danielle DeSantis Date: 5/4/10

Last updated: Nov 15, 2009

This work is dedicated to my ever-supportive parents, Mark and Paula DeSantis, to Robert—my sanity in times of crisis—and to my J's. I could never have finished without all of you.

TABLE OF CONTENTS

LIST OF FIGURES

ABSTRACT

Given the increasing commercialization of the Latin American, and specifically, Central American microfinance sector, this paper seeks to analyze the efficacy of various types of microfinance institutions in order to identify which organizations investors can expect to have the most impact on poverty alleviation in the coming decade. In the process of measuring efficacy, it became clear that microfinance organizations must balance two contradicting goals: depth of outreach and sustainability—which must be measured using household impact assessments and portfolio assessments, respectively. This paper examines two influential MFIs, a bank and an NGO in two Central American countries, in order to determine which organization is most efficient, and thereby, worthy of investment. These profiles demonstrate that banks and NGOs serve separate niches within the microfinance sector, offering different services and servicing different loan sizes, and, therefore, should be able to coexist within the Central American microfinance sector. Looking forward, there will be successful and not successful MFIs of both types—NGOs and commercial banks. A successful institution will balance these two goals of outreach and sustainability, and to that end, will be willing to continually innovate and reassess their practices—and particularly, will incorporate lessons learned from the experience of their competitors.

I. Introduction: The Roots of Microfinance

When Muhammad Yunus, a Bangledeshi banker and economist, first began circulating microfinance loans in the late 1970s, the driving principal was one of inclusion. Microfinance, conceptually, is about incorporating people into the formal economy who are otherwise too poor to register attention from traditional commercial banks. The idea was, essentially, that a small loan would allow those in poverty to access the initial capital necessary to enter the market and begin making profits, which, once applied on a large scale, could lead to "development" in a region. Or, as Hiatt describes the process, "microcredit appears to improve the lives of those who are poor by increasing their buying and investing capability, thus lifting them onto a higher economic plane."[1]

Muhammad Yunus defines poverty as "that characteristic of being in a state of joblessness, illiteracy, landlessness, homelessness, lack of adequate capital, facilities and food to earn a decent living and also powerlessness."[2] He believed poverty, by definition, to be directly correlated to a lack of resource capital. The logic that follows is that "if access to credit can be improved [...] the poor can finance productive activities that will allow income growth, provided there are no other binding constraints."[3]

Thus, Yunus founded Grameen Bank as an "experimental research project providing credit to the rural poor."[4] Grameen Bank operated in rural Bangledesh, issuing small scale loans to groups made of up five individuals that had self-selected to work together. Each member then

---

[1] Shon R. Hiatt and Warner P. Woodworth, "Poverty through Microfinance: Village Banking Outcome in Central America," *The Social Science Journal* 43 (2006): 476.
[2] Nikhil Chandra Shil, "Micro Finance for Poverty Alleviation: A Commercialized View," *International Journal of Economics and Finance* 1.2 (August 2009): 191.
[3] Heather Montgomery and John Weiss, "Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America," (ADB Institute Research Paper Series, no. 63, February 2005): 5.
[4] Montgomery and Weiss, "Great Expectations," 2.

"identifies the purpose of his or her loan with guidance from the other members of the group."[5] These borrowers attend a training program during which they are informed of the Bank's rules and regulations. Each group member is responsible for the entirety of the loan amount in the case that another group member defaults. This reinforced repayment of the loan and deterred free riders. Also, as Shil explains, Grameen Bank adopted a model "of providing individual loans to a target group of poor households, rather than providing loans for group projects which suffered from a free rider problem."[6] The loans are repaid in weekly installments over the next year with an interest rate of 20 percent per annum.[7] This model has since become the basis of successful microfinance institutions all over the developing world.

Though initially "driven by a strong sense of developmental idealism," Grameen Bank has become the epitome of a thriving microfinance institution.[8] Large multilateral organizations such as the World Bank—the major players in the development sector at that time—"favored a large-scale, top-down method in which huge loans were given to governments and large corporations."[9] This policy was propelled by a belief in the economics of scale—the belief that by investing in the capital of governments and corporations, they could "create employment in the private sector, and that poverty would gradually be reduced."[10] Because the principals of microfinance were counter-intuitive to this trickle down theory, microfinance was rejected as a development strategy as being "of little consequence—too little money, given to poor families who are unemployable, and who are not credit worthy."[11] To the chagrin of the members of the

[5] Shil, "A Commercialized View," 193.
[6] Shil, "A Commercialized View," 192.
[7] Shil, "A Commercialized View," 193.
[8] Montgomery and Weiss, "Great Expectations," 2.
[9] Hiatt and Woodworth, "Poverty through Microfinance," 472.
[10] Hiatt and Woodworth, "Poverty through Microfinance," 472.
[11] Hiatt and Woodworth, "Poverty through Microfinance," 472.

World Bank and other similar organizations, microfinance has become the shining star of development strategies and is now being incorporated into development frameworks of both the World Bank and the Inter-American Development Bank.

The brilliance in micro-credit is that it operates as a "hand-up" instead of a "hand-out." It was initiated with the "objective of providing poor people with credit without collateral" and has demonstrated that this lack of collateral does not delay or deter loan repayment. Lapenu found that the average repayment of micro loans in the developing world in 1991 was 91 percent, a statistic that grew to 98 percent if weighted by loan volume. [12] Many others have reported numbers exceeding this percentile. This has also attracted the attention of commercial banks, as NGOs have demonstrated small-scale loans are not as "risky" of an investment as initially perceived.

Essentially, because these loans are repaid with interest high enough to cover the cost of processing the loan, Yunus has developed a program that can "positively affect poverty by creating entrepreneurship and a greater self-reliance among the poor"—that is *without cost*.[13] It is this astounding possibility that inspired the Nobel Committee to award the Yunus and the Grameen Bank with the Nobel Peace Prize in 2006.

Yet, despite the work of Yunus and the Grameen Bank, universal access to credit remains a problem. Financial Access Initiative, a research consortium at New York University, recently found that "2.5 billion adults worldwide do not have a savings or credit account with either a traditional (regulated bank) or an alternative financial institution (such as a microfinance

[12] Cecile Lapenu and Manfred Zeller, "Distribution, Growth, and Performance of Microfinance Institutions in Africa, Asia, and Latin America," (FCND discussion paper, no. 114, June 2001): 11.
[13] Hiatt and Woodworth, "Poverty through Microfinance," 476.

institution)."[14] Without formal savings or credit, the poor must "rely on loans from either moneylenders at high interest rates or friends and family, whose supply of funds is limited." [15] The solution, it seems, may be microfinance.

A. The BancoSol Model, An Alternative

While this paper primarily addresses Central American MFIs, it is important to understand the development of the microfinance industry in the larger Latin American context, as the conditions under which the microfinance industry blossomed in Latin America are quite different from those of Bangladesh in 1970. While Yunus had envisioned microfinance to serve the extreme poor in rural areas, in Latin America microfinance banks "developed to address the problems of urban employment and provide credit to the cash-strapped informal sector."[16] While this inclusion of a wider survey of microfinance in Latin American may seem divergent from this central question of Central American institutional efficacy, microfinance efforts, and, likewise, research about microfinance have focused in Bolivia and Peru. Explicitly, BancoSol of Bolivia, has been a "pioneering microfinance institution in the region," and has served as the Latin American model. [17]

BancoSol began operating in Bolivia during the 1980s. The region was fraught with hyperinflation and widespread unemployment, largely due to the breakdown of the García Meza Tejada regime. Thus, microfinance entered the marketplace with a focus in urban micro-enterprise, somewhat counter intuitively to the original model developed by Yunus's Grameen Bank. Montgomery explains that "a typical requirement for access to credit from an MFI has

---

[14] Andrea Retzky, "Half of the World is 'Unbanked'," Reuters, November 2, 2009, http://www.reuters.com/article/idUS133998+02-Nov-2009+PRN20091102 (accessed March 2, 2010).
[15] Montgomery and Weiss, "Great Expectations," 5.
[16] Montgomery and Weiss, "Great Expectations," 2.
[17] Montgomery and Weiss, "Great Expectations," 2.

been that the borrower should be the owner of a micro-enterprise, holding a national identification card and having at least six to twelve months experience in the economic activity for which the loan is to be used."[18] Essentially, whereas the Grameen Bank was a non-profit and rural organization, in Bolivia, as in the rest of Latin America, "the notion of commercial profitability was embraced relatively early," and "was typically urban [...] less concerned with poverty and more focused on micro-enterprise."[19] Instead of following Yunus's vision of inclusion—Latin American microfinance targeted the "economically active poor—people with established business that needed capital to grow." [20] This difference is essential. Essentially, microcredit "was itself seen as a business, potentially a branch of commercial banking," indicating that Latin American microfinance institutions have never been classifiable into two black and white categories of "for-profit," and "for-people."[21]

Since then BancoSol has upgraded, becoming a commercialized, regulated MFI. Seeing BancoSol's successful transition, "at least 39 other important NGOs worldwide [have] transformed into commercial banks over the period 1992-2003." [22] More about upscaling and its implications can be found on page 17.

B. Commercialization

Corroborating these trends of increased commercialization, McIntosh writes, "competitions between microfinance institutions in developing countries has increased." [23] Having proven that "microcredit could actually be a profitable financial product and that the

[18] Montgomery and Weiss, "Great Expectations," 18.
[19] Montgomery and Weiss, "Great Expectations," 2.
[20] Montgomery and Weiss, "Great Expectation," 2.
[21] Montgomery and Weiss, "Great Expectations," 2.
[22] Shil, "A Commercialized View," 197.
[23] Craig McIntosh and Bruce Wydick, "Competition and Microfinance," *Journal of Development Economics* 78 (2005): 271.

institutions offering microcredit also could operate in a profitable way," the Latin American microcredit sector has since been flooded with commercial banks entering the market looking for a profit.[24] Latin American MFIs "wanted to create a replicable model to provide an effective regional response to the enormous demand."[25] As this paper will show, though a replicable and successful model has been produced, this surplus of microcredit providers has transformed the market in unexpected ways that require further investigation.

Having created that replicable model, Marulanda and Otero explain, Latin American MFIs have also debunked the Yellow Pajamas Myth.[26] The Yellow Pajamas Myth refers to the belief that poor people would do anything—including stand outside in the rain in yellow pajamas—in order to receive a loan. Increased competition, explicitly from commercial banks, has proven otherwise.[27] As competition in the market increases this belief becomes increasingly nonsensical—as MFIs need to cater to their customers, particularly by offering lower interest rates, in order to remain viable organizations.

Likewise, this commercialization encourages MFIs to focus on urban borrowers, rather than rural, as monitoring the loan of an urban borrower costs less in time and money.[28] Also, the competition, as a result of the commercialization, results in a focus on serving Moderately Poor, rather than Severely or Extremely Poor borrowers because larger loans return larger profits. As noted by Rhyne, between 1992 and 1998 the average loan in BancoSol's portfolio increased

---

[24] Beatriz Marulanda and Maria Otero, "The Profile of Microfinance in Latin America in 10 Years: Vision and Characteristics," *Accion* (April 2005): 11.
[25] Marulanda and Otero, "Profile of Microfinance," 11.
[26] Elisabeth Rhyne, *Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia,* (Bloomfield, CT: Kumarian Press, Inc., 2001) 152.
[27] Rhyne, *Mainstreaming Microfinance*, 152.
[28] Rhyne, *Mainstreaming Microfinance*, 160.

from $250 to $908.[29] Both of these trends are counterproductive when couched in terms of the Grameen Bank model and its goals of inclusion of the rural-dwelling poor. Ultimately, Latin American MFIs, since their inception have been "seen as a vehicle for the development of the micro-enterprise sector rather than as a tool for the removal of core poverty."[30] This is not to say that microfinance cannot remove core poverty in Latin America, nor that developing the micro-enterprise sector is any less important in terms of lifting people out of poverty and developing a nation. However, it highlights the essential difference between microfinance in Asia and in South America and the necessity to differentiate between them.

Additionally, because Latin America has begun this transition to commercialization and the "provision of a wider range of financial services [and] a move away from traditional group lending to individual loans," the region is, in some ways, a progressive leader in the sector.[31] Thus, it merits analysis in isolation from other, longer lasting, but perhaps more traditional providers of microfinance. This is especially true in light of the recent collapse of the sub prime lending bubble in the United States. As the microfinance sector in Latin America commercializes and becomes flooded with a variety of loan providers, what will the implications be? Which type of institution will come out ahead? What sorts of innovations can lenders make to remain competitive? What sectors of the market will continue to need services, despite the commercialization? Early studies of the Latin American microfinance industry will likely prove useful, if not essential, to the continuity and survival of the industry as it commercializes all over the world.

---

29 Rhyne, *Mainstreaming Microfinance*, 160.
30 Montgomery and Weiss, "Great Expectations," 26.
31 Montgomery and Weiss, "Great Expectations," 4.

However, there are doubts. It seems the focus on urban micro-enterprises, and likewise this commercialization of the microfinance market has generated "the overall impression [...] that compared with Asia, microfinance has reached less far down the income scale and that a significant proportion of borrowers are not in fact below the poverty line, although they may well have below average incomes."[32] This is but one of many doubts that critics raise when proponents encourage and campaign for the installation of the golden child of development—microfinance—in Latin America.

C. Answering Doubts About Microfinance

Doubts and criticisms of microfinance are growing increasingly common. It seems for every believer, there exists an equally impassioned disbeliever. One disillusioned writer went so far as to say that, "if microfinance was born in 1976 with Muhammad Yunus' $27 loan, 2009 was the year it died."[33] Critics claim that microfinance is a, "a trap of indebting the poor; poor are asked to look after themselves; coercion and high rate of interest are common observations; It does not help the poorest of the poor.... NGOs, banks, and corporations have benefited from micro-credit at the cost of the poor. It is being used to promote products of MNCs."[34] Also, it is believed that "the poorest of the chronic poor borrow essentially for protectional purposes given both the low and irregular nature of their income." [35]

Realistically, several studies have raised doubts about microfinance's abilities to reach the "core poor."[36] Sources like the Wall Street Journal have been, in their own words, "skeptical

[32] Montgomery and Weiss, "Great Expectations," 18.
[33] Jeff Raderstrong, "2009: The Year that Microfinance Died," *Change Charity* Weblog, entry posted December 30, 2009, http://changecharity.blogspot.com/2009/12/2009-year-microfinance-died.html (accessed February 15, 2010).
[34] Shil, "A Commercialized View," 196.
[35] Montgomery and Weiss, "Great Expectations," 8.
[36] Montgomery and Weiss, "Great Expectations," 3.

of the more grand claims about what microfinance can do as a panacea for mass poverty," and instead, "continue to believe the best way out of mass poverty is to shift people out of low-productivity jobs and into more productive jobs in modern industry and services."[37] Likewise, recent studies using controlled and randomized trial have produced less than exciting results—no results that demonstrated the sort of "transformative change" people had expected.[38]

It is the belief of this author that microfinance cannot be a panacea to eradicate poverty, and that; likewise, the abundance of doubts and criticism of the industry is likely a result of the high praise it received in its infancy as the ultimate poverty alleviator. The necessity for such a panacea for global poverty has long been recognized. The unrestrained fervor and acclaim for microfinance that erupted at the possibility that these small loans could be that solution created an exceedingly heated reaction when, predictably microfinance did not produce the results that inflated expectations had promised. This statement, by Abhijit Vinayak Banerjee, Esther Duflo and Dean Karlan, summarizes well the opinion of this author, and likewise, demonstrates why further study of microfinance—including this paper—is necessary despite the criticism circulating about the practice:

> "[A]s we see it, microcredit seems to have delivered exactly what a successful new financial product is supposed deliver—allowing people to make large purchases that they would not have been able to otherwise. The fact that some people expected much more from it (and perhaps they are right, may be it will just take longer) is perhaps inevitable given how eager the world is to find that one magic bullet that would finally "solve" poverty. But to actually blame microcredit for not promoting the immunization of children is no different from blaming immunization campaigns for not generating new businesses." [39]

---

[37] "The Microfinance Boom," *Livemint.com* Weblog, entry posted October 27, 2009, http://www.livemint.com/2009/10/27213930/The-microfinance-boom.html?h=B (accessed November 30, 2009).
[38] Raderstrong, "2009: Microfinance Died."
[39] Raderstrong, "2009: Microfinance Died."

Further, while the general efficacy of microfinance remains to be proven, it seems that many of these criticisms result from the inherent paradox of a microfinance institution's simultaneous attempts to be profitable and, also, to be a means of poverty alleviation.

II. The Paradox

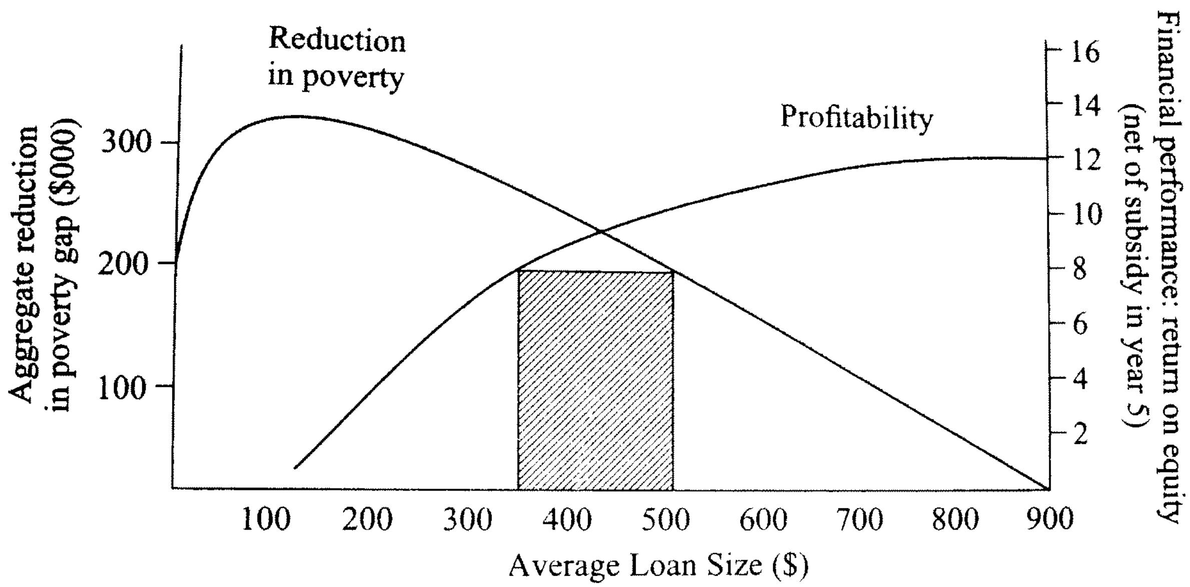


Figure 1. The Paradox Inherent to Microfinance: A Tradeoff Between Poverty Reduction and Profitability[40]

This graph visually demonstrates the inherent paradox of microfinance. Ideally, an MFI would be able to balance the risk of a deep outreach strategy, but also manage that risk efficiently in order to maintain profitability.

The concern for Latin American microfinance is that as the market commercializes, MFIs will move increasingly rightward on this graph, as commercialization is characterized "by profitability, competition, and regulation."[41] Typically, economists see competition favorably

[40] Beatriz Armendariz de Aghion and Jonathan Morduch, *Economics of Microfinance* (Cambridge, MA: The MIT Press, 2005), 263. These numbers are based on Moseley's 1996 study of BancoSol in Bolivia.
[41] Shil, "A Commercialized View," 197.

because it drives down prices for consumers, and, specifically in the case of microfinance, competition drives down interest rates. However, there is some fear that competition, in this case, will prove 'detrimental' for some borrowers because non-profit lenders generally "cross-subsidize," within their borrowers.[42] Cross-subsidation is the process of charging higher interest rates to borrowers with larger loan sizes in order to fund the riskiest and smallest loans--that inspire the most intense poverty alleviation. However, if competition increases and the interest rate in the market decreases, these small loans can no longer be funded, which undermines the original work of the non-profit MFI.

Alternatively, if MFIs move increasingly leftward on this diagram, they will not continue to be commercially viable. Simply put, the costs of administering loans at such a small scale will outweigh the returns in interest, even if the MFI can charge interest rates exceeding 30 percent. This paper seeks to identify which type of MFI is most adept at balancing these two objectives and then offer suggestions as to how each type or organization can improve their efficiency.

III. A Survey: Types of Microfinance Institutions

In order to understand the affects of commercialization within the microfinance sector, we must first understand the various sets of institutional actors involved.

A. By number

One way to classify types of microfinance institutions is by size—both in terms of the size of the organization and the size of the groups to which that organization is lending. The first of these types is village banking. By definition, village banks tend to be small scale, local

[42] McIntosh and Wydick, "Competition and Microfinance," 271.

organizations that serve groups of 20-30 members and do not have more than 25,000 clients in their portfolio.[43]

Other types of MFIs, as categorized by size, include cooperatives and solidarity groups. Cooperative lenders are autonomous associations of borrowers. These organizations usually have between 10,000 and 20,000 members, and "very few" have fewer than 1,000 members.[44] Solidarity groups are similar in principal, but in practice groups (usually about 5 people) borrow collectively, similar to the process introduced by Muhammad Yunus. Lapenu found that 37 percent of solidarity groups have less than 1,000 members and that 93.7 percent have fewer than 50,000 members.[45]

The final lending group size is, of course, the individual. The majority of commercial banks in Latin America—and an ever-increasing number of NGOs in Latin America—are focusing on individual lending. Although according to Lapenu most MFIs have fewer than 30,000 members, this number is constantly growing, with some, like Compartamos in Mexico with client bases as large as 800,000.[46] Unfortunately, this approach has been classified as having a low depth of outreach to the poor, as is consistent with Latin American microfinance's general focus on lending to pre-existing micro-enterprises.[47] Despite Lapenu's suggestion that "individual lending is not well suited to countries [...] with low income and low population densities," because of high management and monitoring costs, the majority of micro loans in Latin America are being issued to individuals rather than solidarity groups or in a village

---

[43] Lapenu and Zeller, "Distribution, Growth, and Performance," 21, 18.
[44] Lapenu and Zeller, "Distribution, Growth, and Performance," 17.
[45] Lapenu and Zeller, "Distribution, Growth, and Performance," 17.
[46] Lapenu and Zeller, "Distribution, Growth, and Performance," 17.
[47] Lapenu and Zeller, "Distribution, Growth, and Performance," 17.

banking style.[48] One explanation for this may be the tendency for Latin American MFIs to develop in urban settings, which defrays the costs of monitoring and loan maintenance. Consistent with other information about commercial banking (which tends to loan to individuals) MFIs that loan to individuals tend to have higher average loan amounts.[49]

Though identifying organizations by size is useful for statistical and methodological reasons, realistically, it may not be the most efficient or relevant way to classify institutions in an attempt to measure the efficacy of their loan services. Instead, I will offer classifications of MFIs by legal status—which will provide a generalized understanding of how each institution operates.

B. By Legal Status

The second, and perhaps more useful method of identifying MFIs is by legal status. There are three obvious types. First, there are NGOs. NGOs are usually not for profit and funded privately. They may offer "business development services, training or consultancy services," in addition to their small-scale loans.[50] Lapenu found that NGOs in Latin America tend to have a "good depth of outreach," largely because poverty alleviation is their primary goal, but low staff productivity.[51] As of 2005, NGOs still represented the largest number of lenders in Latin America despite the commercialization of the market.[52] Some prominent non-regulated NGOs working in Central America include Fundacion Genesis Emprasarial in Guatemala, FINCA in El Salvador, and Asociacion Costarricense para organizaciones de Desarrollo in Costa Rica.

---

[48] Lapenu and Zeller, "Distribution, Growth, and Perfomance,"17.
[49] Lapenu and Zeller, "Distribution, Growth, and Performance," 21.
[50] Marulanda and Otero, "Profile of Microfinance," 5.
[51] Lapenu and Zeller, "Distribution, Growth, and Performance," 22.
[52] Marulanda and Otero, "Profile on Microfinance," 5.

At the other end of the MFI institutional spectrum, there are commercial banks, which have recently begun "incorporating low income segments into their clientele."[53] Predictably, they tend to have "a low depth of outreach and high staff productivity"—precisely opposite NGOs, as their focus must be, foremost, creating profit.[54] However, not all commercial banks offering microfinance services are without a "social and political mission."[55] A variety of actors can invest in these commercial banks—ranging from local to international investors. It is also important to note that as compared with NGOs, commercial banks tend to have higher transaction sizes, as these loans have less risk attached, which is important to these profit-driven institutions. The process of large commercial banks beginning to offer microfinance services is often called "downscaling." Downscaling by these large commercial banks represents one half of the commercialization to which this essay has referred. The largest commercial bank operation in Central America is ProCredit, which operates in a number of countries, but there are others, including, as one example, Banco Popular Covelo in Honduras.

The second half of this commercialization of the microfinance sector is, logically, "upscaling" by NGOs. An institution that has upscaled is one that was once an NGO, but has "transformed," into a commercial institution that is now "regulated by the banking authorities of their country."[56] While Lapenu did not distinguish upscaled NGOs in his study concerning outreach and staff productivity, logic asserts that they would register somewhere between NGOs and commercial banks on both scales.

While these are the three major types of institutions at work, it is important to know there are an array of other actors, including, but not limited to, cooperatives, state run development

[53] Marulanda and Otero, "Profile of Microfinance," 5.
[54] Lapenu and Zeller, "Distribution, Growth, and Performance," 22.
[55] Marulanda and Otero, "Profile of Microfinance," 5.
[56] Marulanda and Otero, "Profile of Microfinance," 5.

banks and other government organizations. Interestingly, in Lapenu's study, government organizations involved with microfinance had the lowest register of both depth of outreach and productivity.[57]

IV. What Does Microfinance Look Like Now?

A successful microfinance organization—both in Latin America and globally—must attend to two somewhat contradictory goals: sustainability and deep outreach.[58] Deep outreach often requires high resource use, particularly if the outreach is focused rurally on the "core poor." Deep outreach also often requires the smallest of loan sizes to begin to incorporate the "core poor" into any market. However, this combined high use of resources and high risk (associated with small loan sizes) are directly counterintuitive to a MFI's second goal—sustainability. Realistically, in this context sustainability can be substituted for profitability. In order for an MFI to continue it's goal of incorporating the underserved poor into the market and reducing poverty through "deep outreach," it must continue to make profits (through interest)—at least high enough to maintain a staff and other costs associated with processing and monitoring loans. Typically, NGOs—whose prime concern is usually inclusion—have cross-subsidized the smallest, and highest risk, loans with larger loans (still classified as microfinance). They then charge the clients with the larger loans a higher than necessary interest rate, which can be recycled into deeper outreach.

Not surprisingly, bankrupt state development banks and governments have been attracted by the "political shining star" of microfinance and often act as donors for less-than-cost-effective NGOs.[59] Likewise, USAID, the UN, and other similar organizations "have begun channeling

---

[57] Lapenu and Zeller, "Distribution, Growth, and Performance," 22.
[58] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 231.
[59] Rhyne, *Mainstreaming Microfinance*, 173.

micro loan funds through small NGOs because of their impressive results." [60] However, as competition increases in an ever-commercializing market, NGOs are faced with the reality that their process of cross subsidizing is not competitive, and thus, not sustainable.

As McIntosh describes, "Bertrand competition between MFIs within the subset of profitable borrowers reduces the ability of a socially motivated leader to generate rents that support lending to the poorest and potentially least-profitable borrowers. [61] As competition intensifies, NGOs seek to remain competitive—or, at least "sustainable," and are forced to lower their interest rates for larger loans and drop the poorest borrowers altogether.

One solution to this problem has been the use of grants and subsidies provided by donor organizations. However, as Hiatt reports, policy experts question this funding and "worry more about [non-profit's] power and societal influence."[62] Others are more concerned that as the market commercializes, microfinance will lose its original intentions of inclusion of the very poor and poverty alleviation. However, this has also be countered by Shil, who claims that NGOs that want to transform into regulated MFIs "cannot as they haven't the required institutional capability in terms of skilled manpower, infrastructure, cost structure etc."[63] Indeed, it would be too simple an analysis to assume that commercial banks are for-profit and NGOs are for-people, as it were. Especially given the complexity of institutions involved in Latin American microfinance, as well as the various transformations involved in both upscaling and downscaling, it seems that the desire for outreach and profitability do exist simultaneously within single organizations. Likewise, the ever-expanding market and the measured success at poverty

[60] Hiatt and Woodworth, "Poverty through Microfinance," 472.
[61] McIntosh and Wydick, "Competition and Microfinance," 272.
[62] Hiatt and Woodworth, "Poverty through Microfinance," 472.
[63] Shil, "A Commercialized View," 198.

alleviation indicate that despite the counter-intuitive nature of the relationship between outreach and sustainability, organizations that have both as goals can produce results.

A. Upscaling

According to Hiatt and Woodworth, "upgraded MFIs continue to account for the largest share of microfinance," in smaller Latin American countries, which may include Central America as well as Bolivia, Peru, and Ecuador.[64] Interestingly, these MFIs play a much less significant role in larger countries like Brazil, Mexico and Argentina.[65] An upscaled MFI is an NGO that has become regulated, operating after the transformation much like a commercial bank instead of a non-profit organization. While BancoSol (Prodem, as an NGO) in Bolivia was the pioneer of this transformation in Latin America, Salvadoran Financiera Calpia (formally AMPES) was the first to upgrade in Central America.[66] Generally, these upscaled MFIs, because they are regulated, are "far more sustainable than unregulated or specially licensed organizations clearly rooted in the non-profit sector."[67] Likewise, by comparing portfolios over time Marulanda and Otero demonstrated that institutions that become regulated have "very high rates of growth."[68] This growth may be linked with a trend toward commercialization of microfinance in the region,"—as growth can only be accomplished when an institution is competitive and in order to be completive NGOs must regulate.[69]

---

[64] Hiatt and Woodworth, "Poverty through Microfinance," 38.
[65] Montgomery and Weiss, "Great Expectations," 3.
[66] Marguerite Berger, "The Latin American Model of Microfinance," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, 39 (Washington DC: Inter-American Development Bank, 2006).
[67] Shil, "A Commercialized View," 197.
[68] Marulanda and Otero, "Profile of Microfinance," 7.
[69] Montgomery and Weiss, "Great Expectations," 3.

The primary reason for an NGO to become a regulated MFI is access to funding—"freeing the institution from dependence on donor funds and capital constraints on growth."[70] As a regulated institution, an MFI can both access "commercial sources of refinance" and gather deposits.[71] These changes allow MFIs to offer a "wider range of financial services," including savings account, mortgages, and other products not related to credit.[72] These products, in turn, allow the MFI to increase their profit, which allows them to remain financially viable and commercially sustainable, while still continuing the quest for deeper outreach to the core poor.

However, there are proven disadvantages to upscaling. Newly upscaled MFIs must "juggle" a complex business model, including a new diversification of both financial products and clientele.[73] Further, they must somehow maintain both a high portfolio quality and continued expansion in outreach to low-income clients. For many NGOs, which usually are less cost effective than commercial banks, this process usually involves a challenging overhaul of policy and practice.

Despite these challenges, upscaled MFIs tend to find success in the microfinance market in Latin America. According to a 2005 study by Marulanda and Otero, upscaled MFIs continue to transform themselves, "adding a large number of financial products designed to meet the needs of low-income families, including products not related to credit."[74] Another avenue towards success for upscaled MFI to "rapidly increase the number of clients they reach," by tapping into "capital markets to fund their lending portfolio," which they could not access as

---

70 Montgomery and Weiss, "Great Expectations," 4.
71 Berger, "The Latin American Model," 38.
72 Montgomery and Weiss, "Great Expectations," 4.
73 Berger, "A Latin American Model," 38.
74 Marulanda and Otero, "Profile on Microfinance," 10.

NGOs from outside the financial system.[75] This increase in portfolio size creates an increase in profits, which theoretically would create the ability to further increase portfolio size, cyclically.

This new trend in upscaling raises, for some, "the question of whether the initial poverty reduction objectives of the transformed NGOs will be subjected to commercial criteria."[76] This is commonly referred to as 'mission-drift.' Essentially, critics counter MFI upscaling by suggesting that the organization will get sucked into the vacuum of profit making and essentially "forget" their original aims of poverty alleviation. However, the assumption that MFIs lose sight of their mission simply because they have become cost effective organizations with streamlined business processes seems shortsighted. Business efficiency and outreach may seem to be a counter-intuitive pair of goals (see IV. The Paradox). However, a more thorough statistically analysis comparing institutional efficacy must be submitted before a hard and fast judgment can be made.

B. Downscaling

The second important trend in the commercialization of the microfinance is downscaling—the movement of preexisting formal financial institutions and banks into the microfinance market. As aforementioned, non-profits operating in this sector have proven that the poor repay their loans, with interest, promptly—which has provoked a creeping downward by large financial institutions that recognize the "market-niche profitability," and likewise, the benefit of "product and market diversification."[77] Likewise, these institutions can be motivated

---

[75] Berger, "A Latin American Model," 46.
[76] Montgomery and Weiss, "Great Expectations," 3.
[77] Beatriz Marulanda, "Downscaling: Moving Latin American Banks into Microfinance," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, 88 (Washington DC: Inter-American Development Bank, 2006).

by the "fulfillment of a social function"—explicitly, the desire to alleviate poverty.[78] However, this is less than required.

Some examples of banks participating in this transformation include Banco National in Costa Rica, Banco del Desarrollo in Chile, Banco Argicola in El Salvador, and Banco Empresarial in Guatemala.[79] Also, Banco del Trabaja "targets consumer loans at salaried medium low and low-income individuals," in Costa Rica, Guatemala, Ecuador, and the Dominican Republic.[80]

Because traditional banks have "the infrastructure necessary to handle large volumes and large markets," they can easily capitalize on the microfinance sector (through both small scale loan and saving initiatives).[81] They are drawn by the extensive potential market of customers, which has previously been demonstrated by NGOs, but only in places where "credit risk can be controlled."[82] Interestingly, this aspect of commercialization (downscaling) seems to be pushed largely by international development institutions such as the Multilateral Investment Fund and the Inter-American Development Bank, both of which have "helped disseminate information [including] country and company case studies."[83] This set of actors may have been pivotal in spurring the commercialization of the market in Latin America.

Downscaling involves ramping up competition in a way that may, ultimately, be counter-productive to microfinance's outreach goals. This idea is corroborated by McIntosh and Wydick's 2005 study which found that "wealthier and impatient borrowers are likely to benefit from increased competition among MFIs [because interest rates on loans will fall], very plausible

[78] Marulanda, "Downscaling," 88.
[79] Montgomery and Weiss, "Great Expectations," 4. and Marulanda, "Downscaling," 83.
[80] Marulanda, "Downscaling," 86.
[81] Marulanda, "Downscaling," 83.
[82] Marulanda, "Downscaling," 104.
[83] Marulanda, "Downscaling," 104.

conditions exist under which an increase in the number of lenders in a market will lower the welfare of the both the poor and the patient."[84] Though McIntosh and Wydick did not identify causation for this observation, one element may likely be the cessation of cross-subsidation by NGOs to fund the smallest loans. Essentially, in a traditional non-profit, NGO microfinance operation "small loans lose money and are cross-subsidized with [the higher interest rates for] large loans," and any profit comes from long-term, repeat borrowers.[85] Commercial banks, however, and particularly those who have downsized to fit an previously identified profitable market niche, will not offer loans which do not garner profits, cutting out the need to cross-subsidize, which lowers interest rates for all borrowers involved. This lowers the interest rate in the market at large, prohibiting NGOs from competing effectively if they continue cross subsidizing. However, some argue that NGOs high interest rates are "unaffordable to the core poor given their lack of complementary inputs," in which case, increased competition can only work in favor of the poor.[86]

Another identifiable pitfall for downscaled banks operating within the microfinance sector exists in the mindset of the staff (particularly loan officers), which have been operating in the commercial market. Loan offers are generally rewarded for providing: more loans, bigger loans, and higher quality loans.[87] Of the three, perhaps only the latter is relevant within the microfinance sector. Armendariz de Agion and Morduch suggest that officers should be rewarded for both cost minimization and measured poverty reduction within the loan process, but warn that these rewards may cause staff to act fraudulently.[88]

---

[84] McIntosh and Wydick, "Competition and Microfinance," 272.
[85] Rhyne, *Mainstreaming Microfinance,* 162.
[86] Montgomery and Weiss, "Great Expectations," 6.
[87] Armendariz de Aghion and Morduch, *Economics of Microfinance:* 280.
[88] Armendariz de Aghion and Morduch, *Economics of Microfinance:* 281.

It is important to note that "formal financial institutions in Latin America and the Caribbean have been slow to downscale into providing credit to microenterprises, especially when compared to the proliferation of nonformal microcredit institutions," however, these types of organizations are innovators in the microfinance field, and yet another set of players within the complicated Latin American microfinance sector. [89]

C. Remaining: Be True to Yourself

Despite all of this action and transformation within the microcredit market, many NGOs choose to remain just that—poverty focused NGOs. Often, this means distributing small loans to rural residents, which results in high costs and high risks for the NGO. However, these NGOs resist upscaling because they want to both provide loans to the underserved, but "also complement those services with training and capacity building…"[90] This means offering "tailored services," which can and does negatively affect these organizations' financial viability.[91] Also, many NGOs manage success because donors perceive microfinance as a "hand up" instead of a "hand out," which can be more attractive than other types of development aid donations.

However, as Montgomery reports, NGOs are generally "not financially sustainable and continue to rely on subsidies," which further decreases pressure for financial viability. [92] Armendariz de Aghion and Morduch contend that these subsidies "can only be useful if microfinance is conceived as a social tool," an opinion which is corroborated by Hiatt and

---

[89] Marulanda, "Downscaling," 79.
[90] Marulanda and Otero, "Profile of Microfinance," 10.
[91] Rhyne, *Mainstreaming Microfinance*, 162.
[92] Montgomery and Weiss, "Great Expectations," 4.

Woodworth's observation that government lenders "tend to appreciate civil involvement and saw NGOs as more flexible and rapidly mobilized."[93]

NGOs remain an important player in the microcredit market, with some lenders maintaining portfolios as large as 30,000 clients. Ultimately, regardless of how commercialized the microfinance sector becomes, there will likely be some role for NGOs—either because a board of directors prefers to remain non-profit or because the "regulatory system is not suitable for MFI regulation."[94] To dismiss their role would be misguided. That said, it is clear that going forward in a commercialized market—NGOs may need to re-evaluate the specific role they play, as well as the source of their funding. This will be further addressed in Section VII. Looking Forward: Recommendations and Forecasts.

D. The Complexities

However, this pigeonhole typology of microfinance institutions as being either upscaled, downscaled, or an NGO does not provide the most accurate understanding of the complexities of the actors at work in the market. While this categorization aids in analysis by type and, essentially, is accurate, it can over simply conclusions, as it does not take into account important relevant factors, particularly the organization's funding source.

Recently, investment funds play an ever-increasing role in the region. These private funds provide funding for MFI's re-finance and often "play a key role as members of the boards of directors of microfinance institutions."[95] This executive role can influence the operational policies of microfinance institutions—leading the institution to act more or less commercially, as per the policies of the investment fund. In some ways, this can skew the data concerning analysis

[93] Armendariz de Aghion and Morduch, *Economics of Microfinance:* 232. And Hiatt and Woodworth, "Poverty through Microfinance," 472.
[94] Berger, "A Latin American Model," 74.
[95] Marulanda and Otero, "Profile of Microfinance," 40.

between non-profit and commercial banks, as what becomes relevant is not the legal status of the microfinance institution itself, but the legal status of the investment fund, as it may be the puppet master of the MFI. Another factor that may influence the day-to-day operations and long term goals for MFIs is prolonged interaction with an organization like Unitis. Unitis, an international nonprofit organization that has been operating in Latin America for seven years, "accelerates the growth of microfinance" by "helping them build capacity, attract capital, and unite with the greater parent network." [96]

Traditionally, MFIs sought funding from donors. These donations essentially subsidized the non-profit organizations and allowed deep outreach and lending to high-risk segments of the population, as the MFI was not obligated to remain cost effective in order to achieve sustainability. However, ultimately MFIs face the reality of donor fatigue.[97] While remaining an NGO may be the preferred option, if an MFI has exhausted their supply of donor funding, they may have no other choice but to upscale in order to remain viable. For this reason, many analysts have suggested that donor funding be channeled into specific capacity building programs within the MFI, rather than being used to finance the loans. By "improving the technical capacity of existing institutions, supporting the research and field testing of new products and technologies, and helping governments to develop regulatory frameworks," donors can invest in microfinance with the promise of long term returns on investment without constantly fronting additional funding.[98] However, this is not always feasible, especially because "helping governments

[96] "ACCION Announces $5.8 Million Project to Develop Savings Account Products for the Poor in Bolivia, Colombia and Ecuador," *PR Newswire*, January 13, 2010 http://www.prnewswire.com/news-releases/accion-announces-58-million-project-to-develop-savings-account-products-for-the-poor-in-bolivia-colombia-and-ecuador-81325707.html (accessed February 27, 2010).
[97] Armendariz de Aghion and Morduch, *Economics of Microfinance:* 252.
[98] Marulanda and Otero, "Profile of Microfinance," 40.

develop regulatory frameworks," does not offer donors the same psychological benefit and sense of direct impact as the type of "face-to-face," lending experienced by initial microfinance donors. A third option for MFIs that neither wish to upscale or redirect donor funding is to form a partnership with a bank. In a simple partnership, "the NGO … introduces micro entrepreneurs to a bank and the bank grants them credit," but in other more complex relationships, banks actually grant lines of credit to NGOs, from which they lend, "assuming the portfolio risk for their own account."[99] In, perhaps the most complex of these relationships "the NGO assumes part of the credit risk through a lower commission as risk increases, or through a contractual agreement with the obligation to buy back the nonperforming portfolio."[100] These relationships, like the relationships among investment funds, donors, and MFIs (nonprofit or otherwise) can effect the operational policies and long term goals of the MFI—and primarily, whether the institution prioritizes sustainability or profit, as financial accountability to the bank will sway business decisions.

The final complexity in understanding the institutional framework of an MFI involves understanding their relationship with the state government. Governments, recognizing the potential in the initial successes of microfinance, are keen to participate. In some places governments have set up "financial intermediate channels," for donor credit, and likewise promoting microfinance internationally as a development process worthy of investment and international aid.[101] In other places state owned banks "began incursions into microfinance [...]

---

[99] Marulanda, "Downscaling," 99.
[100] Marulanda, "Downscaling," 98-99.
[101] Rhyne, *Mainstreaming Microfinance*, 174.

driven by government policies designed to fill a void perceived to be left by private banks."[102] Other governments are much more intent on regulating microfinance as an industry.

Ultimately, as many authors have predicted, going forward the most important private capital entering the microfinance sector will be through commercial banks.[103] Despite this prediction, it is important to understand each actor within the microfinance sector in order to analyze the efficacy of microfinance as a development strategy, and, in turn, to successfully understand the various actors, we must acknowledge the complexities at work in the sector.

In the face of these complexities, MFIs must "reach the poor and reconcile this process with full cost-recovery."[104] They must find "a balance between profitability and poverty alleviation."[105] They must be "committed to serving the poor; and cost-effective."[106] They must juggle the counterintuitive pair of long-term objectives: deep outreach and the risk associated and a cost-effective business plan targeting profitability—that is, "both commercial and social objectives."[107]

Sumir Chandha, director of Sequoia Capital India—an investment fund which has experimented with microfinance investments—was quoted as saying, "As investors we love growth, but in the lending business, you need to be very careful about your customer base." [108] Somehow MFIs must curb this desire to grow—from both a commercial and philanthropic

[102] Marulanda, "Downscaling," 88.
[103] Marulanda and Otero, "Profile of Microfinance," 41.
[104] Stuart Rutherford, *The Poor and Their Money,* (Oxford, NY: Oxford University Press, 2000), 109.
[105] Shil, "A Commercialized View," 198.
[106] Rutherford, *The Poor and Their Money,* 104.
[107] Shil, "A Commercialized View," 198,
[108] Shraddha Nair and Deepti Chaudhary, "Investors Happy as Microfinance Lenders Discipline Growth," *Livemint.com* Weblog, entry posted January 12, 2010, http://www.livemint.com/2010/01/12230210/Investors-happy-as-microfinanc.html (accessed February 4, 2010).

perspective--with a desire to be fiscally responsible. This paper seeks to identify, by institutional type, the organizations that most effectively manage this struggle.

V. Measuring Efficacy

The question in measuring efficacy relates directly to the paradox facing microfinance organizations. How can growth and profitability exist simultaneously with deep outreach and intense poverty alleviation? Explicitly, how one measures the efficacy of microfinance must be determined by which goal—profitability or outreach—that organization is most interested in. Latin America is "extensively covered by MFIs" and likewise, "records the largest volume per transaction."[109] However, "rural outreach remains low," which means that despite high volumes of transactions outreach to the "core poor," may be minimal—but does that mean that all microfinance in Latin America can be labeled ineffective?[110]

Realistically, researchers are split over this issue. Anthropologists and sociologists—researchers from disciplines concerned with people—argue "the efficacy of microfinance as a poverty alleviation tool should be measured on a household level."[111] For this group, efficacy, that is "the ability to produce the necessary or desired results," is dependent on the "desired result" of poverty alleviation, which can, obviously, only be measured accurately on a household level. Their contemporaries entrenched in the discipline of economics will argue, instead, that efficacy can be measured by statistics involving the functioning of institution itself, as their "desired result," is a maximized portfolio, or, simply, a profit. Ultimately, the question of "efficacy" is a question of "desired results." Ideally, however, an effective microfinance institution can juggle the two goals and so too should a successful analytical strategy.

---

[109] Lapenu and Zeller, "Distribution, Growth, and Performance," 32.
[110] Lapenu and Zeller, "Distribution, Growth, and Performance," 32.
[111] Shil, "A Commercialized View," 196.

A. Household Impact

Household impact studies considering the depth poverty alleviation inspired by microfinance have generally had mixed results. These studies may consider any combination of "loan repayment, community development, capacity building, family consumption, and savings," levels.[112] However, very few thorough studies have been conducted on a household level in Central America. Montgomery confirms this assertion: "Despite the current enthusiasm in the donor community for microfinance programs, rigorous research on the outreach, impact and cost-effectiveness of such programs is rare."[113] This may be due to the general difficulties involved in conducting household impact surveys—including the large amount of man power necessary to survey a large enough pool of participants for a long enough period in order for the research to be reliable. Likewise, household studies invariably study a microcosm—and the applicability of the findings, must then, be met with a certain level of skepticism. If the findings are applicable outside of that particular populous, the infinite variables involved preclude applicability outside of regional comparisons.

Yet another reason that household studies may be avoided is the impenetrable logic of microfinance. In its most base form, microfinance operates on a lesson from Economics 101: an increase in capital will result in an increase in profits. Given the banality and widespread acceptance of this principal—investing in a comprehensive analysis of microfinance may seem wasteful, much like proving the existence of gravity.

Ultimately, the results of the existing household impact studies do not demonstrate any solid trend supporting or negating microfinance's ability to combat poverty. For example, Montgomery reports that "the available studies suggest that MFIs, whilst they may be flourishing

---

[112] Shil, "A Commercialized View," 196-197.
[113] Montgomery and Weiss, "Great Expectations," 26.

in commercial terms, and providing valuable service to micro enterprises often run by poor entrepreneurs, have relatively weak impact on those at the very bottom of the income distribution."[114] However, Hiatt reports that "current [microfinance] clients who have participated [...] for more than a year were observed to earn more money daily, and hence, were less poor, than those who had recently joined the microfinance program," and also asserts that this improvement in income is generally higher than for those who have stopped participating in the program.[115] Likely, both sets of findings are true. However, because a household study must examine just a portion of the many hundreds of thousands of borrowers involved in microfinance, reliability and applicability of the data must be considered. Conversely, without household surveys the everyday and long term effects of borrowing on a human level, the level of poverty alleviation and development, cannot be known.

B. Sustainability and Profitability

The other element necessary to a successful microfinance institution is profitability—it must be organizationally efficient and cost effective so as to remain a sustainable and viable business. While a positive impact on poverty alleviation is important, it is not enough to earn the support of the necessary investors. Some worry that the competition encouraged by institutions interested in profitability will drive down interest rates and thereby eliminate the revenue required to offer the smallest and riskiest loans (which often are correlated with the most poverty alleviation). However, as McIntosh states, "competition never makes any profitable institution worse off." (McIntosh 285). Thus, cost effectiveness is key.

Measuring cost effectiveness, and likewise the sustainability of an organization is much simpler than measuring depth of outreach. Profit margins, portfolio sizes, and delinquency rates

---

[114] Montgomery and Weiss, "Great Expectations," 26.
[115] Hiatt and Woodworth, "Poverty through Microfinance," 476.

can be used to rate the strength of a MFI. In studies that have compared the profitability of Latin American microfinance institutions, almost all organizations studies showed positive returns, including NGOs—however, the "most profitable institutions are regulated entities,"—which include both commercial banks and regulated non-bank MFIs.[116]

This is because regulated institutions tend to be more efficient.[117] As MFIs become regulated, they begin competing with commercial banks and operating in a different part of the microfinance sector than non-profit NGOs. Given this increased competition, microfinance institutions must update their strategies and lower costs, becoming more efficient. Some of these strategies include the use of experienced loan offers and the development of a loyal customer base, improved product development [...] introducing new technologies, [and] using market intelligence."[118] These changes are not only good for the company, but often also benefit the clientele of that organization, offering better service, faster service, and more services. Also, regulated microfinance institutions often have a larger client base, and thereby become more profitable via economies of scale.

However, this is not to say the NGOs are completely inefficient and should be dismissed. As previously mentioned, in one study all NGOs in Latin America were registering positive returns, and likewise, "the average delinquency levels of institutions that specialize in microcredit exhibit better indicators than those of commercial banks."[119] One reason for this may be that often, micro loans are distributed with initially small sizes, which are increased when a reliable borrower returns for another loan. This practice is a built in risk management technique which traditional commercial banks do not employ.

---

[116] Marulanda and Otero, "Profile on Microfinance," 11-12.
[117] Berger, "The Latin American Model," 61.
[118] Berger, "The Latin American Model," 60.
[119] Marulanda and Otero, "Profile on Microfinance," 13.

C. Problems with Measuring Efficacy

Having offered this variety of means to measure the efficacy microfinance, I must also address the problems associated with the accuracy of these measures. The following hindrances have been identified with measuring the efficacy of microfinance generally, in response to the growing cloud of skepticism surrounding the reported success of microfinance in alleviating poverty. However, these issues are relevant to an institutional analysis of efficacy, as the two problems both seek to answer the question, "Is microfinance working, and, if so, under what circumstances?"

Armendariz de Aghion and Morduch, in their book *The Economics of Microfinance* offer a clear and through outline of the majority of these issues.[120] First, they identify is that no microfinance organization lends to random citizens.[121] There exists a question of "measurable and immeasurable human traits," which determine who applies for a loan and what he or she does with that capital, some of which the loan selection process screens for, and some of which remain unknown.[122] For example, entrepreneurial drive can neither be quantified, nor removed from the equation of profitability for a micro enterprise. This throws a figurative wrench into the calculations about the efficacy of microfinance.

Next, MFIs, particularly in Latin America, tend located in urban areas.[123] This obviously skews the data, as the most poor (usually living in rural areas) have the least access to microcredit opportunities. Thus, the tendency of MFIs to be in local settings can influence the data about efficacy in such a way that indicates (misleadingly) microfinance, as a development tool, does not affect the people in the lowest rung of the socioeconomic ladder.

---

[120] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 222.
[121] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 232.
[122] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 232.
[123] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 232.

Finally, a change in profit, an increase or a decrease, cannot simply be attributed to a given loan. There are too many other variables that could effect a change in profit, including fluctuating amounts of opportunity in the markets into which micro enterprises join, as well as an infinite number of household variables that may affect the business practices of the enterprise.[124] Likewise, it is important to realize that the loan itself does not create economic opportunity. There must be a niche in the market that needs to be filled in order for the loan to result in increased profitability.

Sometimes the efficacy of microfinance is measured by monitoring the amount of savings before and after receiving the loan. However, many people with very low incomes in rural areas—those who traditional microfinance seek to serve—do not invest safely or systematically. It must also be considered that the poor may not have an institutionalized trust in banking, especially considering the various hyperinflationary crises through which Latin Americans have suffered. They may, instead, invest their savings in livestock or farm equipment, which is not measurable statistically in the way that a simple savings account dollar amount would be. Also, small entrepreneurs may not invest in their earnings in growth of their business, but instead, "other asset-building activities such as children's education, fixing a leaky roof, better nutrition, [and] dealing with emergencies."[125] This lower amount of re-investment into the business may "translate into lower profits and daily income…as profits and accumulated savings are invested in assets other than her business," which can lead to further statistical variance and immeasurability.[126]

---

[124] Rhyne, *Mainstreaming Microfinance*, 188.
[125] Hiatt and Woodworth, "Poverty Through Microfinance," 476.
[126] Hiatt and Woodworth, "Poverty through Microfinance," 476.

However, despite these challenges, analysis of microfinance must continue. As Armendariz de Aghion and Morduch indicate, it is "still possible to evaluate how profit change[s] with [an increase in] capital," and, to this end, this paper seeks to evaluate the affects a newly commercialized market, with a wide array of institutions affects said profit changes.[127] In fact, the difficulty of these innumerable variables and the seeming impossibility of developing a useful statistical methodology for measuring microfinance is further compounded by the "variations found in the practice in the way which microfinance operates,"—explicitly the institutional variations between commercial banks and NGOs[128]

VI. FINCA and ProCredit Profiles

To premise this data set, it must be recognized that there exists a shortage of relevant research concerning microfinance operations in Latin America. Montgomery and Weiss note, " the impact of microfinance on poverty has been less well documented both in a methodological sense and in terms of coverage in individual studies, which tend to be concentrated in a small number of countries, principally of Peru and Bolivia."[129] While this focus on Peru and Bolivia have two of the region's largest gross loan portfolios for microfinance—3,968,209,071 and 1,556,113,293 respectively.[130] However, this paper intends to focus in Central America, as geographically small states tend to be understudied, especially perplexing because they face a separate set of challenges than South American nations. They simply face a different and unique set have infrastructural and resource dilemmas. The problem of limited data is corroborated by

[127] Armendariz de Aghion and Morduch, *Economics of Microfinance*, 234.
[128] Montgomery and Weiss, "Great Expectations," 26.
[129] Montgomery and Weiss, "Great Expectations," 18.
[130] Microfinance Information Exchange (MIX). http://www.mixmarket.org/mfi/region/Latin %20America%20and%20The%20Caribbean.

McIntosh's statement that "A limited amount of work [...] has undertaken a broader look at the industrial organization of the microfinance movement."[131]

The statistics presented in the following section come from the Microfinance Information Exchange, Inc (MIX) unless otherwise noted. MIX is a revolutionary online database that is working towards providing increasing transparency in the microfinance sector, recognizing one of the fundamental struggles of the industry: "the lack of reliable, comparable and publicly available information on the financial strength and performance of microfinance institutions."[132]

Due to the demonstrated complexity of the microfinance sector in Latin America, the scope of this paper does not permit the thorough analysis of the hundreds of organizations operating in the region necessary to produce an exhaustive understanding of varying institutional efficacies. Instead, I offer comparative profiles of two organizations operating in both Nicaragua and El Salvador—FINCA and ProCredit—as a miniature case study.

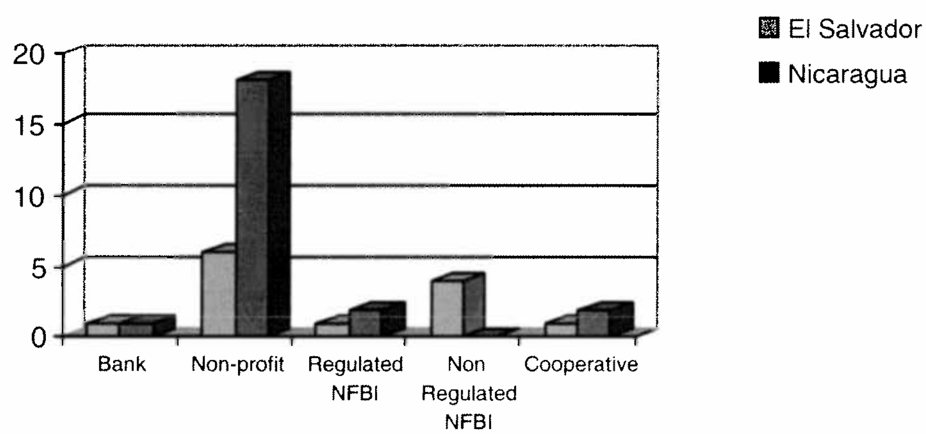


Figure 2. Breakdown of MFIs by Legal Status in El Salvador and Nicaragua

131 McIntosh and Wydick, "Competition and Microfinance," 273.
132 Microfinance Information Exchange. MIX offers information about microfinance organizations organized by region, country, and organization. They also offer business information from market facilitators and donor organizations.

I selected El Salvador and Nicaragua, first because there is a considerable lack of study on microfinance in the sub-region, despite its prevalence—what some call "astounding." [133] As show in the graph above, of the 13 Salvadoran microfinance organizations reporting to MIX, six are non-profit organizations, four are non-regulated NFBIs (Non-Bank Financial Institution), and one of each of the following: a bank, a regulated NFBI, and a credit union/cooperative. Nicaragua has a significantly higher proportion of non-regulated non-profits (18 of 23). There are also two regulated NBFIs, two non-regulated cooperative/credit unions and one bank.

Also, El Salvador and Nicaragua share a political history in which "both the United States and the European Union have desired to develop an entrepreneurial middle-class in the region in order to try to bridge the societal divisions responsible for civil wars during the 1980s".[134] Also, El Salvador and Nicaragua have comparable population makeups, in terms of rural and urban distribution; yet have considerably different GDPs, which offers a deeper layer of understanding about the way microfinance functions microfinance in Central America. The 2008 GDP per capita was $2900 in Nicaragua, while the 2009 GDP per capita in El Salvador registered at $7100.[135]

When determining which organizations I would compare, I attempted to control as many variables as possible, in such a way that the statistical differences can be attributed to institutional variance, as opposed to the size or location of the organization. Ultimately, considering the lengthy literature about the commercialization of the sector, including a bank was imperative. Then, I included a non-profit NGO, given that this type of organization makes up the largest sector of the market in both countries. I selected FINCA and ProCredit because

---

[133] McIntosh and Wydick, "Competition and Microfinance," 275.
[134] McIntosh and Wydick, "Competition and Microfinance," 275.
[135] The World Factbook, (Washington DC: The Central Intelligence Agency, 2009), https://www.cia.gov/library/publications/the-world-factbook/geos/es.html.

they are both large international operations with similar infrastructure. Both operate in El Salvador and Nicaragua, and both have an international headquarters, with branch office spread across the globe. However, this is generally where their similarities end.

FINCA self describes as a "truly global organization," that "builds sustainable programs that achieve the highest standards of financial performance" and simultaneously "retains focus on serving the poorest of the working poor."[136] It functions as a non-profit NGO and relies heavily on donors to fund its operations. Recognizing the "paradox" inherent in microfinance as outlined previously, they describe their work as the "best of both worlds: sustainable, financially-sound programs that serve the very poor." [137] However, they also describe themselves as a "banker with a soul," which, in combination with their non-profit status, suggests poverty alleviation as a primary goal.

ProCredit, alternatively, is a commercial bank that recognizes the "significant untapped demand for credit from individual entrepreneurs and small businesses in [their] countries of operation."[138] ProCredit attempts to offer the lowest possible interest rates, often driving down the market price for loans as it enters a region. When describing their business practices, they use terms like "analyze the debt capacity" and "adequate assessment,"—technical jargon which stands in obvious contrast to the language of FINCA's "banker with a soul." [139]

Concerning the "paradox," ProCredit states, "our business is not only developmentally relevant, but is also profitable, sustainable and very fast-growing."[140] As an organization,

---

[136] FINCA Business Model. http://www.finca.org/site/c.erKPI2PCIoE/b.2604301/k.9A41/Business_Model.htm.
[137] FINCA Business Model.
[138] ProCredit Business Philosophy. http://www.procredit-holding.com/front_content.php?idcat=23.
[139]ProCredit Business Philosophy.
[140] ProCredit Business Philosophy.

ProCredit has been quite vocal against microfinance as a development tool, saying "the claims and hype regarding what microfinance can achieve to be excessive" and also that "microfinance is hardly the solution to the problems of abject poverty."[141] However, before writing off ProCredit as a profit-hungry, corporate evil empire, it is important to consider their "focus on building stable institutions that make vital contributions to building the financial sector."[142] Given each of these factors, it seems that ProCredit may name financial sustainability, as it's primary goal.

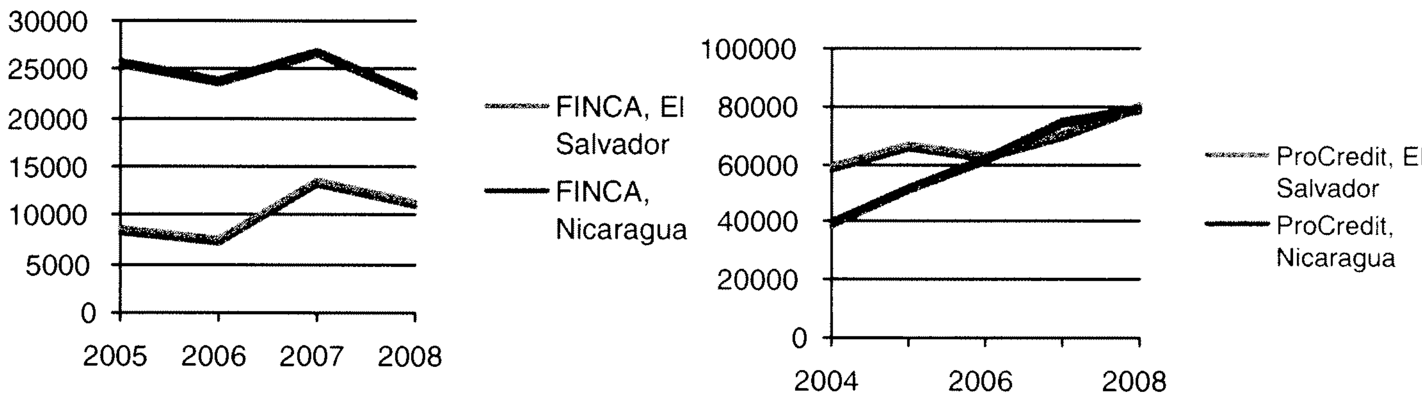


Figure 3. Number of Loan Borrowers from FINCA and ProCredit in El Salvador and Nicaragua

This data suggests a general increase in the number of loans being provided that is consistent with trends across the region. El Salvador has both a smaller population and a larger GDP per capita than Nicaragua, and thus, it can be expected that fewer microfinance loans would be distributed than in Nicaragua, as is demonstrated in the FINCA comparison (left). However, the ProCredit graph (right) demonstrates a relative equality in borrowing in both Nicaragua and El Salvador. This difference may be explained by ProCredit's willingness to provide larger loans that, while still registering as microfinance, are not strictly contributing to deep poverty

[141] ProCredit Business Philosophy.
[142] ProCredit Business Philosophy.

alleviation, but instead, may be supplied to pre-existing micro enterprises or other larger commercial functions. The market for this size of loan is currently expanding.

It must also be noted ProCredit controls a considerably larger portion of the microfinance sector, with the highest number of borrowers from FINCA's portfolio (26994, Nicaragua, 2008) falling far below even the number of borrowers in ProCredit's lowest portfolio year from this data set (40725, Nicaragua, 2004). Also, it seems FINCA's borrowing rends are much more volatile than the steady increase seen in both ProCredit cases. FINCA's reliance on donors for much of their funding may account for this difference. The largest dip in both FINCA trend lines occurs in 2006, a year in which the global financial market was in crisis. Because we live in a globalized world, and certainly in a globalized financial system, this crisis may have vary easily decreased the amount of funds available for distribution within FINCA, especially given the simultaneous decrease in both countries. Given this reality, MFIs analyzing their long-term sustainability must consider their reliance on donors, recognizing the vulnerability inherent to such a dependency. In what appears to be a testament to ProCredit's "focus on building sustainable institutions," the number of borrowers has increased regularly in Nicaragua and at least generally in El Salvador. This is likely due to a focus on long-term sustainability in business policies that involves extensive risk assessment and portfolio analysis.

However, it is important to note that ProCredit's steady increase in number of borrowers does not correlate with a conspicuous or discernible decrease in the number of people borrowing from FINCA. While this author remains hesitant to make sweeping generalizations based on a snapshot of a corner of the microcredit market, this data seems to suggest ProCredit—a commercial bank and FINCA—a non-profit lender, can coexist, despite many overstated concerns about the invasion of heartless commercial banks into micro lending.

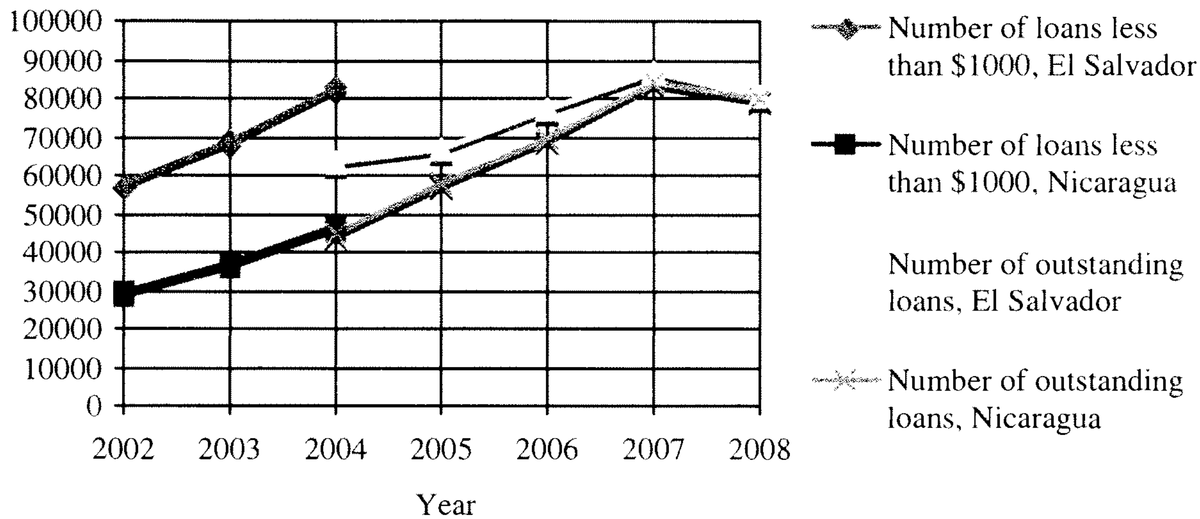


Figure 4. Number of Microloans Distributed in El Salvador and Nicaragua

Unfortunately, these two data sets, coming from separate sources[143]—concerning loans less than $1000 distributed and loans outstanding—only overlap at one point, 2004, thereby severely limiting the strength of conclusions drawn from this graph. This is yet another example of the lack of research concerning microfinance and the degree to which it impinges our understanding of its affects on development. Also, this discrepancy in sources also accounts for, in 2004, the number of loans less than $1000 in El Salvador actually appearing greater than the number outstanding loans in El Salvador. The source of this particular discrepancy may be that some of the lenders from which Berger gathered data might not (yet) be reporting to MIX.

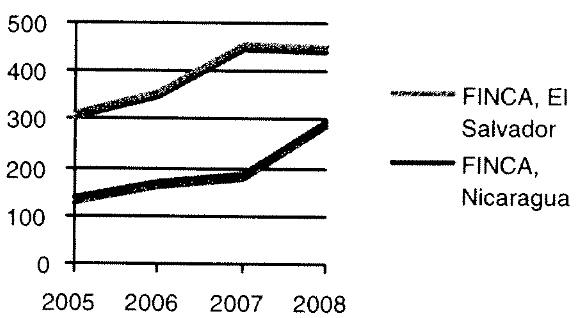
What this graph, despite its shortcomings, does suggest is, first, the continued explosion of microfinance within both Central American countries. Secondly, and more profoundly, the similar slope of all four lines suggests that overall growth of microfinance is expanding proportionately with the growth of the sector that services loans less than $1000. This is a promising indicator that despite concerns that the commercialization of the industry would somehow pervert the principle of inclusion and poverty alleviation inherent to microfinance, the

---

[143] Berger, "A Latin American Model," 55.

expansion of the market and the availability of larger loans does not seem to have hindered the continued expansion of loans less than $1000.

This is corroborated by Berger, who explains that despite a product range in which commercial banks offer loans exceeding $100,000, "disbursing a larger number of micro loans remains their core business."[144] In fact, "some 80 percent of all loans distributed [...] are for less than $1000," which, in turn, legitimizes the possibility that despite being primarily motivated by profit, a commercial bank, like ProCredit, could offer microfinance loans of a size thought that alleviate poverty.[145]



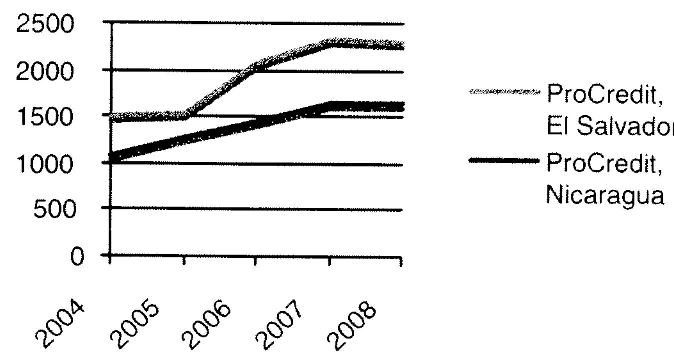


Figure 5. Loan Size Trends in the Microcredit Sector Over Time in Nicaragua and El Salvador

These graphs suggest loan sizes, like the number of loans, in the Central American market, are on the rise. However, it is important note that the average FINCA loan is considerable smaller (about half, in fact) the size of an average ProCredit loan in the two countries being compared.

Further, this set of graphs, like the previous data set, suggests that ProCredit and FINCA—while both operating nominally as microfinance lenders, they may actually lend to

[144] Berger, "The Latin American Model," 54.
[145] Berger, "The Latin American Model," 54.

separate sectors of the market and may not, contrary to popular belief, be in direct competition at this time.

The final factor that must be considered in order to understand the institutional viability of these two organizations is profit margins. A study conducted by Mosley found that loan impact—that is, poverty alleviation as an affect of microcredit—measured in terms of change in borrower income, "was greater in the more financially viable institutions."[146]

The simplest way to compare financial viability is to compare profit margins. While, realistically, non-profit organizations like FINCA do not necessarily need high profit margins to remain viable (as they can rely on donor bail-out), it is nonetheless a measure of good business practices, which in tern, correlate with financial viability. The average profit margin of ProCredit and FINCA operating in Nicaragua between 2004 and 2008 were 8.83 percent and 12.93 percent, respectively. In El Salvador, the profit margins were significantly lower for both organizations, with FINCA registering at -18.2 percent and ProCredit at 7.88 percent. If Mosley's findings about loan impact holds true in this scenario, ProCredit would have a significantly higher loan impact than FINCA—given their significantly higher profit margins. It is important to note that FINCA, in both countries examined in the given period (between 2004 and 2008), registered negative profit margins, while ProCredit's profits were always positive, though sometimes dipping below 2 percent. This difference can be explained in terms of "screening efficiency of higher interest rates and tighter repayment conditions, which deter less financially sound borrowers."[147] Berger corroborates this idea, attributing high profitability with "maintaining high

[146] Montgomery and Weiss, "Great Expectations," 22.
[147] Montgomery and Weiss, "Great Expectations," 22.

loan portfolio quality, maintaining market interest rates, reducing transaction costs, and increasing efficiency in the face of growing margin pressure on interest rates,"[148]

While some Latin American markets have undergone intense commercialization, it seems this has yet to occur in either Nicaragua or El Salvador. At this point, FINCA seems to be relatively stable as an NGO despite its sometimes-ailing profit margins. However, given the industry's incessant growth, commercialization seems imminent. MFIs, traditionally, have taken one of two routes to remain competitive. Either they can "lower interest rates dramatically to make their products more competitive," or "pull away from [their] initial mission of offer smaller loans [...] and instead, lend to a wealthier, more lucrative segment of the market."[149] It seems, then, in terms of sustainability and profitability, commercialized banks and upscaled MFIs—which operate with similar business practices—may be the most effective. Yet, the data produced here suggests NGOs and commercial banks are still serving separate niches within the market, despite coexisting under the blanket term of microfinance, thus debunking the myth that commercial banks and NGOs need be rivals within the market. However, this data, by nature, largely addresses the question of sustainability and profitability of these two organizations, without responding thoroughly to the question institutional efficacy in poverty alleviation and outreach. Unfortunately, there is a severe lack of relevant data, largely due to the measuring constraints described on page 31.

What studies have been done generally indicate, although somewhat questionably, microfinance to alleviate poverty. Hiatt found that the minimum daily wage of current microfinance clients to be the highest ($1.38) compared with ex-clients and new clients (Hiatt

[148] Berger, "The Latin American Model," 64.
[149] Berger, "The Latin American Model," 61. And McIntosh and Wydick, "Competition and Microfinance," 276.

475). Ex-clients had the second highest daily wages ($1.18).[150] A 1996 Hulme and Mosley (in Bolivia) study indicates the "growth of incomes of borrowers always exceeds that of the control group."[151] Likewise, a 2001 study (in Bolivia) found "growth of incomes and assets of borrowers always exceeds that of the control group."[152] Finally, a 2001 Drunn and Arbuckle study (in Peru) showed "substantial increases in net income, assets and employments relative to those of non-participants."[153]

While these studies report favorably about microfinance, none refer to the type of institution distributing the loans, and, likewise, focus on Latin America, but outside of Central America. However, it seems safe to say—because of the pervasiveness of NGOs in the region during the period in which these studies were conducted. However, the literature does suggest that NGOs are effective in their attempts out outreach and poverty alleviation using small-scale loans.

VII. Looking Forward: Recommendations and Forecasts

These results are predictable, yet troubling. Each type of institution is most effective at either sustainability or outreach, not surprisingly, correlating with what their primary objectives seem to be. However, this data also suggests that the two types of institution—non-profits and commercial banks—can coexists within the same market by offering different sized loans. Thus, each type of institution has its own target population upon whom that organization can focus on best serving. In the case of commercial banks, this may involve a concentration on "financial services, in particular, mobilizing savings."[154] Likewise, there are lessons each type of institution

[150] Hiatt and Woodworth, "Poverty through Microfinance," 475.
[151] Montgomery and Weiss, "Great Expectations," 14.
[152] Montgomery and Weiss, "Great Expectations," 14.
[153] Montgomery and Weiss, "Great Expectations," 14.
[154] Lapenu and Zeller, "Distribution, Growth and Performance," 23.

must learn from its competitor. Recall the graph on page 10 describing the paradox of providing microfinance. A successful institution must balance these two goals, and to that end, must be willing to continually innovate and reassess their practices—and particularly, must incorporate lessons learned from the experience of their competitors.

Likewise, it is important to understand the dynamic relationship between poverty alleviation and profitability because as microfinance continues to prove itself as a successful tool for development, increasing volumes of capital will be diverted into this industry. For example, recently a $5 million loan was approved by the Inter-American Development Bank from the Opportunities for the Majority initiative "to help a social-oriented fund invest in microfinance institutions that provide access to basic services to vulnerable populations throughout [Latin America]."[155] This sum will be added to an already existing fund of $25 million to be used in support of microfinance. As the industry continues to grow, researchers must carefully monitor which institutions have the most success—not from a sheer academic interest, but because of the opportunity this fund, and others like it, offers to hundreds of thousands of struggling people all over the world.

Given the preceding analysis, the following question resonates: Can multiple types of MFIs actually share the microcredit market in Central America? The answer, at this time, seems to be a resounding yes. Before BancoSol upscaled and began the transition into regulated finance, "profitability was almost a dirty word."[156] However, today, it seems commercial banks can alleviate poverty and operate in the microfinance sector and simultaneously turn a profit. This author's response to these questions can be extrapolated from the following remark by

---

[155] Inter-American Development Bank, "Microfinance Institutions in Latin America To Deliver Innovative Social Investments With IDB Aid," eGov Mointor, December 15, 2009, http://www.egovmonitor.com/node/32103 (accessed March 3, 2010).
[156] Berger, "A Latin American Model," 62.

Raderstrong: "Microfinance only does what normal loans do: give access to credit. It provides a service where there was none before."[157] Then, question then becomes: What changes must be by the various institutionally actors made to facilitate this coexistence and create the most efficient market?

If the economic tenant that an increase in capital will result in an increase in profit holds true at any level, as microfinance has proven, then fearing larger or more urban lending by commercial banks is irrational. These banks are simply serving another yet unserved niche in the credit market. While NGOs will continue to operate in mostly rural areas, providing the smallest scale loans, commercial banks will serve yet another portion of the market. Yes, there will likely be increased competition. A study by Accion International found that those involved in the microfinance sector in Latin America forecasted that in 10 years regulated microfinance institutions and commercial banks will dominate the microfinance sector.[158] One respondent, working at Mibanco in Peru said, "In ten years I see that large commercial banks will be making a very strong incursion into the industry, maintaining a strong market penetration and offering new products and services."[159] This comment corroborates the data analysis of this paper, and likewise, confirms the role banks are playing in the sector.

It has been demonstrated that in terms of profitability and sustainability, banks are more efficient. Marulanda confirms this, "Even though the upgrading model followed by informal microfinance institutions enables them to provide a full range of financial services, banks can provide these products and services more efficiently."[160] Thus, NGOs have much to learn from the business practices of banks—however, this should be seen by these organizations as an

---

[157] Raderstrong, "2009: Microfinance Died."
[158] Marulanda and Otero, "A Profile on Microfinance," 16.
[159] Marulanda and Otero, "A Profile on Microfinance," 17.
[160] Marulanda, "Downscaling," 105.

opportunity for growth and development. Just as Ford or Toyota must be innovative to remain competitive, so too must NGOs continue to reinvent themselves and their practices to be as efficient as possible. However, simultaneously, "if public policy is to encourage the transformation of NGOs into regulated financial institutions or if the delivery of small loans is to be left to the commercial banking sector, the concern that the client base will change so that poor clients are excluded by application of tighter commercial criteria must be addressed."[161]

First, NGOs must be sure to "restrict grant funding to the poorest potential borrowers," in order to avoid destroying a competitive microfinance sector, and instead, as "client-maximizing non-profit institutions undercut profit-minimizers."[162] Likewise, non-profits must consider stepped lending as a means of sustaining funding and remaining a viable institution. In this process, clients are offered small loans initially, but over time with a successful repayment record, are offered increasingly larger loans. The interest generated by these larger loans, which are likely to be repaid, given the client's history (a built in risk assessment) can be used to fund higher-risk loans and continue to fund poverty alleviation. Also, non-profit microfinance providers must continue to direct both the bulk of their lending as well as the subsidy funds they receive to rural areas, which remain yet unserved. A statement from Hector Chamoro of Banco Santander Banefe corroborates this. When asked about the future role of NGOs in microfinance, he replied, "NGOs should have the principal objective in the future of reaching the distant geographic regions, where larger numbers of individuals will still be unable to access credit."[163] Additionally, NGOs should continue to provide training and consulting services, as well as business development skills training, while also charging interest rates high enough to recover (at

---

[161] Montgomery and Weiss, "Great Expectations," 5.
[162] McIntosh and Wydick, "Competition and Microfinance," 272.
[163] Marulanda and Otero, "Profile on Microfinance," 19.

least) part of their costs. Balancing these tasks is obviously a tall order. However, as Carmen Velasco of ProMujer articulated, "The good ones will survive and be well positioned to serve certain market niches throughout the world. The weak ones that have not been able to reach efficiency and profitability will die."[164]

That said, commercial banks also have some learning to do. Primarily, investors typically want "dramatic profit-linked growth usually brought about by ruthless cost cutting and efficiency in as short a time," which, especially considering the considerably small returns on a micro loan, is not often possible when engaging in microfinance.[165] Instead, banks must attract investors with a social conscious that are willing to wait for returns on investments in exchange for their contribution to a social good.

There is also a role for government in the future of the microfinance sector. Marulanda suggests that the government should curb the "nonprofit mentality of many financial institutions" in which a "culture of nonpayment can exist."[166] However, this author sees the role of government in this sector as being an active decision to remain inactive. It should not offer subsidies to institutions that cannot remain profitable, nor relax rules concerning credit control for non-profits. If an institution is not sustainable, it must either fail or rely on donor support. The primary action items for governments should be the promotion of microfinance, but not actual financial support of the sector.

Microfinance has come a long way since its inception: "only 25 years ago, the ability of microenterprise operators to repay commercial loans was in doubt. Today, it is understood that

---

[164] Marulanda and Otero, "Profile on Microfinance," 19.
[165] Sanjay Anandaram, "Is Social Entrepreneurship an Oxymoron," *India Chief Mentor* Weblog, entry posted February 15, 2010, http://blogs.wsj.com/india-chief-mentor/2010/02/15/is-social-entrepreneurship-an-oxymoron-sanjay-anandaram/ (accessed March 12, 2010).
[166] Marulanda, "Downscaling," 105.

microenterprises not only pay off their loans, but they pay fully and promptly and demand an entire range of financial services."[167] It seems unlikely that Yunus could have predicted the explosion of small scale lending that would follow his initial experiment, and likewise, it is difficult to forecast the condition of the market during the next 10 to 15 years. However, this paper has demonstrated that banks and NGOs should be able to coexist—serving separate sectors and servicing separate goals within the microfinance market. This is good.

In conclusion, while microfinance may not "work as a cause of smile for a vast majority poor people who suffer from acute poverty level in terms of hunger, illiteracy, ignorance, slavery, and insecurity and such other in humanitarian condition," it does provide capital to an otherwise unserved market.[168] Ultimately, the market will demonstrate which types of institutions are most viable for serving which respective niche in the microfinance sector. While additional household assessment surveys considering the efficacy of microfinance would be valuable, the ultimate test will be sheer economics. The organizations that survive as the sector continues to evolve, whether or not they rely on donors, will prove to be the most effective—both in the obvious terms of profitability, but also in terms of success in poverty alleviation. To suggest otherwise would be to suggest that microfinance borrowers are somehow not rational actors and cannot determine which loan provider will best serve their interests. Instead, we must trust the rationality of these borrowers and the strength of the market to eliminate the least efficient lenders, leaving a vibrant and dynamic microfinance sector that is both sustainable and impacting poverty alleviation.

---

[167] Miller-Sanabria, Tomas. "The Future of Microfinance in Latin America," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, 269 (Washington DC: Inter-American Development Bank, 2006).
[168] Shil, "A Commercialized View," 200.

BIBLIOGRAPHY

Anandaram, Sanjay. "Is Social Entrepreneurship an Oxymoron," *India Chief Mentor* Weblog, entry posted February 15, 2010, http://blogs.wsj.com/india-chief-mentor/2010/02/15/is-social-entrepreneurship-an-oxymoron-sanjay-anandaram/ (accessed March 12, 2010).

Anonymous. "The Microfinance Boom," *Livemint.com* Weblog, Entry posted October 27, 2009, http://www.livemint.com/2009/10/27213930/The-microfinance-boom.html?h=B (accessed November 30, 2009).

Armendariz de Aghion, Beatriz and Jonathan Morduch. *Economics of Microfinance.* Cambridge, MA: The MIT Press, 2005.

Marguerite Berger, "The Latin American Model of Microfinance," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, 54 (Washington DC: Inter-American Development Bank, 2006).

FINCA Business Model. http://www.finca.org/site/c.erKPI2PCIoE/b.2604301/k.9A41/Business_Model.htm.

Hiatt, Shon R. and Warner P. Woodworth. "Poverty through Microfinance: Village Banking Outcome in Central America." *The Social Science Journal* 43 (2006): 471-477.

Lapenu, Ceclie and Manfred Zeller. "Distribution, Growth, and Performance of Microfinance Institutions in Africa, Asia, and Latin America." (FCND discussion paper, no. 114, June 2001):1-30.

Marulanda, Beatriz. "Downscaling: Moving Latin American Banks into Microfinance," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, Washington DC: Inter-American Development Bank, 2006.

Marulanda, Beatriz and Maria Otero. "The Profile of Microfinance in Latin America in 10 Years: Vision and Characteristics." *Accion* (April 2005): 1-48.

McIntosh, Craig and Bruce Wydick. "Competition and Microfinance." *Journal of Development Economics* 78 (2005): 271-298.

Microfinance Information Exchange (MIX). http://www.mixmarket.org/mfi/region/Latin%20America%20and%20The%20Caribbean.

Miller-Sanabria, Tomas. "The Future of Microfinance in Latin America," in *Inside View of Latin American Microfinance*?, ed. Marguerite Berger, Lara Goldmark and Tomas Miller-Sanbria, Washington DC: Inter-American Development Bank, 2006.

Montgomery, Heather and John Weiss. "Great Expectations: Microfinance and Poverty Reduction in Asia and Latin America." (ADB Institute Research Paper Series, no. 63, February 2005): 1-30.

Nair, Shraddha and Deepti Chaudhary. "Investors Happy as Microfinance Lenders Discipline Growth." *Livemint.com* Weblog, entry posted January 12, 2010, http://www.livemint.com /2010/ 01/12230210/Investors-happy-as-microfinanc.html (accessed February 4, 2010).

ProCredit Business Philosophy. http://www.procredit-holding.com/front_content.php?idcat=23.

Raderstrong, Jeff. "2009: The Year that Microfinance Died." *Change Charity* Weblog, entry posted December 30, 2009, http://changecharity.blogspot.com/2009/12/2009-year-microfinance-died.html (accessed February 15, 2010).

Retzky, Andrea. "Half of the World is 'Unbanked'." Reuters, November 2, 2009, http://www.reuters.com/article/idUS133998+02-Nov-2009+PRN20091102 (accessed March 2, 2010).

Rhyne, Elisabeth. *Mainstreaming Microfinance: How Lending to the Poor Began, Grew, and Came of Age in Bolivia,* Bloomfield, CT: Kumarian Press, Inc., 2001.

Rutherford, Stuart. *The Poor and Their Money.* Oxford, NY: Oxford University Press, 2000.

Shil, Nikhil Chandra. "Micro Finance for Poverty Alleviation: A Commercialized View." *International Journal of Economics and Finance* 1.2 (August 2009): 191-205.

The World Factbook, (Washington DC: The Central Intelligence Agency, 2009), https://www.cia.gov/library/publications/the-world-factbook/geos/es.html.