For-profit Versus Nonprofit Microfinance:
How Are the Poor Affected?

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Abstract:

Of the world’s 6.5 billion people, 2.8 billion are living in poverty on less than $2 per day. After a general discussion of poverty among several perspectives, this research will focus on the microfinance industry. Microfinance has proven itself an effective poverty alleviation tool.

Traditionally, the microfinance industry has been nonprofit, geared toward helping the poor rise from poverty through the provision of small loans to create or expand businesses. The need for additional funding capital and the growing popularity of the industry have spurred an industry-wide debate between the traditional nonprofit model and newer for-profit microfinance model ideals. Many social and economic trade-offs occur on the spectrum that shifts between these two models. As this industry continues to transform itself rapidly, this study works to explain the major points of the debate within the context of two microfinance institutions from both models (i.e., Alternativa Solidaria and Compartamos). Although there were several limitations such as time and funding, this paper offers ideas of how each might overcome their inadequacies in the future to find a stronger balance between funding, satisfying the market demand for microfinance services, and effectively alleviating poverty.
Introduction

In a world where global poverty affects almost half the population, microfinance has gained a great deal of momentum in recent years because it has proven itself over time to be an effective poverty-alleviation tool. Traditionally, the microfinance industry has been a nonprofit movement geared toward helping the poor rise from poverty through the provision of small loans to create or expand businesses. The need for additional funding capital and the growing popularity of the industry have spurred an industry-wide debate between the traditional nonprofit model and newer for-profit microfinance model ideals. Many social and economic trade-offs occur on the spectrum that shifts between these two models. The purpose of this research is to improve our understanding of the status of global poverty; explain the goals and progress of initiatives set forth to reduce poverty; and explain how microfinance has evolved, how it works on the basic level, the size and depth of the industry, and some of the issues it faces in reaching every person who does not have access to credit. After explaining the major points of concern in the for-profit versus nonprofit debate, operational and financial methodologies of both models of microfinance will be compared and contrasted side-by-side (i.e., ProDesarrollo 2007a, 2007b) in order to determine the strengths and weaknesses of each in reducing global poverty.

Understanding Poverty

This section focuses on explaining several aspects of poverty, such as accepted definitions and measurements, global representation and scale, and factors that sustain its continuation. The Millennium Development Goals, developed by world leaders to address global issues of poverty, are discussed, including their current status and progress toward completion.

Definition of Poverty

On the most basic level, the *Merriam-Webster Dictionary* defines poverty simply as “the
state of one with insufficient resources.” Upon further examination, we see that the definition of poverty can be approached in two ways. The first, sometimes known as the sociological view, is an ambiguous definition describing a particular situation or conditions that an impoverished person might encounter. At the United Nation’s World Summit of Social Development, poverty was described as “a condition characterized by severe deprivation of basic human needs, including food, safe drinking water, sanitation facilities, health care, shelter, education, and information” (Dollar a Day 2006). It is difficult to measure a region’s status solely on these independent factors. Consequently, the second way, or economic view of poverty, was created. Measuring poverty on a statistical basis is normally done using data on income (amount of money someone makes) and consumption (monetary value of goods that a person actually consumes) (Dollar a Day 2006). This information is used to evaluate a region and create a relative poverty line, or minimum level of income deemed necessary to meet a person’s basic needs in that specific area. It is important to note, “poverty lines vary in time and place, and each country uses lines which are appropriate to its level of development, societal norms and value” (World Bank 2008, para. 5). The World Bank set the absolute poverty line in 2001, which is the most common definition of poverty in terms of Purchasing Power Parity (PPP), at an income of $2 a day or less and extreme poverty at $1 a day or less. It is said that 2.8 billion of the world’s 6.5 billion people are living on less than $2 per day. Some 1.2 billion people live on less than $1 per day (World Bank 2001).

Analogies in the Global Village

There are several ways to view the global face of poverty. “The Global Village,” spurred by an anonymous e-mail forwarded to a professor at Stanford University, has been passed around for quite some time now as an interesting and informative representation to grasp the true picture
of the world’s population. Inspiration for this concept has been attributed to Donella Meadows, who wrote the “State of the Village Report” in the early 1990s (Sustainability Institute n.d.). Controversy about accuracy of the original information has surfaced, but time and additional research has allowed the 100 People Foundation to update the numbers to reflect the current, accurate information found in new reports of leading research organizations (100 People Foundation n.d.). Relevant to our discussion of poverty, worldwide, 53 of every 100 people live on $2 a day or less; 17 do not have access to safe drinking water, 31 do not have access to electricity, and 13 out of every 100 males and 23 out of every 100 females would not be able to read and write. Knowing this information changes how developed countries such as the United States are viewed as members of this village. The United States is unique, or above the bell curve so to speak, which is not necessarily reflected in the attitudes and perspectives of its population.

These numbers, though, did not allow me to fully comprehend the concept of poverty. I had heard these statistics and seen television ads or charity campaigns; however, my hand had lifted only to assist “the poor” on the right occasion and at my convenience. Seeing, speaking, and living with people in these situations put the reality of poverty into perspective for me. Throughout my recent travels in South America, I was able to see some of the images behind these daunting statistics. What does it mean when someone does not have “access to safe drinking water”? In the city of Lima, as I stood on the edge of a Peruvian mountain in the Andes overlooking 5 million out of the 9 million people living in poverty along the coastline, I realized the true meaning of these words. It meant the struggle of carrying government-distributed water, which had been poured into large blue barrels, up the side of a mountain for personal/family access. Figures 1–4 will allow one to gain this same visual perspective of the situation described here during my recent trip.
Poverty-mapping Figures

Poverty mapping, or relative graphical representation of poverty facts shown on a scaled map of the world, is a fairly new and innovative approach to forming a visual perspective of global poverty. Several respectable organizations have led the way in providing us with this useful learning tool. Using this analysis, the World Bank (2001) demonstrated that Africa, Asia, and some areas in Latin America have the lowest incomes per capita in comparison with the rest of the world. Similarly, the Center for International Earth Science Information Network (CIESIN 2005) found that South Asia and areas in western Africa represent the worst problem sites for children aged 0-5 years who are underweight for their age and height. Infant mortality in many parts of Africa, as well as in Asia, was shown to be greater than 150 per 1,000 births, or 15 percent. This could be compared to a developed-country ratio of less than 9 infant deaths per 1,000 births. Data showing where the 1.2 billion people living on less than $1 a day live reveals that South Asia, East Asia, and Sub-Saharan Africa were locations with the largest amount of extreme poverty conditions, representing 91 percent of the total in 1999 (World Bank 2007).

Millennium Development Goals

In September 2000, all United Nations Member States gathered and adopted the Millennium Declaration in response to the reality of the facts presented earlier. Within this Declaration is a series of eight goals (Millennium Development Goals, or MDGs), to be achieved by the year 2015. They outline a universal framework of what the leading developed nations are going to do to create a brighter future for all people in this world. The eight MDGs that were declared in 2000 are as follows:

- Goal 1: Eradicate extreme poverty and hunger (United Nations 2007a, p. 6).
- Goal 2: Achieve universal primary education. Ensure that all boys and girls complete a full course of primary education (United Nations 2007, p. 10).
Goal 8: Develop a global partnership for development (United Nations 2007, p. 28).

As we pass the halfway point for the majority of these goals in 2008, it is possible to look objectively at the progress (or lack thereof) using specific indicators/new information to determine success. Although many successes could be cited, Jose Antonio Ocampo, the Under-Secretary-General for Economic and Social Affairs, points out in “The Millennium Development Goals Report 2007” (United Nations 2007, p. 5) that “only one of the eight regional groups is on track to achieve all the Millennium Development Goals.” He also says that projected shortfalls are most severe in Sub-Saharan Africa and that developed countries are not delivering fully on their Official Development Assistance (ODA) commitment targets:

It requires, in particular, the group of 8 industrialized nations to live up to their 2005 pledge to double aid to Africa by 2010 and European Union Member States to allocate 0.7 percent of GNI to ODA by 2015. In spite of these commitments, ODA declined between 2005 and 2006 and is expected to continue to fall slightly in 2007. (United Nations 2007, p. 5)

Factors of Poverty

Poverty is an outcome for the way in which a country’s economic, political, and social processes interact with one another. Variations of these factors all around the world combine to continue poverty (World Bank 2001). In his research, poverty expert and author, Dr. Phil Bartle, distinguishes between causes and factors of poverty: “A cause can be seen as something that
contributes to the origin of a problem like poverty, while a factor can be seen as something that contributes to its continuation after it already exists" (Bartle 2008, para. 5). Consequently, in this discussion, we will spend less time focusing on the causes of poverty, which could be correlated to various events throughout history such as world wars, slavery, and natural disasters, and more time discussing the factors that allow it to continue. According to Dr. Bartle (2008), there are Five Factors of Poverty:

- **Disease.** “When a community has a high disease rate, absenteeism is high, productivity is low, and less wealth is created [as a result] (Bartle 2008, para.16).”

- **Apathy.** “[W]hen people do not care, or when they feel … powerless, they do not try to change things, to right a wrong, to fix a mistake, or to improve conditions (Bartle 2008, para. 20).”

- **Dependency.** When one is “…on the receiving end of charity…” for long periods of time, the person becomes dependent on that support (Bartle 2008, para. 28).

- **Dishonesty.** Corruption occurs on all levels, particularly in the misuse of resources “among persons with trust and power (Bartle 2008, para. 24).”

- **Ignorance.** When people lack information, or knowledge, they are ignorant. “It is different from [both] stupidity… [a] lack of intelligence, and…foolishness…a lack of wisdom (Bartle 2008, para. 11).”

The Five Factors of Poverty cannot only function collaboratively and independently of one another, but they encompass and contribute toward many more secondary factors that continue the cycles of poverty. Examples of these combinations, more tangibly described, are situations like poor infrastructure, bad governance, underemployment, and lack of access to credit. Lack of access to credit, noted from my own travels and extended research, is the single
For-profit Versus Nonprofit Microfinance

most limiting factor that perpetuates a poor person’s dependency. Money has become a fundamental survival tool. When conditions that surround someone create a market failure restricting access to money, one cannot thrive anymore in today’s global society, which may have been possible in the past. In most cases, loan sharks who charge as much as 10 percent interest per day, are borrowers’ only option to gaining access to some form of credit. Grameen Bank describes an example of this typical situation, in which founder and Nobel Peace Prize Laureate Dr. Muhammad Yunus interviewed Sufiya Begum, a 21-year old Bangladeshi woman with three children in a nearby Jobra village. Before Yunus’ Grameen Bank, she borrowed 5 taka (USD 22 cents) from one of these loan sharks to make a bamboo stool (one day’s work) and was required to sell it back to him for 5 taka and 50 poysha. The 5 taka went back to the moneylender, and the 50 poysha (USD 2 cents) was retained by Sufiya to provide for her family. Sufiya Begum earned only USD 2 cents for a day’s total work (Yunus 2003). Fewer than 18 percent of the 2.8 billion people living on less than $2 per day have access to financial services that would provide them with an alternative to this vicious cycle (Meehan 2004).

It is important to understand Dr. Bartle’s conclusion that “each social problem is caused by the big five, and each of them contributes to the perpetuation of poverty” (Bartle 2008, para. 9). Bartle concludes that organizations that focus on eradicating poverty as an objective must take steps to remove these factors to be successful. Director of the Earth Institute at Columbia University Jeffrey Sachs says that one has to approach every country or region much like a doctor approaches a patient (Kiva Organization n.d.).

Each wounded or poverty-stricken area will have specific factors contributing to the continuation of its current circumstances. There may be disease, dishonesty, or apathy. Therefore, as one approaches a specific region with the intention of eradicating poverty from that
area, there must be a comprehensive strategy to address each symptom with the right medicine. In his book, *The End of Poverty*, Sachs (2005) recognizes access to capital as a fundamental part of the “poverty trap.”

The World of Microfinance

*Birth of Today’s Microfinance*

Variations of factors around the world combine to create their own specific poverty situation, ultimately restricting the fundamental opportunities for those affected (World Bank 2001). Over the three decades, a notable strategy has emerged to combat the dependency issue of credit called microfinance. However, this is not a new concept. Various times throughout history, the microfinance concept has been introduced and has failed. This occurred particularly in Ireland from the 1700s until 1950 when it became handicapped by an interest rate cap by the Irish government (Siebel 2003). Islamic banking is another example of past issues. Because exchanging *riba*, or interest, was forbidden by the Koran, banks remained heavily subsidized and unprofitable for many years. Consequently, the Islamic financial system was poorly developed until modern solutions were later found.

Poverty alleviation through the provision of subsidized credit was a centerpiece of many countries’ development strategies from the early 1950s through the 1980s, but these experiences were nearly all disasters…. Inefficient and costly programs created a dependence on government accounts and were eventually drained completely. Loan repayments dropped well below 50 percent; cost of subsidies ballooned and much credit was diverted to the politically powerful, away from the intended recipients. (Murdoch 1999, p. 1571)

However, this time around, microfinance has proven itself an effective poverty
alleviation tool, yielding a remarkable 97 percent repayment rate. This new paradigm of microfinance has been credited to Dr. Muhammad Yunus, an economics professor at Chittagong University in Bangladesh, who began “banking to the poor” outside his classroom in 1976. He felt that it was difficult to teach the effectiveness of economic theory when the reality of poor conditions from the 1974 famine did not at all reflect those theories. Giving access to credit, he says, allows the poor to be “architects of their own fate” (Yunus 2003, p. 130). Some confusion arises between the terms microfinance and microcredit. Microcredit is simply a loan of money to the poor, whereas “microfinance is the supply of loans, savings, and other basic financial services to the poor” (Kiva Organization n.d., para. 1).

How the Microfinance Loan Process Works

Although a variety of microfinance models have been created after the Grameen Bank, the traditional process begins with a group of five women. Why women? While new research is being collected to challenge this idea, it is traditionally believed that loans reach further and help more people when women are the recipients. This is because women generally use their profits to provide for their families in the forms of more nutritious food, better education, additional clothing, and shelter quality. As mothers, women use their new wealth to ensure the satisfaction of their children’s basic needs and future first. Men borrowers, in contrast, actually have been found to save and invest more in physical capital to grow their businesses (Khandker 1998, p. 2). Loaning to women also empowers them to take control of their lives in societies that might not naturally allow this process to happen. Cultural obstacles or household duties make it difficult for women to work in a traditional job, so having their own business allows them to function within these constraints. Once a newly formed group of women at the Grameen Bank is ready to apply for their loan, they must first pass each member through an oral exam to test their
memorization of “The Sixteen Decisions,” or the “Social Development Constitution of the Grameen Bank.” Each of these decisions combines to form the culture, lifestyle, and perspective of a Grameen Bank borrower. Two examples of these decisions include “We shall follow and advance the four principles of Grameen Bank—Discipline, Unity, Courage, and Hard Work—in all walks of our lives” and “We shall educate our children and ensure that we can earn to pay for their education” (Counts 1996, pp. 347–348).

Once they become official members and are approved for their specific loan amounts, the first of the five borrowers receives a loan. Upon repayment, each member thereafter will take her turn respectively to receive a microfinance loan. This aspect of the group lending process is sometimes referred to as “social collateral.” Because no collateral for the loan is taken as with traditional banks, fellow members not only help in the development of each other’s businesses but also are genuinely interested in the success of other group members because they will not be permitted to receive their loan or additional loans if another member fails to repay. Borrowers use the loan to form a business or to finance expansion of an existing one, ranging from buying raw materials, to making a blanket, to purchasing a cow for milk production. With the profits, they are able to repay their loans and provide for themselves as well as their families (Chiapas Project 2008). They are then eligible to receive a higher loan amount, by a process known as progressive lending, which will allow them to grow their businesses with the hope of an eventual departure from a poverty-stricken life. Common phrases that capture the concept of microfinance are “a hand up, not a hand out” or “teaching one to fish.”

The Microfinance Industry

Yunus has now grown the Grameen Bank since it was founded in 1983 to serve over 2.5 million people. He has been given the official title “father of microcredit,” and has received the
2006 Nobel Peace Prize for his efforts. The United Nations recognized the relief that microfinance brings to the impoverished and declared 2005 the International Year of Microcredit (Hermes and Lensink 2007). With the combination of these events came the influx of attention and analysis directed toward microfinance and the many factors that function within it.

Today, the microfinance industry has grown dramatically, providing financial services to the poor around the world so that they can help themselves out of their own poverty situations (Yunus 2003). However, what does the microfinance industry look like? How many institutions are in which countries with how many borrowers? The Microfinance Information Exchange (MIX) reports their collected data and surveys of the microfinance industry in 2007:

By combining data with the MicroBanking Bulletin, the Microcredit Summit Campaign (MCS), and Inter-American Development Bank (IDB), they were able to provide detailed information on the number of microfinance institutions (MFIs) and borrowers in developing markets. [T]heir reported results [are]: 100 countries with a total of 2,207 microfinance institutions with 77 million borrowers. (Nelson 2007, p. 1)

The real power of microfinance comes with the fact that the 76.9 million borrowers listed here are not the sole beneficiaries. Their families benefit as well, amounting to an approximate total of 384.5 million people. Also, it is important to point out where these borrowers are in relation to where the poverty is from our earlier discussion. Approximately 85 percent of borrowers are in the African and Asian regions, which are home to 91 percent of people living in extreme poverty (i.e., less than $1 per day) (World Bank 2001).

Responding to the Global Issues

At the Global Microcredit Summit in 2006, Dr. Yunus responded to the failing status of the MDG’s halving poverty by 2015, as a leader among nations, with his own proposed
commitment within the microfinance industry. The Microcredit Summit Campaign's two new goals are to “ensure 175 million of the world's poorest families have access to credit by 2015,” affecting 875 million family members, and to “help 100 million of the world's poorest families move above the $1 per day threshold by 2015,” affecting 500 million family members (Bangladesh 2006, para. 1).

*Industry Growth and Change for the Future*

Donor contributions are an integral part of the continued growth of this industry, even though it has traditionally been thought of as a temporary resource. Theoretically, microfinance institutions begin with donor subsidies to offset start-up costs and achieve financial sustainability once specific costs and borrower measures are met. The prevailing conventional time frame for this is 3–5 years of subsidized funding to obtain sustainability, or profitability (Harrington et al. 2006). If an MFI can operate effectively on its own without donor support, it is financially sustainable (Murdoch 1999). Unfortunately, departing from donor subsidies and achieving financial sustainability is extremely difficult to realize.

Whereas a commercial bank normally lends larger amounts to fewer customers, a microfinance institution focuses primarily on lending very small amounts to a large amount of customers without collateral. High transaction costs, personnel, and technology are only a few of the many barriers (Murdoch 1999). Whether an institution remains subsidized or becomes sustainable requires careful consideration of the trade-offs that each approach brings. Institutions that remain subsidized are not financially sustainable; they cover only around 70 percent of costs on average. They do achieve operational sustainability, which is when an institution is able to pay for operating costs but not the full cost of capital. Subsidies come to microfinance institutions through direct grants and soft loans, given far below the market rate of interest, and
with soft equity, otherwise known as tax holidays or loan guarantees (Murdoch and Armendariz 2007).

Many argue this reliance on donors is a handicap because if they stop giving, these institutions will slowly deteriorate (Murdoch 1999). Although this reality of the industry exists, research shows how the benefits of even those microfinance institutions that remain subsidized have a larger reach in helping the poor than existing alternatives. There are many critics of alternative methods used over time to alleviate poverty. Since 1946, the United States alone has provided over $146 billion in foreign aid. This strategy, while it has good intentions, can bring negative indirect consequences. Corrupt governments have misused funds for personal gains. Programs that offer free food for all as aid handouts bankrupt local farmers who cannot compete (Bovard 1986). Results of a cost-benefit ratio analysis, which compares microfinance against other local poverty-alleviation strategies in Bangladesh, show that for every dollar of benefit to clients, there is a cost of $91 to the Grameen Bank. Other options were $1 to $0.71 for the World Bank’s Food for Work scheme and $2 to $0.62 for CARE (Murdoch 1999, p. 1593). Thus, it is important to note that while some banks remain subsidized by donors, the benefits of microfinance still surpass alternatives to which donors could have contributed.

Consequently, the microfinance industry has divided and labeled microfinance institutions according to whether they have a profitable or subsidized status. Both nonprofit and for-profit models are represented throughout the various tiers. As a microfinance institution moves from the lower Tier 4 to the higher Tier 1 status, its ability to raise capital in the donor and commercial markets improves. This is mainly because higher tiers are more profitable, and, therefore, more attractive to investors. Profitability is the same as sustainability, which is an industry language difference between investors and donors (Harrington et al. 2006). This
becomes an important situation to study and improve upon, as 90 percent of MFIs are labeled either Tier 3 or 4 (unprofitable or almost profitable) and are in need of more capital to grow, and fewer than 10 percent are profitable (Tiers 1 and 2). According to microfinance expert Drew Tulchin, moving from a start-up microfinance institution to achieve sustainability (profitability) requires on average 3–5 years of subsidies (Harrington et al. 2006).

Access to Commercial Markets

“Microfinance analysts estimate only 10 percent of the market has been penetrated” (Tulchin and Bhaskar 2004, p. 4). According to the Small Enterprise and Education Promotion (SEEP) Network, if we wanted to provide access to credit to everyone in the world who needs it, there would be a market demand of U.S. $300 billion. This projected market demand, of course, assumes some unknown interest rate; however, it has been found that borrower response to the variation of interest rates (20 percent to 100 percent) is relatively inelastic, or not typically a deterrent for borrower participation in microfinance programs. “Donors have historically provided between U.S. $800 million and $1 billion a year to the industry,” combining to create an approximate total market supply of $4 billion (Harrington et al. 2006, para. 2). The “capital gap” in this industry is obvious here, but let us pretend for a moment that all donors in the United States choose to give to microfinance rather than to the great alternatives that are available, such as Cancer Research or Youth AIDS. The total of all philanthropy (donations and grants) in the United States is $225 billion. Since this situation is highly unlikely and could not even fund the $300 billion of need the industry demands, the microfinance industry has moved to position itself in other ways to obtain the financial support of the Private Investments with Social Goals and Socially Responsible Investment Funds. This shift has created a new paradigm for microfinance institutions in search of new capital to fuel this rapidly growing industry among all tiers.
Meehan (2004) examined the breakdown of the various types of financing available to each tier of microfinance institutions, with Tier 1 being the most financially secure and Tier 4 the least financially secure. Note the distinction among both Tiers 1 and 2 of nongovernmental organizations (NGOs) and legally recognized financial institutions (FIs). As a microfinance institution moves from an NGO status to a regulated Financial Institution, it gains additional opportunities for financing. It is important to note, from the earlier discussion of Tiers, that 90 percent of MFIs are among Tiers 3 and 4. It can then be concluded that the majority of MFIs face limited options to finance growth. When comparing financing options of NGO and FI even on a Tier 1 basis, an FI has more options and opportunities to expand from various sources. The concept of nonprofit versus for-profit microfinance and the trade-offs each bring has been the dominant debate in recent years within the microfinance industry. All types of organizations around the world have rapidly responded in order to assist the need for capital among institutions and borrowers, provide assistance, education, and technology to growing MFIs, and research the progress of industry efforts while looking for ways to improve. Each has its own position and approach in this growing debate/industry.

Methodology

Each region or circumstance within this debate makes microfinance a very complex issue to understand and analyze with limited time and money for additional research. To better understand both sides of this issue, this study analyzes two leading microfinance institutions in Mexico: Alternativa Solidaria and Banco Compartamos (one nonprofit and the other for-profit, respectively). After first explaining each institution’s history and background information, I will compare and contrast their methodologies and financials side by side in order to draw as many
conclusions as possible in terms of global poverty reduction. What are some of the main points of this debate? What similarities and differences exist among the operation methodologies, financial, and outreach indicators of Banco Compartamos and Alternativa Solidaria?

Discussion of the For-Profit Versus Nonprofit Debate

The limited flow of funding restricts the ability of all MFIs to provide those in need with access to credit. It is clear that as a microfinance institution becomes a more regulated financial institution, such as in the case of Banco Compartamos, it is able to receive a more diverse group of funding sources. This transitional process brings many secondary implications for microfinance. A regulated for-profit microfinance institution is a business, not a charity. It is common to have charity work toward the objective of alleviating poverty. However, as the transition occurs from NGO to regulated institution, the question arises whether or not a for-profit entity can continue to uphold a mission of reducing poverty while meeting its fiduciary duty to maximize profits. Normally, shareholders or investors in a for-profit business want to maximize returns. Shareholders or donors in a nonprofit microfinance organization want to further that organization’s social goal, whatever that may be. Each separate organization has created bottom-line goals and objectives that it hopes to achieve. Can a for-profit, regulated microfinance institution accomplish a “double bottom line” in alleviating poverty while making reasonable profits? It is possible to do this as shown by some instances; however, others have not been able to balance these two missions, producing dangerous results and negative news articles, such as “Microfinance Misses Its Mark” (Karnani 2007) and “The Ugly Side of Microlending” (Epstein and Smith 2007). Where does microfinance end and loan sharking begin?

Another topic of concern for many is whether a for-profit microfinance institution can continue lending to the poorest of the poor. For many reasons, some have begun lending to the
“richer of the poor,” which does not necessarily contribute to the goal of alleviating poverty. The tendency to change focus slowly away from poverty alleviation and toward profits has been commonly referred to as “mission drift” in the industry. Providing microfinance loans and services to the poor is expensive. It costs approximately the same amount for a bank to create a new account or loan whether it is $100 or $1,000. Some organizations (typically NGOs, because they are subsidized themselves) subsidize interest rates. For-profit financial institutions generally do not subsidize interest rates, which keeps rates above 60 percent per year. The main point is whether the poor can afford these high interest rates. Also, if it is a for-profit entity, is an organization justified in gaining profit from interest rates that could be potentially lowered? Since they are receiving loans, paying them back, and taking out more, many believe that this means they are satisfied with the service and can pay these rates. Others think that they do not have a choice so they take this situation as their best option. Jonathan Murdoch and Beatriz Armendariz (2007) present an economic theory that suggests the poor can pay higher interest rates than others. A sewing business’ profit growth increases substantially with the first loan to buy a sewing machine (from hand to machine). It may also be the case that if microfinance proves to be profitable in the commercial markets, then basic supply and demand of competition will drive interest rates down further (Rosenberg 2007; ProDesarollo 2007a, 2007b; Bruck 2006; Microfin n.d.).

In order to improve what we know in this debate, as well as analyze some of the similarities and differences between for-profit versus nonprofit microfinance, we continue our discussion focus within the context of two specific circumstances: Alternativa Solidaria and Banco Compartamos.

Banco Compartamos, a For-Profit Organization
In 1990 Banco Compartamos, which means “let’s share” in Spanish, was established as a NGO by Gente Nueva to provide microfinance services to the poor in Mexico. Headed up by Carlos Labarthe and Carlos Danel, bank operations were converted to a regulated for-profit finance company in 2000. At the time, they were serving about 60,000 borrowers. This made Banco Compartamos in Mexico, as suggested in a previous section, eligible to receive funding from more diverse options. In 2002, Banco Compartamos issued roughly $70 million in bonds for the first time on the Mexican Securities Exchange. In 2006, they were commissioned by the Mexican government to operate as a full-service bank. This was significant because of La Ley de Ahorro, which restricts unregulated organizations by the government (microfinance institutions) from taking deposits or keeping savings for clients. Before this, Banco Compartamos could not leverage deposits as a funding source to make more loans, as so many banks around the world do. On April 20, 2007, Banco Compartamos went into the history books when it became the first microfinance institution in Latin America to issue an initial product offering (IPO) on the stock market and became Mexico’s most profitable bank. It sold about 30 percent of existing private stock shares to new investors, which brought in about $450 million. This action quickly became extremely controversial in the industry because the results did not bring in new capital for more loans, but allowed profits for those private investors who were “cashing out” (Rhyne and Guimon 2007; Rosenberg 2007; ProDesarollo 2007a, 2007b; Meehan 2004; Microfin n.d).

*Alternativa Solidaria, a Nonprofit Organization*

Alternativa Solidaria Chiapas, or AlSol, was established as an NGO microfinance institution in Mexico in 1999. Its primary area of service is in rural areas throughout the state of Chiapas, specifically outside the city of San Cristobal de las Casas. AlSol has achieved record growth in terms of the number of borrowers over the past few years. It also has identified and
taken steps to satisfy other needs of microborrowers with new services offered such as literacy and business education programs, and health partnerships. It has succeeded in qualifying for funding from reputable organizations such as the Ford Foundation, Grameen Foundation, and KIVA. AlSol functions within the niche of serving the poorest people with microfinance using the Grameen Bank model and methodology in rural areas of need throughout Chiapas, Mexico (AlSol n.d.; Chiapas Project 2008).

Side-by-Side Comparison

Both AlSol and Banco Compartamos are leading microfinance institutions in Mexico. They follow very different strategies in order to deepen their impact of providing financial services to the poor. While at first glance, these two institutions may not seem comparable due to size differences, further examination of their similarities and differences reveals the opportunity to learn more about them and this growing debate in microfinance. Table 1 compares them side-by-side in terms of operation methodology, financial indicators, and outreach indicators.

As I suggested earlier, the commercial Banco Compartamos is much larger than NGO AlSol in terms of borrowers, employees, and interest rates (up to 101 percent versus 51 percent annually depending on the area of distribution). Banco Compartamos’ interest rates are nearly double that of AlSol, while retained profits from borrowers both hover around 41 percent. Banco Compartamos has a much larger infrastructure across Mexico to run; however, many have criticized these high rates and profits. The main difference in the use of the interest income between these two entities is in their use of interest income. AlSol uses interest income to cover operating costs and leftover profits are then reinvested back into the organization to provide additional loans. With Banco Compartamos, after covering operating costs, they choose between reinvesting profits and paying dividends to stockholders. Average loan size and loan balance are
also much larger at Banco Compartamos, which may suggest progress among poor borrowers to higher loan amounts or a bank’s lending shift to the “richer of the poor.” This allows a microfinance institution to diversify costs among more profitable clients; however, it does not directly contribute to the social bottom line of alleviating poverty. AlSol is able to leverage more borrowers per staff member at a lower cost, which is remarkable when considering economies of scale. Although a relatively young organization, AlSol is growing at 24 percent versus Banco Compartamos’ growth of 14 percent per year. In looking at the variety of services that each organization offers, Banco Compartamos and AlSol both provide traditional microcredit products and life insurance. Because Banco Compartamos is a regulated financial institution recognized by the Mexican government, it is allowed to take and hold savings. In June 2001, the Ley de Ahorro was passed, which prohibits any organization type other than a regulated financial institution approved by the Mexican government from collecting savings from borrowers. This law was meant to protect consumers from unqualified organizations and people; however, many Mexican MFIs (especially NGOs) are negatively affected by this law. It has been revised a number of times to address appeals, but is not likely to change within the context of microfinance in the near future (Cámara de Diputados del H. Congreso de la Unión 2007). Banco Compartamos has a powerful advantage as a regulated financial institution because it can use cheaper capital from savings to finance growth. This concept of leveraging savings is the base lending strategy of any traditional bank. By keeping a specific percentage of savings in reserves, it is able to leverage at least ten times that amount. For microfinance, that would be a useful tool in reaching more of the world’s poor while helping them create their own wealth. AlSol is doing a money guarantee program for borrowers. In this, a borrower pays a certain amount for “deposit” when they receive their loan; however, they receive 100 percent back at the loan’s
repayment date. This works in some respects like a traditional savings account, but its growth is limited by the Ley de Ahorro. AlSol provides a few more “social” services to its borrowers than Banco Compartamos. Both provide training on rules of the bank upon initial loan disbursement. AlSol has set up literacy classes for borrowers where they can learn to read and write, created business development classes that teach basic accounting for borrowers (many did not know the difference between revenues and profits), and contracted with a local hospital to give free consultations to AlSol clients. In this manner, microfinance is used as a venue to provide additional services to the poor in order to relieve more of the negative consequences of poverty.

In terms of financial structure, Banco Compartamos is able to leverage more commercial capital (41 percent) as its primary source of funds. This would include any loans from other banks, bonds issued, or equity sold. Retained profits from microborrowers represent 41 percent of the companies’ assets, development agencies and private donors represent 13 percent, and private social investors represent 5 percent. AlSol’s funding sources are 42 percent from microborrower-retained profits, 31 percent from subsidized loans or grants, and 27 percent from commercial loans. These variations of capital sources are clearly a by-product of each entity’s legal structure.

In terms of financial indicators presented in Table 2, Banco Compartamos has achieved a higher percentage in several categories (Loan Portfolio Outstanding, Return on Assets, Return on Equity, Operational and Financial Self-Sufficiency). In evaluating these numbers as well as the portfolio at risk, it would be extremely difficult to determine if the differences are due to greater efficiency or economies of scale without a more in-depth study. These indicators are also effective for identifying trends across various years. For example, increasing operational and financial self-sufficiency ratios is a positive trend. The operational self-sufficiency ratio measures the ability of institutions to cover operating costs with internally generated revenue.
The financial sustainability ratio shows the ability for institutions to cover all costs (financial, operation, cost of capital) with internally generated income. Banco Compartamos’ 20 percent ratio of total expenditures versus the 16 percent of AlSol suggests Banco Compartamos has more expenses relative to its active portfolio. It is also interesting to note that while the operating cost per borrower is much cheaper for AlSol, the cost per peso loaned is higher. This means that, theoretically, it costs less money for AlSol to operate when serving a borrower but it is more expensive to obtain the actual money lent. This could possibly be another by-product of variation in capital funding for both institutions.

Conclusions

There were a few major limitations to this study. I found some financial information to be different when compared among a variety of microfinance sources, so I only included those numbers that were verifiable or comparable between the same organization for both AlSol and Banco Compartamos. Also, with more research time and funding, a larger comparison among many institutions of both models could greatly enhance our ability to identify and learn more about whom these institutions are serving and how they are progressing. Several new social performance and poverty report cards are now being created to evaluate the outreach, impact, and success of a microfinance institution. This has not been done officially, to my knowledge, for Banco Compartamos or AlSol. The industry is moving toward a more transferable and transparent evaluation process with criteria led by rating organizations such as MicroRate, M-Crïl, Planet Rating, Standard and Poor’s, and Rating Fund. Ratings have become increasingly important for microfinance institutions so that more liquidity is created for future and existing products in the commercial market. New, innovative ways are being used to provide more capital to microfinance institutions, such as the introduction of microfinance funds like Gray Ghost
Capital or Microvest that sell their own equity, or issue debt to make loans to microfinance institutions. Large institutions like Citigroup, Morgan Stanley, and Deutsche Bank are entering into the microfinance industry with large existing infrastructure and access to cheaper capital. Another strategy to raise funds, pioneered by the Grameen Foundation USA, is called loan guarantees. Instead of donating large sums of capital consecutively, donors sign up to use their bank account balances as collateral without personal liability, so that it can be leveraged to provide more funds for institutions. The concept of microfranchises, such as the Grameen Phone, which was named one of the top ten innovations that could change the world, has proved to be a very effective way to not only influence a borrower’s success with a working “business in a box,” but a way to transform communities by influencing the kind of businesses that borrowers create with their microloans.

The poverty that exists all around the world is undoubtedly a major issue facing today’s global society. Throughout this paper, we have considered poverty from many perspectives, what factors allow it to continue, the status of the MDGs, and how the microfinance industry has grown to help millions of poor people all around the world rise from poverty with dignity. The world of microfinance is growing and developing extremely fast. Many issues must be considered as we all learn from our strategies and evaluate their results. This study helps to look at some of these issues, among the variation of microfinance models at this point in time, and within the context of two leading institutions in Mexico: Banco Compartamos and AlSol. It has been presented that each has its own position and approach in this growing industry. Although it cannot be concluded at this time which separate approach to microfinance is better in terms of poverty alleviation, I believe that each example represents an extreme position along the spectrum of microfinance. AlSol’s focus is more complete in terms of poverty alleviation.
services that address the many needs and problems clients have, while Banco Compartamos effectively reaches traditional commercial funding to provide a smaller variety of services to more people. Over time, a for-profit microfinance institution that is funded by the commercial market of socially responsible investors and funds will emerge toward the center of this same spectrum. In this case, market investment will be based on criteria of both social and economic returns, also known as the “double bottom line.” By providing a greater variety and transparency of social and economic indicators, rating agencies will provide an investor information to evaluate both returns accordingly. The participation in this way on a larger scale will also make this market of microfinance investment products more liquid and less risky. This satisfies the need for funding of additional nonprofit services offered and the need for regulation of for-profit microfinance institutions. An institution that receives a bad social evaluation would not be considered an attractive investment, because the market criterion for social investors requires both. Optimistically, with the cooperation of governments in developing social indicators and returns, these microfinance investment products might eventually provide tax benefits to the social investor, which would increase their economic return indirectly.

Microfinance has proven itself over time to be an effective poverty alleviation tool and has the ability to play a major part in “putting poverty into the museums,” as Dr. Yunus (2003) eloquently writes. This study seeks not to be critical of either method, but to look at the industry’s debate with its initial goal of poverty alleviation in mind. By continuing to work and understand what aspects must be improved for these issues to be overcome, together we can achieve a world without poverty.
References


Table 1. Comparison Indicators of a For-Profit and a Nonprofit Microfinance Organization

<table>
<thead>
<tr>
<th>Comparison Indicators</th>
<th>Compartamos (For-profit)</th>
<th>AliSol (Nonprofit)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mission Statements</td>
<td>To be a social company committed to the people. To generate development opportunities within the lower economic segments, based on innovative and efficient models on a wide scale as well as transcending values that create external and internal culture, fulfilling permanent trusting relationships and contributing to a better world.</td>
<td>To collaborate in poverty reduction in rural and semi-urban areas granting financial services to women of scarce resources with quality, responsibility, professionalism, and respect to our clients, and additionally, to support their training through specialized institutions.</td>
</tr>
<tr>
<td>Years of Existence</td>
<td>18 years</td>
<td>9 years</td>
</tr>
<tr>
<td>Type of Organization</td>
<td>Commercial Bank</td>
<td>Nongovernmental Organization</td>
</tr>
<tr>
<td>Number of Branches</td>
<td>187</td>
<td>N/A</td>
</tr>
<tr>
<td>Number of Employees</td>
<td>3,203</td>
<td>48</td>
</tr>
<tr>
<td>Number of Active Borrowers</td>
<td>705,236</td>
<td>13,753</td>
</tr>
<tr>
<td>Growth of Total Borrowers</td>
<td>14%</td>
<td>24%</td>
</tr>
<tr>
<td>Borrowers per Staff Member</td>
<td>328</td>
<td>430</td>
</tr>
<tr>
<td>Interest Rates</td>
<td>101% annually</td>
<td>51% annually</td>
</tr>
<tr>
<td>Average loan Size</td>
<td>USD $446</td>
<td>USD $176</td>
</tr>
<tr>
<td>Average Loan Balance per Borrower</td>
<td>USD $7,444</td>
<td>USD $3,083</td>
</tr>
<tr>
<td>Products/Services Offered</td>
<td>Microcredit</td>
<td>Microcredit</td>
</tr>
<tr>
<td></td>
<td>Life Insurance</td>
<td>Life Insurance</td>
</tr>
<tr>
<td></td>
<td>Savings (very new)</td>
<td>Literacy/Business Education</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Health Consultations</td>
</tr>
<tr>
<td>Organization Financial Structure</td>
<td>Private Social Investors 5%</td>
<td>Subsidized Loans/ Donors 31%</td>
</tr>
<tr>
<td>---------------------------------</td>
<td>-----------------------------</td>
<td>------------------------------</td>
</tr>
<tr>
<td></td>
<td>Retained Profits 41%</td>
<td>Commercial Loans 27%</td>
</tr>
<tr>
<td></td>
<td>Agencies/Private Donors 13%</td>
<td>Equity/ Retained Profits 42%</td>
</tr>
<tr>
<td></td>
<td>Commercial Sources 41%</td>
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</table>

Table 2. Financial Indicators of a For-Profit and a Nonprofit Microfinance Organization

<table>
<thead>
<tr>
<th>Financial Indicators</th>
<th>Compartamos</th>
<th>AlSol</th>
</tr>
</thead>
<tbody>
<tr>
<td>Gross Loan Portfolio Outstanding</td>
<td>$3,337,709,719</td>
<td>$24,118,233</td>
</tr>
<tr>
<td>Return on Assets</td>
<td>11.80%</td>
<td>7.80%</td>
</tr>
<tr>
<td>Return of Equity</td>
<td>26%</td>
<td>21%</td>
</tr>
<tr>
<td>Operational Self-Sufficiency = Financial Income / (Financial and Operation Costs + Loan Loss Provision)</td>
<td>187.97%</td>
<td>150.95%</td>
</tr>
<tr>
<td>Financial Self-Sufficiency = Financial Income / (Financial and Operation Costs + Loan Loss Provision + Imputed Cost of Capital)</td>
<td>188.00%</td>
<td>149.00%</td>
</tr>
<tr>
<td>Ratio of Total Expenditures = Financial Expenses + Operation Expenses + Loan Loss Provision / Total Active Average Portfolio</td>
<td>20%</td>
<td>16%</td>
</tr>
<tr>
<td>Cost per Borrower = Operational Expenses / Average Borrowers</td>
<td>835</td>
<td>349</td>
</tr>
<tr>
<td>Operation Cost per Peso Loaned</td>
<td>7%</td>
<td>13%</td>
</tr>
<tr>
<td>Portfolio at Risk &gt; 30-days Ratio</td>
<td>1.55</td>
<td>0.27</td>
</tr>
</tbody>
</table>

Figure 1. Government truck distributing water for community

(Photo by author)
Figure 2. Blue barrels used for water transportation to homes.

(Photo by author)
Figure 3. The battle of carrying water up to your home

(Photo by author)
Figure 4. Five million out of 9 million people in Lima, Peru

(Photo by author)