Microfinance in Latin America:

Evidence Found in Mexico and South America

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1. Introduction

The seeds for this paper were sown almost two years ago, when I first met Professor Paul Melendez. His ethics course went beyond covering American issues related to ethical business practices and magnified ethics to an international level, opening my eyes to an entirely new way of thinking. I was attracted to the complexity of international ethics, an interest that expanded further when I was granted the opportunity to attend the Costa Rica Study Tour with Professor Melendez and other students.

For roughly two weeks in May 2008, I would travel through San Jose, San Ramon, and Puerto Viejo listening to a series of speakers on topics such as the Central American Free Trade Agreement (CAFTA), the impact of ecotourism on the local economy and environment, and local business practices (corporate social responsibility, or CSR). It was during a talk concerning environmentally friendly tourism, called ecotourism, that I first heard about microfinance. The lecture occurred during our stay at Hotel Villa Blanca, an eco-friendly tourist resort in the cloud forest near San Ramon; the speaker was Senor Rodrigo Carazo, former Vice President of Costa Rica and Villa Blanca's founder and owner. Towards the end of his speech, he briefly mentioned an exciting new microfinance venture starting up in San Ramon.

Although he didn't know much about the project, my finance interest was piqued. Even with a finance major, this was a term I had never heard mentioned in my courses. Soon after, Professor Melendez offered all of us the opportunity to mentor with him to complete a thesis on microfinance and, hopefully, this new venture in San Ramon. After some debate, I grew convinced that this was a wonderful opportunity to expand both my knowledge of finance and my knowledge of ethics; remembering how passionately Senor Carazo spoke of the project helped galvanize my commitment to research it for my honors thesis. Unfortunately, despite the best efforts of Professor Melendez, Senor Carazo, and myself, the necessary information about the San Ramon project was unattainable. Therefore, case studies will be used instead to supplement my discussion of microfinance.

To begin, it is necessary to understand the underlying ideas behind microfinance as well as the general definition of what constitutes microfinance. Microfinance is actually the tool of a much larger concept called "the fortune at the bottom of the pyramid" (BOP). Therefore, this paper opens with a brief introduction to the BOP and microfinance, along with a typology to help classify the different forms of microfinance. Then, it moves on to a deeper discussion of these concepts with a detailed literature review of the authors whose ideas are the driving force behind the microfinance movement coupled with supporting literature specific to Latin America. This leads to the series of case studies, which are classified using the typology to showcase three microfinance ventures microfinance found in Mexico and South America. Finally, conclusions are drawn about what aspects of these microfinance programs allow them to work best in Latin American countries.

Overview of the Bottom of the Pyramid and Microfinance

We begin with what C. K Prahalad terms the "fortune at the bottom of the pyramid." The bottom of the pyramid, or BOP, consists of the world's 4 billion poor (Prahalad, 2005, p. 3). Prahalad believes that the disadvantaged are very resourceful and resilient people; as a result, it should be possible to partner with them financially to lift them from poverty. First, we must create a better approach – one that is innovative, sustainable, and actively engaged – to improve the poor's lot in life at the same time that the companies providing products and services to them are profitable (Prahalad, 2005).

This new approach is microfinance, the tool used to engage the bottom of the pyramid. According to researchers at Stanford, microfinance refers to “financial services delivered in small denominations to poor clients who lack the collateral, credit history, or other assets to enter the formal financial system” (Datar et al, 2008). The approach was first championed in 1977 by Muhammad Yunus, the founder of Grameen Bank in Bangledesh; today, many microcredit institutions today are modeled after Grameen.

Over the years, microcredit initiatives grew to provide a larger variety of services. It should be pointed out that the terms microfinance and microcredit are often used interchangeably; however, microcredit generally refers only to lending, while microfinance refers to an extended range of financial services for the poor. Ideally, the goal is to provide those at the bottom of society with access to not only credit but also savings and insurance. It is important to note that microfinance is not charity. Rather than giving people a “hand out”, it seeks to give them a “hand up” by expanding their opportunities to financially sustain themselves, a concept important in both Prahalad and Yunus’ work.

According to Prahalad, there are three sectors that can give this “hand up” to the base of the pyramid: Non-governmental organizations, commercial banks, and government (Prahalad, 2005, p. 5). However, this paper will slightly modify Prahalad’s model. Because governmental and non-governmental organizations appear to work in similar ways, in this paper they will be combined in a single category while the “commercial bank” category will be split into both multi-national corporations and smaller scale efforts by individual entrepreneurs. Also, a new funding category will be added for communal lending, a common source of funds in highly collectivist cultures. When these adjustments are made, there are four sources of funding available for microfinance: Government/non-governmental aide organizations, commercial banks, individual entrepreneurs, and communities (see Figure 1).

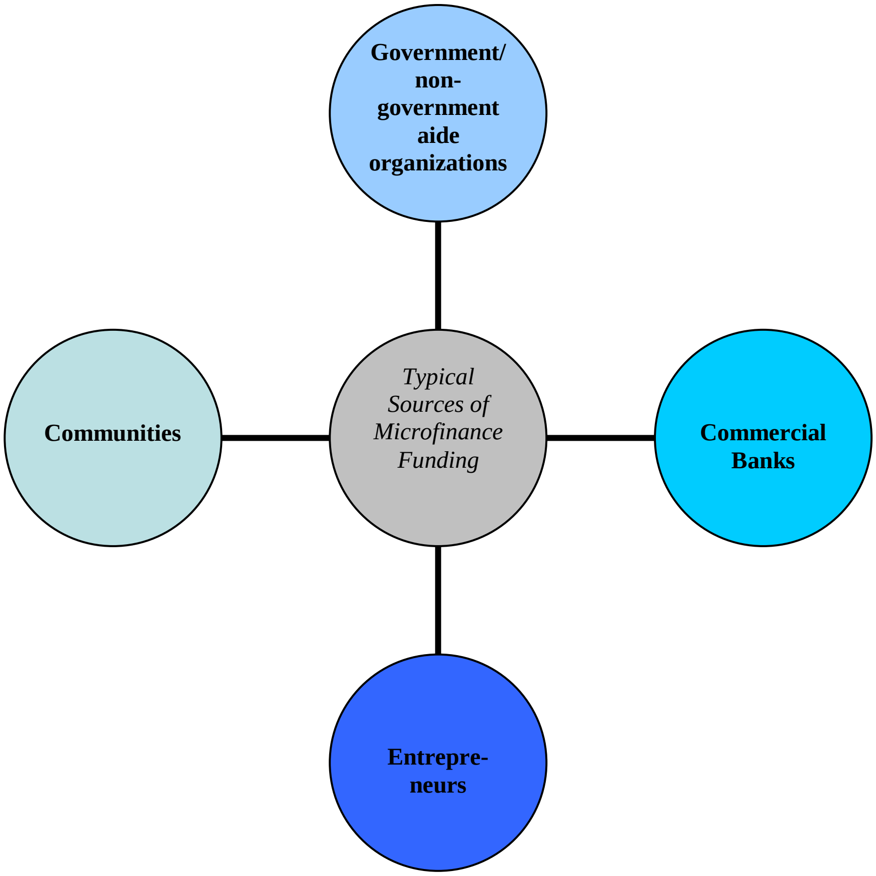

Figure 1: A typology of the four known sources of funding for microfinance.

The above typology will be used to categorize the Latin American case studies described later in the paper. Because microfinance is a relatively new field, this paper will attempt to make a modest contribution to microfinance literature by determining a link between types of funding as described in the typology and the types of programs used by microfinancial institutions that appear to work best in a Latin American setting.

<u>2. Literary Review</u>

This section will begin by defining and examining the concept of the bottom of the pyramid in detail, including a discussion on reducing corruption – a commonly perceived problem in Latin America. A detailed discussion of microfinance follows, including support and criticisms. Finally, specific examples of microfinance are summarized using the current literature, as a prelude to the Latin American examples to be discussed in the Case Study section of this paper.

<u>The Fortune at the Bottom of the Pyramid</u>

As mentioned in the introduction, the “fortune at the bottom of the pyramid” refers to efforts made to work with the world’s 4 billion poor to provide products and services that still create profits for the providing companies. Ideally, innovative approaches should “create opportunities for the poor by offering them choices and encouraging self-esteem” (Prahalad, 2005, p. 5). To make these innovative ventures possible, Prahalad proposes three basic assumptions:

1. The poor should not be ignored.
2. BOP provides new growth opportunities for firms.
3. BOP markets should be integral to the firm, not just part of a corporate social responsibility (CSR) venture.

Though these assumptions seem simple enough, there is a dominant logic problem to overcome before the three sectors mentioned in the introduction – government, NGO’s, and corporations –

can begin serving the BOP. Dominant logic is the "lense through which we perceive the world…colored by our own ideology, experiences, and established management practices" (Prahalad, 2005, p. 6).

The dominant logic of government is a form of distributive justice is practiced through taxation and handouts (Prahalad, 2005). It is difficult for both politicians and the poor to give up long-held beliefs and dependencies on things like government subsidies – which arose out of a stigma of "rural poor, urban rich" – and welfare. From the government's standpoint (and also the NGO's, who use donated funds to provide aide), handouts are necessary because corporations are unable to help the poor. For microfinance to evolve out of this sector, the government must first admit that the old models of "hand outs" are ineffective.

The dominant logic of corporations is based in profit perception. Corporations generally believe that the poor cannot be target customers either because they cannot afford the products or services or because they have no use for the products sold in developed countries. This second perception is especially prevalent with technological innovations, as most corporations assume only developed countries appreciate, pay for, and can use these innovations. Unfortunately, it is hard to break these biases in large firms because the culture and thought is typically entrenched in the corporate structure (Prahalad, 8). To begin serving the BOP, corporations must first recognize them as viable consumers.

The Nature of the BOP Market

Prahalad argues that the main reason the poor are viable consumers because their sheer virtue of numbers creates a large combined purchasing power that corporations are foolish to ignore (Prahalad, 2005). In addition, distribution access to the vast BOP markets is more possible than corporations believe, especially for the urban poor, where dense populations allow for intense distribution opportunities. Though rural access is problematic, opportunities exist if corporations modify their business model. For example, "Avon ladies" in villages in Brazil reach even remote areas. In a similar manner, other corporations can set up individuals within a village to act as distributors for various products. These individuals can also act as educators and advisors of products in "media-dark" areas where television and radio advertisements cannot be used (Prahalad, 2005, p. 12).

Despite being media-dark (most of the BOP does not have access media to forms such as television or radio), marketing access to these markets is also relatively simple. The BOP market is more connected than some might think, and information spreads rapidly. Telephone ladies in villages, prepaid phone cards, and low cost computer kiosks connect the poor rather than individual cell phones and computers. Even without technology, word of mouth spreads quickly concerning quality and value of products. Because even consumers at the BOP are brand-conscious, corporations must keep this in mind when creating products and marketing to the BOP (Prahalad, 2005).

Finally, BOP consumers also accept technology far more readily than corporations expect. The previously mentioned computer kiosks are used by farmers to check the prices of their crops with not only the local markets but the Chicago Board of Trade. ITC, the Indian conglomerate that started the program, was surprised at how quickly people learned to use the kiosks. Prahalad suspects that the poor are more willing to adopt new technology because they have nothing previous to forget (Prahalad, 2005, p. 15). A classic counterexample is found here in the United States, when the new 2007 version of Microsoft programs was released. Many previous users were conditioned to the old interface, and learning the new system was difficult. An absence of previous interface experience makes it easier to learn new systems.

The Market Development Imperative

Though the nature of the BOP makes it a more viable consumer than originally thought, in order to develop the BOP market corporations must keep several things in mind. First, corporations must create the capacity to consume; traditionally, this meant providing the product or service free of charge (Prahalad, 2005, p. 16). However, BOP consumers do not need these “hand outs” once corporations learn to access the market differently. For example, smaller, single-serve unit packaging that can be bought daily is more affordable to the poor than the economy-sized portions frequently sold here in America. With changes like this in mind, Prahalad suggests that corporations follow the “Three A’s”:

1. Affordability: single serve packaging or new purchasing schemes
2. Access: later store hours for those who work from dawn to dusk and stores location closer to home, because the poor generally walk to their destinations
3. Availability: the poor cannot defer buying decisions because these decisions are based on the amount of money they have on hand. Therefore, products need to be available immediately (Prahalad, 2005, p.15).

While addressing this core list of market development innovations, corporations can also begin to provide opportunities for new products and services for both the BOP and developed markets when creating the capacity to consume at the BOP level. Energy is one good example. Limited power grids and unreliable available power have forced new energy innovation for companies operating in the BOP in order to make energy reliable, affordable, and accessible to the poor. To fulfill this need, solar, wind, and water power were used by Tecnosol in Nicaragua to provide renewable energy to homes. Technology is another example. PRODEM FFP, a Bolivian financial services company, created fingerprint ATMs and use color-coded touch screens to give the illiterate access to banking services (Prahalad, 2005). Such innovations could have worldwide use in BOP markets and work their way into developed markets as well.

These examples speak to another benefit of serving the BOP. By allowing the poor new access to products and services, they "acquire the dignity of attention and choices from the private sector that were previously reserved for the middle-class and rich" (Prahalad, 2005, p. 20). Going back to the ITC farmer kiosk example, the new system created online village meeting places that allowed farmers to check the price of produce for local merchants and also on the Chicago Board of Trade. Previously, these farmers would take their produce to the local mandi (merchant) and sell at whatever price they could get that day, because they could not take their wares home and bring them back again. Often, the merchants were demeaning, insulting the farmer's produce. With this new system, farmers are able to choose where to sell their produce before leaving the village and no longer face the same poor treatment (Prahalad, 2005).

To accomplish any of these gains, however, corporations must also focus on building trust between themselves and the consumer. To begin, the consumer must trust the product or service, but the corporation must in return trust the consumer, especially if financing is offered. Corporations often assume that the default rate among the poor will be quite high, higher than with their rich customers. This is generally not the case; rather, the poor pay on time and default rates are low, as can be seen later in Grameen Bank (with a payback rate of 98%) and the case studies (most of which have a default rate around 2%). An example cited by Prahalad is ICICI bank in India. Out of a customer base of 200,000 the default rate is less than one percent.

Clearly, corporations must make an effort to create mutual trust and responsibility between themselves and the BOP in order to properly and fully serve these populations (Prahalad, 2005).

Twelve Principles of Product Innovation

In providing products and services for the BOP, the basic economies of the market are "based on small unit packages, low margin per unit, high volume, and high return on capital employed" (Prahalad, 24). Also, as discussed previously, because infrastructure varies substantially managers cannot assume availability or reliability when creating products and services. They must be aware of this and offer innovative solutions.

Prahalad suggests twelve "Principles of Innovation" for companies to succeed in the BOP markets (p. 28-46):

1. Focus on Price Performance: not lowering prices, but lowering costs while maintaining excellent quality of goods and services.
2. Hybrid Solutions: watered-down, traditional versions of technology cannot satisfy BOP markets. More advanced technologies must be creatively combined with existing infrastructure to serve the needs of the BOP.
3. Scale of Operations: corporations must focus on solutions that work at a local, small-scale level, but which can then be scaled to worldwide BOP use for the four to five million other people who could benefit from their product or service.
4. Sustainable, Eco-Friendly Development: with so many people to serve, solutions cannot use resources the same way they do in developed markets. Instead, they must be sustainable and ecologically friendly.

5. Functionality: BOP markets may require different functionality from products than that demanded in developed markets. For example, in India, prosthetics must perform more movements and be comfortable as well as durable. Developed markets demand less of prosthetics.
6. Process Innovations: this is a critical step in making products and services affordable to the poor. "How to deliver is as important as what to deliver" (Prahalad, p. 37).
7. Deskilling of Work: in most BOP markets, labor is unskilled and work must be "deskilled" while still providing quality service. For example, Voxiva created disease picture stages to aide in the identification of possible infectious outbreaks by making diagnosis possible with little training.
8. Education of Customers: because many areas of the BOP are media-dark, corporations must reach customers face to face to explain how products and services work and their potential benefits.
9. Designing for Hostile Infrastructure: design of products and services must take into account issues with power or water supply that developed countries do not deal with.
10. Interfaces: design of interfaces must be crafted for first-time users who do not have the luxury of going through a long or difficult learning curve.
11. Distribution: reaching rural BOP markets is an issue and corporations must be creative in their distribution solutions. Solutions range from computer kiosks to direct distribution of products through village sellers.
12. Challenge Conventional Wisdom: success in the BOP markets will help break the patterns of "dominant logic" that suggest the BOP is not a viable profit option. Not only can the BOP be served profitably, but the solutions created for the BOP can be

> extended to benefit developed markets as well, such as clean, renewable energy solutions or specialized, inexpensive health care.

BOP Summary: A Global Opportunity

The above review has covered four main sources of opportunity for large firms according to Prahalad. One, BOP markets can be as large and attractive as stand-alone entities. Two, many local innovations have global BOP opportunities, which increases the potential profitability of these projects. Three, some innovations created for the BOP can be extended to developed markets, further increasing profit. Four, as mentioned in the twelve principles of innovation, lessons from the BOP can influence management practices for the better by focusing on innovation and price performance (Prahalad, 2005, p. 47).

In order to successfully engage the BOP, companies need to begin with requirements from the BOP's point of view, then build business models and management processes around these requirements (Prahalad 2005, p.48). Because of the large population base and potential to expand into other markets, companies should be prepared for explosive growth. This means the management process must be innovated to keep up – in large firms, management typically only geared for slow growth and ill-prepared for the type of growth experienced in BOP markets (Prahalad 2005).

In short, the BOP has many lessons for corporations to learn. Costs must be kept low and capital used efficiently to maintain a profit. When this is done, the sheer volume of sales makes up for low margins (Prahalad, 2005, p.55). Sustainable development must take into account the total cost of ownership. Though single-serve packaging has been mentioned as a way to create consumer demand at the BOP, the environmental impact of the amount of packaging involved is an issue (Prahalad, 2005). Finally, innovations must focus on value and price performance to win over the BOP market (Prahalad, 2005). However, even when companies take these steps to begin serving the BOP, there can be issues outside of their control. The next section discusses corruption in Latin America, and how this can affect corporation's ability to serve the BOP.

Corruption in Latin America

The main problem created by corruption is that it can block companies from serving the BOP. Corruption impacts corporations' ability to operate in BOP markets (which is discussed further in the section of transaction governance capacity) and is a problem that appears widespread in many Latin American countries. According to Husted (2002, p.414), rampant corruption in Latin American has affected people's confidence in both the public and private sectors. Bribes and fraud are not uncommon incidents in Latin American businesses. Costa Rica, specifically, was ranked 5.6 in 1998 and 4.5 in 2001 on the Corruption Perceptions Index provided by Transparency International; Latin American countries as a whole average at a ranking of 4 (Husted, 2002, p.414). The index measures the corruption perceptions of business people and country experts for 91 different countries, with corruption being defined as the misuse of public power to benefit privately and measured on a scale from 0 to 10, where 10 is a corruption-free country.

These relatively high corruption perceptions exist despite the passing of anti-corruption agreements in 1996 and 1997. The first agreement, approved by the Organization of American States (OAS) in 1996, is the Inter-American Corruption Convention (Husted, 2002, p.415). This agreement develops standards of conduct for public officials along with ways to enforce these standards. Enforcement includes the creation of systems that will monitor the source income for public officials, assure transparent hiring practices, and protect “whistle-blowers”. Nations who sign the agreement are asked to prohibit domestic bribery and are prohibited from offering bribes internationally as well.

The second agreement was passed a year later by the Organization of Economic Cooperation and Development (OECD) (Husted, 2002). Signatory nations include Chile, Mexico, and Argentina. Though the OAS convention included bribery issues, the OECD agreement focused specifically on the bribery of foreign officials. It attempts to create a standard for the treatment of bribery between national and international levels and provides for monitoring and enforcement of these requirements.

The issue with attempts to standardize the regulations and penalties for bribery or corruption is that these attempts generally fail to take in to account the cultural diversity of Latin American countries. There are four main cultural dimensions that are important to corruption perceptions in Latin America: power distance, individualism/collectivism, uncertainty avoidance, and masculinity/femininity. Latin America usually has high power distance, high collectivism, high uncertainty avoidance, and high masculinity (Hofstede, 2001, p. 86-88, 150, 215, 285-286). The following detailed explanations of these cultural dimensions reveal that most of the corruption in Latin America is caused by issues of enforcement. These issues of enforcement will later be applied to the case studies, as these cultural dimensions can help microfinance institutions develop programs less susceptible to default.

Power Distance

Cultures with higher power distance are characterized by low-power members who willingly accept that power is unequally distributed. In such cultures, leaders are perceived as deserving of special privileges. Thus, strong leaders are looked up to and are the most likely to influence change in society (Hofstede, 2001, p.85). At the same time, the tendency to allow the more powerful "special privileges" causes laws and regulations to be applied inconsistently.

Collectivism

In highly collectivist societies, preference is shown to people in the "in-group" (Husted, 2002, p.416). According to Triandis, "the standard of fairness within the in-group is one of equality, while the standard of fairness outside the in-group is one of equity" (as cited in Husted, 2002, p. 416). This means that the law is more flexible when personal relationships are involved, which in turn means that the impersonal mechanisms for enforcement emphasized by the OAS and OECD conventions probably will not hold for long in collectivist Latin America. Rather, these impersonal rules will be bent for people in the in-group and strictly applied to those in the out-group. The uneven enforcement of these laws only furthers the sense of corruption in Latin American society (Husted, 2002).

This issue may be remedied by adjusting the type of punishment. Collectivistic societies generally find that more influential punishments are those that create a sense of shame, while individualistic societies experience effective punishment through guilt (Husted, 2002). Shame occurs when an individual fails to live up to personal or community ideals, whereas guilt occurs when an individual experiences moral societal imperatives. Therefore, punishment that is group-based or affects the individual's relationship with the group will work more effectively in Latin American cultures, as long as it is enforced consistently.

Uncertainty Avoidance

In contrast to their high collectivism, Latin American countries also generally have high uncertainty avoidance, which creates an orientation towards formal rules in an effort provide structure and reduce anxiety (Husted, 2002). Ironically, sometimes the formal rules are very complex, and the "cultural tendency will be to break the laws in practice since they do not fit perceived reality" (Husted, 2002, p.418). Again, the issue here is that enforcement breaks down and creates corruption by allow the misuse of power.

Masculinity/Femininity

Issues of enforcement are where the masculinity/femininity dimension becomes important. Hofstede finds most of Latin America to be masculine countries; in masculine cultures, emphasis is placed on success and money, whereas in feminine cultures it is placed on relationships(2001, p.285-286). Therefore, fines would be more appropriate in masculine countries whereas jail terms would be more effective in feminine countries, due to their interrupting effect on relationships (Husted 2002). Unfortunately, Latin American countries differ in their levels of masculinity and femininity. Costa Rica, for example, is a very feminine country when compared to other Latin American countries. Therefore, punishments will be more effective when local legislatures can determine methods of consistent enforcement for breaking anti-corruption laws.

Building Transaction Governance Capacity

As mentioned previously, the main problem created by corruption is that it can block companies from serving the BOP. Prahalad suggests that market efficiency relies partly on what he calls “transaction governance capacity” (TGC) – making a transaction transparent, widely understood, and clearly and consistently enforced rules (Prahalad, 2005, p. 81). When this occurs, corruption disappears, investors are free to seek the best opportunities available, and poverty reduction can commence. According to Prahalad, most developing countries do not actually understand how completely corruption impacts private-sector development and, by extension, poverty alleviation (p. 78). Prahalad refers to Hernando De Soto’s The Mystery of Capital to drive this point home. Initially, it was assumed that poor countries lacked resources, which meant aide was seen as a way of alleviating this problem. However, De Soto argued that companies can actually be asset-rich but capital-poor (Prahalad, 2005). In order for private companies to move in and begin using these assets for poverty alleviation, countries need a system of laws that allows for ownership and transfer of property, a process for changing the property right laws that is clear and unambiguous, system of regulations that accommodates complex transactions, and institutions that allow the laws to be implemented fairly, in a timely fashion, and with transparency (Prahalad, 2005, p.84). In countries where there are no enforceable contract laws, commerce is conducted by a “vibrant extralegal or informal sector (or the black market)” which is small, inefficient, and cannot attract capital to increase operations (Prahalad, 2005, p.79). As mentioned in the section on corruption above, in countries with contract laws, sometimes there are no real means of enforcement or enforcement is local and varied, typically unwritten but clearly understood and sometimes enforced by “strongmen” (Prahalad, p. 79).

Prahalad believes that the heart of the problem is with how bureaucracies deal with citizens. Because corruption is really about "providing privileged access to resources and recognizing the time value of money", bureaucrats can use micro regulations to control access, transparency, and time of transactions (Prahalad, 2005, p.85). Therefore, he suggests four criteria from the point of view of the citizen to clean up regulations:

1. Increased access to information and transparency for all transactions.
2. Increased process clarity so that selective interpretation by bureaucrats is reduced or completely eliminated.
3. Increased speed with which the processes can be completed by citizens.
4. Increased trust in the system, a result of the first three criteria and a crucial component.

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In order for new systems to work, the fourth criterion is perhaps the most important. Building confidence in the system requires that citizens and companies experience a variety of services continually without corruption. They must be convinced that operating within the system is cheaper than operating outside of it, such as on the black market (Prahalad, p. 96). If the cost to being in the system is not lower than being outside of it, government has failed to provide one or more of the four criteria because the citizen or company still sees the process as providing privileged access to those who can pay for it. When TCG is made transparent and easy to use, a vibrant private sector can begin to bloom and create opportunities for the BOP that help alleviate poverty (Prahalad, p. 81).

<u>Overview of Microfinance</u>

One of the ways in which the BOP can be lifted out of poverty is through microfinance. When microfinance institutions are unavailable, poor people must resort to other means of obtaining loans or saving money. When people are making only a few cents a day, collateral for loans is nonexistent, and traditional banks unusable. Commonly, they borrow or save with moneylenders, who often charge exorbitant fees for their services. Critics of microfinance argue that the reason traditional banks do not provide micro credit lies in the difficulty of covering costs for such small denomination loans. If this is the case, microfinance would be impossible to sustain.

Fortunately, sustainability is possible. Some micro credit institutions have been sustained for many years and continue to grow, a prime example being Grameen, which is discussed later. However, the Stanford Social Innovation Review argues that certain needs must be met for this sustainability to be possible. First, Client-friendly products and practices that consider individual client needs are a must. This includes considering how the client will use the loan and what burdens clients may bear during repayment. Second, access to loans is not a solution in itself. Clients also need access to other services, such as savings accounts, health care insurance, or other human services. Finally, training and support throughout the service process is critical.

Even if sustainability is assured, there are pros and cons to the microfinance system. Supporters of microfinance believe that small loans lead to economic self-sufficiency. They point to research that shows microloans “increase household consumption, give women more clout in their communities… and improve the nutrition of young children” (Datar et al, 2008). Critics, on the other hand, claim that the poor are in no position to take on the risks of entrepreneurship. They claim stable jobs in large industries are what lift people out of poverty.

They point to research that shows microloan clients will “scrimp on food, sell their furniture, borrow from loan sharks, and take second jobs” to repay loans (Datar et al, 2008). They argue that husbands, sons, and fathers-in-law often take control of women’s loans and that microfinance in general fails to be distributed to the poorest people.

The Stanford Social Innovation Review believes the two camps “disagree partly because studies of microfinance are, indeed, inconclusive” (Datar et al, 2008). Microfinance institutions often vary drastically in their missions, strategies, and tactics, which make it impossible to assess their overall impact or compare them to each other. The Review also argues that few Microfinance institutions have articulated what it means for microfinance to work and be successful (Datar et al, 2008). That is why this paper will focus on examples from Latin America and assess their success in context of the surrounding culture. Before discussing Latin American successes, however, the following is a brief history of some of the first recognized successes in microfinance institutions, whose stories speak for themselves.

Examples of the First Successful Microfinancial Institutions

Two of the first successful microfinancial institutions were Grameen Bank in Bangledesh and Bank Rakyat Indonesia (BRI) in Indonesia. Both are prime examples of microfinance operating with sustainable growth and serve as an initial introduction to successful microfinance ventures.

Grameen Bank

“When policy makers finally realize that the poor are their partners, rather than bystanders or enemies, we will progress much faster than we do today.”

Muhammad Yunus, Banker to the Poor (p. 137)

From its humble beginnings in the village of Jobra, Bangladesh, in 1976, Grameen has grown to multiple companies providing a range of services throughout Bangladesh, including cellular service and health programs (Yunus, 215-231). In 1983 it was transformed into a formal bank by a special law passed solely for its creation (Grameen Bank, 2009). Today, Grameen borrowers own 95% of the bank. The other 5% is owned by the government. Since the beginning, Grameen had no trouble making a profit almost every year.

With 7.61 million total borrowers and total loans disbursed since inception of US $7.43 billion, Grameen has a loan recovery rate of 98.24% (Grameen Bank, 2009). The bank now finances all of its loans from deposits, though prior to 1995 Grameen accepted donor funds from the government and other sources. Currently, Grameen more closely matches an independent financial institution, whereas it previously could be listed as a government organization.

As with most micro-credit programs, Grameen does not require collateral to give a loan. Instead, the bank requires each borrower to belong to a five-member group, which oversees its members to ensure that no one gets into a repayment problem. The group helps encourage and bolster individual members (Yunus, p. 85). However, group members are not required to pay if one of their members defaults. Repayment is the sole responsibility of the individual borrower (Grameen Communiciations, 2008). Women account for 97% of borrowers, supporting the idea that microcredit helps empower women in developing countries. Yunus argues in his book, Banker to the Poor, that women are better to lend to than men because women will use the money in ways that benefit families as a whole. In this way, women help to improve the standard of living, reduce poverty, reduce inequality, and create dignified employment in developing countries (Yunus, p. 100).

Yunus does not agree that the poor must be trained to be successfully employed entrepreneurs. He argues that the poor already have small business skills, especially in developing countries where basic skills in farming and weaving can create ample opportunity to create and sell merchandise (Yunus, p. 130). Most people assume the poor are poor because they lack the skills necessary to work. Yunus argues that the poor are poor because they were previously unable to keep the returns of their labor when borrowing from moneylenders or buying their raw materials from the same merchant to which they sold their finished product.

Finally, Yunus contends that traditional views of the poor as unmotivated are outdated. These traditional views often create problems that trap the poor in poverty, with welfare being a classic example. When the government continually gives "handouts" to the poor rather than a "hand up", it creates a dependent poor. In reality, when given the right opportunities, the poor can achieve great things (Yunus, p. 205). As Yunus points out, "Poverty is not created by the poor. It is created by the structures of society and the policies pursued by society" (p. 205).

Bank Rakyat Indonesia (BRI) and Bank Dagang Bali

BRI, like Grameen, has been showing profits since it was restructured for sustainability in 1986. Loans are provided for any viable productive activity, and borrowers may re-borrow as often as desired as long as their repayment history is good (Robinson, p. 264). By the end of 1995, their long-term loss ratio was 2.3% (Robinson, p. 269).

Another company in Indonesia, Bank Dagang Bali, began in 1970 with a husband and wife entrepreneurial team. By the end of 1995, their long-term loss ratio was under one percent (Robinson, p. 271). They, too, have been profitable every year since they opened. Dagang Bali is extremely active on the savings side of microfinance. They provide many services, including daily routes to customer homes and work places to collect deposits and process withdrawals. Because of this system, people save regularly, often daily (Robinson, p. 272).

Robinson calls the banks like these "new microfinance" because they are sustainable, self-supporting institutions that offer more than just loans (p. 272). She argues for ten reasons that these banks have performed so well. These include:

1) knowledge of local markets
2) convenient, secure bank locations at the local level
3) provision of loans to all segments of the local populations (rather than providing, for example, agricultural credit, credit to women, or credit for local industry)
4) provision of a set of deposit instruments designed to be appropriate for local demand
5) a spread between loan and deposit interest rates that covers all costs and enables institutional profitability
6) a system under which each bank unit operates as a profit center
7) staff accountability for financial performance
8) simple, uniform, and transparent reporting procedures
9) careful and continuing attention to staff training and motivation
10) an effective institutional organization and management structure (p. 272)

Robinson points out, however, that before microfinance banks become self-sustaining they must find an initial funding source. Donors may be able to help the emergence of commercial microfinance by giving funds for start-up equity in firms that are "committed to attaining full self-sufficiency" (Robinson, p. 278). However, donor programs should be careful to separate social from financial services so microfinance can be commercially managed and self-sustained.

Once separated, social services, such as health, nutrition, family planning, literacy, and training, can continue to finance through donor contributions when appropriate, but financial services should seek to be self-supported (Robinson, p. 278). The following case studies are examples of microfinance institutions in Latin America who grew into self-supporting, viable ventures.

3. Case Studies

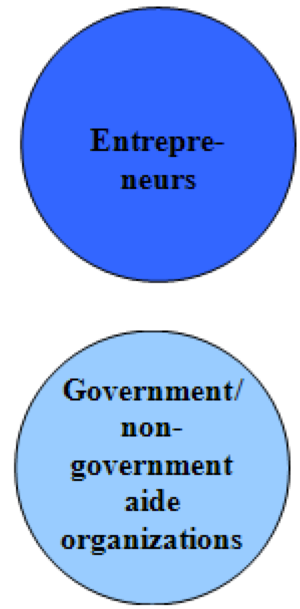
The following are examples of microfinance from Etla in Mexico and Bolivia and Brazil in South America, classified using the typology created in the Introduction and evaluated within their cultural context. These institutions have programs that are set up to work well within a Latin American setting, especially since Latin America's social structure is more collective than individual.

Mexico

How People Save in Mexico

According to Brigit Helms, spokesperson for the Consultative Group to Assist the Poor (CGAP), Mexicans save using both informal and formal mechanisms. Most save small amounts for emergencies or other short term needs. Bank savings were typically for long term goals like future land or home purchases (Helms, 40). Three categories of savings occur: bank savings, tandas (rotating savings and credit association), and physical assets. Typically, the poor save in physical assets, while tandas are popular in the middle class and banks reserved for the wealthy (Helms, 40). Fortunately, microfinance is beginning to change the way the poor save.

Compartamos



"Banco Compartamos portrays itself as the gentler lender to Mexico's poor" (Epstein and Smith, 2007, para. 1). Meaning "let's share," it was founded by José Ignacio Avalos Hernández in 1990 when he converted a nonprofit food and clothing donation company into "one that made loans guaranteed by borrowers' neighbors" (Epstein and Smith, 2007, para.1). Every Tuesday, women from nearby villages gather in Etla, Mexico, typically in groups of 12 or more, to meet a Compartamos loan officer and repay their loans. If a borrower is unable to repay, the rest of the group covers for her. The loans last 16 weeks and are for business purposes only, with each woman borrowing about $100 or more for businesses such as making tortillas and raising pigs (Epstein and Smith, 2007; Engardio, 2002). This routine is "typical of the way microcredit operates in many poor nations" (Engardio, 2002, para. 2).

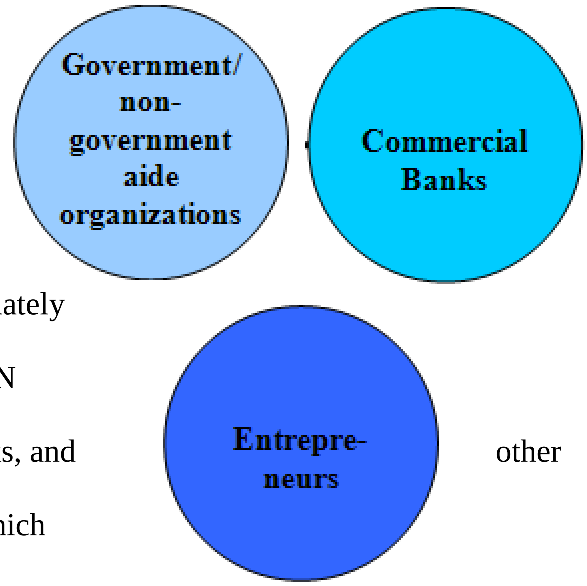
Compartamos boasts some impressive financials. In 2002, with an average loan of only $270, the company enjoyed a 16% return on its $40 million in assets (Engardio, 2002). In 2000, it was looking to increase its efforts by becoming for-profit. After winning a government-banking license, Compartamos became a true bank in 2006 (Epstein and Smith, 2007; Engardio 2002). As of 2007, Compartamos had lent "$316 million…to 765,000 clients, dwarfing nonprofit micro-finance organizations in Latin America" and become "one of Mexico's most financially successful banks" (Epstein and Smith, 2007, para. 3).

Despite the many success stories, the structure of Compartamos can create enormous social stress for its borrowers. Because it is loaning primarily to women in a Latin American country, Compartamos' borrowers face social ostracism if they default. For example, Eva Yanet Hernández Caballero took out a series of loans ranging from $200 to $1,800, at an APR of 105%, to finance the yarn for her knitting machines. "The money…increase[d] their weekly output from 800 dozen pairs of socks to 1,500 dozen... [which] brought in $800 a week, more than enough to sustain an extended family of six" (Epstein and Smith, 2007, para. 6). However, once customers began falling behind on payments, it was all over. The "steep interest rates took an unremitting toll, as Hernández and her relatives each missed several $130 payments to the lender…[which was] a lot for the rest of the 23-member borrowing circle to make up" (Epstein and Smith, 2007, para. 7). Those who helped with the payments soon felt resentful, and Hernández and her family were "banished from the group" after Compartamos ran their story as a success in a pamphlet (Epstein and Smith, 2007, para. 7).

No longer able to receive loans because her social circle will not back her, she lacks the capital to continue the same level of production as before. Earnings dropped to 500 dozen pairs of socks, only about $270 per week (Epstein and Smith, 2007). However, according to Carlos A. Danel, co-chief executive of Compartamos, such tales are inevitable. However, "the rule is you're liable for each other's loans", and he believes the bank's rates are fair, pointing out that rates have actually fallen significantly in recent years (Epstein and Smith, 2007, para. 9). In a cultural context, this rule should theoretically cause less default because women borrowers are highly attuned to the social consequences of default. Unfortunately, there will always be cases where outside circumstances make it difficult to continue paying, which makes the social consequences seem harsh. For women in Latin America, however, this is an accepted reality (according to Hofstede), and this microfinance institution uses that reality in their loan structure.

Bolivia

BancoSol began in 1986 as PRODEM, a microlending institution created by ACCION and Bolivian business leaders (ACCION, 2007). Within two years, the program grew so large that the local banking system was no longer able to adequately supply lending capital. Eventually, in 1992, ACCION International, Calmeadow Foundation, Bolivian banks, and other investors helped PRODEM morph into BancoSol, which ACCION claims was the "first private commercial bank in the world dedicated exclusively to microenterprise". It was also the first microfinance institution to issue dividends, which occurred in 1997.



Today, BancoSol boasts 82,051 active clients who make up a roughly $209 million portfolio (ACCION, 2007). Only 3.7% of this portfolio is at risk of being unrecoverable. First loans range from $40 to $2,301, and the average loan made is $2,547. Forty-six percent of their borrowers are women who work as "market vendors, seamstresses, bakers, candy makers", etc. (ACCION, 2007). Though begun in Bolivia, BancoSol now has regional headquarters in La Paz, Santa Cruz, Cochabamba, El Alto, Oruro, Tarija, Potosi, and Sucre, with 48 urban/city branches throughout Bolivia.

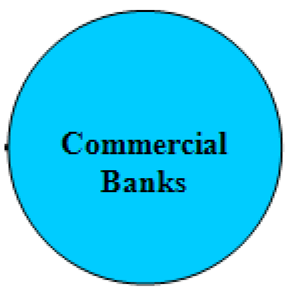
According to Weiss and Montgomery, whose article on microfinance in Asia and Latin America was published in the Oxford Development Studies, BancoSol is the most studied institution in Latin American poverty impact studies (2005, p. 407). They site a study done by Hulme and Mosley (1996, table 4.1) which measured the affect of BancoSol's microloans on income. Borrowers who were approved borrowers but who had not yet taken out a loan were used as a control group (Weiss and Montgomery, 2005, p. 408). Comparing this group to current active borrowers, they found that borrowers experienced a much higher an average annual increase in income – about 28% for borrowers versus 14.5% for the control group. An estimated 8% of borrowers crossed the poverty line in 1992 alone (as cited in Weiss and Montgomery, 2005).

Regression analysis of income increase per household relative to the control group income increase shows a positive relationship; this means that household income and gains from borrowing appear correlated, although at a declining rate (Weiss and Montgomery, 2005). Therefore, BancoSol has a positive poverty impact; however, because only about a third of their borrowers fall below the poverty line, this impact is diminished. Unfortunately, this impact does not appear to be reaching the poorest of the poor. Weiss and Montgomery argue the following:

> "When the core poor (those in "extreme poverty" defined in Bolivia as those living on half the poverty line) are considered, it is clear that none of the MFIs studied are reaching them. From a sample of 200 borrowers over 6 years for four institutions, there is only one case of the removal of extreme poverty, hence this segment of the poor was not reached." (2005, p. 408)

Given all the analysis that has been done on BancoSol, it is easy to see that there are aspects that separate it from other microfinance intermediaries. However, its basic loan structure is very similar to that of Compartamos. Called a solidarity loan, beginning borrowing is capped at US$ 2.000 per client or US$ 6.000 per solidarity group. Groups consist of three to four people (BancoSol website). Group members share the responsibility for repaying the loan, which means the same basic social principle applies: if a borrower defaults, they may be ostrasized from the group. This may be why BancoSol requires "complete affinity among the members", though when affinity is difficult to judge the requirement does not hold much weight. Interestingly, BancoSol prohibits family links; this may be to ensure that the borrower is allowed to keep the money they are given, especially if the borrower is female. In this way, BancoSol takes both collectivism and power distance into account within its loan structure, first by utilizing a group loan structure and second by attempting to monitor the nature of the group.

Brazil



In Brazil, Banco do Nordeste (BN) created CrediAmigo in 1997. Accordng to Brigit Helms, "the bank's president envisioned BN as a world-class microfinance provider and was determined to find a more effective way to reach the poor than directed credit lines" (2006, p. 78). In the beginning, loan officers were "hastily trained" and "pushed to lend" without fully considering capacity to repay (Helms, 2006, p. 78). As the loan portfolio began to deteriorate, BN's management sought support from the World Bank and advice from CGAP and ACCION, committing to manage growth more carefully. Today, BN has 299,975 active clients comprising a $138 million portfolio, of which only 1.5% potentially unrecoverable (ACCION, 2007). First loans range from $56 to $293, with an average loan of $461. These lower loan balances indicate that CrediAmigo serves more of the poorest of the poor than does BancoSol. In fact, in March

2007 BN launched a new credit program called Crediamigo-Comunidade, which focuses on reaching the “extremely and very poor microentrepreneurs in the Northeast” (ACCION, 2007). The program has 9,225 active clients with an average loan amount of less than US $120; about 50% of clients are women.

CrediAmigo has branches and service centers throughout northeastern Brazil. It is considered one of the better microfinance providers in Brazil, and is one of the largest programs in all of Latin America (Helms, 2006, P. 78; ACCION, 2007). The loans are similar to the previous examples: small groups of three to five borrowers “cross-guarantee each other’s loan” (Skoufias et al, 2004, p.3). These solidarity loans usually last three months. First-time loans are limited to $130 to $300 with repeat loans capped at $1,700; initially, rates on these loans were 5% monthly but are now around 2% (Skoufias et al, 2004, p.3).

Though CrediAmigo’s group program creates similar societal issues as the other programs, it also adds something new. A 15% discount is offered on interest payments if all installments are paid on time. Additionally, borrowers are eligible for personal credit after two solidarity loans are successfully paid back. These measures move beyond reducing default through negative social consequences by adding rewards for good repayment practices.

4. Conclusions

Microfinance is a viable tool for serving the BOP and giving those at the poverty level a "hand up" rather than a "hand out". There are four main sources of funding for microfinance ventures: government/nongovernmental agencies (such as non-profit), individual entrepreneurs, communities, and commercial banks. Though the three Latin American microfinance institutions mentioned above vary in terms of their funding sources, all appear to have similar structures: group loans guaranteed by all group members. Therefore, it does not appear that the source of funding is a significant factor in microlending; rather, cultural differences make certain microfinancial structures more effective than others.

In the case of Latin America, where society is highly collective, the group setting serves to encourage payment because defaulting causes social stress. However, because some businesses fail for reasons outside a borrower's control, the social ostracism individuals may face can seem harsh. At the same time, it is difficult to justify offering credit when no collateral is available, unless this group guarantee system is used. This is why CrediAmigo's program appears ideal - because it slowly moves beyond requiring group loans and eventually allows individuals to take personal credit. It also offers discounts for on-time payment, making it easier to repay. Provided that a borrower is able to reach these goals (on time payment and personal credit), the CrediAmigo program addresses the male half of their borrowers especially, who are usually driven by success.

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