

AN INSIDE LOOK AT MICROFINANCE: THE ALCHEMY OF
MFI SUCCESS INDICATORS

Sophaseila Sakett

Thesis submitted to KDI School of Public Policy and Management in partial
fulfillment of the requirements for the degree of

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Committee in charge :

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Abstract

This thesis attempts to extract from the microfinance literature a package of measures, or index, which can be used by microfinance institutions (MFIs) to gauge their success as financial institutions, as well as their broader societal impact as welfare organizations. The author turns to the major sources of data that are generally accepted in microfinance and did not conduct primary data collection himself, given what is available today.

We learned that MFIs, unlike any traditional financial service providers such as banks and insurance companies, are largely unregulated and therefore tend to use a variety of non-standardized measures to assess their success and sustainability. Furthermore, we show that these institutions cannot easily trade-off those measures that track institutional success, for those that measure the community impact as a result of borrowing money and planting a small business or SME, since a number of confounding factors make direct correlation difficult.

Finally, we propose a measure toolkit by applying the simplified Balanced Scorecard (simplified BSC) framework to measure MFI success matrices. We use the MFI data that reports on the financial status of the organization, its internal business practices, the rate of borrower success, and lessons learned. Moreover, the MFI assumed to impact the borrower community at large can use the same framework to aggregate these data across borrower communities and monitor them along with certain health and welfare data to infer a degree of behavioral impact. Then, we apply the proposed measure toolkit on a real case MFI in Cambodia in order to assess the appropriateness of the matrices.

This work is dedicated to my mother, **Kimly Thay**, and the memory of my beloved father, **Sam Sakett**, for supporting and encouraging my sister, **Elitda Sakett**, and me to strive for the best in everything, despite the hindrances that were bound to crop up in life.

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Acronyms

BRI [Bank Rakyat Indonesia]

miCDO [Collateralized Debt Obligation]

CGAP [Consultative Group to Assist the Poor]

ECA [East Europe & Central Asia]

IFAD [International Fund for Agricultural Development]

IFC [International Finance Corporation]

IFI [International Financial Institution]

ILO [International Labor Organization]

IMF [International Monetary Fund]

LAC [Latin America & the Caribbean]

MENA [Middle East & North Africa]

MFI [Microfinance Institution]

MIX [Microfinance Information Exchange]

MIV [Microfinance Investment Vehicle]

NGO [Non-Government Organization]

RDI [Rural Development Institute]

SCP [Subsidized Credit Program]

SHG [Self-Help Group]

SEWA [Self-Employment Womens Association]

UNDP [United Nation Development Program]

USAID [United States Agency for International Development]

Glossary Terms

Micro-loan: Loan generally offered through non-formal banking institutions. This loan is made available mainly to some micro and small enterprises. The small-enterprises which would qualify for micro-loan are the smaller of the small enterprises.

Profit: The difference between the revenue gained from the sale of outputs and the monetary cost of inputs (including time and labor).

Success: A client who services his/her loan payments on-time, and on a regular basis and has benefited in the business, the household or personally.

Micro-Enterprise: A business which has five or fewer workers (often owners family or friends). It is owner-operated and produces simple unsophisticated products based on traditional technology. It tends to receive its raw materials from the local markets and sells to local consumers. It is usually operated in the informal sector.

SMEs: Many advanced countries define SMEs as firms employing between 10 and 250 workers (or, in some countries, 500). SMEs are generally viewed as occupying the middle of the firm size distribution – larger (and typically more formalized) than micro-enterprises, which are usually informal units employing at most a handful of people. In many small and less-developed countries, it should be noted, firms employing 250 or 500 people could well be among the larger firms in the country.

Entrepreneur: An individual who is capable of conceiving an idea and putting that vision into action, usually for profit. As owner (in micro-businesses the owner also manages the enterprise), the entrepreneur finances the supply of capital to the firm; organizes production; estimates the rate of output; finds and utilizes

new combinations of materials, new processes and products; and accesses new markets. The entrepreneur assumes high levels of risk in performing these activities due to: limited access to credit (particularly long-term financing); constraints in price and availability of inputs; and access to markets. As a catalyst of change, the entrepreneur is a crucial factor in the economic development process.

Informal Sector: This sector is comprised of entrepreneur businesses engaged in activities which do not fully comply with government regulations; appropriate taxes are not paid, businesses are not registered and activity is not counted by national statistics. Functioning within the sector can be monetized, consist of bartering and/or in-kind contributions. Entry is relatively easy in the sense that entrepreneurs can set up shop anywhere with little capital required. Besides, there is no structure regarding type of goods and/or services sold, and hours of operation depend solely on the owner.

Formal Sector: This sector is considered the legal and federally recognized sector of the economy. Functioning within the sector is completely monetized. It is monitored by the government to ensure members are legally registered and pay the necessary taxes. Entry into the sector is difficult in that it requires the applicant to complete a variety of forms. Fees to obtain licenses and permits are high and obtaining notice of registration can exceed six weeks.

Chapter 1

Introduction: What Lies Beneath

No Society can surely be flourishing and happy, of which the far greater part of the members are poor and miserable. - Adam Smith, the Wealth of Nations

Poverty remains a widespread phenomenon in the developing world, despite significant progress in raising living standards in many countries in recent years. According to the estimates of Chen and Ravallion (2004), the percentage of the worlds population living on less than \$1 a day¹ has halved from 40 per cent in 1981 to 21 per cent in 2001 when China is included. Chen and Ravallion noted that although a clear trend decline in the percentage of people who are absolutely poor is evident, with uneven progress across regions, the developing world outside China and India has seen little or no sustained progress in reducing the number of poor. Bringing relief to the worlds poorest remains, therefore, one of the central policy issues of the new millennium. In that context, new development efforts and strategies aimed at reducing poverty, are continually being designed and implemented. One such development effort is microfinance.

Microfinance² may be described as the provision of banking services such as loans, savings, and payment services to clients from the poorest populations of less

¹World Bank defines extreme poverty as living on less than \$1 (PPP) per day, and moderate poverty as less than \$2 a day.

²Strictly speaking, microfinance is the provision of small scale loans for investment purposes with payment substantially deferred until the investment matures. Microcredit is the provision of small scale

developed countries using unconventional risk assessment and client service techniques. For the most part, loan clients are engaged in independent microenterprise or subsistence-level farming. Savings and remittances services are used by a wider selection of poor clients. Often considered to be a modern development intervention, microfinance initiatives are designed to provide people with the resources to help themselves. Modern microfinance substantially dates from the 1970s and there are now estimated to be more than 10,000 MFIs worldwide (Sources). The exemplar MFIs are generally considered to be the Bangladeshi Grameen Bank (Hassan, 2002), the Bank Rakyat Indonesia (Robinson, 2001), and the Bolivian BancoSol (Navajas et a, 2000).

Despite the importance of microfinance for both poverty reduction and equitable economic growth, experts estimate that only 5 percent of low-income households around the world have access to such services, and it has not developed evenly across regions in term of depth of outreach and average loan size (see Table 2.1). The development and economic perspectives come together, or rather collide, in a current popular controversy over the actual social effectiveness and long term sustainability of MFIs (Jain & Moore, 2003).

On the thread of thought within this controversy holds that business process effectiveness within MFIs enhances their social effectiveness (Jain & Moore, 2003). That is to say, the most efficiently run MFIs have the biggest social impact. However, in the majority of studies and evaluations of microfinance to date, success has been measured in terms of loan repayment as there was no accurate way to gage the business process effectiveness. This paper attempts to explore a systematic way to gauge both financial success and socio-economic impact in the spirit of this perspective.

Some MFIs, because of their commitment to micro-enterprise development, may also include the number of jobs created, increases in sales and equity for the micro-enterprise, and change in income for the entrepreneur. However, researchers believe that sustainable impact of a microfinance program can only be determined

by assessing its long term impact (Adams, 1993; Galtung, 1993; Jazairy et al, 1992). Has the program provided micro-enterprises and the entrepreneur with the elements necessary (both social and financial), to produce a long term positive change to their current situation?

1.1 Purpose of the Thesis

This thesis (1) explores the characteristics of MFIs and their stated or potential impact on poverty eradication, health status and empowerment, (2) reviews the operation and measures of success of MFIs, including their similarities and differences from commercial banks, (3) presents current thought on the institutional sustainability and economic impact of MFIs, (4) and finally applies a proposed performance matrices by employing the Balanced Scorecard strategic framework to a functioning microfinance organization based in Cambodia to test its appropriateness.

1.2 Scope of the Thesis

First, this thesis mainly focuses on general MFIs with particular emphasis on generally acceptable good practices in the industry. The strategic framework is limited to analyzing the financial performance (sustainability) and socio-economic impact of microfinance institutions in terms of profitability ratio, loan uses, borrower satisfaction, credit impact, etc. the Balance Scorecard strategic framework is then used for explaining both financial sustainability and economic impact. Second, in this thesis, the scope expands from Latin America to encompass the entire world drawing on published microfinance literatures, articles, studies and data sources (for hard numbers). The author turned to the major sources of data that are generally accepted in microfinance and did not conduct primary data collection himself, given what is available today.

1.3 Thesis Outline

Thesis outline is shown in the following figure. The first chapter is simply an introduction, second chapter focuses on the history and literature review of the microfinance movement, including a review of its origins, promises, scale and objectives in general, third chapter describes about the paradigm shifts in microfinance, fourth chapter studies the organizational structure of the MFIs, fifth chapter evaluates the review of MFI performance matrices, and finally sixth chapter focuses on analyzing the full-fledged proposed performance package using a functioning MFI to test its appropriateness and on drawing conclusions and recommendations.

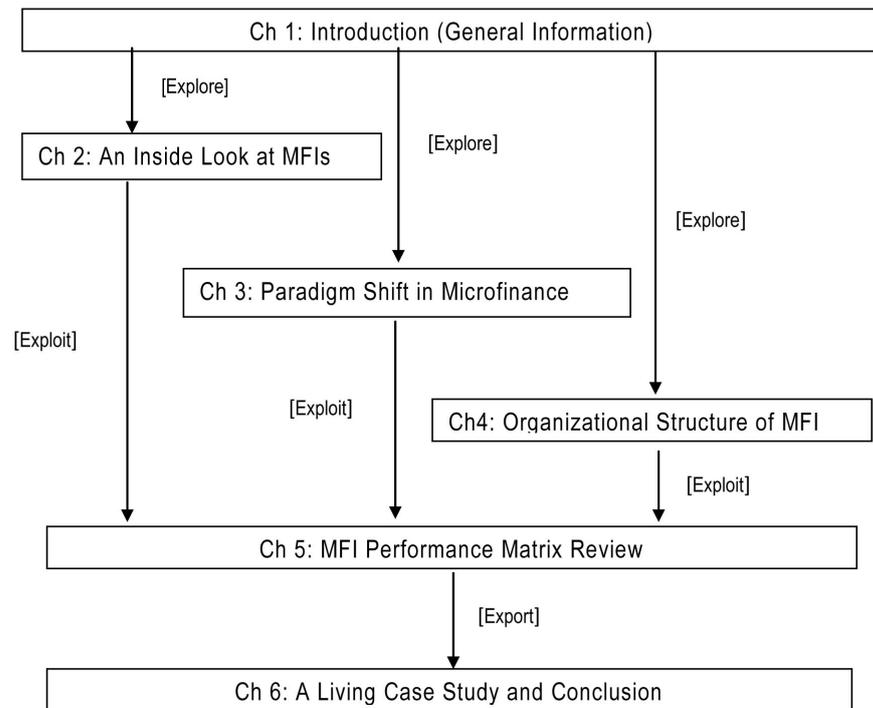


Fig. 1.1: Thesis Structure

Chapter 2

An Inside Look At MFIs

Microcredit is an innovative concept that marries compassion for the poor with personal empowerment. It is people like you [Muhammad Yunus] who inspire the rest of us to turn our thoughts into actions -
Anna Kinard, the United States

The global economy today can be viewed as one striking dichotomy: those with the ability to produce and consume and those with no promise of either. Those who produce and consume at the highest level, tend to be the affluent residents of both developed and developing countries, where they enjoy the comforts and lifestyles afforded those with the financial resources to both produce and consume. Those without the requisite resources to produce and consume, are confined to an existence characterized by severe deprivation, malnutrition, vulnerability to infectious disease, inadequate levels of education, insufficient shelter, and a lack of access to resources that would allow them to work their way out of poverty.

Nearly 80 per cent of the world population (90 per cent in developing world) does not have access to credit and saving institutions. Commercial banks ignore the poor because of the high costs associated with lending small amounts to borrowers whose creditworthiness is difficult to gauge. As a result, the poor have traditionally been forced to rely on family members, friends, or money-lenders for short-term loans. Unfortunately, these options are more likely to entrench rather than relieve poverty. Certain alternatives exist, such as rotating credit

associations, but they do not sufficiently diversify risk and prove inadequate for larger-scale projects. This is precisely where microfinance has met an important need.

This chapter focuses on the history and literature review of the microfinance movement, including a review of its origins, promises, scale and objectives. Also included in this chapter is a discussion of the link between microfinance and poverty, poverty and health, and microfinance and empowerment. The chapter concludes with a consolidation of the micro-and-macro measures covered in the portions of the paper to assess the potential financial and social impact of microfinance.

2.1 What is Microfinance?

Microfinance also referred to as micro-credit or micro-loan, is the extension of small loans to clients too poor to qualify for the formal banking loans. These customers are poor and cannot offer standard collateral. Normally the loans are of only a few hundred dollars at most, with a repayment period of about a year or so, on average. Women are the major recipients of these loans, and the destination of the funds primarily includes agricultures, small animal husbandry, the production and trading of goods and crafts, and small processing industries. Administrative costs are high in relation to the size of the transaction. In reaching these underserved clients, MFIs help alleviate poverty¹, support investment in business opportunities and contribute to the development of a country's financial system (Morduch, 2000).

Microfinance is based on the recognition that the latent capacity of the poor for entrepreneurship would be encouraged if they had access to small-scale loans that would permit them to enter into the small-enterprise sector. The premise is that integrating the poor into the business sector would result in a higher degree

¹Some authors argue that microfinance is based on a neoliberal approach to poverty, interpreting it as a mere lack of unfulfilled market potential. They claim that microfinance hardly addresses the real causes of poverty, i.e. broader socio-economic issues such as the societal relations of power and domination (see for example Milgram, 2006 and Weber, 2006).

of self-reliance, the creation of employment opportunities, and at last, the engagement of women in economically productive activities. Furthermore, it has been demonstrated that microfinance provides the rural population with access to savings within the local area and with a certain cushion against economic fluctuations. A distinction of the microfinance industry is the formation of Solidarity Groups or Trustee Banks. Most institutions organize their borrowers into groups, which decreases the risk of default and provides effective mechanisms through which to disseminate valuable information on ways to improve health, legal rights, sanitation and other relevant concern of the poor.

Various institutions are involved in the delivery of microfinance services. They include formal commercial banks, rural banks, cooperative institutions, credit unions and non-governmental organizations. In addition, large international institutions, such as World Bank, the United Nations, ILO, ADB, IMF, and USAID provide financial and technical support to MFIs around the world. Their lending methodologies range from solidarity groups (like the Grameen Bank) to institutions dealing with individual clients (Credit Unions) to self-managed self-help groups (Banco Solidario). Some institutions have gone beyond credit to offer micro insurance and other financial and social services (UN Report 1997:6-7). Figure 2.1 is the evolution of modern MFI. ²

In many developing countries, lack of jobs led people to start small businesses. Yet without collateral or credit history, banks did not consider them credit worthy. Lack of working capital kept many enterprises at subsistence. NGOs began to make loans to address poverty, most starting with a single loan product. The poor also needed ways to save. In Asia, many programs were driven by savings rather than lending. Over time, MFI experience showed that micro entrepreneurs would repay their loans, and that it was possible both to manage risk and operate profitably.

²Adapted from The Omidyar-Tufts Microfinance Fund: Striving To Reshape The Social Enterprise Capital Markets by Michael Chu and Jean Steege Hazell, N9 307-078, Boston, MA, Harvard Business School Publishing, January 30, 2007, p.13

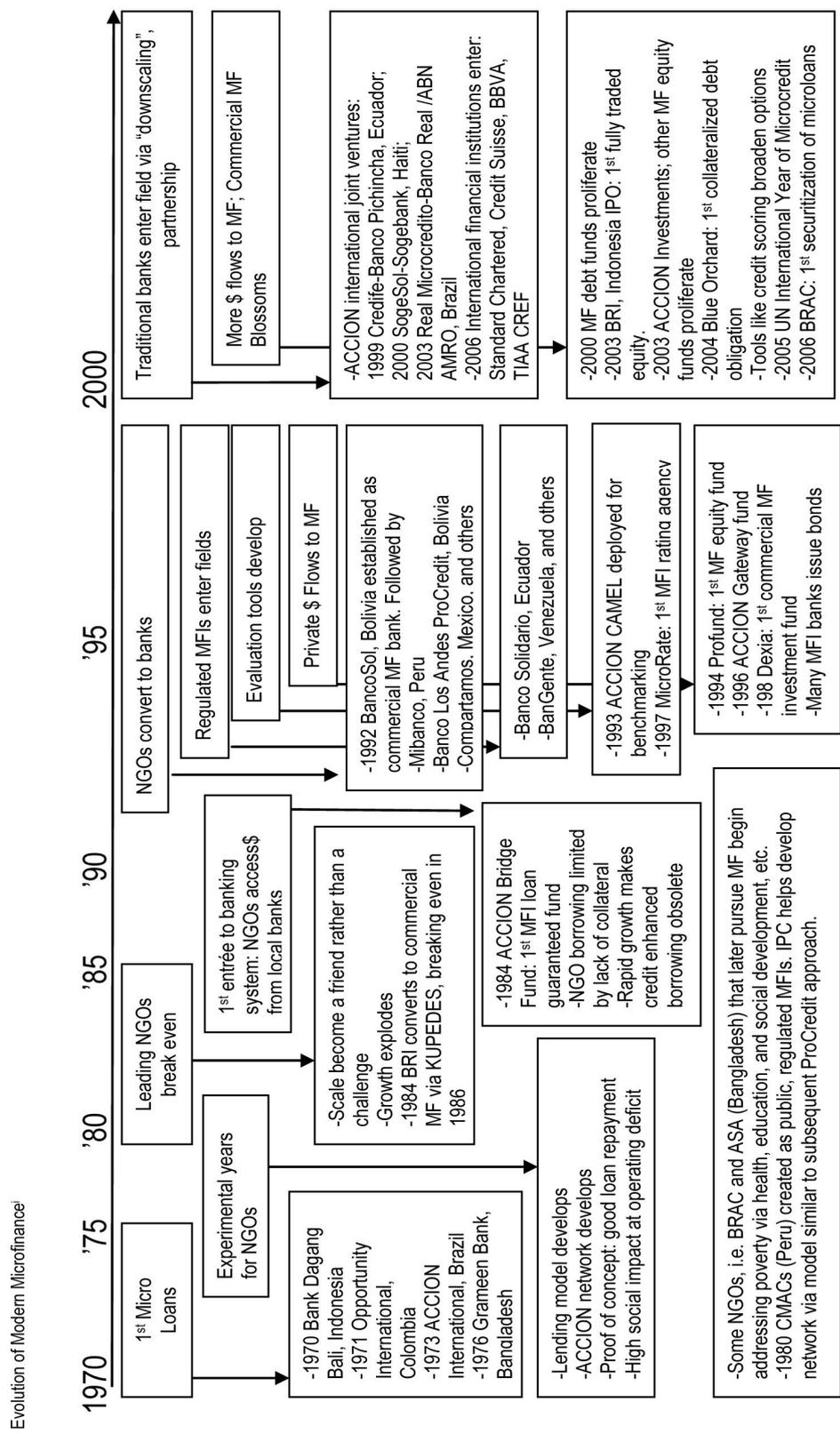


Fig. 2.1: Evolution of Modern Microfinance

Leading MFIs experienced increasing demand for loans, requiring access to capital. The ACCION Bridge Fund was the first to provide credit enhancement so MFIs could borrow from local banks. MFI demand soon exceeded what they could borrow with Bridge Fund guarantees. In order to access capital markets directly, in 1992 the operations of an NGO in Bolivia were converted into Banco Solidario (BancoSol), a private, for-profit bank solely dedicated to microfinance. BancoSol was profitable from its first year of operations, and by 1998 led Bolivia's banking system with ROE of 28.9%. Such success, with the credibility of regulated information, led to a proliferation of MFIs. Tools to enable industry information exchange and risk management began to develop, and the growing number of successful institutions engendered new forms of investment in the field.

MFI success inspired traditional banks to seek ways to enter the field. Increasing numbers of commercial players led to a more competitive market, driving MFIs to diversify their products, improve efficiency in order to lower interest rates, and enhance service. Increasing amounts of capital began to flow into microfinance, as the field's track record became increasingly known among investors and the public at large.

2.2 The Promise of Microfinance

From its earliest beginnings in the 1970s and 1980s, microfinance has evolved a grand vision in which all people across the globe who need savings or credit have access to high quality financial services. Such services provide one powerful tool in the global fight against poverty. Low income and poor families can use financial services to improve their quality of life, protect against risks and invest in the future. In the process of building the institutions to supply these services, societies can open their economies increasingly to the less advantaged portions of their population. Microfinance promises both to combat poverty and to develop the institutional capacity of financial systems through finding ways to cost-effectively

lend money to poor households³.

2.3 The Scale of Microfinance

Thanks to the development of the information technology, the size of microfinance services for low income people can be scaled, but no one can answer definitely the question of how many people are being reached.

There are several competing data sources, all incomplete and most based on self reporting, and therefore not 100% imperfect. Each database reveals something slightly different about the scale of supply. The Microfinance Information Exchange (MIX) collects data from leading microfinance institutions that are able to produce and willing to release complete financial statements⁴. These institutions generally consider themselves part of the microfinance community and may be thought of as the core of microfinance, with exceptions noted below. MIX data for 2004 shows a worldwide total of 30 million borrowers served by 675 organizations.

The Microcredit Summit publishes data on numbers of borrowers and includes institutions that are not direct providers of financial services but are microfinance movements⁵, as well as data from some public sector development banks⁶. Its estimates for the same year are 92 million active borrowers, a difference from the MIX of 62 million. Exactly half of this difference (31 million) is explained by the Summit's inclusion of two self-help group (SHG) movements⁷ in India, the NABARD Self-Help Group Bank Linkage Program and the Society for the Empowerment of the Rural Poor.

³See, for example, Brugger and Rajapatirana (1995), Hulme and Mosley (1996), Otero and Rhyne (1994) and Morduch (1999) for broader discussions of microfinance programs.

⁴All data from the MIX comes from its website, www.mixmarket.org.

⁵The term Microfinance Institutions includes a range of different organizations. Microfinance started as public-interest projects, normally operated by Non-Governmental or Non-Profit Organizations (NGOs/NPOs). However, theoretically, it is illegal in China for NGOs/NPOs to provide financial services (Sun 2008).

⁶The 2005 State of the Microcredit Summit Report presents end of 2004 data on progress made toward the Campaigns goal. www.microfinancesummit.org.

⁷The SHGs are traditional womens savings and credit groups.

Comparison of these two databases reveals a surprising consistency, despite the differing totals. There is a core group of microfinance institutions reaching roughly 30 to 50 million borrowers. The core group includes banks, finance companies, NGOs and other types of institutions. About 400 to 500 institutions form this core, although there are another 2,000 to 3,000 small institutions serving fewer than 2,500 borrowers each and making a negligible contribution to global aggregates. Another 25 million people are involved in the Indian SHG movement, and finally, millions more are served by government-owned institutions (especially in Asia), which are not directly associated with microfinance, but which do reach substantial numbers of lower income people. Credit unions play a minor role overall (about 7 percent of the MIX total) but are very important in certain countries.

Turning from supply to demand, one can only speak in the most general terms. However, there is a consensus that worldwide total demand numbers at least several hundred million families and that microfinance has not developed evenly across regions in term of depth of outreach and loan size (see Table 2.1) ⁸. For instance, there are 25 registered MFIs and 60 non-registered MFIs operating in Cambodia. Most of them have plans to continue expanding rapidly with the establishment of more branches and more lending at existing branches. However, MFIs lack funding with the demand for loans far exceeding the supply, due to the lack of deposits and the under-developed banking system in the rural areas. The micro loan portfolio amounted to \$134 million in 2007, which is much less than the estimated demand of \$200 million (Hang, 2008).

In each region, microfinance has distinct characteristics that reflect the nature of regional population and economies. South Asia (49 million active borrowers) accounts for the largest outreach, followed by East Asia (13.7 million active borrowers), Latin America (14.2 million active borrowers) and Africa. MFIs in MENA and in ECA reach the fewest clients. In the MENA region there are still not many

⁸This table produces current scale statistics the MIX Market in 2009. Data includes all MFIs in the MIX Market database with more than 5,000 borrowers. Another 297 institutions in the MIX Market reach fewer than 5,000 borrowers each. These smaller institutions are excluded here. They account for only a total of 1.5 million additional borrowers.

Region(No. MFIs)	Active Borrowers (Mil)	Loan Portfolio (\$ Mil)	Average Loan(\$)
Africa(194)	7.9	4,800	356
S. Asia(174)	49.2	7,300	148
E. Asia(121)	13.7	24,300	1,773
LAC(345)	14.2	19,700	1,387
MENA(65)	2.5	1,200	480
ECA(222)	2.7	7,400	2,740
ALL(1953)	91	64,900	535

Table 2.1: Current Scale of Microfinance

MFIs.

Average (typical) loan sizes show striking regional differences, ranging from less than \$150 in South Asia where poverty is deep and microfinance has been aimed at very poor people, especially women; to about \$1,000 in Latin America, where poverty is not as deep in absolute terms (few people live under \$1 per day) and microfinance has grown up with a micro-enterprise development focus; to over \$2,500 in Eastern Europe, where incomes are significantly higher⁹.

The picture becomes even more diverse when individual countries are examined, with regards to the market penetration in smaller and larger countries. Within regions, some countries, most of them relatively small, have highly developed microfinance sectors such as Mongolia, Cambodia, and Nicaragua (see Table 2.2). Bangladesh stands out as an exception on all fronts, as a large country in terms of population with many MFIs and extraordinarily small average loan sizes. With 9 per cent of all people in Bangladesh counted as microfinance borrowers, the penetration of microfinance in Bangladesh exceeds that of all other countries.

⁹See Table 2.3 where Average Loan size in Russia is \$5,064

This 14 % penetration rate in Bangladesh could be used as an upper bound for very large national penetration of microfinance. This figure reflects the early start Bangladesh got in microfinance, as well as the high percentage of the population living in circumstances that make them potential microfinance clients. Other countries shown below also have significant market penetration, and the capacity for microfinance to continue growing. It is notable that aside from Bangladesh most of the countries with high penetration are dominated by bank and finance company providers of microfinance, reflecting policy environments that have been supportive of microfinance integration into the financial sector.

Table 2.2: Countries with High Microfinance Penetration in 2009

Note that in countries with high penetration of microfinance, clients may have loans from several MFIs, making double counting of customers possible

Source: the MIX Database.

Country	MFIs	Loans	Borrowers	Average loan	Penetration Rate	Population
	#	\$Mil	Mil	\$	%	Mil
Bangladesh	73	2,300	20.6	111	14	147
Mongolia	6	553	0.38	1,455	12.6	3
Bolivia	26	1,900	0.87	2,184	9.6	9
Bosnia	15	832	0.37	2,248	9.2	4
Cambodia	16	828	1.1	752	7.8	14
Nicaragua	32	472	0.39	1,210	6.5	6

The biggest gaps in meeting demand occur in some of the largest developing countries: Indonesia, Brazil, China, India, Pakistan and Nigeria (See Table 2.3). Again, Bangladesh is the exception, as is Mexico, which has significant penetration. To achieve the same moderate level of penetration as Mexico, India would have to add 20 million clients; Nigeria needs additional 5 million clients. It is notable that most microfinance in the large countries, with BRI in Indonesia and Banco do Nordeste in Brazil as notable exceptions, is provided through NGOs. Policymakers in large countries have generally been less willing to support the integration of microfinance into the mainstream.

There are major differences between urban and rural supply of financial ser-

Table 2.3: Microfinance in Populated Countries (over100mil)

The data is available at the MIX Database.

Source: the MIX Database 2009

Country	Banks& NBFIs	NGOs, Credit Union, Other	Total Portfo- lio	Client	Average loan size	Client per pop.	Total popu- lation
	#	#	\$ Mil	Mil	\$	%	Mil
China	19	0	18,600	1.6	NA	NA	1,313
India	138	20	4,300	25.9	166	2.36	1,095
Indonesia	57	5	90.1	0.3	300	0.10	245
Brazil	34	0	934.5	0.8	1168	0.40	188
Pakistan	29	9	199.5	1.3	153	0.78	166
Bangladesh	73	43	2,300	20.6	111	14.0	147
Russia	97	1	167.7	0.09	1,863	0.00	143
Nigeria	15	2	64	0.46	148	0.30	132
Mexico	54	3	2,700	4.5	600	4.2	107

vices, with rural supply still representing a major challenge in most parts of the world. The rural population is hard to reach because it is in remote areas or spread thinly over a large region. Microfinance products have focused on working capital for trade or business, rather than for agricultural production. Expansion into rural areas is especially important because of the generally higher incidence of poverty in rural areas. While substantial development of MFIs has taken place, most of the poor, particularly the rural poor, are still beyond the coverage of the formal financial sector including MFIs (Hang, 2008).

2.4 The Origins of Microfinance

Microfinance has its origins in the Rural Development institutions of the early 1960s and 70s. Although these met with failure, they laid the foundation for the surge of microfinance institutions and programs that was to follow. Below is a description of the Rural Development Institutions. It is followed by an over of the three premiere pioneer micro-lending organizations: the Grameen Bank, featuring its group loan format; ACCION International, focusing on its ability to access micro-lending institutions in Latin America to capital markets; and the Baden

Kredit Kecamatan (BKK), showcasing its efforts to provide village banking to the rural poor of Indonesia.

2.4.1 The Rural Development Institutions

During the 1960s and 70s, development agencies and third world government funneled large sums of money to numerous state-run RDIs that provided agricultural credits to poor farmers. As a general rule, the RDIs offered credit at highly subsidized terms to famers, targeted credit for specific uses, and did not offer savings services.

From the beginning these RDIs were plagued by a number of problems, including a hand-out mentality amongst clients, high overhead and transaction costs, and heavy corruption. Impact was almost non-existent: the production achieved among the farmers was negligible. Worse yet, RDIs suffered from abysmal repayment rates. This lead to a discontinuation of donor funding, and the inevitable failure of RDIs, which gave rise to even lower repayment rates, since borrowers had little incentive to repay loans to institutions whose futures were in doubt.

2.4.2 Microfinance Institutions

When the concept of microfinance came to international attention, MFIs were mainly non-governmental organizations (NGOs). Their primary sources of funding were international donors, private benefactors and governments. They did not aim at a monetary return but concentrated on creating social benefits. The well-known MFI Grameen Bank of Bangladesh was founded on that basis and initially received significant grant funding. Although it has since evolved, it serves as a living example in the first part of this section to illustrate the characteristics of charitable MFIs. Today, many MFIs try to combine a social impact with financial goals, but a focus on developmental effects normally implies continued reliance on donor funds. MFIs that focus primarily on their social goals are henceforth called charitable MFIs.

Over time, the non-governmental MFIs found that poor clients hardly reduce their demand when interest rates rise. Consequently, MFIs can generate more funds for re-lending and cost-recovery than was previously considered possible. First, MFIs found it possible to reach operational sustainability, the ability to cover operational and administrative costs from revenues. Later, some even attained financial sustainability, the ability to operate without donor funds and cover commercial costs of capital. They recover their costs or even achieve a positive return on investment. They receive their funds from private capital markets. They might not be able to act socially where that reduces financial soundness, but they are independent from donors.

As a result, many MFIs that were founded as charities but manage to become independent from grants transform into licensed financial intermediaries or even fully regulated banks . Since independence from subsidies raises the prospect for an institution to sustain itself in the long run, this paper uses the terms financial sustainability or simply sustainability. Cost-recovering or profitable MFIs that focus on financial performance more than on social impact are called sustainable MFIs. BancoSol is an example of an MFI that managed to become self-sufficient. The second part of this section presents its case study, illustrating the characteristics of sustainable microfinance institutions.

The tendency towards sustainable microfinance raises questions about the sectors aims and directions for future development. One controversy is whether primarily socially-oriented charitable MFIs are needed or whether sustainable MFIs can produce higher developmental benefits. Rhyne (1998) contends that a combination of both profits and developmental impact is possible, while Paxton and Fruman (1997) rather find a correlation between poverty outreach and subsidy dependence and emphasize that a variety of methodologies is needed for the different market niches of microfinance.

Depending on the underlying assumptions about poor agents behavior and their utility functions, nearly every strength or weakness can be attributed to

either charitable or sustainable MFIs. For example, assuming a low sensitivity of credit demand to interest rates emphasizes the importance of subsidies to reach the poorest microfinance clients. In contrast, the currently prevailing view that the credit demand of the poor is not price-sensitive rather supports the view that sustainability is a reasonable aim for MFIs (Aghion and Morduch, 2005). Despite discussion of the issue in almost every current microfinance conference and its prominent role in the UNs International Year of Microcredit 2005, the sector remains divided between the proponents of charitable and sustainable MFIs.

Charitable MFI Protagonist: Grameen Bank

The origin of Grameen Bank can be traced back to 1976 when Professor Muhammad Yunus then Head of Rural Economics Program at the University of Chicago launched a field based research project to examine the possibility of designing a credit delivery system to provide banking services to the rural and landless poor. The Grameen Bank Project (Grameen means rural or village in Bangal language) came into operation with the following objectives:

- Extend banking facilities to poor men and women;
- Eliminate the exploitation of the poor by money lenders;
- Create opportunities for self-employment for the vast multitude of unemployed people in rural Bangladesh;
- Bring the disadvantaged, mostly the women from the poorest households, within the fold of an organizational format which they can understand and manage by themselves; and
- Reverse the age-old vicious circle of low income, low saving, low investment, into virtuous circle of low income, injection of credit, investment, more income, more savings, more investment, more income.

The research project, which was carried out between 1976 and 1979, illustrated the potential for extending microfinance to the landless poor in Jobra (a village

adjacent to Chittagong University) and in some of the neighboring villages. With the sponsorship of Bangladesh's central bank and the support of the nationalized commercial banks, the project was extended to Tangail district (a district north of Dhaka, the capital city of Bangladesh) in 1979. Following the success of the project in Tangail, it was extended to several other districts in the country. In October 1983, the Grameen Bank Project was elevated to the status of an independent specialized financial institution.

The Grameen Bank maintains that the lack of access to credit is the biggest constraint for the rural poor. Consequently, the mission of the Grameen Bank is to channel credit directly to the poorest and the least empowered, in hopes of improving their living standards and hence those of their families. The Bank founder, Professor Muhammad Yunus reasoned that if financial resources could be made available to poor people on terms and conditions that are appropriate and reasonable, these millions of small people with their millions of small pursuits can add up to create the biggest development wonder.

To better meet its ultimate goal of social and economic development, Grameen Bank targets more women than men. Bank staff noticed that women experience poverty more acutely than men, they behave differently because of it. As Bornstien noted in his biography of Yunus, as the mother, seemed to have a more profound impact on the family as a whole. When a woman brings in income, the immediate beneficiaries are the children. A mother is interested in buying better food or cooking utensils, or patching the roof. She pays more attention to the children's clothing and to their bedding.

Along with providing credit, Grameen Bank offers guidelines to members for codes of conduct and activities aimed at improving their social and financial conditions. It also provides training to women in maternal health, nutrition, and childcare to generate greater demand for basic healthcare services. The Grameen Bank has revolutionized conventional banking practices by removing the need for collateral and by creating a banking system based on mutual trust, accountability,

participation and creativity.

Contrary to the practice of formal finance, the Grameen Bank lends, in small amounts, to the poor based on group responsibility, where individual access to credit depends on group repayment behavior. Group lending uses peer pressure, or social collateral, to monitor and enforce contracts and helps screen good borrowers from bad ones. As an insurance measure, the Grameen Bank fosters saving schemes that provide protection against default, an internal source of finance, and a stake for the member of bank operations. Each member is required to save 1 Take each week and to buy a Grameen Bank share worth 100 Takas. In addition, each borrower contributes 5% of the loan amount to a group fund and 5 Takas every 1000 Takas (above loan size greater than 1000 Takas) to an emergency fund (www.grameen-info.com/bank/hist.html).

The bank today continues to expand across the nation and still provides small loans to the rural poor. By 2006, Grammen Bank branches numbered over 2,100. Today the rural poor whom it serves are the majority owners of the Grameen Bank: the borrowers of the bank own 92% of the shares, while the remaining 8% is owned by the government.

Throughout the developed and developing world, the Grameen Bank is considered the forefather of microfinance banking. It is perhaps the most documented and replicated banking institution of our time. The Grameen Bank has inspired people and institutions throughout the world with its success in poverty alleviation. Thousands of people from some 100 countries have gone through Grameens training and exposure programs since its inception. Some of those visitors have returned to their countries and replicated the Grameen Bank financial system to help the poor people in their own country to overcome poverty. In total, there have been more than 200 Grameen replication programs in 58 countries during the last decades. Taken together, they have reached hundred thousand poor borrowers with credit around the world.

Sustainable MFI Protagonist: BancoSol

MFI Alliance and Network: ACCION

ACCION is a private, non-governmental organization founded in 1961 with the mission of giving people the financial tools they need to work their way out of poverty. By providing micro-loans, business training and other financial services to poor men and women who start their own businesses, ACCION helps people to work their way up the economic ladder, with dignity and pride.

Begun as a student-run volunteer effort in the shantytowns of Caracas, Venezuela, ACCION today is one of the premier microfinance organizations in the world, with a network of lending partners that spans through Latin America, Africa, Asia and the United States. ACCION became an early standout among promising microenterprise programs in the 1970s by recognizing that, in order to work effectively, micro loans could not be structured aid. We priced our product according to cost and discovered that micro-lending can be done on a commercially viable basis, say Maria Otero , current President and CEO of ACCION International.

The microloans that Michael Chu , former President and CEO of ACCION International, calls the first grains of sand now represent a collection of increasingly sophisticated financial arrangement that could have remarkable social impact. ACCION has had a role in some of the most revolutionary such arrangements, and is likely to begin the next wave through such vehicles as its International Gateway Fund, designed for institutional investors to invest in ACCIONs network. Most of the world is poor and the only way to seriously combat this problem is on an economically viable basis, says Chu. Micro-lending is an economic firepower of sufficient magnitude in relation to the problem.

It works like this: ACCION borrowers pay interest on their loans enough to cover the expense of making a loan. In this way, each borrower helps finance the cost of lending to the next. The more people the program reaches, the more resources it has to reach even more people. This focus on financial sustainability has helped ACCION and its partner network increase the number of active clients

it serves from 13,051 in 1988 to 3.12 million in 2007. What distinguishes ACCION International from some of the other microfinance organizations is its recognition that the international capital markets are the only source of sufficient funds to make a real impact on world poverty. Although increasingly more micro-lenders are accessing commercial funds in the form of bank loans to then on-lend to their clients, far fewer have been able to tap into the capital markets through the issuance of their own debt instruments, most typically as Certificates of Deposit or as bonds.

This is because to tap into the capital markets, micro-lending institutions must become commercially viable, covering both operating and financial costs with interest income and fees. Perhaps 50 of the estimate 7000 to 10000 micro-lenders worldwide have achieved this. ACCION is now working to design and implement financial instruments that can be issued into the capital markets, including the securitization of micro-lending portfolios. Some ACCION affiliates have not only reached commercial viability but have subsequently been incorporated into their countrys financial system as regulated institutions. This allows them to also offer savings and other financial services to their micro-business clients. Examples include Banco Sol in Bolivia; FINSOL in Honduras; Banco ADEMI in Dominican Republic; FINAMERICA and Cooperative Emprender in Colombia; Mibanco in Peru; and Banco Solidario in Ecuador. Moreover, ACCION has long been active in helping its network affiliates access to commercial capital; thereby vastly increasing the number of people they can reach (<http://www.accion.org>).

- In the 1984, ACCION created a guarantee fund, the Latin America Bridge Fund (LABF) to meet its affiliates growing demand for capital to fund their microloan portfolios. The first of its kind, LABF is capitalized by donations and private deposits. The Fund issues letters of credit that allow ACCION affiliates to borrow directly from local banks, dramatically increasing their pool of capital for microloans, and effectively linking microenterprise with the formal banking sector. The LABF is currently capitalized at over \$6.7

million as of May 2005 and invests mainly in El Salvador, Ecuador, and Paraguay. The Financial Services Department of ACCION International manages the ACCION LABF, operating from Washington DC.

- In 1992, ACCION helped launch Banco Sol in La Paz, Bolivia, the worlds first commercial bank serving businesses of the poor. Since 1994, with the help of ACCION, became the first example of an NGO transformation to a commercial bank and thus became the first regulated microfinance bank. Banco Sol surpassed other Bolivian banks in profitability and became the first MFI to access international capital markets. Following this successful example, at least 39 other important NGOs worldwide transformed into commercial banks over the period 1992- 2003 (Fernando, 2003). With 81,500 clients, Banco Sol is today the most profitable bank in the Bolivian banking system, with a 1998 ROA of 4.1 % and a Return on Equity of 29.8%.
- ACCION was a founding member and remains a shareholder in ProFund, the worlds first private equity fund solely dedicated to microfinance investment. Based in San Jose, Costa Rica, ProFunds strategy is to achieve superior financial returns through the purchase of debt and equity in regulated financial institutions dedicated to serving small businesses and microenterprises in Latin America and the Caribbean.
- In 1995, the ACCION affiliate in Paraguay which was non-profit Fundacion Paraguaya de Cooperatcion y Desarrollo issued 350 million guaranties of debt through the Asuncion Securities Exchange. New, regulated microfinance institutions. Non-profits in the process of transformation to a regulated financial status. Already-established, regulated microfinance institutions.

Currently, the Fund has \$5 million of committed capital provided by multilateral institutions. ACCION expects the fund to reach \$10 million with the future participation of socially responsible institutions and investors. In addition to providing long-term capital, Gateway Fund staff participate in governing these

MFIs, helping to assure they remain financially sound and committed to social mission. Prevent investments include Mibanco (Peru), Banco Solidario (Ecuador), Banco Sol (Bolivia), BanGent (Venezuela) and Genesis Empresarial (Guatemala).

ACCION has also undertaken research to determine the impact of its model on family income. One ACCION study conducted in Bolivia, for instance, showed family income increasing an average of 30 per cent after a few small loans. In the United States, a three-year ACCION study of 849 clients released in April 1998 revealed that after two loans over 17 months, take-home income jump 38%, an average of \$455 per month. ACCION borrowers with the lowest incomes saw take-home income jump 54%, an average of \$515 per month. As a group, the 849 borrowers realized a \$228,000 increase in monthly business profits and contributed \$215,000 more each month to their households than they did before entering ACCION affiliated micro-lending programs. A sub-group of 312 clients who received three loans or more reported the cumulative net worth of their businesses grew by over \$1 million.

At the same time, separate studies have looked at the impact of ACCIONs programs on employment. In Latin America, impact studies conducted by ACCIONs programs in Colombia, Honduras and the Dominican Republic show that:

- Microloans help stabilize existing jobs;
- Microenterprises hire one additional employee for every \$1,000 loaned.

In the United States, to date, ACCION has not seen significant job increase amongst its borrowers as a whole. Short term U.S. borrowers, however, do show growth in jobs, adding, on average 26 per cent more full-time equivalent jobs to their businesses. This may be because short-term borrowers tend to have larger, more established businesses and to quickly graduate from ACCION programs to bank loans.

Other Earlier Efforts

In India, the Self-Employment Womens Association (SEWA), initially a trade union, established a cooperative bank in 1974 to provide credit and savings services to women denied access to commercial banks. In the mid 1970s, the Integrated Rural Development Program in India began providing credit and subsidies so poor people could acquire assets for self employment. In 1981, Tulay Sa Pag-unlad Inc., based in the Philippines, began providing credit to women in metro Manila. In the early 1980s, the Indonesian government converted an ailing agricultural credit program into a successful banking network capable of extending small loans to millions of villagers.

In 1984, USAID helped establish the Kenyan Rural Enterprise Program to generate employment through small loans using a group methodology similar to the Grameens. In 1986, the first full-fledged Grameen replication opened in Malaysia. In 1987, Results (a Washington based citizens lobby) with the help of Yunus to push a bill that would make provision in USAID's budget for at least \$50 million in microenterprise loans to poor people. In December 1997, Congress passed and President Reagan signed a measure providing \$125 million for microenterprise lending over two years. The world was viewing the microfinance contagion as a direct hit on poverty.

In contrast to the RDI of yesteryear, the microfinance today emphasizes small-scale short term lending; the need to charge market or near-market rate of interest; the importance of mobilizing savings amongst the poor; the need to gain access to capital markets; the value of convenience to poor borrowers; low overhead and simplified transaction processes; and social, rather than financial, collateral to ensure repayment (Woller et al. 1997).

2.5 The Impact of Microfinance

The objective of microfinance is to provide profitable and sustainable financial intermediation to the poor, who are otherwise excluded from the formal credit system because of lack of collateral.

2.5.1 Impact Versus Efficiency

In Latin America, where ACCION has the bulk of its experience, microfinance efficiency seems to be the exception rather than the rule. Of the 29 performance indicators that ACCION monitors, the efficiency ratio consistently ranks the lowest. The reason for this inefficiency is two-fold. First, many MFIs have not fully exploited the economies of scale required to maximize efficiency. There are many small MFIs serving too few clients to operate efficiently. Second, many programs operate in noncompetitive environments where there is little pressure to improve efficiency.

The main goal for many MFIs was to serve as many poor people as possible, not to control costs. Scale, in terms of number of clients reached, remains the hallmark measure of impact. As such, portfolio volume is used to justify high cost structures. Some MFIs count on potential sales growth to achieve economies of scale, and blame inefficiency on the lack of loan volume rather than high cost structures. However, if a certain loan is unprofitable on a unit cost basis, making more does not improve the level of self sufficiency.

Some MFIs resist justifying the cost of their impact by identifying qualitative gains like education and empowerment. Only recently have we begun comparing MFIs to other types of financial institutions rather than social programs to measure how much ones investment can be leveraged. The focus on loan size as a measure of social impact has put undo emphasis on product features, diverting attention from how efficiently resources are used to achieve desired outcomes.

2.5.2 The Impact of Microfinance on Poverty

Poverty is defined as an income (or more broadly welfare) level below a socially acceptable minimum and microfinance as one of a range of innovative financial arrangements designed attract the poor as either borrowers or savers. In terms of understanding poverty, a simple distinction can be drawn within the group the poor between the long-term or chronic poor and those who temporarily fall into poverty as a result of adverse shocks, the transitory poor. Within the chronic poor one can further distinguish between those who are either so physically or socially disadvantaged that without welfare support they will always remain in poverty (the destitute) and the larger group who are poor because of their lack of assets and opportunities (the non-destitute). Furthermore within the non-destitute category one may distinguish by the depth of poverty (that is how far households are below the poverty line) with those significantly below it representing the core poor, sometimes categorized by the irregularity of their income. In some Latin American cases for example the core poor or destitute are taken to be those below 50% of the poverty line (although Latin American poverty lines are generally higher than in Asia).

In principle, microfinance can relate to the chronic but non-destitute poor and to the transitory poor in different ways. The condition of poverty has been interpreted conventionally as one of lack of access by poor households to the assets necessary for a higher standard of income or welfare, whether assets are thought of as human (access to education), natural (access to land), physical (access to infrastructure), social (access to networks of obligations) or financial (access to credit) (World Bank 2000:34). Lack of access to credit is readily understandable in terms of the absence of collateral that the poor can offer conventional financial institutions, in addition to the various complexities and high costs involved in dealing with large numbers of small, often illiterate, borrowers. The poor have thus to rely on loans from either moneylenders at high interest rates or friends and family, whose supply of funds is very limited. MFIs attempt to overcome these

barriers through innovative measures such as group lending and regular savings schemes, as well as the establishment of close links between poor clients and staff of the institutions concerned. Keeping interest rates relatively low is critical, since the advantage of microfinance programs lies in their offering services at rates that are more attractive than competitors rates. Thus, the Bank Rakyat Indonesia and BancoSol of Bolivia charge high rates, but they keep levels well below rates that moneylenders traditionally charge (Morduch, 1999).

The case for microfinance as a mechanism for poverty reduction is simple. If access to credit can be improved, it is argued, the poor can finance productive activities that will allow income growth, provided there are no other binding constraints. This is a route out of poverty for the non-destitute chronic poor. For the transitory poor, who are vulnerable to fluctuations in income that bring them close to or below the poverty line, microfinance provides the possibility of credit at times of need and in some schemes the opportunity of regular savings by a household itself that can be drawn on. The avoidance of sharp declines in family expenditures by drawing on such credit or savings allows consumption smoothing.

2.5.3 Poverty & Health Status

Microfinance and AIDS

To date the AIDS virus has infected close to 50 million people, and shows no signs of slowing. In developing countries the disease continues to spread aggressively. Indeed, of people who are HIV positive, some 95% live in poor countries.

At a macro level, the impact of AIDS is felt gradually, but at the micro level the household level- AIDS hits with the strength and speed of a hurricane. When a breadwinner develops AIDS, his or her family is impoverished, not once, but twice: first the afflicted loses of his or her income; then other contributions are lost when relatives are forced to dedicate time and money to nursing the patient. Often, daughters are required to drop out of school to help. Worse, HIV tends not to strike just one member of a family, but has been known to systematically infect

entire clan (Economist 1999). Studies suggest that by 2010 the AIDS epidemic will have left behind 40 million orphans in the 19 sub-Saharan countries.

For poor countries, the only practical course is to concentrate on prevention. However, the severity of the situation beg for tactics that are beyond those that traditionally involve training and education in disease transmission and prevention. Because of its potential impact for alleviating poverty, stalling urban migration, and empowering women, micro-credit should be included on the menu of strategies that can avert tile transmission of HIV, specifically:

Poverty: Those who cannot afford television find other ways of passing the evening. People cannot afford antibiotics, so the untreated sores from STDS provide easy openings for my. The creation of jobs may do more to avert the spread of my better than health training and education.

Migrant Labor: Since higher wages can often be found away from the home, or even outside the country, it is common for migrant workers to engage in sex with new or multiple partners. This is particularly prevalent where migrant workers spend most of the year in single-sex dormitories surrounded by prostitutes. Providing these same workers with the resources and training to start their own micro-enterprise may mitigate their chances of contracting HIV from prostitutes, or transmitting the disease across urban and rural boundaries.

Sexism: In most poor countries, it is hard for a woman to ask her partner to use a condom. Wives who insist risk being beaten up. At the same time, where war is ongoing, rape is common, and forced sex is a particularly effective vehicle for my transmission, because of tile extra blood. Making microfinance available to qualified women can help build their self-esteem, particularly where the extension of a loan leads to the establishment or expansion of micro-enterprises¹⁰

As is illustrated in this section, the merits of microfinance include not only poverty alleviation, but also disease prevention. Instituting a program that increases one's opportunity to generate income will have a positive impact on the

¹⁰Mayoux, Linda. "The Magic Ingredient? Microfinance and Women's Empowerment." A Briefing Paper prepared for tile Microcredit Summit. Washington, DC, 2-4 February 1997.

health status of children and adults alike. Chances are that some portion of that income will be used to purchase better provisions; pay for transportation to health services for vaccinations, and other primary health services; install a well, and procure firewood to boil water; and matriculate children in school. Microfinance can serve to stall urban migration and the sexual promiscuity that accompanies it. And finally, gainful employment can give a woman the confidence to take charge of her reproductive life.

2.5.4 The Impact of Microfinance on Empowerment: The Drive to Extend Credit to Women

Nejira is a Bosnian refugee from a small village near Srebrenic . Like most women from this region she lost her husband and her home during the recent conflict. She lived with her two children in a refugee center near Tuzla on humanitarian aid. She had nothing to do except to think about the past and cry. Under the Local Initiatives Pilot Project initiated by the World Bank, a Bosnian NGO proposed small loans for income-generating activities. Nejira hesitated for sometime. She had never handled money ;that had been the responsibility of her husband. Finally she decided to borrow USD 330 to buy a goat She knew how to raise the farm animals and she could sell the milk. Since then, she and her children feel some hope that life can begin anew.

Microfinance programs are currently being hailed as a successful strategy for addressing both poverty alleviation and women's empowerment. Mayoux(1997) has suggested that giving women access to microfinance for tile establishment or expansion of micro-enterprises can potentially contribute to:

- Increased women's income levels and control over income, resulting in greater economic independence
- Improved access to networks and markets, offering loanees exposure to the world beyond the home or village
- Enhanced perceptions of women given their contributions to household income and family welfare, precipitating a greater decision-making role in tile

household

Indeed, studies, such as the one conducted by Amin et al., have demonstrated that by extending micro credit to women, these programs have significantly increased women's authority, economic sovereignty, self-confidence, and status within the household and the community.

Further substantiating Amin's findings are those generated through the work of Ruhul Amin, Stan Becker and Abdul Bayes, who during 1998-99 attempted to explore the relationship between poor women's participation in microfinance programs and their empowerment. The team used empirical data from rural Bangladesh (The Journal of Developing Areas, winter 1998, Vol. 32, No 2, Pages 221-236) to study the relationship between participation in credit and credit-related activities and the level of empowerment of the members compared to non-credit members. The study also looked at the association between the duration of credit membership and women's empowerment. The research was undertaken by examining quantitative data collected from a representative sample of the female borrowers, as well as qualitative data from selected female borrowers in five NGOs from rural Bangladesh. The authors compared NGO credit members from an NGO program area with non-members from a non-program area to infer whether or not variation in empowerment could be explained by the variation in memberships. Similarly, non-members of NGO program areas were compared with non-members from non-program areas to consider the diffusion effect of NGO credit membership on women's empowerment among non-members".

The concept of women's empowerment was divided into three components and measured separately to better identify the factors that underlie women's empowerment. These separate indexes are the intersperse consultation index, individual autonomy index and authority index. The three options were given different weights - "generally" was assigned a value of 1, "never" a value of 0 and "occasionally" a value 0.5.

The results showed that the NGO credit members are ahead of the non-

members in all three indexes of empowerment, irrespective of nonmembers' residence in program areas or non-program areas. Moreover, the nonmembers within NGO program areas show a higher level of empowerment on the autonomy and authority indexes than do the nonmembers within the comparison areas. The results further indicate that education, house type, yearly income etc. tend to be positively associated with autonomy and authority indexes. Also positively associated are duration of NGO membership and non-agricultural occupations.

At the same time, the findings from this study are contrasted by other, less scientific studies and anecdotes.

Edith Kagino is a casualty of micro-credit. Before she was married, Edith used to help her mother to keep cattle in Luwero, where she developed an interest in dairy. After marriage she worked in her husband's workshop. In 1991, she opened a savings account with the Uganda Women's Finance and Credit Trust and she was a regular saver. She acquired a loan in 1992 for two in-calf heifer calves for the construction of a small cow shed. She used a portion of the loan to plant napier grass to feed the cows. Edith started off very well, with the first cow calving normally. Problems started when her husband instructed her to return to her previous job in his workshop. Forced to return, she could no longer take care of the cows, and eventually she lost one of them. She had discussions with her husband about the importance of her project and the repayment of her loan, but he insisted that she should remain in the workshop. Her husband eventually chased Edith away from her home. She had to find shelter for herself and her seven children. Her husband claimed the cows as his, so she was not allowed to take them. After some months, the husband called her back. But he had already sold the roofing sheets and construction materials of the cowshed and all the grass was gone. After a period, she got pregnant again, and soon after her husband decided to live with another wife. As a result Edith's project is marked as a doubtful debt.

Stories like Edith's suggest that there is a darker side to the microfinance phenomenon (Mayoux 1997). There is evidence that many programs have had negative, as well as positive impacts on women. The establishment of small enterprises by women may lead to small incremental increases in income, yet this often comes at the cost of heavier workloads and repayment pressures. Other accounts

tell of loans being pirated by spouses or male family members to set up their own enterprises, over which women have little control. In some cases women have been employed as unpaid family workers with little benefit. There are even examples showing that women's increased autonomy is only temporary and can lead to the withdrawal of male support.

Susan Johnson's work¹¹ reveals that recognizing gender issues in microfinance, as in any project intervention, requires more than targeting a program towards women. It means recognizing the position of women in relation to men as actors in society: in the context of husbands and families; local community and authority and more broadly their position in society at the national level as governed by laws and custom. Programs must then be prepared to support women to overcome the obstacles they face in these relationships, which prevent them from achieving their financial goals.

Johnson developed the matrix (see fig. 2.2) to illuminate which constraints inhibit women borrowers from using their loans to achieve their financial goals, and where these constraints are manifested.

¹¹Johnson, Susari. "Gender and Microfinance: Guidelines for Good Practice." Unpublished. <http://www.soc.titech.ac.jp/icm/wind/gendersjonson.html>

	Individual Level	Household Level	Wider Community Context
	Refers to constraints that operate because of the woman's own endowment of skills, experience, knowledge, confidence	refers to the nexus of social relation as within the household, primarily husbands and wives, but not precluding sons and daughters, parents and other relatives to constrain the set of choices, which a woman faces	refers to behavioral norms, legal rights and perceptions of the value of what women do.
Financial	Women lack access to banks/financial services in own right...	Men's control over cash income; men's expenditure patterns differ. . . .	Perception of men as controllers of money/loans
Economic	Women undertake activities which produce low returns; women have a heavy domestic workload	Gender division of labor; unequal access and control of land, labor and inputs; unequal control of joint household produce and income stream from this	Women underpaid for equal work; women locked in low paid jobs; stereotypes of appropriate roles for women in the economy; women lack access to markets for inputs and outputs if mobility constrained due to social norms
Social/ cultural	Women not literate or educated; girls education not prioritized	Limited role for women in household decision making; polygamy results in conflict/competition and discrimination between wives; violence towards women	Banks and financial institutions do not view women as a potential market; women's mobility constrained by social norms
Political/ Legal	Women lack confidence to claim political/legal rights	Women lack legal rights to jointly owned household assets	Women's legal rights to household assets not defined in law or useful for collateral; women lack political positions to establish appropriate laws; women lack legal rights to land both traditional and formal

Fig. 2.2: Gender based obstacles in Microfinance and Micro-enterprise

Broadly speaking, strategies to address these constraints are likely to fall into three categories:

1. strategies which address women directly with awareness, literacy and related skills development.

2. strategies directed at men in the community, in which the project is working, to affect men's behavior towards women within the household and the local community.

3. strategies aimed at affecting social norms and legal frameworks, which might include advocating work through the media, as well as lobbying to give women properly rights.

The research undertaken to look at women's empowerment as a result of income generation implies that microfinance can help poor women in three ways: First, by providing independent sources of income outside home, microfinance tends to reduce economic dependency of the women on husbands, and thus help enhance autonomy. Second, the same independent sources of income, together with their exposure to new sets of ideas, values and social support, should make these women more assertive of their rights, And finally, micro credit programs - by providing control over material resources - should raise women's prestige and status in tile eyes of husbands and thereby promote intersperse consultation. At the same time, however, the success of some microfinance institutions in enlisting large numbers of women as their members has propagated the belief that microfinance is an intervention uniquely beneficial to the needs of women. On the contrary, microfinance cannot right the power imbalances, which result from gender inequalities that are deeply embedded in cultural mores. Microfinance can, however, make notable contributions, but only if there is a commitment to such an outcome, coupled with a sound strategic approach.

2.6 Lesson Learned From Chp.2

This portion of this paper underscores the potential impact of microfinance on macro-measures, such as: poverty alleviation; urban migration; women and childrens health status, including HIV transmission; and womens empowerment. Similarly, Chapter 2 hints at several micro-metrics that are strengthened through mi-

crofinance, including: higher saving rates, return on equity and assets, new business development, loan size average, enhanced group cohesion, increased household income, and elevated rates of local employment. What is not featured in this discussion is a package of macro-and micro-metrics that can be employed by MFIs to systematically assess their contribution to these outcomes.

However, a careful review of the text discloses several possible metrics, such as:

- The increase in the number of employees hired by a micro entrepreneur.
- The increase in the loan groups saving rate over time.
- The utility of Lending Groups to monitor or enforce contracts and to help screen good borrowers and strong business ideas.
- The relation of interest rates charged by microfinance institutions to those charged by commercial banks.
- The increase in RoE and RoA over time.
- The extent to which microfinance organizations are conveniently located to their clients, and the simplicity of their product offerings and transactional processes.
- The number of annual start-ups and their solvency at specific time intervals.
- The proportion of income used, over time, on health care services, provisions, hygiene, and childrens schooling.
- The availability of information, through the microfinance program, about such topics as health, legal rights, sanitation, and other relevant concerns.
- The rate of fertility as related to increased household income through a micro-enterprise endeavor.
- The rate of HIV infection in microfinance program areas.

- The rate of contraceptive prevalence amongst members of MFIs.

The next section of this paper will discuss the paradigm shift in microfinance in chapter 3 and then the organization of MFIs will be studied in chapter 4 which will explore topics, such as governance, sources of capital, new trends in profit transfer, and the allocation of credit. Once again, a metrics lens will be applied to distill the micro-and-macro-metrics that can facilitate the assessment of MFIs.

Chapter 3

Paradigm Shifts in Microfinance

You know that mantra, "Give a man a fish, he'll eat for a day. Teach a man to fish, he'll eat for a lifetime"? It's missing something: microfinance is the fishing rod, the boat, the net, etc. Cash and dignity, side by side. Maybe the mantra should be: "Give a man a fish, he'll eat for a day. Give a woman microfinance, she, her husband, her children and her extended family will eat for a lifetime." - Bono, the New York Times, September 21, 2005

The paradigm shift in microfinance in the developing world is marked by the change from government and donor-funded subsidized credit to sustainable financial intermediation (See figure 3.1).



Fig. 3.1: Paradigm Shifts in Microfinance

Institutional microfinance is characterized worldwide by what has been called the absurd gap between demand and institutional supply . Thus, despite the widespread demand for financial services for both credit and savings facilities - it is estimated that institutional finance is unavailable to about 90 per cent of all households in developing countries (Christen et al., 1994; Rosenberg 1994; Robinson 1995). This includes most of the poor people in the developing world.

The primary reasons for the low institutional supply of microfinance demand are: (1) the pervasive misunderstandings about local financial markets that are widespread on the part of many governments, financial institutions, and donor agencies; and (2) the low level of influence in their respective societies of those who constitute the demand. Changing the former helps to change the latter.

Institutional commercial microfinance is an important component of effective social and economic development. However, this is not widely known. Where available, savings services permit people to store wealth and seasonal or temporary excess liquidity safely for future use, and to obtain returns on their assets. Credit services enable the use of anticipated income for present investment or consumption. Commercial institutions supplying microfinance increase the options of the working poor by helping them to decrease risks, to obtain higher returns on investment, to improve management and productivity, and to improve the quality of their lives and those of their dependents (Christen et al., 1994).

Within the last decade or so, a new, sustainable approach to microfinance has been developed by the Bank Rakyat Indonesia (BRI) and has been demonstrated successfully throughout Indonesia. The shift there from donor subsidized credit delivery to profitable financial intermediation at the local level and now to commercial bank has enabled, for the first time, the demand for microfinance to be met on the large scale.

A decade ago, it was not obvious that this would occur. At that time there were no large-scale examples of commercial microfinance in any developing country. Derived from supply-leading finance theory, the old paradigm of subsidized credit for lower-income borrowers in rural areas was well entrenched in Indonesia during the 1970s, as in most of the developing world. Microfinance as a commercial institutional activity was generally perceived by policymakers and by the formal financial sector as unimportant for the economy, unprofitable for financial institutions, and unnecessary for the poor. This remains the prevailing view in most developing countries today. However, the new microfinance, profitable, sus-

tainable financial intermediation with services delivered at the local level at full cost, was pioneered in Indonesia, and is beginning to be adapted elsewhere. The new ideas are spreading rapidly.

The examples of BRI and of other self-sufficient institutions that provide finance to large numbers of lower-income households are of significance globally for three reasons. First, it has been demonstrated within the last decade that commercial financial institutions can provide credit profitably from about 5 to 20 per cent of the interest rates that lower-income borrowers can obtain from the informal commercial credit market. Second, the massive demand for institutional microfinance worldwide is far too large to be met by donor or government funds. Third, we now know that it is possible for commercial institutions to provide microfinance profitably in widely varied contexts. What is essential is an enabling macro-economic and regulatory environment, a reasonable level of political stability, and a sufficient population density and degree of monetization.

Banks and other financial institutions in Bolivia, Colombia, Costa Rica, the Dominican Republic, Ecuador, the Cameroons, Egypt, Kenya, Senegal, South Africa, Bangladesh, India, the Philippines, and others in addition to a number of institutions in Indonesia have either established commercial microfinance programs or are in various stages of actively learning about or becoming self-sufficient providers of commercial microfinance. Many have visited BRI in Indonesia to learn about profitable financial intermediation at the local level. The paradigm shift in microfinance can be illustrated as follows:

THE OLD FORM: SUBSIDIZED CREDIT PROGRAMS

- Lower-income people need credit for productive inputs.
- Because their incomes are low, they cannot save enough for the inputs they need.
- They also cannot afford to pay the costs of the credit they need. Therefore

subsidized credit programs are required.

- Lower-income people are generally uneducated and do not trust banks; they either do not save, or prefer to save in non-financial forms.
- If such people are to save in banks, they need to be taught financial discipline.

Therefore, compulsory savings are required as a condition of obtaining an institutional loan.

THE CURRENT TREND: SUSTAINABLE FINANCIAL INTERMEDIATION

- Subsidized credit programs of many financial institutions serving the local areas of developing countries have consistently resulted in high arrears and heavy losses.
- Subsidized loans are provided to the borrower at below market rates, and are therefore desirable. These loans encourage corruption, and in the process often reach the local elites rather than the target population of lower-income borrowers.
- Credit subsidies provided to borrowers at the local level frequently discourage institutional savings mobilization. This occurs because regulations often require that the interest rates charged for subsidized loans are lower than the interest rates paid on deposits, thus providing a negative spread and a disincentive for the institution to capture savings. Despite the relatively high interest rates mandated on deposits in such cases, institutions without an incentive for savings mobilization find ways not to attract depositors (restrictions on withdrawals, cumbersome procedures, etc.).
- There is extensive demand for micro-loan at commercial interest rates on the part of many lower-income people in developing countries. Where micro-loan has been provided by institutions at commercial interest rates, and where local savings have been mobilized, loans tend to be widely available and

repayment rates high. Repayment is high primarily because borrowers want to keep open the option to borrow again at what are highly attractive rates in comparison with the interest rates charged on the informal commercial market.

- When credit subsidies are replaced by commercial microfinance, there can be substantial savings to governments and donors. These accrue both from the subsidies not provided and from the losses not incurred. Where needed, these savings can be made available for poverty alleviation programs.
- Lower-income people generally do not need to be taught to save; they already save. In case of emergencies, they have fewer options than wealthier people and therefore many save regularly in cash kept in the house and in a variety of non-financial forms such as gold, agricultural commodities, and durable goods.
- There is massive demand at the local level in developing countries for institutional savings services that offer a combination of security, convenience, liquidity, and returns. Outside Indonesia, however, this demand is usually unrecognized and very few institutions provide such services.
- Voluntary savings contrast sharply with compulsory savings required as a condition for credit; these reflect two different underlying philosophies. The latter assumes that the clients must be taught financial discipline and the savings habit. The former, a basic component of the new microfinance, assumes that most of the working poor already save, and that what is required for effective savings mobilization is for the institution to learn how to provide instruments and services that are appropriate for local demand.
- There is higher demand for voluntary savings services than for credit at the local level (BRIs unit banking system has six times as many deposit accounts as loans, and more than twice the rupiah amount in deposits than in credit outstanding).

- Given enabling macro-economic, political, regulatory, and demographic conditions, commercial institutions can be developed to provide financial intermediation, delivering services at the local level profitably, sustainably, and without subsidy.
- In contrary, institutions that on-lend donor funds at subsidized interest rates, that combine social and financial services, and that do not mobilize voluntary savings effectively cannot become self-sufficient. Some, such as the Grameen Bank of Bangladesh, are highly effective at providing credit to poor people and recovering loans. However, institutions of this type are dependent on continuing donor or government injections of low-cost funds. Unless they raise interest rates on loans, mobilize voluntary savings, and separate social and financial activities, these institutions cannot become sustainable.
- The demand for institutional microfinance can be met only by sustainable financial institutions. There are not enough donor and government funds to meet a significant proportion of the worldwide demand for microfinance. The Grameen model is not globally affordable. However, the Indonesian model can be both adaptable and affordable for some institutions in many developing countries.
- When one or more institutions have demonstrated in a particular country that microfinance can be profitable, the formal banking sector will begin to enter the market. This has already occurred in Indonesia where large private banks have become aware of BRIs profits and have entered the microfinance market for the first time.
- Sustainable microfinance can be achieved in a country without great expenditures on the part of government or donors. Only the institutions that provide the initial examples may need assistance; later the country's own banking sector will learn that microfinance represents a large, unsupplied, and profitable market.

3.1 The Future Outlook: Innovation Financial Institutions

3.1.1 Drivers of Change

Microfinance is affected by powerful change-producing forces. Noticeably, there are four major drivers of change, which are already unevenly present in all countries, and which many believe will continue to evolve and markedly change the way microfinance operates in the next decade. These four drivers are: competition, commercial entry, technology and the enabling environment.

Competition

Competition has been a fact of life for several years in some countries, such as Bolivia, Nicaragua, Bangladesh and Uganda. In other countries, it is just beginning as evidenced by recent tensions among microfinance providers in India's state of Andhra Pradesh. For consumers, competition means greater choice. It puts consumers in a position to demand the range and quality of services they want at a price they want to pay. For that reason, competition has the power to force MFIs to rethink and reform.

Bolivia provides an illustration of microfinance under competition. Its microfinance sector has been competitive for nearly a decade. In Bolivia, clients can choose from several microfinance institutions. They have become price sensitive, and this competition has driven interest rates down from an average of nearly 30 percent in 1998 to 21 percent at the end of 2004 (see Figure xx).

To offer lower prices, Bolivian MFIs have faced enormous pressure to become much more efficient and to broaden their product mix to include larger loans. BancoSol increased productivity, reduced costs, and increased loan terms to bring its operating expense ratio from the high teens in the late 1990s to the single digits today, a rate once considered unreachable.

As competitive conditions spread to other countries, competition will exert

the same kind of pressure toward efficiency. With the help of another of our four drivers, technology, the cost of delivering tiny loans will eventually drop to little more than that of commercial banking. This process will greatly challenge those institutions which are unable to incorporate these efficiency gains.

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Commercial Entry

The entry of commercially oriented providers will substantially change the microfinance field. After struggling for many years to attract the attention of the mainstream, microfinance is now experiencing a surge of interest from the private sector. Though aware of large unmet demand from low-income households, banks traditionally shunned them because of their perceived high risk. But the demonstration effect of the last decade, coupled with the success of the first movers into this market (especially early-adopter banks), is encouraging a growing number of private players around the world to consider microfinance.

The right conditions for rapid entry by new commercial players are now present in the marketplace: demonstrated profitability, business models that can be copied, and competencies for working with low income populations. The history of financial sector innovation suggests that once such conditions are present, spread can be very rapid. Change will not necessarily occur in the orderly way one might like, and the largest changes may not come from the expected sources. Consider, for example, the potential to amass large volumes of customers quickly when big box retailers like Tesco in the United Kingdom or Elektra in Mexico begin offering financial services. Or consider the implications for scale of telecommunications companies offering payments services by cell phone text message. These innova-

tions have already occurred. They will spread, and more will follow.

Technology

The technologies to transform microfinance already exist. Among the available technologies are magnetic stripe and chip (smart) cards, point of sale devices, ATMs, cell phones, satellite communications, the internet, credit scoring, data mining, biometric recognition and more. These technologies will require microfinance institutions to redesign their business models and educate their employees and customers to master new ways to deliver and receive services. Such changes will not always be easy, but the benefits will be dramatic. They include greater convenience and lower cost for customers, ability to reach more remote customers, and increased security. Innovation in technology will occur in three main areas: payments, credit underwriting and back end systems. And even while we work to apply existing technologies to microfinance, those technologies will themselves evolve, changing the way the financial system operates and making possible things we cannot even envision at present.

Breakthroughs in the use of technology require that microfinance institutions have already incorporated technology thoroughly into their operations. To date, technology in microfinance has served to manage information, that is, primarily on the back end. MFIs with strong MIS can standardize their operations, produce timely and transparent financial reports, and report on their operations as otherwise needed. These attributes will be sine qua non for future microfinance institutions.

While wider application of technology will reinvent microfinance, its incorporation will not be smooth for all. The wide variety and disparity in quality and design of existing back end software used in microfinance will delay the introduction and deployment of front end and other uses of technology. Additionally, new technologies will require fundamental changes in the way an institution relates to its clients, which to date has consisted of high cost, high touch contact, and such

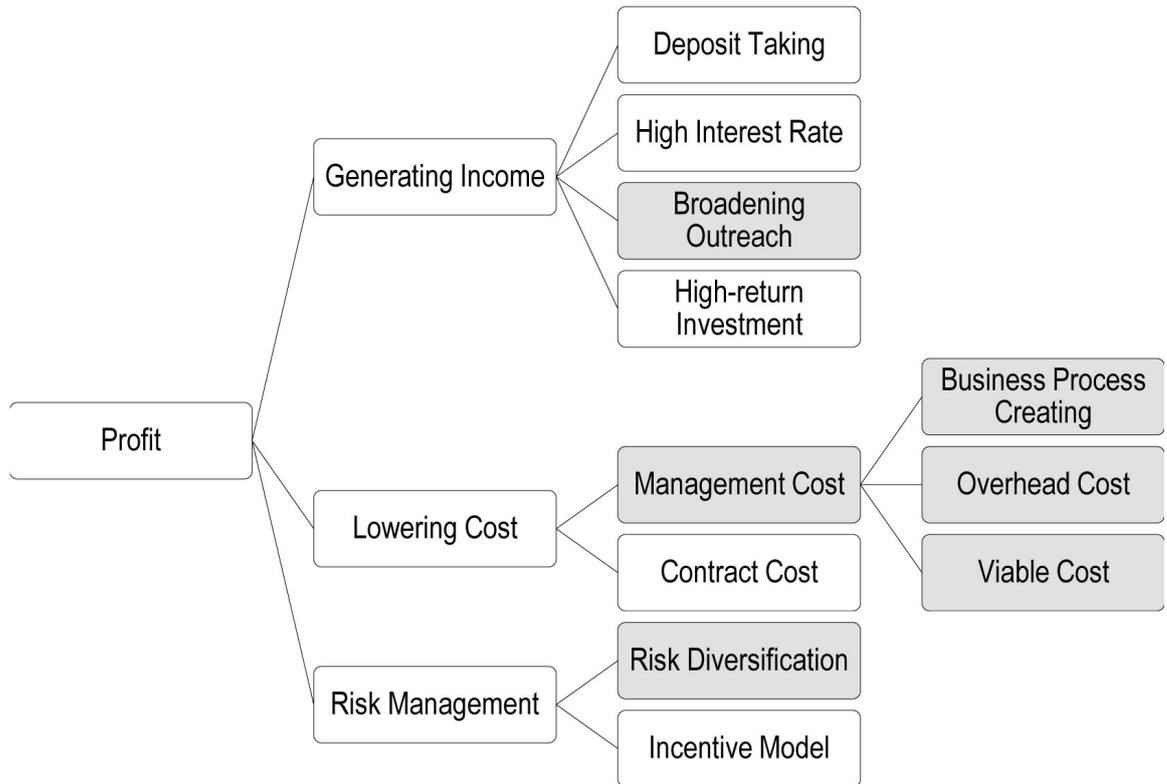


Fig. 3.2: New Technology Profit Model

changes will most likely be met with both internal and external resistance.

Policy and Regulatory Environment

Microfinance can only progress if the enabling environment is supportive. The policy environment will determine which regions and countries will close the demand gap most successfully. The trajectory of policy and regulatory environment has until recently been from state-controlled and distorted financial markets toward more liberalized financial markets, and this has been good for microfinance. Microfinance has flourished in settings where the government did not follow directed credit policies, allowed interest rates to be market-determined, kept credit allocation separate from politics, and was not itself involved in direct lending. In some countries, special microfinance regulatory frameworks have been very helpful, supporting the particular needs of microfinance institutions in countries like Uganda, Indonesia, Peru and Bolivia. This trend is under threat in some places,

however. Some governments want to turn back the clock, implementing interest rate caps, and politicians increasingly see microfinance as an attractive target for their attentions. Because scale brings high visibility, actions to restrain or interfere with microfinance are more likely to appear in exactly those countries where microfinance grows fastest.

In addition, governments can do more by removing artificial policy and regulatory obstacles to MFI and SME lending, importantly, policies that promote greater competition within the financial sector as a whole are generally likely to be especially good news for smaller lenders like MFIs and borrowers like SMEs. External actors can help too for example by promoting development of credit information systems and reform of collateral regulations. Government can also usefully play a selective pump-priming role; for example, they can partially guarantee commercial lenders moves into SME or MFI lending. This approach has been used by the US Federal Reserve under the President Obama Administration to buy SME loan portfolio in order to channel funds to the current credit freezing economy.

3.1.2 Future Outlook

If the rich distribution channels and existing information platform of telecom operators can be employed by MFIs, they will be able to enhance operational efficiency, reduce management costs, increase outreach, and achieve sustainability by renewing their profit model. New technology such as mobile banking will help to ensure that the microfinance industry will be flourishing in the near future and will take MFIs to a new level of sustainability.

Although mobile banking has successfully been adopted by some African countries with sparsely-located populations and a wide coverage of mobile networks, it may take some time to find solutions to a number of regulatory issues. For instance, many MFIs in China are restricted to operating within a certain region and would therefore be unable to profit from the dramatic expansion in outreach

that mobile banking would offer.

3.2 Summary on Chp.3

Most of the MFIs originally began as NGOs that offered microfinance as an additional service. While policy and regulations have played crucial role in the earlier development stage, marketing, distribution channel and Information Technology have becoming increasingly important due to competition and new entry players. While most traditional MFIs rely heavily on direct distribution channels, new innovation in Information Technology presents opportunities to improve efficiency in distribution, increase staff productivity and better manage a larger number of client records. Information technology will play a critical role in the success of microfinance. In addition, favorable regulations by the central bank allow MFIs to cross-sell other financial products and services such as micro life and accident insurance which could create another source of revenues for MFIs as well solidify the relationship between lender and borrower. To achieve this objective MFIs must be well positioned to leverage on Information Technology such as automation and biometric.

Chapter 4

The Organizational Structure of MFIs

Microfinance describes seemingly very different forms of financial services offered by equally dissimilar organizations. Nonetheless, microfinance always refers to credit extended by formal institutions to individuals or informal groups. Normally, the formal institution has been set up or is currently financed or supported by donor aid or what constitutes the Corporate Social Responsibility program of a commercial bank. Microfinance concerns very small amounts: initial loan amount rarely exceed \$200 and usually are below \$50. Although business development is often a major rationale behind microfinance programs, microfinance is also used for construction, emergency consumption, education and social expenditure.

Like its more traditional counterparts, institutions involved in extending micro-loans are subject to the problem of asymmetric information and opportunism. The lenders are neither certain of the reliability of their loan recipients, nor what they will ultimately use the loan to accomplish. They rely on the word and faith of the loan group or village extension workers to help with the selection process. Unlike more traditional banks, however, MFIs have little flexibility in dealing with the problem of delivery costs; microfinance deals with small loan amounts, tiny but frequent repayment, and rapid loan roll-over, therefore, cost efficient delivery

Table 4.1: Current Roles of Microfinance Providers by Type

	Type of Provider	Advantages/Disadvantages
NGO	Most numerous group, especially in Bangladesh and India; Many in process of transformation; Deep outreach	Social mission, focused on poor, close to customer, non-financial services / high cost, smaller outreach, limited access to resources.
Specialized MFI or Finance Company	Strong providers, many post-transformation NGOs, growing rapidly	Knows microfinance customer; financially sound, increasing access to finance, product innovators / lacking deep pockets for investing in future; higher cost.
Credit Union	Important deposit-takers; still lagging in loans	High trust by members; low cost structure / governance issues, lack of resources for investment.
Public Sector Bank	Massive deposit; urban rural money transfer; rural outreach	Widespread branch networks, social mandate / sluggish, subject to political capture.

systems assume great importance.

For these reasons, governance of MFIs is critical to their sustainability. This chapter describes some of the guidelines, policies and procedures employed by MFIs, including: borrower selection; loan utilization; the location of the loan establishment; loan size and repayment schedules; rate of interest; saving mechanisms; and training programs (See Figure x)¹.

In addition, Chapter 4 will also detail the sources of microfinance and the allocation of financial capital by offering a detailed discussion of the approaches used in micro-financing the micro-enterprise. Last but not least, Chapter 4 concludes with a consolidation of the financial and outreach indicators covered in this portion of the paper to assess the potential success of MFIs.

4.1 MFI Governance Matrix

The matrix of MFI governance can be illustrated as below.

¹This figure is adopted from Yu Sang Chang, Toward A Unified Theory of Operations Management, KDI SCHOOL teaching Note (2006).

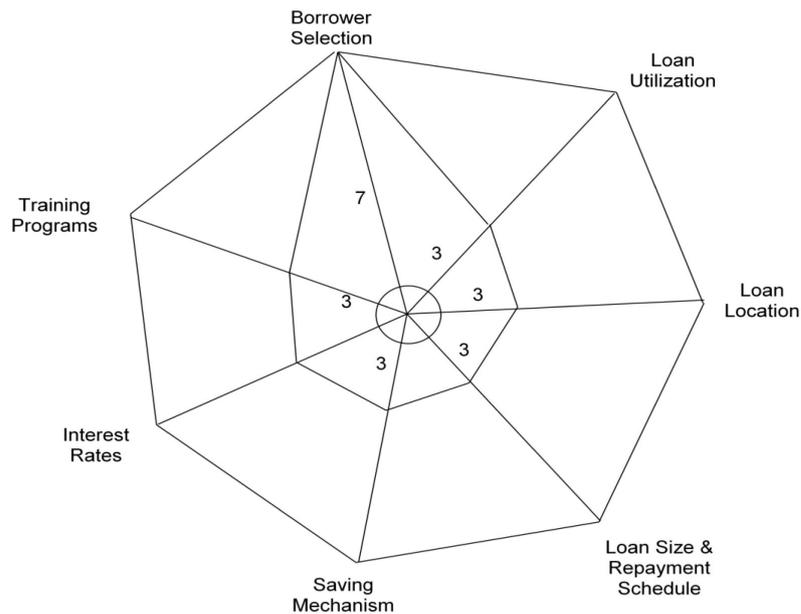


Fig. 4.1: MFI Governance Matrix Profile

4.1.1 Borrower Selection

There are generally three targeted borrowers: women, young adults, and the rural poor. Some lenders specifically target microfinance at women, who are usually seen as economically less independent than men in the same social group. The rationale behind this is that benefits from their economic empowerment directly extend to their children. Therefore, from a social equity point of view, women are often seen as more desirable borrowers than men.

Another important group at which microfinance is sometimes targeted is young adults. With high unemployment and insufficient job creation by the formal sector, school drop-outs face disillusionment. An unemployed, impoverished adult may well be seen as a threat to the social fabric of society. Hence, creating opportunities for income generation is considered a priority by some lenders and donors.

An alternative target group may comprise rural people because they are seen as unable to benefit from development and employment creation in cities and towns. Finally, other social criteria for selecting a target group may be factors such as ethnicity or nationality, factors of social disadvantage like a physical disability. Targeting specific sections of the population has not only social but also economic

implications. There are two sides to it. First, different groups may be variably efficient in utilizing micro-loans in creating viable enterprises, and second, different groups typically have different repayment patterns, thus impacting on the sustainability of micro-lenders. Therefore, the social desirability of lending to a specific group of people does not imply financial sustainability for the lending institution (Reinke, 1998).

In most credit schemes it is found that women are better risks than men. They pay more punctually, and they default less often. Therefore, the targeting of women is not only socially desirable, but also makes economic sense. Lending to youth is different. Young borrowers, those below 25 or 30 years, typically have lower repayment rates than older borrowers. So, while it may be seen as socially desirable to lend to young adults, there is a risk premium attached. And not only is it more expensive to lend to youth, they also appear to be less successful in using the loans for setting up viable enterprises (Reinke, 1999). Reaching the rural poor is difficult. It is expensive to maintain outreach structures in rural settings with poor infrastructure and low population density. However, as Grammens Yunus often argues, the higher social stability in rural communities aids the reliability of financial relationships, through the building of social capital amongst members of the loan groups.

Indeed, over time microfinance and group credit have become almost synonymous. Terms such as solidarity and peer pressure have become associated with sustainability, high repayment rate, and outreach. This association is arguably attributable to the well-publicized success of the Grameen Bank in Bangladesh (Hossain, 1988). However, international experience, such as that of Renke, is more diverse, and suggests that sustainability and cost efficiency are more easily achieved without the so-called Group Loan Methodology.

Group vs. Individual Credit

Group lenders have extensive relationships with their clients. Often they offer advice and support that is quite unrelated to enterprise development. Social empowerment and even health matters are often discussed, and sometimes, social gatherings or parties are part of their working procedures. Frequent meetings are an important part of group lending schemes: they are crucial to the transparency and information sharing on which joint liability depends. Meetings are usually fortnightly, with an attendance of around six borrower groups, usually around thirty borrowers, and are attended by a credit officer. The function of meetings and other forms of social interaction, in group credit is not purely economic; while meeting are part of the credit operation, they also have a social role. Group credit schemes have, therefore, more functions than credit extension alone.

By the same token, social interaction is time-consuming, both for borrowers and for credit officers. Therefore, group credit is expensive if borrowers value their time. Also, maybe even more important, the time-consuming nature of interaction between borrowers and credit officers limits the number of borrowers who could be served by a credit office. While it is often claimed that credit officers can supervise several hundred group members, experience in Southern Africa shows that 150 is a more realistic aim. Due to the group lending structure, this implies that per credit officer, only about 30 loans would be outstanding at any time. Hence, credit extension will be staff intensive and transaction costs accordingly.

Avoiding group structures will greatly reduce the costs associated with establishing and maintaining group networks. However, extending credit to individuals without collateral and without group pressure exposes the lender to greater vulnerability towards free-riding and opportunism. Therefore, sufficient safeguards need to be applied to aid the selection of appropriate candidates and to enforce their compliance with rules and obligations. Several credit schemes now exist that do lend to individuals with great success. The safeguards they apply range from training requirements to credit rationing; some require that borrowers pledge savings as security; other tap local knowledge by requesting character certificates

from local withies who are compensated according to the performance of their flock.

Through various mechanisms, these rules create an incentive structure that penalizes default through forced withdrawal from the scheme. Several studies show that micro-lenders that apply such safeguards for lending to individuals extend credit more efficiently than group lenders, taking into account both administrative costs and defaults.

In summary, group credit may be more appropriate in densely areas with high social stability and low wage costs; under these conditions, meetings can be convened without long travels, groups can be expected to be long-living and the time-intensive nature of lending would entail relatively lower costs. Credit schemes lending to individuals are better suited where efficient transfer mechanisms are available, and where non-credit services-community development- is less important.

4.1.2 Loan Utilization

Microfinance is often associated with small business development. However, money is fungible and small businesses are often practically parts of private households. Therefore, microfinance may find its way into financing projects of which the lender is unaware. Still, the question should be considered whether credit should be targeted at specific activities.

Some credit schemes do not seek to target their loans to any specific use. They may assume that poor people themselves know best how to better themselves, and that some apparently consumptive expenditures may well have investment properties. Conversely, offering consumption credit to the poor may lead them into debt and deepen their economic dependence. Societies with little debt problem and a strong entrepreneurial culture may thus be a better environment for offering untied microfinance than societies where entrepreneurial activities need decisive encouragement. This view and objectives of a lender will determine the choice.

More controversial, generally, is the question whether specific sectors are more promising for the establishment of small enterprises, and whether loan availability should be made conditional on the sector identified in a business proposal. Many new business ventures at the micro level are, in fact, based on trading activities, either hawking or operating truck shops. Arguably, the establishment of more trading enterprises in specific locations does not increase the purchasing power of their clienteles and offers few developmental benefits. More traders implies reduced profits for those already in business, and potentially undermines the viability of all. Therefore, the common argument is that microfinance should be directed away from trading activities. Opponents of this view, which is supported by empirical evidence, hold that trading is often the start of a more creative enterprise; trading profits can be reinvested into manufacturing equipment.

4.1.3 Location of the Loan Establishment

When designing the lending technology of a micro lending, two important decisions need to be made about the role and establishment of a branch network: first, are branches needed? And second, where should they be located?

Decisions about the location of a micro-lender are largely determined by the intended target group. Many think that if you serve a rural clientele, you should reside in the countryside. If you serve a poor urban clientele then you should operate in those areas in town where hawkers live and artisans work. In many instances, such reasoning leads to poor choices. Cities, and city centers, usually have the best infrastructure. From the central bus station of a city or town, one can usually reach more rural people within one or two hours, using public transport, than from any place in the countryside. The city center is usually easier to reach for a larger number of people than an outlying area.

Obviously, this problem is relevant only when contact with clients is part of the lending strategy. If no such contact is necessary, then location should be determined based on considerations of cost or convenience. Hence, the necessity

of maintaining a branch network is determined by the role of follow-up procedures and the choice of payment systems.

The question about the necessity and location of branches is closely related to the need for finding an appropriate payment mechanism. Credit extension is, from one angle, the service of getting money out to people and getting repayments back from people: lending is the business of moving money. When microfinance established itself, many practitioners thought of it as village banking . At this time, the image dominated the minds of donors and aid officials of community bankers living in villages and providing services in their neighborhood. Such community bankers are cash-carrying agents, working on behalf of larger, formal microfinance institutions. However, since then, a wide variety of methods have been developed and successfully applied. Cash-carrying credit officers are not the exception rather than the rule. Several institutions have started to use electronic transfer systems to move funds between clients and lenders in cooperation with commercial banks, which operate sophisticated transaction infrastructure. Such facilities are not available in all developing countries, but they have been successfully used in South Africa and are available in towns and large villages in Botswana. At an intermediate level, postal saving banks exist in most developing countries. Their transaction systems, although typically not as fast and with slightly higher marginal costs, can handle small and frequent payments, to and from every post office.

4.1.4 Loan Size and Repayment Schedule

Loan size, it is sometimes argued, follows the decision of the target audience: if the very poor are aimed at, then loans should be very small. If the capital requirement of entrepreneurs is high, loans need to be large. This view defines loan sizes from the perceived loan needs of the borrowers. While there is little to disagree with such a view, it should be considered that loan size is a principle weapon in fighting opportunism: Just the right dose of credit rationing may help to enforce

repayments. Most microfinance institutions use staged credit programming to enforce repayment. Access to future larger loans is made dependent on punctual and full repayment of small initial loans. Such staging requires that entrepreneurs are kept hungry for capital. Loan staging in microfinance is similar to the assessment used by credit card companies, which base overdraft limits, partially, on repayment history. Generally loan decisions in the micro-field are more similar to those in consumer lending than those in formal business finance.

There are instances where credit rationing and staging is not an option; such cases include entrepreneurs requiring capital goods, i.e. lumpy expenditure. In these cases, other enforcement systems must be found. Such loan schemes are likely to be administratively more expensive and possibly more cumbersome from the borrower perspective. Loan schemes where staging is not used tend to operate better when a long-term relationship exists between lender and borrower. Such a relationship may be based on extensive training or long-standing social relationships. This condition could be met, for example, by graduates of vocational training schemes, wishing to borrow for setting up their own business, or members of credit unions.

4.1.5 Interest Rates

As in the case with any loan institution, charges and interest rates need to be set high enough to cover costs. Still, other factors, such as fairness and redistributions objectives also influence the level of interest rates, or the range of services offered. Although even large and supposedly successfully institutions subsidize their interest rates, the goal of cost-recovery persists, so creative forms of self-subsidy exist. In some cases, charges, such as membership fees, can be used to hide interest rates. In other cases, micro-lenders generate income from non-credit services, for example by selling business implements to their clientele. Some institutions have used such lines of business successfully to establish their viability.

According to Economic Perspectives (2004) , MFIs must charge interest rates

high enough to enable them to cover all their costs, including loan losses and the cost of raising new capital to expand. MFIs should achieve sustainability within five to seven years by charging adequate interest rates, controlling operating costs, and maximizing their efficiency. Business service providers must offer their services on a commercial/fee-for-service basis or cover their costs by embedding them in other transactions. Offering these services on a non-commercial basis distorts the business services market and threatens its long-term sustainability. In fact, most microfinance programs offer more than merely loans; typically, flexible savings, remittance services and business advisory services are available with an affordable fee, some schemes offer insurance or bonus payments, and some even more extensive support relating to social and economic issues. Micro-lenders then claim that charges and high nominal interest rates contain payment for these non-credit services.

4.1.6 Saving Mechanism

Many micro-lenders require their clientele to accumulate savings both prior to and during borrowing. Saving can perform various functions: people who save are more prudent, so arguably they make more reliable borrowers; saving behavior helps to determine their debt capacity; and savings can be used as collateral. Thus, self-selection, screening, and enforcement may be aided by savings accumulation.

However, saving requirements have disadvantages: they exclude potential borrowers, they slow the expansion of credit extension, and they seem to contradict the very logic of micro-lending. One important question, fought over with vigor, is whether savings should be used to obscure real interest rates. Especially when savings are pledged as collateral, with difference of deposit and lending interest rates providing profit for the lender. There is a heated discussion whether such profits are a justified means for making micro lending schemes viable.

Although many micro lenders incorporate into their lending strategy a compulsory savings component, only few operate discretionary saving schemes. Such

schemes can appear desirable, since saving mobilization and the development of self-sufficient intermediaries are higher policy objectives than the formation of subsidized lenders. However, discretionary saving schemes are relatively expensive to run and may not be easily compatible with the demands on an efficient micro-lender. Some micro-lenders use their clients deposits as loan funds. This is an important factor for the viability of a micro lender. Some institutions claim that their savings scheme provides a low-cost source of funds for their lending operation.

4.1.7 Training Program

In many microfinance programs, there is an intimate linkage between training and credit. The benefits of linking credit with training are many; from the perspective of micro-lenders the most important effects are self-selection and capacity building. While many people will want to borrow, fewer are prepared to undergo training in order to become eligible for credit. Most entrepreneurs are unaware of their skill deficiencies, and therefore they are unlikely to seek training voluntarily. Nonetheless, when access to credit is conditional on undergoing training, many come to appreciate the value of training.

Training can be offered basically in two forms: there is vocational training to equip entrepreneurs with the technical skills needed for running a service or manufacturing enterprise, and there is business training to help entrepreneurs to cope with the managerial aspect of running their own enterprise. Technical-skills training requires more generous funding and typically takes much longer. Business skills training can be fruitful on a very basic level, and is often urgently needed prior to set-up. In many cases, both types of training are offered jointly, and both lead to better self-selection and enhanced survival rates of new enterprises. From the lenders perspective, this has the benefit that more borrowers will succeed in their business plans, and more will be able and willing to repay their loans. However, there are obvious disadvantages: training is costly, and training will

exclude some potential borrowers.

When working with poor people, it is unreasonable to expect that they will pay for their training up-front. Hence, training requires an initial outlay from the lender or a separate donor. Where appropriate training programs already exist, potential lenders may target their lending at its graduates. In this case, the advantage of access to selected and able borrowers can be enjoyed without associate costs undermining the viability of the microfinance scheme.

However, the problem of exclusion still arises. Even when training is offered free of charge, some borrowers will not be able to afford the time. Those who do already have a business may feel that they cannot afford to be absent for long, others may have family commitments. Very poor people cannot afford to take a few days off, not even for training. In response, some lenders have organized very short training courses, some taking as little as two hours. The benefit of very short training will be much reduced, both in terms of self-selection effects and learning. But it may still pass on basic business knowledge, especially when concepts such as interest, capital, credit and repayment need some explanation.

4.2 Sources of Financial Capital

To grow and prosper, businesses of all sizes and in all countries need access to financial services. Such access is a particular challenge for poor families around the world that need loans, credit, and savings to establish, sustain, and expand small businesses and micro enterprises. Once considered peripheral to mainstream development policy, access to microfinance is now at the forefront of a global anti-poverty strategy that has tremendous potential to generate income and expand employment at both the local and national levels.

Over the last ten years, certain strong MFIs in developing countries have shown that after five to seven years of operations, they can achieve the size and efficiency levels that enable them to cover their operating and financial costs, without re-

quiring additional subsidies. The savings of program clients are often used to expand further loan capital and credit operations, therefore reinforcing sustainability. However, many more MFIs in developing countries are still operating at small and intermediate scales, requiring a mix of grants concessional lending, loan guarantees, and commercial rate lending by commercial banks and financial institutions.

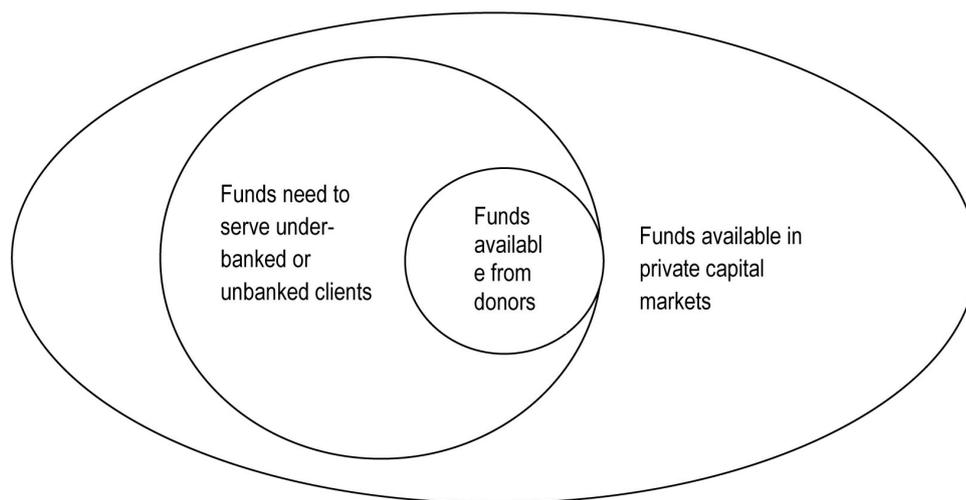


Fig. 4.2: The Relation of Private Funds and Donor Funds to the Needs of Potential Microfinance Clients

4.2.1 Grants and Donations

For the thousands of existing MFIs still operating at small and intermediate scales and for new MFIs, grants and donations are needed to support their early years. Grant funds are needed to finance salaries and training of staff, the establishment of basic service infrastructure, and the building of loan portfolios that enable these institutions to demonstrate strong repayment performance. Grants and donations are also needed to fund program innovations, as more mature MFIs seek to provide an expanded range of services to their clients. The key sources for this type of assistance are multilateral and bilateral aid programs and national and local governments. Other sources are private donors, grant-making organizations, service clubs, religious organizations and corporations.

Even during the early stages of a program's development, care needs to be

taken to ensure that these external funds support rather than substitute for local mobilization of funds. Many of the strongest MFIs, particularly in Africa, have the savings of very poor clients as the main sources of their loan funds. Where possible, external grants should be structured in order to support the build-up of the capital base of the MFI. With a strong capital base, MFIs can build their operational capabilities and loan portfolios, and leverage commercial funds without relying on permanent, external support.

4.2.2 Concessional Loans

Loans to microfinance programs at subsidized rates from international financial institutions such as World Bank, IMF and the regional development banks, and private socially responsible investors are important for fueling rapid growth of loan portfolios in the early stages of a MFIs development. These funds help underwrite a transitional period during which the young institution is moving toward sustainability, but is still in need of special support. The use of soft loans should be provided in an environment of business discipline. In order for concessionary funds to accomplish this, rather than becoming a cover for inefficiency or dependence, the granting of such monies should be subjected to clearly articulated and measurable financial return.

4.2.3 Guarantees

Guarantees are another way for donor agencies and institutions to make efficient use of their limited resources by stimulating a flow of credit from financial market into microfinance programs. Guarantees are a good interim measure for MFIs in the process of moving from the nonprofit sector into the commercial one. These microfinance programs benefit from the assistance of donor extended guarantees while they adjust to the discipline of financial market requirements. To ensure this process, guarantee funds must be extended after conducting an assessment of the financial performance of the MFI. While the very nature of a guarantee fund means

that risk is being assumed and a degree of loss accepted, no guarantee should be extended if, at the point of approval, an applicant program is not perceived on a professional basis to have the means of repaying the obligations it is undertaking.

4.2.4 Commercial Loans

Market-rate loans to microfinance programs from commercial sources will be essential for fueling the expansion of those programs that have achieved scale sufficient to reach economic viability.

4.2.5 Potential Mix of Loans and Grants

Credit as a tool to develop a project has a cost, which must be compared to the expected yield of that project. Basic capital budgeting techniques show that for any project, the expected yield should be higher than the cost of funds used to finance it. An entrepreneur would have little interest in developing a project if this were not the case. When the entrepreneur invests little of his or her money in the project, the funds used to finance the project consist solely of the money borrowed by the entrepreneur, so the cost of funds is only the cost of credit. Thus, the capital budgeting rule is as follows: credit can help to develop only those projects that yield higher than the interest at which credit is priced. High interest credit, therefore, only encourages entrepreneurs to develop projects that yield high profits. Mixing credit with grants on an ad hoc basis provides a way to allow the financing of high-yielding activities other than trade. This approach is based on the fact that many potentially high yielding income-generating activities present a low-yield because of important cash outlays that occurred at the outset of the project (Garson 1998:5).

4.2.6 New Trends of Profit Transfer

To ensure that micro enterprises have access to the business services they need in order to be competitive, donors should promote a strong business services sector by

facilitating linkages between micro enterprises and private sector service providers, not by subsidizing the services themselves.

Donor Involvement

Several large IFIs are increasingly turning their attention to the blue ocean microfinance industry. Some, such as the Consultative Group to Assist the Poor (CGAP) and the Special Unit for Microfinance (SUM) are newly spawned efforts to support the strengthening of microfinance operations. Others, like the ILO, have long been committed to social finance.

The CGAP was formally launched in June 1995. Now it represents a multi-donor effort to address poverty through a microfinance program, with the distinct objectives to: coordinate donor micro-finance programs, improve the political environment for MFIs, distill and increase the best practices in the industry, and use these lessons to deliver sustainable banking services to the poor.

Members of the CGAP include: Canada, France, the Netherlands, the United States, the African Development Bank, the Asian Development Bank, the International Fund for Agricultural Development, the UN Capital Development Fund, the UNDP and the World Bank. Approximately, \$200 million in programs and cash were pledged by the member donors to the CGAP.

CGAP, an umbrella organization at the World Bank for microfinance, has looked into providing online training for microfinance recipients in the field, but has found that too often there is a problem with internet connectivity. The United Nations Capital Development Facility houses the Special Unit for Microfinance (SUM), which was established by the Administrator of the United Nations Development Program in August 1997. SUM aims to bring together the growing work of the UNDP in the area of microfinance with the established credit and microfinance portfolio of the United Nations Capital Development Fund. Both the UNCDF and UNDPs MicroStart Program aim to build the capacity of MFIs. Each program brings unique contributions to the joint effort by working with three types of mi-

crofinance service providers: 1) new entrants to the field; 2) organizations that work in rural areas in the poorest countries, particularly in Africa; 3) established institutions that seek to expand their markets with new microfinance products and services.

The MicroStart Program works with a variety of institutions, including NGOs, banks, credit unions, and special investment funds to develop new microfinance product and capacity to deliver them to growing markets. SUM aims to support the growth of effective MFIs that have transparent track records and solid institutional and financial performance, which enable them to reach poor clients, particularly women, on a sustainable basis. Within the UNDP, SUM strives to foster an understanding of microfinance best practices, while assisting UNDP country offices and other UN agencies to incorporate those elements into program. Specially, SUM offers young and new institutions an incubator environment, which provides:

Technical assistance to start-up and promising institutions by contracting the services of experience microfinance service providers. Small capital grants, up to \$150,000 as a complement to technical assistance for investment in fixed assets, such as computers and other information technology; to cover a percentage of operational costs; or as a complement to the organization's own loan funds, or other donors grants, or as leverage for commercial loans. Promotional assistance for microfinance innovations in rural Africa and in other difficult areas where the UNCDF operates. Support for the entry of new players into the market, through the sharing of lessons learned and best practices. Finally, the ILO has always been committed to the social dimension of microfinance. It directs its efforts at striking a balance between equity and efficiency; at creating level playing field for all financial market participants, and at putting disadvantaged groups back into the mainstream of economic activities. The ILO is called upon to examine and consider all international and financial policies and measures in light of social justice.

4.3 Allocation of Financial Capital

4.3.1 Different Approaches to Micro-financing the Micro-Enterprise

The microfinance movement has come to be divided by two broad approaches regarding the best way to help the poor through access to financial services: the institutionalist approach and the welfarist approach.

Institutionist versus Welfarist Approach

The institutionalist approach focuses on creating financial institutions to serve clients who either are not served or are under-served by formal financial system. Emphasis lies on achieving financial self-sufficiency; breadth of outreach (number of clients) takes precedence over depth of outreach (meaning the levels of poverty reached); and positive client impacts are assumed. The center of attention is the institution, and the institutional success is generally gauged by the institutions progress toward achieving financial self-sufficiency. The best know examples are ACLEDA in Cambodia, Banco Solidario (BancoSol) in Bolivia and Bank Rakyat Indonesia (BRI).

Institutionalists argue that a primary objective of microfinance is financial deepening, the creation of a separate system of sustainable financial intermediation of the poor. Theirs is a financial systems approach to microfinance, in which the future of microfinance is dominated by numerous large-scale, profit-seeking financial institutions that provide high quality financial services to large numbers of poor. Because of their insistence on financial self-sufficiency, institutionalists eschew subsidies of any kind.

Welfarists, on the other hand, emphasize the depth of outreach. They are quite explicit in their focus on immediately improving the well-being of participants. Welfarists are less interested in banking per se than in using financial services to alleviate directly the worst effect of deep poverty amongst participants and

communities, even if some of these services require subsidies. Their objective tends to be self-employment of the poorer of the economically active poor, especially women, whose control of modest increases of income and savings is assumed to empower them to improve the conditions of life for themselves and their children. Their center of attention is the family. The most prominent examples of welfarist institutions are the Grameen Bank in Bangladesh and its replicas elsewhere, and FINCA-style village banking programs in Latin America and, more recently, in Africa and Asia. Like the institutionalists, welfarists have assumed more impact than they actually have been able to document.

The Income-Generation Approach Versus The New Minimalist Approach

The Income-generating approach to reducing poverty holds that the governments and donors should seek to develop income-generating activities since these are the activities that are likely to increase the revenues of the poor.

The New Minimalist approach to the role of credit in poverty eradication holds that credit should be extended to any poor person able to repay a loan itself enough to fight poverty. New Minimalists think that controls on the way in which a borrower uses the money are unnecessary.

Both approaches have their own rationale. The New Minimalist approach is implicitly based on a law of large numbers: On average credit extended to the poor is likely to ultimately increase income even if some of the poor use it for immediate consumption. The desired result in terms of poverty reduction is achieved when the institutions delivering credit are made sustainable. This will happen when the number of poor borrowers serviced by institutions is quite large. The New Minimalist approach directs its attention to the institutions delivering financial services rather than to the poor benefiting from the services of the institutions.

4.3.2 Poor Entrepreneur vs Poor Non-Entrepreneur

There are two categories of poor: the entrepreneurial poor (EPs) and the non-entrepreneurial poor (NEPs). The EPs are generally wealthier and more educated than the NEPs and can therefore create activities that would enable them to move closer to or above the poverty line. The NEPs are unable to do so and would need to be financially supported permanently by governments, because they lack the personal skills and because they are so destitute that they are in no position to develop any meaningful economic activities in the environment in which they live.

The concept of entrepreneurial poor allows the anti-poverty policies to move from purely direct assistance (subsidies) to mixes of direct and indirect assistance (subsidies for the NEPs and financial assistance or credit for the EPs). Naturally, governments and donors are more interested in direct assistance because it targets the causes of poverty rather than the poor themselves, making anti-poverty policies more cost effective. According to the 1981 Reserve Bank of India report of the Committee to Review Arrangements for Institutional Credit for Agriculture and Rural Development, the poor can be classified into three categories:

- Those who would need only credit to undertake an economic activity that would eventually lift them out of poverty;
- Those who would need credit and a capacity subsidy to undertake such an activity; and
- Those who would remain poor, thus always requiring direct assistance through subsidies and welfare.

4.4 Summary on Chp.4

This chapter of the paper explores the organization of MFIs, especially governance, sources of financial capital, new trends in profit transfer, and the allocation of credit. What surface are the tremendous complexities involved in borrower

selection and loan disbursement. It is incumbent on the lending institution to determine whether it will extend loans to groups or individuals; whether it will specify how loans can be used; how much interest should be charged to cover the cost of administering the loan; the amount of saving that should be required of each loan recipient or group; whether to cater to the entrepreneurial poor or the non-entrepreneurial poor; and whether to push for the number of clients or the depth of clients served as a target of success. Once again, the coming portion will cover a rich range of financial return and social impact measures that can facilitate the assessment of MFIs.

- Proportion of borrowers selected from pool of applicants.
- Repayment rates for group versus individual borrowers.
- Institutional breakdown of loans by their utilization and income (ROI).
- Repayment rate and return on investment, according to location of loan establishment
- Average loan size per institution.
- Average interest rate per institution.
- Average saving rate per institution.
- Level of self-sufficiency.
- Proportion of MFIs catering to Institutional versus Welfarist approach.

The next chapter of this paper will review those indicators presently employed to assess the impact of MFIs. It will also offer a discussion of what leading microfinance scholars contend should be included in any performance package.

Chapter 5

MFI Performance Matrix Review

Thus far, this paper has showcased microfinance as a gateway to modest prosperity for the otherwise impoverished. And yet, for all the many positive development outcomes than can be attributed to participation in microfinance programs, there are important methodological weakness in the literature documenting their impact and replication.

Over the years, those who have studied micro-lending schemes have employed a wide range of measures to assess the merits of a given approach or method. The earliest measures centered on repayment rates and quantitative impact assessments. These combined to provide micro metrics to evaluation the institutions, and macro metrics to measure the impact of the approach or method on the economies of their participants and communities. If there was evidence that the situation was improving then the approach was declared success. At the same time programs that used an excessive proportion of their funds for administrative matters were labeled less successful than their more frugal counterparts.

In the early 1990s, development projects in general, and microfinance projects, in particular, came under increasing pressure to demonstrate that returns on investment were real and sustainable. This sustainability dilemma boils down to a trade-off between three competing objectives (see Figure x). How do MFIs find a balance between 1) coverage, providing benefits that meet the needs of large

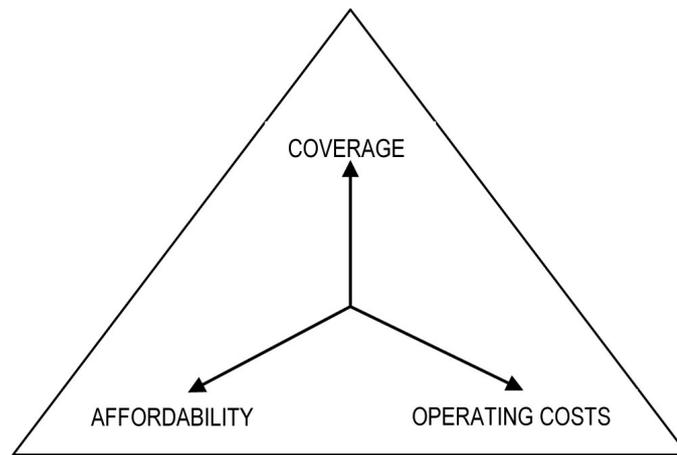


Fig. 5.1: Striking a Balance: the Microfinance Challenge

volumes of low-income people, 2) costs, operating costs and transaction costs for the MFIs, and 3) affordability, representing the price and transactional costs for clients?

This section of the paper will review two important works that, in turn, propose measures of institutional performance and economic impact.

Institutional Performance

Microfinance has traditionally linked institutional performance with sustainability as measured in terms of self-sufficiency, or cost-recovery, the ratio of income to expenses. The lowest hurdle, operational self-sufficiency, measures the degree to which cash-operating income covers cash expenses, excluding adjustments such as depreciation, inflation, subsidies, and possibly unrealistic loan loss recognition. Institutions that cannot cover these costs require periodic injections of outside funds in order to keep running. Financial self-sufficiency is generally used to describe the ratio between operating income and total expenses, including the above-mentioned adjustments.

5.1 Financial Indicator: In search of Institutional Sustainability

Achieving both profitability and strong social performance is the ultimate promise of microfinance. It is not impossible, but neither is it easy and a handful of micro-lenders are there yet. Ten years ago it had been hoped that achieving both goals would simply be a matter of raising interest rates on loans. If borrowers were willing to pay, say, 50% interest per year for a loan, rather than 30%, the micro-lenders profits would see an immediate boost, and, it was hoped, the well-being of clients would not be seriously hurt. Both parts of the claim are true up to a point, but increasing interest rate too high can bring financial and political difficulty and risk undermining social impacts.

The concept of sustainability drives much of the microfinance agenda today. Many in the industry are coming to agree that financial sustainability is a *sine qua non* for long-term breadth and depth of outreach. It has become increasingly clear that MFIs subsidize clients at the expense of their own financial health, since they seldom survive the high delinquency rates, which exist. Typically, clients view subsidized development lenders as politically motivated, and regard their loans as disguised grants. However, delinquency management is critical to the development of sustainable microfinance institutions and a healthy financial sector in which poor people can rely on consistent access to financial services.

Nonetheless, preliminary results from the Microbanking Bulletin (MBB) indicate that the MFIs examined in 1997 edition of the Bulletin have financial statements that look quite strong prior to adjustments: They all exceeded 90% operational self-sufficiency (cash operating income divided by out of pocket. Amongst 28 MFIs, 21 institutions achieved a self-sufficiency rate of 95%.

5.1.1 RoA and RoE as Profitability Measures

Commercial banks do not use self-sufficiency to measure their overall financial performance. This cost recovery indicator is embedded in donor and beneficiary mentality which dictates that a lack of cost-recovery means the beneficiary institution will continue to need fresh donor funds to continue operating. Bank owners, by contrast, are more concerned with profits in comparison with their investment. Consequently, they rely more on profitability indicators: Return on Equity, and Return on Assets. The former, ROE, measures profits in relation to the equity owners have invested. The latter, ROA, measures profits in relation to the size of the business. It is independent of the banks debt-to-equity leverage, and is the generally-used measure of the financial efficiency of a banking activity.

Using unadjusted RoA and RoE to measure the profitability of the 28 participating MFIs, we find performance that would be the envy of commercial bankers anywhere. The average Return on Assets for the 28 microfinance organizations was 7.4%, compared to the 1.5-2% level which would keep most bankers happy. The average Return on Equity was 18%, which would also be considered quite acceptable in most countries banking sectors.

But neither operational self-sufficiency, nor unadjusted RoA or RoE, reflect the effects of inflation, subsidies, and possibly unrealistic loan loss recognition. As discussed above, the MBB adjusts reported financial results to reflect these variables. These adjustments permit us to understand an MFI as if it were a commercial enterprise. This procedure implies no value judgment that all MFIs necessarily should be run as commercial enterprises. Rather, it allows us to understand and to meaningfully compare the financial performance of MFIs operating under very different circumstances.

5.1.2 Adjusted RoA and RoE to Measure Financial Self-sufficiency

The financial self-sufficiency ratio, which includes the effect of the adjustments, shows three of the six peer groups¹ operating at negative levels. Likewise, for the group of 28 the adjustment process reduces average RoA of 7.4% to ARoA of 1.7%. Two peer groups were particularly hard hit by the inflation adjustment. In Latin America, both village level institutions and microfinance institutions (MFIs) in lower income countries rely heavily on donated funds, so the adjustments reduced their profitability by two-thirds: RoAs of 6.6% and 18.6% fell to ARoAs of 2.1% and 7.6% respectively. The least affected peer group was that of the Microbanking Institutions, whose strongly leveraged position and relatively low dependence on subsidized funds, minimized the impact of the adjustments; RoA of 3.3% dropped to ARoA of 2.5%.

Overall, 21 of the 28 MFIs were financially self sufficient. Stated in another way, they had a positive real return on assets, after all adjustments. Average performance of these 21 sustainable MFIs stood at: a) Financial Self-Sufficiency of 117%, b) Adjusted Return on Assets of 4.5%, and c) Adjusted Return on Equity of 15%. A 4.5% return on assets would be an extremely attractive profit for most bankers. A 15% Return on Equity is less stellar in comparison with commercial bank performance.

In any case, the 21 sustainable MFIs demonstrate that financial services for the poor can be provided in a manner consistent with the long term exponential growth of the industry. These 21 MFIs were drawn from a variety of economic environments, institutional structures, geographical settings, lending methodologies, and most notably poverty levels of target groups. This reaffirms the basic

¹The 28 participating MFIs into 6 peer groups, based on four selection criteria: program size, income level of country, region, and lending methodology. Similarities between MFIs are more pronounced in some peer groups than in others. The 6 initial peer groups are as follows: Microbanking Institutions in Middle Income Countries, Latin American Microcredit Institutions in Lower and Middle Income Countries, Latin American Microcredit Institutions in Upper Income Countries, Latin American Village-level Institutions, Asian Village-level Institutions, Microcredit Institutions in the Rest of World.

conclusion of Christen, Rhyne and Vogel (1995) that financial sustainability is more likely to complement than to conflict with outreach goals.

5.1.3 Expenses in relation to Profits

Today micro-lenders instead see that the key has as much to do with managing expenses as with raising revenues. Profit is the excess of income over expense. Thus, a given level of profit can be produced at very different levels of income and expense. The data from the 28 participating MFIs reveals significant differences among peer groups in this respect. The peer group that shows the greatest profits generated those profits by charging a nominal interest rate well above its costs of funds. Latin American MCIs in lower income countries achieved a 7.6% ARoA, in spite of relatively high administrative expenses (24%), by obtaining a yield of 65% on its loan portfolio. The profit margin averaged 20% of operating income. The second highest ARoA (2.5%), achieved by the group of commercial MBIs resulted from a below-average administrative cost structure (16%), combined with a slightly lower than average yield (40%), and a slightly higher than average profit margin (7%) on total operating income. The poorer performing peer groups usually had either relatively low yields on their portfolios or relatively high operating costs, but not both.

Yield data, interest income divided by average loan portfolio, shows that institutions in Latin America charge average nominal rates of interest that are twice as high (53%) as those charged by MFIs in the rest of the world (27%). Latin American MFIs generate more than twice as much income (42%) as institutions in Asia (21%) and the rest of the world (15%). When distilling the Asset Utilization Rate from profits and various expenses, it becomes evident that Latin American MFIs are not significantly more profitable than Asian institutions. Instead, it is believed that most of Latin Americas higher interest yield is consumed by higher operating costs. Latin American operating costs average 39%, compared to 19% for Asia and 15% for the rest of the world.

Many Latin American countries have experienced long, severe and repeated bouts of inflation. As a result, the general population has become accustomed to paying high rates of interest on all types of loans. Unfortunately, the ability to charge high interest rates may reduce the incentive to pare costs through rigorous efficiency measures. MFIs may feel that it is easier to reach self-sufficiency through high interest rates than through high productivity. Client behavior would seem to reinforce this perception, since high interest rates rarely dissuade micro-clients from taking loans. On the other hand, interest rates are clearly the quickest path to self-sufficiency, and many MFIs in other parts of the world could enhance their long-term sustainability and outreach by increasing their interest yields.

5.1.4 Average Loan Size

MFIs need to tailor the micro-loan size that would reflect the realities of the clients business opportunities, cash flow, and collateral. Whether MFIs offer individual or group loans, amounts are likely to be relatively small and repayment schedules short-term, collateral requirements flexible, and transaction costs low. Tailoring products to the very poor and rural households is particularly important in order to maximize microfinances potential to reduce poverty. Market research often reveals that clients demand products beyond credit such as flexible savings or remittance services.

Table x shows the average loan size for the 28 MFIs, according to the income level of the country each operates in. Although average loan balance increases as the income level of the country increases, this average loan balance as a proportion of GNP per capita decreases, at a far more rapid rate. Similarly, the larger MFIs tend to be concentrated in the lower income countries where their client group is more representative of the general population, while the smaller MFIs are likely to be in higher income countries, where they serve a more economically viable segment of the population.

5.1.5 Operating Efficiency and Productivity

Salaries usually compose about two thirds of an MFIs total administrative expense. The financial productivity of staff results from a combination of three productivity indicators: 1) the number of active clients each staff member manages, 2) the average salary of each staff member, and 3) the average loan balance per client. As the number of active clients per staff member decreases (lower productivity), the average loan balance must increase, or the average staff salary must decrease, in order to maintain the same financial result. The authors of the study found that it is instructive to express average loan balances and average staff salaries in relation to GNP per capita, to allow more meaningful cross-country comparison, without obscuring the impact of these elements on financial productivity.

The interplay among these productivity variables can be illustrated by comparing the composition of the salary burden for two of the peer groups, Asian MFIs and MFIs in the rest of the world. Both have a salary burden of 9% of average total assets. The Asian MFIs have lower average loan balances, but compensate with a lower average staff salary and a somewhat higher number of clients per employee. MFIs in the rest of the world have higher staff salaries and fewer clients per employee, but compensate with higher average loan balances. This composition is consistent with the poverty focus and small loan size of the Asian MFIs. In order to deliver these tiny loans, they have sought out staff who will accept lower wages while carrying somewhat higher client loads.

On the other end of the spectrum, Latin American MFIs in upper income countries have a high salary burden (28% of assets) in spite of the fact that they pay salaries that are relatively low in their local context. What is problematic is that, according to authors, their loan balances are small, 16% of GNP per capita (compared to 23% in the Asian MFIs). Further, they have relatively few clients (77) per employee. As indicated earlier, these MFIs have fewer clients to choose from in any given area because their target group represents a relatively smaller sub-sector of the overall population than the target groups of MFIs in poorer

countries.

5.1.6 Liability Structure

Financial intermediaries take resources from savers and make them available to borrowers. They obtain a license to do so from a government which usually requires their owners to put their own resources at stake in the form of equity. This equity safeguards depositors by providing a cushion which is a first line of defense to absorb operating losses which could imperil depositors funds. Thus, the business of financial intermediation consists of leveraging owners equity investment by obtaining further funds from the general public to finance the intermediaries lending operations.

Given the limited willingness of donors and governments to grant equity for microfinance, MFIs, who aim at national impact, must eventually behave like banks and capture commercial liabilities, either from banks and other large investors, or from savings of their target clientele. Many MFIs in the study have begun this process of leveraging their equity with liabilities from outside sources.

In summary, several lessons can be learned from the authors work. First, financial sustainability is what will relieve MFIs of donor dependence, but not unless it is calculated in its adjusted form. Hence, although Return on Asset and Return on Equity constitute important indicators of profitability, if they are not adjusted for inflation, they can grossly overestimate the institution profit. Therefore, financial self-sufficiency is best measured by the financial self-sufficiency ratio.

Second, in addition to being overshadowed by interest rates, profit margins are also threatened by high administrative expenses, which are best carefully controlled or mitigated through the collection of nominal interest rates above the cost of capital.

Third, profits must be protected through a cautious balance of operating effi-

ciency and productivity. Specifically, salaries must be kept at bay, the client load must be greater, or the loan balance must be increased.

Finally, MFIs should adopt a behavior more akin to commercial banks and seeks a higher level of equity to provide a safeguard for borrowers.

Economic Impact

Murdoch J. (1999) stated that anecdotes abound about dramatic social and economic impacts of microfinance, but there have been few impact evaluations with carefully chose treatment and control group. He further contends that those studies that have been undertaken yield a mixed picture of impacts.

5.2 Outreach Indicator: In search of social & economic development

5.2.1 Depth of Outreach

Assessing the depth of outreach or access of the poor to microfinance programs, it is important to note from the outset that most MFIs probably do not consider their institutional mission to be serving the poorest of the poor. Particularly in Latin America, most MFIs report a broader agenda to provide financial services to poor communities or specific groups such as female entrepreneurs who would not otherwise have access. Among MFIs that report to the Mix Market, slightly less than half of those in Asia identified specifically targeting very poor clients as their institutional mission. In Latin America, the share is even smaller: only around 10%. Of the Latin American MFIs that claim to target very poor clients, only two use some sort of targeting tool to identify clients. In Asia, most of the MFIs that specifically target the very poor use some sort of targeting tool, such as a means test, participatory wealth ranking or a housing index to identify the target group.

5.2.2 Impact of Microfinance on community

For those MFIs that do explicitly aim to serve the poorest within their community, recent work on poverty outreach of MFIs has focused on constructing a poverty index that can be used to establish whether the target group is being reached. The Consultative Group to Assist the Poorest (CGAP) has developed a poverty assessment tool (PAT) that can be used to compare clients and non-clients of MFIs in the same community. This is based on the construction of a weighted index of poverty based on a range of indicators covering the human resources of households, characteristics of their dwellings, measures of food security and their assets. The different indicators are weighted by principal components analysis, which allows weights to differ between cases (Zeller et al 2001).

The approach here is to sort a non-client sample into three equal groups (high, intermediate and low) on the basis of their poverty score. The poverty index scores at the cut-off points between the three groups then become a reference point for the client or participant sample and their distribution between the three categories can be compared with that of the non-clients. As the non-client groups are divided equally, any deviation from equal proportions amongst the clients signals a skew either for or against greater poverty outreach².

Murdochs work reveals some of the extended micro-loan can have on a community, once a significant number of members have become borrowers. First, fertility rates, at the member level, should show a decline over time, since increase female employment has been shown to reduce fertility. This is, in part, due to the increase in opportunity costs with a greater number of children. Second, there should be a higher enrollment in school for children of members, and this includes female children, who in some societies are denied in the face of destitution. Third, there should be a higher rate of employment amongst those of employable age. Such

²CGAP reports that the CGAP-PAT has been used to assess the relative poverty level of clients of 7 MFIs - 2 of these are in Asia and 2 in Latin America. 3 of these MFIs who explicitly identify serving the poorest of the poor as an institutional mission appear to be succeeding in that goal. Institutions with broader goals tended to serve a clientele that is more representative of the communities in which they operate, which may or may not be poorer than the national average.

impact measures get to the core of all development efforts: improve nutrition; educate more children; increase access to healthcare, and the ability to purchase medicine; reduce fertility rates; empower women; and elevate the number of households that can generate an income level beyond subsistence (i.e. where saving is possible).

However, evaluative research has yet to integrate itself into the protocol of microfinance institutions. The principal reason is mainly because data collection is both costly and distracting. Most programs prefer to modify their strategies and tactics through trial and error. Once the mechanisms work reasonably well, standardization and replication can be done, with minor adjustments made only peripherally.

Murdoch is right on when he suggests that a portion of donor money would be well spent systematically evaluating the impact of microfinance program; by returning to the early commitment to experimentation, innovation and evaluation (Journal of Economic Literature 1572). At the same time, Murdoch warns against undertaking research that does not account for common flaws, specifically those relating to: 1) concomitant factors that may have a greater weight than credit extension in the observed outcomes, and 2) systematic sample selection bias, resulting in overly favorable outcomes.

5.3 Summary on Chp.5

Granting small loans to help poor people start businesses has become a popular poverty alleviation tool, but as the works of the *Microbanking Bulletin* and *Jonathan Murdoch* have demonstrated, the prospects for institutional sustainability and economic impact remain embellished by the development spectators. It is imperative that a package of micro and macro metrics be formulated that can be systematically collected by microfinance institutions and programs.

The final section of this paper will propose a simple package of metrics, some

of which are proxy measures of indicators that would be prohibitively costly to collect.

Chapter 6

An Application of BSC on PRASAC MFI

6.1 A Beginning to the End

the first part of this paper underscored the potential impact of MFI on macro-measures, such as: poverty alleviation; urban migration; women and children's health status, including HIV transmission; and women's endowment. Similarly, **Chapter 2** hinted at several micro-matrices that are purported to be strengthened through microfinance, including: higher savings rates, return on equity and assets, new business development, enhanced group cohesion, increase household income, and elevated rates of local employment.

Chapter 3 and 4 of this paper explored the paradigm shifts and organization of MFI, specifically innovation in technology, governance, sources of financial capital, new trends in profit transfer, and the allocation of credit. What surfaced were the tremendous complexities involved in borrower selection and loan disbursement. **Chapter 5** revealed some of the key functions of the lending institutions, such as determining: whether it will extend loans to groups or individuals; whether it will specify how loans can be used; how much interest should be charged to cover the cost of administering the loan; the amount of savings that should be required

of each loan recipient or group; whether to cater to entrepreneurial poor or the non-entrepreneurial poor, and whether to push of the number of clients or the depth of clients served as a target of success.

Finally, the last part of this paper reviewed key studies by the Microbanking Bulletin and Jonathan Murdoch. Their research demonstrated that the prospects for financial sustainability and economic impact remain embellished by the development spectators. In their view, the micro-matrix are not properly adjusted to account for inflation, and interest rates are overused in lieu of reducing operating costs. Macro metrics are equally misleading, since they subject to selection and sample biases, the data are not collected routinely, and their interpretation does not always account for confounding factors.

At this juncture, it is clear that a package of measuring matrix needs to be formulated that can be systematically collected by microfinance institutions.

The final section of this paper will use a living case study to propose a simple measuring package, some of which are proxy measures of indicators that would be prohibitively costly to collect.

6.2 A Review of the menu of Matrices

To begin aggregating and dismantling the many measures presented thus far in this paper, a table (refer to Table 6.1 & 6.2) has been constructed showing all of the key measuring matrices alluded to, according to section of the paper in which they were presented.

The matrices contained in the table below illustrate the range of indicators that are used by MFIs to assess short term performance and longer term impact. Some of the indicators are too expensive to collect routinely (i.e. contraceptive prevalence rates, institutionist vs. welfarist philosophies) and fall outside the direct influence of increased household income (i.e. HIV infection, elevated education levels, fertility rates). MFIs would be far better off employing a package of met-

rics that can demonstrated direct association between the activities of the entity and the outcomes.

Chp.2	Ch.4	Ch.5
<ul style="list-style-type: none"> • Utility of Lending Groups to monitor or enforce contracts and help screen good borrowers and strong business ideas. • Relation of interest rates charged by microfinance institutions to those charged by commercial banks. • Extent to which microfinance organizations are conveniently located to their clients, and the simplicity of their transaction processes. • Number of annual start-ups and their solvency at specific time intervals. 	<ul style="list-style-type: none"> • Proportion of borrowers selected from pool of applicants. • Repayment rates for group versus individual borrowers. • Institutional breakdown of loans by their utilization and income (return on investment). • Repayment rates and return on investment according to location of loan establishment • Average loan size per institution. • Average interest rate per institution. • Average savings rate per institution. • Level of self-sufficiency. • Proportion of micro credit institutions catering to Institutionalist versus Welfarist approach. 	<ul style="list-style-type: none"> • Average adjusted return on investment per institution. • Average adjusted return on equity per institution. • Average profit margin per institution. • Average loan size per institution • Number of active clients each staff member manages. • Average salary per staff member. • Average loan balance per customer. • Proportion of capital inflows that take form of equity.

Table 6.1: An Aggregation of the Micro matrices presented in Ch.1-5

Chp.2	Ch.4	Ch.5
<ul style="list-style-type: none"> • Increase in the number of employees hired by a micro-entrepreneur. • Increase in the Loan Group's savings rate over time. • Availability of information, through the micro-credit program, about such topics as health, legal rights, sanitation, and other relevant concerns. • Proportion of income used, over time, on health care services, provisions, hygiene, and children's schooling. • Rate of fertility as related to increased household income through a micro-enterprise endeavor. • Rate of HIV infection in micro-credit program areas. • Rate of contraceptive prevalence amongst members of micro-credit institutions. 		<ul style="list-style-type: none"> • Proportion of income used, over time, on health care services, provisions, hygiene, and children's schooling. • Increase in the Loan Group's savings rate over time. • Rate of fertility as related to increased household income through a microenterprise endeavor. • Rate of school enrollment over time of members' children. • Rate of employment in program community over time.

Table 6.2: An Aggregation of the Macro-matrices presented in Ch.1-5

6.3 Using the Balance Scorecard to Package Matrices

As was previously mentioned, the purpose of microfinance is to use financial means to help very poor people start or expand businesses so that they might elevate their standard of living. To do this, MFIs employ a number of different strategies that allow them to increase the probability of a successful profit transfer, while reducing the possibility of loan defaults. In assessing the performance and impact of microfinance, it is important to collect a discrete bundle of both micro and macro matrices.

The traditional measures of a MFIs performance are generally historical, fi-

nancial measures. With the popularity of economic value added and market value measures, the Balanced Scorecard model can be adopted to gauge forward-looking financial measures for MFIs. A balanced scorecard is a management tool used to:

- Help put a MFIs strategic plan into action.
- Use measurement devices to evaluate performance relative to the strategic plan.
- Provide feedback mechanisms to allow for continuous improvement toward the strategic goals.

Robert Kaplan and David Norton of the Harvard Business School developed the concept of a balanced scorecard to address the need of conventional financial firms to balance the needs of customers, financial needs, internal management needs, and the needs for innovation and learning within the enterprise. They contend that single metrics do not adequately address the strategic objectives of a company; rather, multiple measures both lagging and leading indicators should be used to meet a company's strategic goals. These measures, referred to as key performance indicators, include short-term and long-term measures, financial and non-financial measures, and historical and leading measures. The balanced scorecard, therefore, goes beyond the traditional financial measures of the rate of return and profitability to capture other dimensions of a company's performance and use this information to help attain the company's strategic goals.

Process

The balanced scorecard is really a process of determining the MFIs strategy, identifying measures to evaluate whether the MFI is meeting its short-term and long-term goals, setting targets, and then providing feedback from these measures. This process is illustrated in Figure 6.5. The actual balanced scorecard does not prescribe the measures to use, but rather specifies the dimensions of the MFI that should be considered in the system.

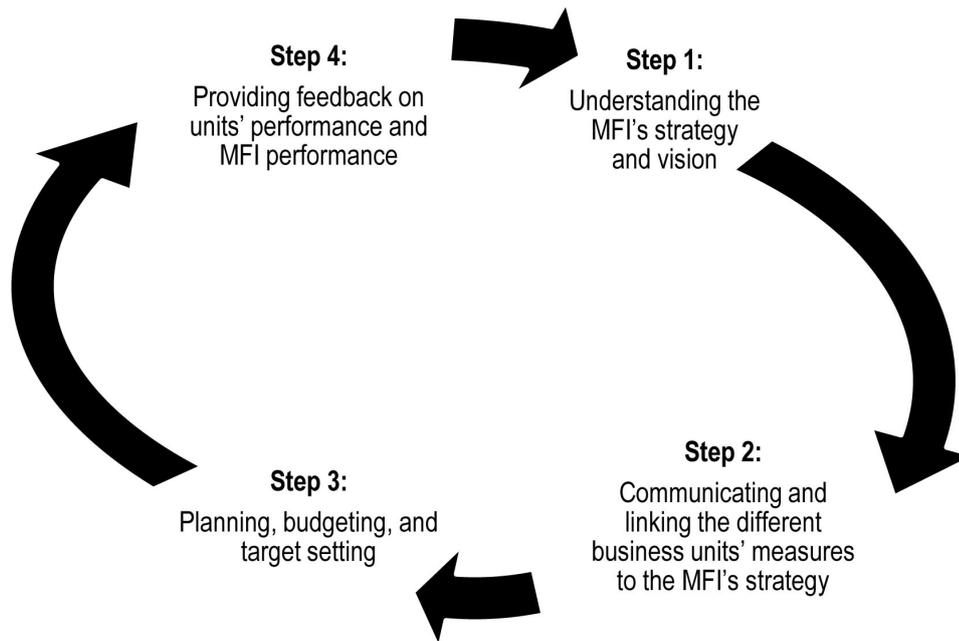


Fig. 6.1: the Balanced Scorecard Process

Measures

The developers of the balanced scorecard argue that measures and metrics used to evaluate different business units and the MFI should represent different dimensions of performance, including financial performance, customer relations, internal business processes, and organizational learning and growth. These dimensions are shown in Figure 6.3. However, no specific measures are prescribed; rather, the choice of measures should be tailored to the MFIs individual situation. The basic idea, however, is to select the key performance indicators (KPIs) that capture the four dimensions. Within each of these dimensions, there may be any number of different measures. These measures are generally tailored to the specific business and should be consistent with the MFIs or units goals. A number of possible metrics within each of these micro and macro matrices is shown in figure 6.2.

6.3.1 Micro-dimensions

For purposes of this exercise, we will assume that micro-dimensions refer to specific measures collected by MFI to:

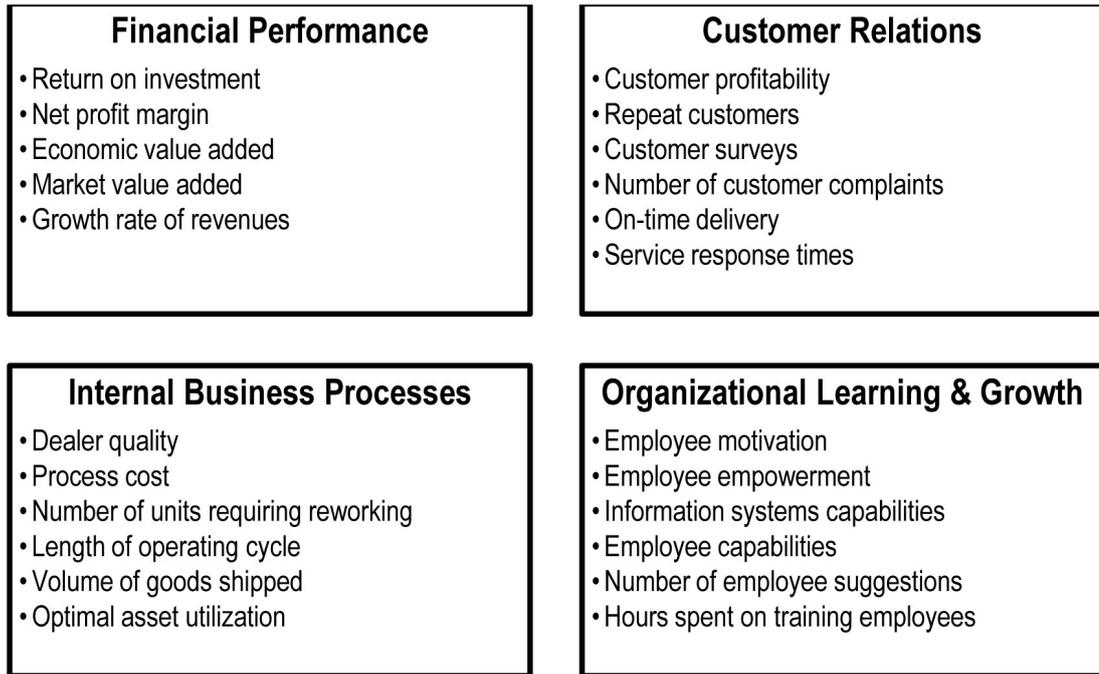


Fig. 6.2: Possible Performance matrices in the Four suggested Dimensions

- **Financial Performance** : Assess the flow of capital: who received money, how much was loaned? And what portion of the loan is still outstanding.
- **Internal Business Process** : Assess the processes and procedures used to evaluate projects, to provide business training, to extend loans, to collect payments, to offer technical assistance and to follow-up on defaults.
- **Organization Learning and Growth** : Assess the collection, documentation and application of lessons learned.
- **Customer Relations** : Assess the profits of the customer’s business and its growth.

6.3.2 Macro-dimensions

In the context of this paper, macro-dimensions will refer to gross measures of impact, such as:

- **Financial Performance** : Assess the flow of capital has increased the local economy, the saving rate, and the increase in employment.

- **Internal Business Process** : Assess the impact processes and procedures involved in issuing credit have had on creating a trickle-down effect, for instance, old borrowers helping new borrowers to access funding .
- **Organization Learning and Growth** : Assess the collection, documentation and application of lessons learned.
- **Customer Relations** : Assess the impact of profit and/or wage increases on the community.

6.3.3 Simplifying Balanced Scorecard for Microfinance

What the balanced scorecard concept does is to remind MFIs to evaluate themselves and their path to their strategic goals by including the different dimensions of performance, hence providing a more comprehensive look at the MFIs.

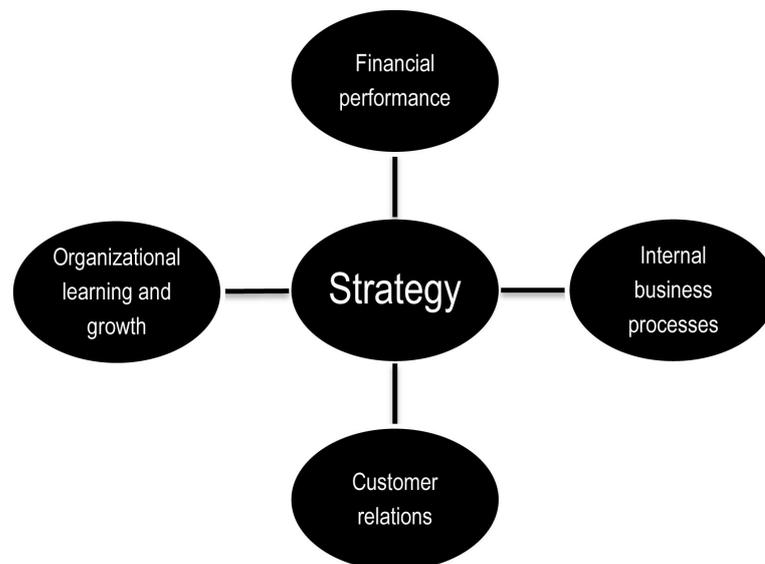


Fig. 6.3: Relation between Strategy and Dimensions of Performance

This comprehensive look, however, does not come with a ready equipped list of key measures or drivers. Nor does the balanced scorecard come with a system of examining these measures, which may quickly turn into a case of too much information. One estimate is that on average a company's management may be faced with examining 83 financial and 49 internal business-process matrices. Limiting

the number of measures to key drivers is preferred, but this is not necessarily the way in which this concept has been applied in practice.

Aside from the wealth of matrices available and used, the development of a balanced scorecard requires balancing. Yet, in practice, there are generally a greater proportion of financial measures relative to the other dimensions. This is likely due to the traditional use of financial measures in gaging performance, along with the ease of obtaining or calculating these measures. However, most of the financial measures used by MFIs are historical measures that do not provide the richness that the scorecard system requires to address the MFIs strategy.

The purpose behind the simplified balanced scorecard approach to MFIs is to help MFIs measure and manage their performance with respect to the MFIs strategic goals. As with many methods that seek to change the way companies manage themselves, the success of the method depends on its support throughout the MFI and its implementation. Whereas some MFIs managers believe that the scorecard helps the MFI work toward its strategic goals, others do not feel that approach is helpful. The evidence regarding whether MFIs using the balanced scorecard outperform those that do not use such an approach should be a subject of further investigations.

The scope of this paper is such that it is not possible to test this Balanced Scorecard across a reasonable sample of microfinance organizations, rather the model will be applied to a single microfinance organization based here in Cambodia, PRASAC MFI. PRASAC offers an interesting case study. Like its international counterpart microfinance institutions, it extends credit to the poor, and uses the group loan mechanism to ensure repayments and provide support to borrowers. Furthermore, like the majority of international micro-lending programs, PRASAC has yet to achieve full financial self-sufficiency.

6.4 A Profile: PRASAC MFI

PRASAC Microfinance Institution Limited, a licensed micro-finance institution (PRASAC), was incorporated in Cambodia and registered with the Ministry of Commerce as a private limited liability company under register number Co-6931/04P dated 12 August 2004. Its activities are an offshoot of the PRASAC Credit Association (PCA), which was managed and funded by the European Union (EU). PCA was initially established in 1995 as a support program for the agricultural sector in Cambodia, covering 10 provinces around Phnom Penh.

Mrs. Dam Toch, 35 years old, is PRASAC's client who is successful in her business with PRASAC's loan. Presently, she is living in Sdok Slart village, Phnom Touch commune, U dong district, Kampong Speu province. She spends most of her daily time on raising pigs and doing housework. She and her husband, Seng Than, a wine producer, wanted to raise more pigs to expand their business. After getting advice from their sister, they decided to request for USD 2,000 loan from 21 months from PRASAC to support their limited capital. After selling some pigs, Dam Toch got a better living standard and was able to repair her house and buy more furniture. Dam Touch becomes our client; she repays regularly and will pay off soon. She said with smiling face and hope that, " I am really thankful to PRASAC that always provides more both financial supports and motivation and advice to do business so that i can get more incomes. - Company resource 2010

PRASAC's operations are based on the asset transfer document dated 10 May 2005, effective from 31 December 2004, whereby the net assets of PCA were transferred to PRASAC as subordinated debt, as discussed in note 19 to these financial statements. PRASAC obtained its license from the National Bank of Cambodia (NBC) to conduct business as a micro-finance institution in the Kingdom of Cambodia as set out in the NBC's register No. 10 dated 15 November 2004. The license expired on 1 December 2007. PRASAC obtained renewal of its license for an indefinite period from the NBC on 14 December 2007.

PRASAC is engaged primarily in the provision of micro-finance services to the rural population of Cambodia through its headquarter in Phnom Penh and various provincial and district offices in the Kingdom of Cambodia. The amended

Memorandum and Articles of Association for the changes in shareholders were certified by the Ministry of Commerce and the National Bank of Cambodia on 14 October 2008 and 6 November 2008 respectively. As at 31 December 2009 the Company had 1,246 employees (31 December 2008: 1,024).

PRASAC firmly believes that its program of credit and technical assistance, combined with its philosophy of delegating authority to small groups of individual borrowers, gives individuals access to the resources they need through a program design to help them help themselves. PRASAC's commitment to taking a holistic approach to strengthening the business skills and opportunities of its customers suggests that it is a organization seeking Total Customer Solutions as seen in figure 6.4.

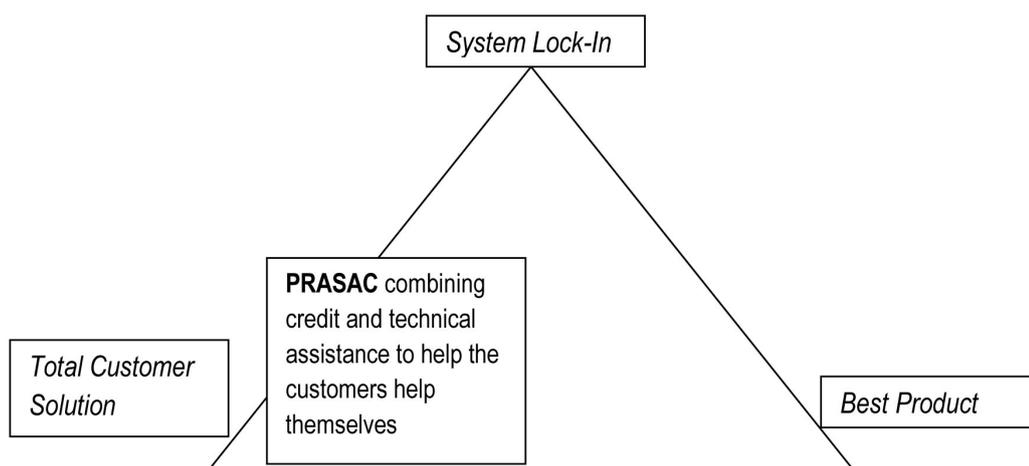


Fig. 6.4: The Delta Model

6.5 Framework for Analysis: Value Chain of PRASAC

6.5.1 Mission

The vision and mission of PRASAC is to contribute to sustainable rural economic development in order to improve the living standards of the rural people through creation of sustainable access to financial services for rural communities and micro-enterprises.

Thus, the mission statement provides more than a business mantra; it is the modus operandi of both the PRASAC organization and its customers.

6.5.2 Source of Fund

According to the audited financial report in 2010, the share capital of the Company as at December 2009 was KHR 15 Billion (Fifteen billion Khmer Riel) distributed among the five shareholders 18% each BIO, Dragon Capital Group (DCG), The Netherlands Development Finance Company (FMO), Lanka Orix Leasing Company (LOLC), Oikocredit, and 10% for PRASAC Staff Company (PS Co.).

BIO is a member of EDFI, the Association of European Development Finance Institutions. BIO participates in European Financing Partners / EFP, a co-financing facility established by ten of the EDFI-members. Its purpose is to facilitate the financing of private sector projects in the ACP states in collaboration with the European Investment Bank.

Dragon Capital Group (DCG) is a diversified investment banking institution offering traditional financial products and services with an exclusive focus on Vietnamese capital markets. The firm is known both within Vietnam and international financial circles as one of the premier Vietnam focused financial institutions. Dragon Capital Group serves the investment banking needs of international and domestic businesses to enable them to realize their investment goals in Vietnam.

The Netherlands Development Finance Company (FMO) supports the private sector in developing countries and emerging markets in Asia, Africa, Latin America and Central and Eastern Europe. We do this with loans, participations, guarantees and other investment promotion activities. Lanka Orix Leasing Company strives to deliver financial services to its customers with both corporate and rural grass roots level, in every region where it operates in Sri Lanka. Since its inception in 1980, it has been working with small and medium size entrepreneurs, which represents over 80% of its client portfolio. The Company innovates continuously in providing adapted financial solutions such as leasing products, factoring

services, savings and deposit products, small loans and insurance broking services.

Lanka Orix Leasing Company strives to deliver financial services to its customers with both corporate and rural grass roots level, in every region where it operates in Sri Lanka. Since its inception in 1980, it has been working with small and medium size entrepreneurs, which represents over 80% of its client portfolio. The Company innovates continuously in providing adapted financial solutions such as leasing products, factoring services, savings and deposit products, small loans and insurance broking services.

Oikocredit started as a pioneer in the field of development financing. Today, it is one of the largest financiers of the micro-finance sector worldwide. Oikocredit is one of the few ethical investment funds, which finances development projects in the South benefiting disadvantaged and marginalized people. Privately owned, Oikocredit is a unique cooperative society, which encourages investors to invest their funds in a socially responsible manner.

PRASAC Staff Company (PSCo.) was established under the law and general provisions of Kingdom of Cambodia and has the following objectives: To make equity investments in PRASAC MFI Ltd and to manage the investments in accordance to high moral and professional standards, with transparency and good governance. The company might be engaged in any other capital and asset management, investment and trading and other financial or other activities and services which relate directly or indirectly to the above objectives or similar purposes, and are characteristic of the development of the company's operations.

6.5.3 Development and Assessment of Loan

PRASAC offers two main products to its clients.

Group Loan: is used in which the group members are self-selected between 2 to 5 members with one group leader. Each member can borrow amount of money ranging from USD 15 to USD 250 within 12 months loan period. Following criteria is for the group loan:

- 2 - 5 members, and one is selected as a group leader
- One member from each household
- Permanent residents in the village
- Similar loan purposes (not homogeneous)
- Age between 18 - 65 years

Individual Loan: The target clients are micro and small enterprises. The clients can borrow either in Riel or Dollar with the amount ranging from KHR 300,000 to KHR 100,000,000 or USD 75 to USD 25,000 with the period up to 26 months. The monthly interest rate is 2.7% to 1.6% with following criteria:

- Permanent resident in the village
- Aged between 18 - 65 years
- Have/show profitable business
- Contribute 20% of their own capital into the business activity
- Have physical collateral and personal guarantee

From the very beginning, group loans form the foundation of the PRASAC, and are essential to the success of both the members and the program overall. Active participation in loan groups provides the necessary support micro-business owners require for succeeding at their business and with their loans.

The group loan / individual loan assessment model starts with the identification of individuals in a poor community who have some business savvy and little funding for a start up, or have an ongoing business but little extra income for expansion. These individuals are sought out by PRASAC affiliates or staff from the Community Development Corporation. Soon after a group of interested individuals is identified, they are invited to a series of sessions in which they receive

information about PRASAC, and training in conducting a cash flow analysis, and drafting and reviewing a business plan.

At the close of the training, the members can decide with whom they wish to form a group. The newly established group formulates a vision and a plan for their group, chooses a name, establishes by-laws, and elects officers. PRASAC provides a loan application and materials about procedures, but is not involved in the decision-making process; rather, the loan groups themselves are responsible for reviewing the loans. The loan groups review each loan proposal against the same criteria, which include aspects about 1) the character of the applicant, 2) the success-ability (feasibility + viability) of the business idea, and 3) the soundness of the contingency plan. The entire review process can be completed in as little as an hour, and, once the loan group's approval form is signed and submitted to PRASAC, a loan check is cut and sent within days. The delegation of this activity is in keeping with PRASAC's goals of instilling self-sufficiency and accountability.

The PRASAC peer-lending model is based on the most successful micro-lending programs in the world, including the Grameen Bank in Bangladesh and the FINCA program in Central America. Central to these programs is the establishment of peer lending groups to review loan applications, and advise group members on basic business practices.

6.5.4 Project Support and Implementation

At PRASAC, all business and lending decisions are in the hands of the customers, or loan groups. This lending mechanism not only empowers members, it also serves to reduce the costs of lending, since peer pressure is severe, and a default on a payment freezes future loans for the entire loan group. PRASAC loans range from an initial \$100 to as much as \$20,000. Members also receive PRASAC's business curriculum, a series of training materials and exercises that cover essential components of business management.

In addition to training materials, members of the PRASAC community are the

beneficiaries of many strategic alliances. These alliances are essential to the success of PRASAC. Remarkably, they are precisely what many of the other international microfinance institutions featured throughout this paper lack.

6.5.5 Strategic Alliances

- **PRASAC provides loans to beneficiaries of ECOSORN project:**

PRASAC contracted with ECOSORN project in order to contribute to poverty reduction through the improvement of physical access to financial services such as credit and savings. At the same time, the project helps increasing the household income; particularly, through increasing agricultural productivity and local community empowerment in selected rural areas of Cambodia.

PRASAC reaches the expected results of the contract with remarkable achievements, by established 19 offices in 14 districts 40 communes and 91 villages in three provinces, Siem Reap, Battambang and Banteay Meanchey. As a result of the cooperation, PRASAC targeted 13,962 beneficiaries in which 4,577 borrowers, 3,248 savers with KHR2,780,975,500 of disbursement amount from November 2007 to December31, 2009 in ECOSORN target communes.

- **PRASAC also provides financial literacy to the poor:**

Besides credit operations, under the support of ECOSORN project, PRASAC also provides financial literacy training to the households in three provinces. Particularly, this training focused on two modules such as Savings and Budgeting for the purpose of increasing the households understanding on households savings and savings disciplines on how to set savings goal and make savings plan, and how to analyze their familys financial situation.

As a result, in 2009, we organized 74 courses conducted in three provinces, Battambang, Banteay Meanchey and Siem Reap with total of 3,467 participants in which 74% are women. From this social commitment, we hope

that the household living standards will get more improvement, the rate of migration from remote areas will be reduced and there will be more saving increment and alleviation of high risk from emergency expense.

- **PRASAC provides loan for Biodigester Production:**

Relation to the Millennium Development Goals, PRASAC has been collaborating with the National Biodigester Program (NBP) since 30th November 2007. In terms of social responsibility, the collaboration is not only for poverty reduction but also environment protection since it can save on traditional energy sources, fossil energy sources and improving soil fertility. To comply with the partnership goal, PRASAC has formed the new biogas loan product to serve the people who plan to buy the biogas production in 8 biodigester programme provinces, Prey Veng, Svay Rieng, Kadal, Takeo, Kampong Speu, Kampot, Kampong Cham, and Kampong Chhnang.

As a result, by December 2009, PRASAC served 2,559 clients with convenience services, low interest rate with total of USD1,450,670 loan disbursement. Moreover, besides getting easier with renewal energy resource especially the use of biogas cooker instead of firewood, the biogas also help protect human health as well as reduce indoor environmental pollution with the improvement of hygienic circumstances and dung management.

6.5.6 Ongoing Technical Assistance and Networking Opportunities

Once the PRASAC customer receives their loan, they are provided with regular technical assistance and ample networking opportunities. PRASAC offers some technical assistance, but plays a greater role in matching customers or loan groups with local experts, who provide business counseling free of charge on a scheduled basis. Additionally, PRASAC works with the local Community Development Corporation to organize networking events around trade shows, marketing seminars,

and business openings. Often PRASAC customers attend these events in their loan groups. As is evident, PRASAC attempts to add some measure of value to its customers throughout the life of the loan and, in some cases, beyond. Figure 6.5 is a summary depiction of PRASAC's value chain.

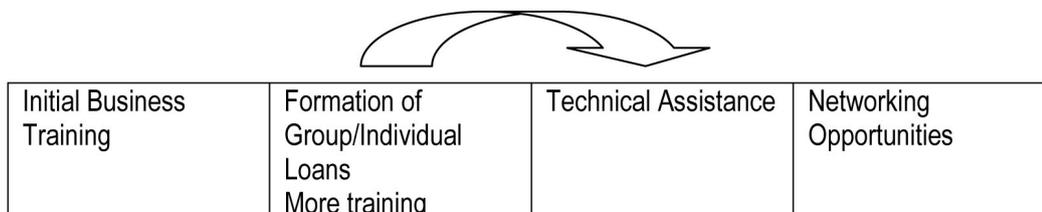


Fig. 6.5: PRASAC's Value Chain: Strategic Alliance

What we are really talking about here is "profit transfer," that is, we are examining the phenomenon whereby one body transfers its excess cash flow to an intermediary body (PRASAC) who apportions small amounts to qualified customers, so that they might, in turn, generate their own profits. But how is this transaction tracked? How is it evaluated?

As was mentioned previously, when assessing the impact of microfinance, it is important to examine both micro- and macro-matrices, or measures of impact.

6.6 The Matrices of Profit Transfer

6.6.1 Micro-matrices

Again, we will assume that micro-metrics refer to specific measures collected by the micro-financing organization to:

Financial - Assess the flow of capital: who received money, how much was loaned, and what portion of the loan is still outstanding. The information pertaining to who received money, the amount loaned, and the amount outstanding is closely tracked by PRASAC. Each month data is collected regarding the number of outstanding loans, the amount of principal outstanding, the percentage of

group members with loans, the number of loans 90 days overdue, and the dollar value of loans write-offs. The information does not disaggregate the loan recipient below province level, and does not break-out default figures by type of business or by demographic characteristics of loan recipient, all of which would allow loan officers to avert high risk geographic locations, business endeavors, and borrower profiles.

Internal Business Process - Assess the processes and procedures used to evaluate loans, provide business training, extend loans, collect payments, offer technical assistance and follow-up on defaults. In regard to internal business processes, PRASAC tracks the hours staff devote to the specific activities of: working at branch or sub-branch office , conducting outreach, serving in training groups, and undertaking other activities. However, PRASAC does not track the number of loans accepted for folding out of those that apply for funding - very important matrices when looking for patterns of success.

Learning and Growth - Assess the collection, documentation and application of lessons learned. According to its CEO, Senacheert Sim, PRASAC has learned one important lesson as it has watched its default rate increase from 3% in the early 2000, to 5% later on in the decade. Senacheert feels that this decrease in payments is due to the glut of low-interest credit available, forcing PRASAC to extend credit to highly risky individuals. In recent years, the causes of default have been traced to clients who have multiple loans with different MFIs. To deal with this, PRASAC will design and institute a better screening program.

Customer - Assess the profits of the customer's business and its growth. PRASAC compiles the following aggregate data to reflect the impact PRASAC has had on an average customer's business after a period of 12-months, i.e. change in sales, change in profit, change in customers, or change of nature of business.

6.6.2 Macro-matrices

Once again, in the context of this paper, macro-matrices will refer to gross measures of impact. The data cited in this section is drawn from a study done by internal research study of PRASAC in which 361 past and present PRASAC customers (members) were examined.

Financial - Assess how the inflow of capital has increased the local economy, the savings rate, and the increase in employment. As in other small businesses, hours worked in the business, and the amount of personal investment, have a strong impact on the businesses' success. However, after controlling for both business characteristics and personal characteristics, the study revealed that being an active member of PRASAC, and the number of subsequent loans received from PRASAC, have a significant impact on business sales.

There was no data available concerning any other matrices prescribed above; however, there was proxy data concerning employment levels: The number of businesses registered with the government increased by one-fifth (from 59% to 72%) since the owners joined a PRASAC loan group. Overall, this translates into approximately 280 newly registered, tax-paying businesses.

Internal Business Process - Assess the impact the various processes and procedures involved in issuing credit have had on creating a trickle down effect (i.e. old borrowers helping new borrowers to access funding). The Study found that there is in fact a good deal of borrower cooperation. 80% of those interviewed have referred customers to other loan group members, while 70% report receiving referrals to their business. Nearly half of the active group members have cooperated with another group member on a business activity (i.e. joint advertising, co-purchasing a piece of equipment). Over half of the active members have made business contacts with PRASAC members from other borrowing groups.

Learning and Growth - Assess the collection, documentation and application of lessons learned. The clear lesson learned through the Study is that it is important to keep PRASAC members active; they tend to have better repayment

records, improved profits, increased sales and hours worked.

Custom - Assess the impact of profits and/or wage increases on the community. According to the Study, PRASAC had the following impact on the customer:

- Profits increased by an average of 68%, from an average of \$ 870 per month before involvement in PRASAC to over \$1,500 per month after becoming a PRASAC member.
- Over half of those participating in a PRASAC loan group for 3 or more years increased their profits, compared with 39% of 1-2 year participants, and 36% for those participating for a single year.
- Active PRASAC members devote an average of 38 hours per week to their businesses; non-active members devote an average of 31 hours. Moreover, the study demonstrated that an important result of PRASAC's program is that it enables members to make positive changes in their lives, not only business and economic changes, but personal ones as well.

Findings from the study indicate that PRASAC customers experience an increase in self-esteem and in self- efficacy. They are better at confronting problems and feel empowered to take on issues in their communities. Below are some illustrative findings:

- 44% of active members of PRASAC reported that they feel more confident than they did before joining.
- Low-income individuals (those with earnings at or below 125% of the poverty line) report the greatest increase in confidence (51%) since becoming a member of PRASAC, compared to those with higher earnings.
- Minority members (55% women, 65% men) said they feel more confident about personal, community and economic aspects of their lives, compared to lower levels of white members. Finally, it is important to note that the

impact of PRASAC's program goes beyond the business and the household and into the community. Results from the study found that active minority members were the most likely to be active in at least one community group. Overall, 15% of those interviewed said they had become more involved in local business groups.

6.7 Summary and Recommendations

Microfinance programs extend small loans to poor people for self-employment projects that generate income, allowing them to care for themselves and their families. In most cases, microfinance programs offer a combination of services and resources to their customers, in addition to credit for self-employment. This is the hallmark of PRASAC - the degree of value added to the loan process - which offers training, networking, and peer support, as part of its routine package of services.

Microfinance is a powerful anti-poverty tool that has demonstrated relevance to people on six continents and in nearly every country. At the same time, the data used to assess the impact of microfinance projects are weak, non-standardized and largely survey-based, rather than systematically and routinely collected. It would be advisable for entities like PRASAC MFI to employ the Balanced Scorecard model to measure the impact of their programs.

Table 6.2 & 6.3 are a simplified version of the model, which takes into account the data available and that which might be feasible to collect.

Although microfinance is not a panacea, it has potential for transforming the lives of the very poor. Nonetheless, improved metrics need to be used by institutions and programs like PRASAC MFI, if they want to provide measurements of success which are of import to the organization, the donors, politicians, and of course, the customers.

6.8 Parting Thoughts

This paper attempted to extract from the literature a package of measures, or metrics, that can be used by microfinance programs and institutions to gauge their success as financial institutions, as well as their broader societal impact as welfare organizations.

What was learned is that microfinance organizations, unlike more traditional financial institutions, are largely unregulated and therefore tend to use of variety of non-standardized measures to assess their success and sustainability. Moreover, it is clear that microfinance institutions can not easily trade-off those measures that track institutional success, for those that measure the well-being of the community as a result of borrowing money and mounting a micro-enterprise, since a number of confounding factors make direct correlation difficult.

Indeed, the successful and solvent microfinance organization will make it a point to collect regularly data that reports on the financial status of the organization, its internal business practices, the rate of borrower success, and lessons learned. Moreover, the microfinance organization that assumes to impact the borrower community at large will aggregate these data across borrower communities and monitor them along with certain health and welfare data to infer a degree of behavioral impact.

Micro-Metrics	Macro-Metrics
<p>Financial Amount of loan and % outstanding, according to:</p> <ul style="list-style-type: none"> • Name and age of borrower • Type of business and location • No. of previous loan • Duration of business in operation • Adjusted RoE • Adjusted RoA • Operating efficiency and productivity 	<p>Financial</p> <ul style="list-style-type: none"> • % change in no. of registered companies • % change in customers on welfare/below poverty line • % change in customers' saving rate <p>Figures in aggregate should be collected for:</p> <ul style="list-style-type: none"> • Adjusted RoE • Adjusted RoA • Operating efficiency and productivity
<p>Internal Business Process</p> <ul style="list-style-type: none"> • % projects accepted for loans of those presented • No. of training events by type • Type and duration of technical assistance offered to borrowers • Type of loan: Individual vs. Group loans • No. Interfaces between lender and borrower per month 	<p>Internal Business Process</p> <ul style="list-style-type: none"> • Level of borrower cooperation • % members retained
<p>Customer</p> <ul style="list-style-type: none"> • % change in sales • % change in profits • % change in staff size • % change in salary • % change in no. customers 	<p>Customer Figures in aggregate should be collected for:</p> <ul style="list-style-type: none"> • % change in sales • % change in profits • % change in staff size • % change in salary • % change in no. customers
<p>Learning and Growth Data available from other 3 perspectives should provide ample information concerning lessons learned and growth needs.</p>	<p>Learning and Growth Data available from other 3 perspectives should provide ample information concerning lessons learned and growth needs.</p>

Table 6.3: Simplified Balanced Scorecard

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