COMMERCIAL RETURNS & SOCIAL VALUE:  
THE CASE OF MICROFINANCE  

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In recent years, there has been increasing attention paid to the intersection of business and the poor, driven by two main interests. On one hand, in the business world, various longstanding barriers which effectively insulated markets have crumbled away, among them the Berlin Wall, high tariff barriers, asymmetrical access to information and prohibitively high communication costs. As a result, competition has become both global and intense --- in a flatter world,\(^1\) apparently nobody’s market dominance is safe any more. In nature, when pastures have a surfeit of grazing mouths and there are no more green valleys left, adaptable species begin to be drawn towards the previously ignored vegetation growing on the rocky sides of the mountains. From time immemorial, the pastures of the leading businesses of the world have been at the top of the socio-economic population pyramid. In response to today’s heightened global competition, a discerning observer like C.K. Pralahad exhorts the large global companies to look at The Fortune at the Bottom of the Pyramid.\(^2\)

At the same time that conventional business is beginning to look in the direction of low income populations, those that have always labored there in search of social change and economic development are starting to cast their own equally timid glance at business, seeing it for the first time as a potentially positive protagonist. Similarly, this is a result driven not by choice but by necessity. At the end of World War II, humanity embarked on what is arguably the greatest, most concerted effort ever in terms of time, treasure and intellect to eradicate poverty. Over half a century later, these efforts have resulted in colossal institutions such as the World Bank and the United Nations and a proliferation of bilateral and multilateral development banks and agencies, through which to one degree or another virtually every developing nation has been touched. To this has been added the significant resources injected by philanthropy and civil society via foundations, nongovernmental organizations (NGOs) and private citizens. Despite instances of success, after six decades the prevailing feeling is that poverty still holds the upper hand. In this struggle, business --- the one sector that even its detractors recognize as characterized by effectiveness in obtaining results --- has been largely absent. Under these circumstances, whether there is an appropriate role for business in responding to global poverty is a question that is beginning to be asked with increasing expectations.

\(^1\) In the sense coined by Thomas L. Friedman in his book The World is Flat: A Brief History of the Twenty-First Century (New York, NY: Farrar, Straus & Giroux, 2005)
One of the principal innovations that has given weight to this line of inquiry is the emergence in the developing world of commercial microfinance: the provision of financial services to low income populations on a financially sustainable basis. This is mainly associated with microcredit and the mobilization of savings, but includes all other forms of financial services, such as housing loans, equipment leasing, insurance and remittances. It is an element that is being introduced into the lives of the poor in increasing numbers as successful microfinance institutions continue expanding at very fast rates. In the process, microfinance has become a force difficult to ignore by the social sector, either as a factor encountered on the streets of the poor or in meetings with development agencies, the donor community and governments. At the same time, with almost all the leading microfinance institutions no longer NGOs but financial entities regulated by national banking authorities, the results of their operations have become a matter of public record. The credibility of data provided under oversight frameworks that mandate the quality and transparency of the information has allowed the business sector to both discover the financial performance of microfinance and ascertain its economic viability. In addition, modern microfinance is not a recent phenomenon --- it has been developing for over 30 years, with the commercial form only its latest expression, and so has acquired the legitimacy of longevity. Accordingly, microfinance is well suited as a natural point of departure in understanding the convergence of the social and the commercial. The depth and breadth of the field makes it fertile ground to pose the key questions that are relevant to any business enterprise dedicated to serving low income populations. At the heart of the inquiry lies the fundamental question: can an activity catering to the poor create simultaneously both commercial and social value?

To arrive at a conclusion, this paper examines various fundamental aspects of microfinance. From the perspective of commercial value, it seeks to answer the following questions:

- Is the base of the pyramid a legitimate commercial market? Can it sustain levels of profitability that are comparable to those obtained at the top of the pyramid?
- Are the poor a distinctly separate segment or are they part of a continuous market in which relatively minor adjustments to existing business models are sufficient to serve them effectively?
- How has the business model of successful microfinance evolved? Are models at the base of the pyramid essentially stable after a “killer” concept opens the market or is constant change the more likely pattern?
- Are the key success factors of commercial microfinance generalizable across geographical boundaries and cultures or are they location-specific?

From the perspective of social value, the paper takes an initial step in examining the following questions:
• How is social value created by microfinance, and is it similar to the ways it is
generated by other businesses at the base of the pyramid? Are there common
measurements for the social value created by any business?
• How can the effectiveness of microfinance as a response to poverty be assessed?
How can it be evaluated in relation to other types of initiatives seeking the same
end?

From the perspective of the joint creation of commercial and social value, the paper
looks at the following issue:

• What is the role of economic returns in the fight against poverty? Does the
concept of a “fair” economic return make sense when doing business with the
poor? When is the creation of economic value and social value antagonistic and
when is it complementary? When do high business returns contribute to reducing
poverty and when do they increase it?

While the answers in this paper are specific to microfinance, they contain insights that are
applicable to any commercial enterprise operating in low income markets.

THE CREATION OF COMMERCIAL VALUE

Microfinance as a Legitimate Commercial Market

Since its earliest days, the study of microfinance has been burdened by a
particular complication: it is an activity centered on the poor. As a result, it is difficult for
analysts not to enter the field with preconceptions about poverty, imbuing microfinance
with their own fears and hopes, and notions of success. In the 1970s, when modern
microfinance got started, it was severely and harshly criticized by the development
community in Latin America for an approach advocating not only charging interest on
the loans to the poor but setting them at levels calculated to cover all costs plus inflation.
The prevailing view then was that the poor needed and deserved subsidies. Thirty plus
years later, the pendulum has swung to the other end, where business at the base of the
pyramid is beginning to be fashionable in vanguard circles, a sign of both smart
management and advanced social responsibility. This underscores the need for rigor in
the analysis of any commercial approach targeted at the poor, at both ends. The creation
of social value cannot be taken at face value, but neither can any delivery of goods and
services to the poor at a price be considered, without scrutiny, bona fide business.

At its most basic, for an activity to be part of business, it must be able to generate
a revenue stream sufficient to cover all the related expenses and yield a surplus. No
matter how traditional or unconventional, whether practiced for millennia or just a spark
in the eye of an innovator, an activity that exhibits these characteristics or seeks to have
them in the future is in the realm of business. In addition, to this static definition must be added the element of time: profitability needs to be sustained, to make certain the attributes of business are not the result of a temporary accident. A third element is the level of profitability: over time, the activity must generate financial returns at least equal to the average of those with similar risk profiles so as to attract and retain the capital necessary to sustain it. Failing that, even when revenues may exceed costs, economic rationality will dictate that the surplus produced will migrate elsewhere, causing the activity to eventually become unsustainable. At times, conscious decisions are made to continue with an activity regardless of its sub-performance. An acceptance of unprofitability or subprofitability as a steady state condition removes the activity from business to other areas of human endeavor, such as social enterprise, corporate social responsibility, philanthropy, politics or personal hobby. This is regardless of the type of the organization undertaking the activity. A stand-alone unprofitable or subprofitable line of activity that exists permanently within a large multinational corporation does not mean that it is a business itself. On the other hand, an activity within a nonprofit charitable organization that permanently generates market levels of profitability is part of the business sector, whether it likes it or not.

Despite the large number of organizations that currently deploy one or another microfinance product, whether microfinance can meet the standard of sustainable, market-level profitability is a question to pose to a relatively small group of institutions that for all intents and purposes define the market. As has been noted,

A rough rule of thumb in the field places the total number of entities in the world providing some form of microfinance in the range of 7,000 to 12,000. It is probable that virtually all the significant share of any relevant measure --- size of assets, number of loans, annual growth, earnings, financial returns --- is concentrated in no more than fifty MFIs [microfinance institutions]. This, again, is typical of the development of an industry. While there may be many entrants, the direction of the new field is set by the handful of leaders. Accordingly, in looking at the future of microfinance, the relevant starting point is the industry as it has been defined by this core of leading MFIs.

These leaders, with few exceptions, operate under general charters and statutory frameworks established by the national banking or financial authorities of their respective countries. This is irrespective of their origins. Some evolved from NGOs that pioneered

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3 This is not to imply in any way that it is improper for corporations to be involved with social initiatives. Increasingly, commercial enterprises are seeking such involvement, either on an in-house basis or in partnership with civil society organizations. These social activities by themselves may not be profitable, or even revenue-bearing, but when they are integrated into the corporation’s core business, they become part of how the corporation goes to market and hence a part of the business and its cost structure. On the other hand, if a corporation launches a line of business directed at the base of the pyramid and continues it for the long run in the face of unprofitability or subprofitability, it cannot be considered as part of business, unless it is somehow integrated to the core economics of the firm.

the practice, and in time exchanged their role from direct operators to shareholders once
the financial institutions were created; others are financial institutions newly formed to
enter the field; yet others are specialized subsidiaries or divisions of traditional
commercial banks diversifying into a new segment, and one is the reincarnation of a
state-owned failing agricultural bank. All have grown rapidly, both in terms of number of
clients and volume of assets, and represent the dominant microfinance presences in their
markets. This group is also the source of the best practices in the industry in terms of
market penetration, innovation, cost efficiency, profitability and solvency.

In Latin America, a comprehensive study of microfinance estimated that out of
3.3 million active clients in the region at December 2004, 2.4 million or 73.3% were
accounted for by regulated banks and microfinance institutions. This concentration is
even higher in terms of loan portfolio. Out of an estimated $3.35 billion in loan balances
outstanding at year-end 2004, the regulated entities accounted for $2.97 billion or 89%. The
activities of these institutions and their leading NGO colleagues take place in the
low-income urban neighborhoods, and some rural areas, across the region. The loans are
disbursed to merchants in open-air markets, metal fabricators producing pots and pans
from their backyards, bakers with ovens off unpaved streets, weavers in adobe huts and
women selling their wares by the side of the road. Do these activities meet the standards
of commercial business?

The same study reported that in 2004 non-bank regulated single-purpose
institutions in microfinance earned a return on assets (ROA) of 3.5%, with a return on
equity (ROE) of 19.5%. Commercial banks engaged in microfinance earned a ROA of
4.2%, with a ROE of 31.2%. Surveyed NGOs, representing the largest and most efficient
in the region, actually showed a higher ROA of 5.6%, but with less capability to assume
leverage, the resulting ROE was lower at 13.2%. In comparison, conventional
commercial banking in Latin America in 2004 yielded an average ROA of 1.6% and a
ROE of 16.5% (see Table 1).

Table 1. Financial Returns of Microfinance and Conventional Banking in Latin America

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Microfinance</td>
<td></td>
<td>ROA</td>
<td>ROE</td>
</tr>
<tr>
<td>• NGOs</td>
<td>5.60%</td>
<td>13.20%</td>
<td></td>
</tr>
<tr>
<td>• Regulated finance companies</td>
<td>3.50%</td>
<td>19.50%</td>
<td></td>
</tr>
<tr>
<td>• Commercial Banks</td>
<td>4.20%</td>
<td>31.20%</td>
<td></td>
</tr>
<tr>
<td>Conventional Banking</td>
<td>1.60%</td>
<td>16.50%</td>
<td></td>
</tr>
</tbody>
</table>


6 Ibid, p. 11.
7 Worldscope
The top performers in Latin American microfinance performed substantially better. Taking a three-year mean (2002-2004) to smooth out the results of 2004 as an above-average year of economic recovery for the region, Table 2 shows that for the top 12 performers, the average ROE was 33.2%, ranging from a high of 52.2% to a low of 23.4%. By contrast, the universe of commercial banks in Latin America during this period had an average ROE of 11.2%. In a recent comprehensive overview of microfinance in *The Economist*, the journal made the same point in a table showing that, even considering a limited universe of only the microfinance institutions rated by specialist MicroRate, in 2004 there were 17 entities with ROEs that “outshone” Citigroup.

<table>
<thead>
<tr>
<th>Microfinance Institutions - Most Profitable</th>
<th>Type</th>
<th>Country</th>
<th>Average ROE 2002 - 2004</th>
</tr>
</thead>
<tbody>
<tr>
<td>BancoSol</td>
<td>RU</td>
<td>Bolivia</td>
<td>26.3%</td>
</tr>
<tr>
<td>Credife (Banco de Pichincha)</td>
<td>RD</td>
<td>Ecuador</td>
<td>50.9%</td>
</tr>
<tr>
<td>Compartamos</td>
<td>RU</td>
<td>Mexico</td>
<td>52.2%</td>
</tr>
<tr>
<td>Confía Banco Procredit</td>
<td>RU</td>
<td>Nicaragua</td>
<td>39.3%</td>
</tr>
<tr>
<td>Banco del Trabajo</td>
<td>RD</td>
<td>Peru</td>
<td>33.8%</td>
</tr>
<tr>
<td>Findesa</td>
<td>RU</td>
<td>Nicaragua</td>
<td>32.0%</td>
</tr>
<tr>
<td>Fundación WWB / Cali</td>
<td>NGO</td>
<td>Colombia</td>
<td>31.5%</td>
</tr>
<tr>
<td>Edpyme Crear Arequipa</td>
<td>RU</td>
<td>Peru</td>
<td>29.7%</td>
</tr>
<tr>
<td>BanGente</td>
<td>RD</td>
<td>Venezuela</td>
<td>29.0%</td>
</tr>
<tr>
<td>Banco Solidario</td>
<td>RD</td>
<td>Ecuador</td>
<td>25.2%</td>
</tr>
<tr>
<td>FIE</td>
<td>RU</td>
<td>Bolivia</td>
<td>25.2%</td>
</tr>
<tr>
<td>Sogesol</td>
<td>RD</td>
<td>Haiti</td>
<td>23.4%</td>
</tr>
<tr>
<td>Simple Average</td>
<td></td>
<td></td>
<td>33.2%</td>
</tr>
<tr>
<td>Conventional Banking</td>
<td></td>
<td></td>
<td>11.2%</td>
</tr>
</tbody>
</table>

RU: Regulated “Upgrading”  
RD: Regulated “Downscaling”  
NGO: Non Governmental Organization


Just as important, the profitability of these Latin American microfinance leaders has survived the test of time. Banco Solidario S.A. of Bolivia, or BancoSol as it is known around the world, the first commercial bank chartered under the regular banking laws of its country solely dedicated to the base of the socio-economic pyramid, has operated in the black ever since its founding in 1992. While it has had its ups and downs, particularly at the onset of the intense competitive pressure that characterizes the Bolivian microfinance market, BancoSol both in the late 1990s and in recent years has ranked among the most profitable and solvent institutions in the Bolivian financial system.

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8 Simple average, not weighted for asset volume.  
9 Marulanda & Otero, Profile of Microfinance, p. 12.  
10 Worldscope, simple average of the years.  
While BancoSol’s performance may be the most widely known, it is not an isolated case in Bolivia. The data compiled by ASOFIN, the industry association for regulated microfinance institutions that includes the leading industry players$^{12}$ accounting for 84% of the microcredit loan portfolio of Bolivia,$^{13}$ indicates that:

- In 2004, an extremely difficult year for Bolivia in general,$^{14}$ all the ASOFIN members were profitable, with five institutions earning double-digit ROE, led by BancoSol (22.6%) and FFP FIE (24.7%). In the same period, the conventional Bolivian banking system$^{15}$ reported a loss, resulting in a negative ROE of 2.2% (see Table 3).
- For the first nine months of 2005, the conventional banking system returned to profitability, with an ROE of 3.4%. While one ASOFIN member was operating in the red, three continued to earn double-digit ROEs, with the leader, BancoSol, generating an ROE 6.4x that of conventional banking (see Table 3).

**Table 3. Microfinance & other Finance Institutions: Bolivia**

<table>
<thead>
<tr>
<th></th>
<th>Returns on Equity</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31-Dec-04</td>
</tr>
<tr>
<td>Asofin</td>
<td></td>
</tr>
<tr>
<td>BancoSol</td>
<td>22.6%</td>
</tr>
<tr>
<td>Banco Los Andes</td>
<td>12.4%</td>
</tr>
<tr>
<td>FIE</td>
<td>24.7%</td>
</tr>
<tr>
<td>Prodem</td>
<td>18.6%</td>
</tr>
<tr>
<td>Eco Futuro</td>
<td>4.1%</td>
</tr>
<tr>
<td>Fortaleza</td>
<td>5.5%</td>
</tr>
<tr>
<td>Fassil</td>
<td>13.1%</td>
</tr>
<tr>
<td>Agro Capital</td>
<td>2.3%</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>-2.2%</td>
</tr>
<tr>
<td>Cooperatives - open</td>
<td>7.5%</td>
</tr>
<tr>
<td>Cooperatives - closed</td>
<td>13.4%</td>
</tr>
</tbody>
</table>

Source: ASOFIN

- This difference in profitability was not at the expense of asset quality. The ASOFIN members, both for 2004 and the first nine months of 2005, had late payment to gross loan portfolio ratios in the low single digits (from 2.05% to 6.57%), while the same ratio for conventional banking was above 14% (see Table 4). Often, the comparison between microfinance and regular banking is made difficult by potentially wide differences in the way similar financial terms are

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$^{12}$ Asociación de Entidades Financieras Especializadas en Micro Finanzas, La Paz, Bolivia, whose members are: BancoSol and Banco Los Andes ProCredit (banks); EcoFuturo, Fie S.A., Prodem, Fortaleza and Fácil (fondos financieros privados or FFPs, regulated institutions chartered as single-purpose microfinance entities); and AgroCapital (FFP license pending). Website: www.asofinbolivia.com


$^{14}$ The year was marked by severe political upheaval, with major highways cut, isolating key cities, leading to the economic standstill of the country and the ousting of the constitutionally-elect President.

$^{15}$ Excluding the two microfinance banks: BancoSol and Banco Los Andes Procredit.
applied, but in this case all institutions, ASOFIN members and conventional banks alike, are reporting to the Bolivian Superintendency of Banks using uniform definitions, under a system where misreporting carries penal liabilities.

Table 4. Microfinance & other Finance Institutions: Bolivia

<table>
<thead>
<tr>
<th></th>
<th>Late Payments / Gross Loan Portfolio</th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>31-Dec-04</td>
<td>30-Sep-05</td>
</tr>
<tr>
<td>Asofin</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>BancoSol</td>
<td>3.69%</td>
<td>4.10%</td>
<td></td>
</tr>
<tr>
<td>Banco Los Andes</td>
<td>2.44%</td>
<td>2.09%</td>
<td></td>
</tr>
<tr>
<td>FIE</td>
<td>2.62%</td>
<td>2.05%</td>
<td></td>
</tr>
<tr>
<td>Prodem</td>
<td>2.14%</td>
<td>2.50%</td>
<td></td>
</tr>
<tr>
<td>Eco Futuro</td>
<td>3.47%</td>
<td>3.22%</td>
<td></td>
</tr>
<tr>
<td>Fortaleza</td>
<td>4.21%</td>
<td>4.35%</td>
<td></td>
</tr>
<tr>
<td>Fassil</td>
<td>4.39%</td>
<td>2.17%</td>
<td></td>
</tr>
<tr>
<td>Agro Capital</td>
<td>5.67%</td>
<td>6.57%</td>
<td></td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>14.50%</td>
<td>14.87%</td>
<td></td>
</tr>
<tr>
<td>Cooperatives - open</td>
<td>8.93%</td>
<td>8.41%</td>
<td></td>
</tr>
<tr>
<td>Cooperatives - closed</td>
<td>9.98%</td>
<td>10.21%</td>
<td></td>
</tr>
</tbody>
</table>

Source: ASOFIN

- In arriving at the profitability and asset quality indicators above, the income statements of the ASOFIN members already reflect a higher provisioning for late payments than that taken by the conventional banks. Seven of the eight ASOFIN institutions have provisioned significantly above 100% of their late payments (with one member, FFP FIE, providing for them 3x over) compared to 85.5% for the traditional banks at year-end 2004, and 75.5% at the end of September 30, 2005 (see Table 5).

By demonstrating that it can consistently generate returns superior to banking at the top of the pyramid, microfinance in Latin America has gradually gained acceptance as a legitimate component of the business sector. Reflecting this, microfinance institutions have begun to participate directly in the bond markets. Two recent examples are Financiera Compartamos in Mexico and Mibanco in Peru.

Financiera Compartamos, with 402,000 active clients and a loan portfolio of $144.3 million at September 30, 2005, is the largest microfinance institution in Latin

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16 For example, Bank Grameen arrears rate includes only amounts overdue after at least a year (see Marguerite S. Robinson, *The Microfinance Revolution: Sustainable Finance for the Poor* (Washington, DC: The World Bank: 2001), p. 93, Table 2.8.
17 Financiera Compartamos is a SOFOL (*Sociedad Financiera con Objetivo Limitado*), a single-purpose finance company licensed and regulated by the Mexican Superintendency of Banks. It is not permitted to take deposits from the public.
18 The discussion that follows is based on Cesar Lopez, “Microfinance approaches the bond market – the cases of Mibanco and Compartamos” in *Small Enterprise Development Vol. 16, No. 1, March 2005*, pp. 50-56.
19 Source: Financiera Compartamos, via ACCION International
America. It is among the top-earning microfinance entities in the world, with an ROE in 2004 of 48.5%\textsuperscript{20}, while its client base continues to be predominantly rural and to which it lends an average outstanding loan of $359.\textsuperscript{21} In July 2002, Compartamos made a private placement of $15.0 million in local currency 3-year bonds through Banamex-Citibank, at Mexican treasury rate + 250 basis points. Later on in the year, it followed with a supplemental placement of $5 million, under the same terms. In 2003, Compartamos entered into the market again to place $5.0 million, extending the term to 3.5 years, at a slightly higher price of Mexican treasury rate + 290 basis points. In 2004, Compartamos launched a $50 million bond program, with a first tranche of $19 million, pushing the maturity to five years.

**Table 5. Microfinance & other Finance Institutions: Bolivia**

<table>
<thead>
<tr>
<th></th>
<th>Loan Loss Provisions / Late Payments</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>31-Dec-04</td>
</tr>
<tr>
<td>Asofin</td>
<td></td>
</tr>
<tr>
<td>BancoSol</td>
<td>151.5%</td>
</tr>
<tr>
<td>Banco Los Andes</td>
<td>177.3%</td>
</tr>
<tr>
<td>FIE</td>
<td>265.5%</td>
</tr>
<tr>
<td>Prodem</td>
<td>181.0%</td>
</tr>
<tr>
<td>Eco Futuro</td>
<td>142.2%</td>
</tr>
<tr>
<td>Fortaleza</td>
<td>91.1%</td>
</tr>
<tr>
<td>Fassil</td>
<td>134.3%</td>
</tr>
<tr>
<td>Agro Capital</td>
<td>146.3%</td>
</tr>
<tr>
<td>Conventional Banks</td>
<td>85.5%</td>
</tr>
<tr>
<td>Cooperatives - open</td>
<td>116.1%</td>
</tr>
<tr>
<td>Cooperatives - closed</td>
<td>119.6%</td>
</tr>
</tbody>
</table>

Source: ASOFIN

Mibanco, a commercial bank established in 1998 from the pioneering microcredit work of its predecessor NGO, had 138,700 active clients and a loan portfolio of $180.5 million at September 30, 2005,\textsuperscript{22} with an average ROE for the period 2002-2004 of 23%, a profitability “well above the average for the Peruvian banking sector during the same period.”\textsuperscript{23} In December 2002, it issued $5.8 million in local currency 2-year corporate bonds into the Peruvian capital markets via Dutch auction, at a fixed interest rate of 12.0%. In September 2003, Mibanco issued another $5.8 million of bonds, extending the maturity to 2 years and 3 months, but at a significantly lower rate of 5.75%. A month later, it followed it with a $2.9 million issue of 18 month paper at the same pricing. Table 6 summarizes the bond market activity of Compartamos and Mibanco. From this experience, the following observations can be made:

\textsuperscript{20} MIX Market, www.mixmarket.org.
\textsuperscript{21} At September 30, 2005 - Source: Financiera Compartamos, via ACCION International
\textsuperscript{22} Source: Mibanco, via ACCION International
\textsuperscript{23} Cesar Lopez, “Microfinance approaches the bond market”, p. 53.
Table 6. Results of the Compartamos and Mibanco bond issues

<table>
<thead>
<tr>
<th>Compartamos Bond Issues</th>
<th>1st - 2nd</th>
<th>3rd</th>
<th>4th</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue:</td>
<td>$15 M</td>
<td>$5 M</td>
<td>$19 M</td>
</tr>
<tr>
<td>Coupon</td>
<td>CETES + 250 bps</td>
<td>CETES + 290 bps</td>
<td>NA</td>
</tr>
<tr>
<td>Rating</td>
<td>MX A+</td>
<td>MX A+</td>
<td>MX AA</td>
</tr>
<tr>
<td>Tenor</td>
<td>3 yrs</td>
<td>42 months</td>
<td>5 yrs</td>
</tr>
<tr>
<td>Placements:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sale Mechanism</td>
<td>Private placement</td>
<td>Private placement</td>
<td>Private placement</td>
</tr>
<tr>
<td>Credit Enhancement</td>
<td>None</td>
<td>None</td>
<td>34% guarantee IFC</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Mibanco Bond Issues</th>
<th>1st</th>
<th>2nd</th>
<th>3rd</th>
</tr>
</thead>
<tbody>
<tr>
<td>Issue:</td>
<td>$5.8 M</td>
<td>$5.8 M</td>
<td>$2.9 M</td>
</tr>
<tr>
<td>Amount demanded</td>
<td>$6.38 M</td>
<td>$12.7 M</td>
<td>$4.93 M</td>
</tr>
<tr>
<td>Tenor</td>
<td>2 yrs</td>
<td>2 yrs 3 months</td>
<td>1 yr 6 months</td>
</tr>
<tr>
<td>Interest Rate</td>
<td>12% p.a.</td>
<td>5.75%</td>
<td>5.75%</td>
</tr>
<tr>
<td>Rating</td>
<td>AA</td>
<td>AA</td>
<td>AA-, A+</td>
</tr>
<tr>
<td>Placements:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mutual funds</td>
<td>17.5%</td>
<td>32.5%</td>
<td>21.1%</td>
</tr>
<tr>
<td>Public entities</td>
<td>28.8%</td>
<td>59.4%</td>
<td></td>
</tr>
<tr>
<td>Pension funds</td>
<td>82.5%</td>
<td>26.2%</td>
<td>19.5%</td>
</tr>
<tr>
<td>Banks</td>
<td>10.0%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Insurance agencies</td>
<td>2.5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>TOTAL</td>
<td>100%</td>
<td>100%</td>
<td>100%</td>
</tr>
<tr>
<td>Credit Enhancement</td>
<td>50% USAID</td>
<td>50% CAF</td>
<td>None</td>
</tr>
</tbody>
</table>


- The bond markets welcomed microfinance. In all seven instances, the Compartamos and Mibanco issues were oversubscribed. As the market got to know the issuer, the oversubscription was significant, reaching 219% and 170% in the last two issues of Mibanco.
- The bond markets in Mexico and Peru have come to accept microfinance institutions on a stand-alone basis. Compartamos made its first three issues without any credit enhancement at all, going to a partial 34% guarantee only when it expanded its program to $50 million, extended the maturity of its bonds to 5 years and wanted to make sure it accessed the institutional market. Mibanco issued its first and second bonds with a 50% guarantee, but went with no credit enhancement in its last round, with only a marginal drop in rating and no meaningful decline in buyer interest.
- Buyers of microfinance bonds reflect the normal universe of the bond capital market: pension funds, mutual funds, public entities, insurance companies, banks. The purchasers of Compartamos and Mibanco bonds did not show a

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24 Author’s conversations with Carlos Labarthe, Director General, and Carlos Danel, Co-Director General of Financiera Compartamos.
particular predisposition towards social issues but appear to have made their
decision on purely economic grounds. The marketing efforts were
conventional and included such standbys as roadshows and the usual materials
such as prospectuses and private placement memoranda.

- Traditional rating agencies, both international\textsuperscript{25} and local, are already serving
  microfinance. This extends a practice that began in the late 1990s, when these
  rating services started to qualify the leading regulated microfinance
  institutions as part of their coverage of the banking sector.\textsuperscript{26}
- The goals of the two microfinance issuers were similar to that of conventional
  corporate issuers (lower borrowing costs, diversification of funding sources,
  extension of maturities in the capital structure) and these objectives were
  amply met. For instance, Mibanco lowered its total funding costs on average
  by 50 basis points; Compartamos accessed debt at 450 basis points lower than
  the available commercial bank lines of credit.\textsuperscript{27}

The successful experience of Compartamos and Mibanco followed in the path of
BancoSol, which issued $5 million in dollar-denominated 2-year bonds at 13%, credit-
enhanced by a 50% guarantee provided by USAID, in March 1996.

If profitability is the minimum requirement for admissions into the world of \textit{bona
fide} business and access to bond markets one of its privileges, full membership in the
club may be acceptance as an asset class suitable for equity investment. Various
microfinance banks are, in a formal sense, public --- their shares are registered in the
stock exchange of their country. An example of this is BancoSol. But the exchanges they
are listed on are so illiquid that the shares trade “by appointment only” and in practice
they remain private corporations. One notable exception is Bank Rakyat of Indonesia,
where microfinance is a major component --- and some would say the most important
source of its profits --- which launched an initial public offering in 2003 that gave it a
truly public listing. Notwithstanding, for all intents and purposes, microfinance equity
transactions, whether at founding or subsequently, have virtually all been privately
negotiated deals. Up to now, the major investors have been NGOs, multilateral
development organizations and governments, with some participation by sophisticated
socially-responsible private investors. These protagonists have acted alone and through
specialized equity investment funds, whose numbers have been growing in recent years.
The first of these was formed in 1995 through an initiative headed by ACCION
International, Calmeadow of Canada, FUNDES of Switzerland and SIDI of France. This
effort

raised $23 million to create Profund, a Latin American investment pool intended
to demonstrate that investing in microfinance could be commercially viable. It
was designed to run for ten years, and true to its mission it sold off its last
investment [in the] summer [of 2005]. By liquidating its portfolio and turning it

\textsuperscript{25} Standard & Poor’s, Moody’s and Fitch are all involved.
\textsuperscript{26} The rating of microfinance institutions, including those that are not as visible to the traditional rating
services, was pioneered by specialists such as MicroRate (www.microrate.com).
\textsuperscript{27} Lopez, “Microfinance approaches the bond market”, pp. 55-56.
into real cash, it became a yardstick for the investment performance of a microfinance institution.\textsuperscript{28}

By November 2005, Profund had either fully realized or sold but not yet collected on the sale of all its assets.\textsuperscript{29} On that basis, fund management estimated that the annualized internal rate of return over the ten years of the fund would be 6.61\%.\textsuperscript{30} As \textit{The Economist} put it,

At first sight, its returns look unexciting … But on closer examination, this was a remarkable performance. All of Profund’s capital was contributed in dollars and then invested in local currency. In every country it operated in, its dollar returns were reduced by local currency depreciations, reflecting the economic chaos in much of Latin America during the decade.\textsuperscript{31}

In fact, to gauge the performance of microfinance equity investing compared to conventional asset categories, a more appropriate measure is, not absolute returns, but the position of Profund relative to the other equity funds deployed during the same time in the emerging markets. Applying this criterion, the IFC,\textsuperscript{32} a Profund investor, has calculated that:

- Against a widely-accepted industry benchmark of emerging markets venture capital and equity funds raised in 1995, Profund’s IRR of 6.61\% placed it squarely in the top quartile. In this universe of 14 funds, the pooled mean return to investors was a loss of 0.37\% and the median was a loss of 0.60\%. The lower quartile returned a negative 8.27\%.
- There were only two other funds that provided a higher return to their investors, and the top performer returned 12.16\%.

Profund’s accomplishment is all the more remarkable when consideration is given to the small size of the fund, $23 million. Because of this, management costs represented a larger proportion of the funds under management than normal. Profund’s IRR before operating and financial expenses was 9.03\%.\textsuperscript{33}

Superior returns generated by serving the financial needs of the poor can also be found outside of Latin America. Perhaps the most successful microfinance institution in the world is also one of the least known by the general public, Bank Rakyat of Indonesia (BRI). A wholly state-owned bank until its partial privatization in 2003, it is also the oldest bank in Indonesia, tracing its origins to 1895. In the early 1970s, BRI developed an extensive national infrastructure reaching deep into rural areas to deploy agrarian credit

\textsuperscript{28} The Economist, \textit{Hidden Wealth}, pp. 8-9.
\textsuperscript{29} As of November 3, 2005, Profund was in the process of collecting the cash proceeds related to its last sales of assets.
\textsuperscript{31} The Economist, \textit{Hidden Wealth}, p. 9.
\textsuperscript{32} Source: The International Finance Corporation of the World Bank, information shared at Profund meeting, November 3, 2005.
\textsuperscript{33} Profund, \textit{Presentation to Shareholders}, November 3, 2005.
as part of Indonesia’s drive for rice self-sufficiency. This became the framework for what today is its formidable microfinance operation. At June 30, 2003 BRI’s assets totaled $11.1 billion, of which $5.7 billion represented government bonds, cash and securities, and $5.3 billion was the gross loan portfolio. Of that, $1.6 billion fell in what the bank calls its microloan portfolio (representing 3 million loans with an average balance of $532). On the other side of the balance sheet, BRI funds itself with $9.0 billion in deposits, of which $3.0 billion is captured by its rural and urban microfinance operations in 29 million accounts. This base of business provided outstanding returns: for the years 2001, 2002 and the first six months of 2003, BRI had ROAs of 1.5%, 1.9% and 2.7%, yielding ROEs of 24.0%, 28.2% and 38.3%, respectively. With this level of financial return and the size of its operations, BRI has been able to spearhead microfinance in many ways. Mention has already been made of BRI as the first institution identified with microfinance to be publicly listed. In September 2003, it also went into the global capital markets to issue $150 million of Subordinated Notes due 2013. As in Mexico and Peru, both BRI equity and debt issues were oversubscribed.

Financially successful microfinance institutions are to be found also in Africa and Eastern Europe. One of them is Uganda Microfinance Limited (UMU), a local NGO founded in August 1997 which achieved break even in 2001. The following year it reported a ROA of 4.3% and a ROE of 12.7%. In 2003, it had increased that to a reported ROA of 12.36% and ROE of 48.4%. While returns for 2004 were not publicly available, the level of profitability continued to be superior. At year-end 2003 UMU had 28,099 active borrowers and 47,529 active savers. In July 2005, UMU obtained a license from the Central Bank as a Microfinance Deposit Taking Institution and became a regulated institution. Another African example is K-Rep Bank Limited, the first microfinance bank in Kenya licensed in 1999. Its return on capital employed has been 7.69% in 2001, 9.89% in 2002, 11.55% in 2003 and 9.93% in 2004. In Eastern Europe and elsewhere, the experience of the Pro Credit banks, the network in 14 countries connected to Internationale Projekt Consult GmbH (IPC), has also been profitable. A recent review of the group found that “Overall, the return on equity of the banks in the network, measured in book value terms and weighted by the banks’ equity, is above 10 per cent.”

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35 PT Bank Rakyat Indonesia (Persero), *Offering Circular*, October 31, 2003, p. 39
36 Idem, p. 75 and p. 81
37 Idem, p. 81. The number of savings accounts are not equivalent to number of clients, as customers may have more than one account.
39 Idem, p. 37.
41 UMU website, www.umu.co.ug
Looking to capitalize on the potential of these new entities to create economic returns based on serving the poor, several equity investment funds focused on microfinance have followed Profund’s trail. The second one was ACCION’s Gateway Fund, an experience that subsequently led to the creation in 2003 of ACCION Investments in Microfinance SPC, targeted at both Latin America and Africa, and currently in the process of extending its reach globally. Another leading microfinance investment fund is ProCredit-Holding AG (formerly Internationale Micro Investitionen AG), seeking to extend the ProCredit bank network world-wide. Others are regionally focused, such as AfriCap in Africa. Recently, three microfinance funds have started operations in India, with eight more likely to come in the next two years, including veteran ACCION.44

The expansion of microfinance to Africa and Eastern Europe reflects the impact of the intellectual capital accumulated in three decades of development in Latin America and Asia. Shaped into a body of expertise and transmitted by the industry’s management consultants such as ACCION International, IPC, ShoreBank and others, it has allowed African and Eastern European microfinance operators to achieve in a few years levels of commercial profitability that took Latin Americans and Asians decades to reach.45 This is of fundamental importance, as the field will continue for the foreseeable future to be mostly populated by an overwhelming number of microfinance operations that are economically unsustainable and for whom providing financial products to the poor is not a business enterprise but an extension of social services. Periodic shakeouts, the usual evolutionary mechanism through which new industries advance, are hard to come by when donor funds, with the best of intentions, continue to play primitive roles. Accordingly, the assurance that, regardless of geography, leaders of microfinance can and will continue to meet the most stringent definitions of business is the final guarantee that serving the financial needs of low income people is a legitimate commercial market.

Microfinance as a Separate Commercial Segment

The single most important factor behind the commercial returns obtained by microfinance has been the ability to charge prices that more than cover the extraordinarily high costs per unit when the average size of the transaction (whether credit, savings, insurance or any other product) is so small. Table 7, showing the effective annual interest rates of a handful of Latin American microfinance institutions rated by specialist MicroRate, drives home this point: the price of credit for the poor in the region ranges from the low 20s% to just under 90%. What this may mean in social terms will be addressed later. In terms of understanding the creation of commercial value at the base of the pyramid, given the enormous disparity between these rates and those prevalent at the top of the pyramid, a relevant question may be why this difference can exist and for how

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44 Wall Street Journal, “Funds Flock to India in Effort To Tap Robust Loan Demand”, November 16, 2005, p. B4A.
45 Taking into consideration, as is necessary, the years of development prior to achieving commercial sustainability, a task pioneered by NGOs, foundations, nonprofit specialists and, in the case of BRI, an agrarian credit state bank.
long can it be sustained? And if these rates seem exorbitantly high from the perspective of the affluent, how is it that they can be paid by the poor?

Table 7. Average Interest Rates for Microfinance Loans in Latin America
Institutions rated by Microrate as of December 31, 2004

<table>
<thead>
<tr>
<th>Institution</th>
<th>Country</th>
<th>Effective Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Compartamos</td>
<td>Mexico</td>
<td>87.50%</td>
</tr>
<tr>
<td>Fincomun</td>
<td>Mexico</td>
<td>80.22%</td>
</tr>
<tr>
<td>D-Miro</td>
<td>Ecuador</td>
<td>46.08%</td>
</tr>
<tr>
<td>WWB Popayan</td>
<td>Colombia</td>
<td>41.85%</td>
</tr>
<tr>
<td>Procredit</td>
<td>Nicaragua</td>
<td>41.27%</td>
</tr>
<tr>
<td>Findesa</td>
<td>Nicaragua</td>
<td>40.79%</td>
</tr>
<tr>
<td>Proempresa</td>
<td>Peru</td>
<td>40.73%</td>
</tr>
<tr>
<td>WWB Bucaramanga</td>
<td>Colombia</td>
<td>40.70%</td>
</tr>
<tr>
<td>Crear Arequipa</td>
<td>Peru</td>
<td>40.45%</td>
</tr>
<tr>
<td>WWB Bogota</td>
<td>Colombia</td>
<td>38.92%</td>
</tr>
<tr>
<td>WWB Medellin</td>
<td>Colombia</td>
<td>38.89%</td>
</tr>
<tr>
<td>CMAC Sullana</td>
<td>Peru</td>
<td>37.65%</td>
</tr>
<tr>
<td>Edyficar</td>
<td>Peru</td>
<td>36.99%</td>
</tr>
<tr>
<td>Crear Tacna</td>
<td>Peru</td>
<td>36.88%</td>
</tr>
<tr>
<td>CMAC Santa</td>
<td>Peru</td>
<td>35.90%</td>
</tr>
<tr>
<td>Confianza</td>
<td>Peru</td>
<td>35.47%</td>
</tr>
<tr>
<td>Nueva Vision</td>
<td>Peru</td>
<td>35.39%</td>
</tr>
<tr>
<td>Pro-Mujer</td>
<td>Bolivia</td>
<td>34.48%</td>
</tr>
<tr>
<td>Nieborowski</td>
<td>Nicaragua</td>
<td>33.64%</td>
</tr>
<tr>
<td>CMAC ICA</td>
<td>Peru</td>
<td>33.11%</td>
</tr>
<tr>
<td>CMAC Arequipa</td>
<td>Peru</td>
<td>33.06%</td>
</tr>
<tr>
<td>WWB Cali</td>
<td>Colombia</td>
<td>32.68%</td>
</tr>
<tr>
<td>CMAC Trujillo</td>
<td>Peru</td>
<td>30.91%</td>
</tr>
<tr>
<td>CMAC Tacna</td>
<td>Peru</td>
<td>30.48%</td>
</tr>
<tr>
<td>CMAC Cusco</td>
<td>Peru</td>
<td>28.17%</td>
</tr>
<tr>
<td>D-Frif</td>
<td>Bolivia</td>
<td>27.85%</td>
</tr>
<tr>
<td>Banco Procredit</td>
<td>El Salvador</td>
<td>22.07%</td>
</tr>
<tr>
<td>Asofin (1)</td>
<td>Bolivia</td>
<td>21.76%</td>
</tr>
</tbody>
</table>

Source: ASOFIN, Microrate

One part of the answer lies in what has already been mentioned. Financial services for the poor is a retail business characterized by the smallest packaging size in the whole market. In addition, although ever-more efficient methodologies continue to be honed, it is by and large a high-contact business, requiring a level of interaction between the staff of the microfinance institutions and their clients makes it similar not to commercial lending but to personal private banking. Both elements make the cost to serve a microfinance product extremely high in comparison to those placed with the more affluent. It is not coincidental that Compartamos, the institution charging the highest rate
in Table 7, also has one of the lowest average loan sizes of any microfinance institution ($330 in 2004\textsuperscript{46}).

The higher cost of serving the base of the pyramid has been easy for traditional banking to intuit and has often been the first consideration for commercial bankers when asked to approach low-income segments. In addition, there has been the perception that costs would be further augmented by a much higher credit risk and, to top it off, the underlying asset pool was too small to make the effort worthwhile. Other serious challenges, such as the need for different personnel profiles, compensation plans and skill sets, are usually less clear at the outset. All these obstacles are grounded to one extent or another in substance, especially given the natural structure of commercial banks, and all contributed to why microfinance did not evolve naturally from the established financial system. Yet, with the benefit of hindsight, it seems clear that what prevented banking strategists from seeing the low-income populations with whom they have co-existed for hundreds of years as potential customers was one single insight: the pricing paid by the people at the base of the socio-economic pyramid bears little relation to that paid by the inhabitants at the top. So long as the question was posed in terms of having to meet the higher costs of serving the base with the prices paid at the top, banking for the poor remained a dilemma without solution. Because it could not be solved, the poor had no other recourse than pay the price set by those among them with surplus funds: the local moneylender and the very last link of the distribution chain.

The rates charged on the streets for money in this “informal” financial system has been widely documented. Since the rates far surpass any prevailing inflation or devaluation, there is a commonality to them in the Third World that transcends geography. The range within a given city, town or neighborhood is extremely wide as there is no accepted standard format, and loans can have daily, weekly or monthly repayments calculated on a wide variety of bases, making the calculation of effective annual rates a challenge for even the most quantitative MBA.\textsuperscript{47} From the Andes to Zambia, interest rates for the poor can range from 5% a week to 30% a month (with cases of 100% a month and more also recorded). This translates into rates per annum of 1,100% to 2,200%, and higher. Yet empirical observation on the streets of the poor indicates that the bottleneck is not the search for new clients but the capital base of the moneylenders. Despite the dramatic growth of the leading microfinance institutions, the market still belongs to the informal moneylenders. How can the poor afford to pay such prices?

There are three fundamental reasons why it makes sense for the poor to pay the going rates on the street. The first one is that street loans are extremely short in duration, thus limiting the compounding effect of the high interest rates. An effective annual interest rate in excess of 1,000% may translate to a $1.50 charge for $100 lent for two days, an amount payable by a woman who has invested the $100 in shirts sold for $110 over the same two days.

\textsuperscript{46} Financiera Compartamos, via ACCION International.

\textsuperscript{47} For a review of four specific cases clearly illustrating the terms and conditions of moneylenders, see Robinson, \textit{Microfinance Revolution: Sustainable Finance}, pp. 14-15.
Secondly, financial costs are only one component of the total costs incurred by the borrower. This was one of the seminal insights that lay the foundation for commercial microfinance in Latin America, as it permitted microfinance pioneer ACCION International to understand why the interest rate charged for loans was often not the most important consideration for the clients it was seeking to serve. In 1989, ACCION laid this lesson out in a publication aptly entitled “What Microenterprise Credit Programs can Learn from the Moneylenders.”\textsuperscript{48} In it, in addition to \textit{direct financial costs}, it defined two others: \textit{transaction costs}, the indirect costs imposed by the lenders as a result of their delivery systems but which add no value in terms of additional income to the borrower (such as financial and legal documentation); and \textit{accessibility costs}, the business opportunities lost because of the inefficiencies of the credit delivery system (e.g. missing delivery of a shipment of shirts or losing a piece of machinery sold to others). The author then compared two alternative funding sources from the perspective of a borrower: a local moneylender with a $200 loan for 60 days at 10\% a month and a credit union charging 2\% a month but requiring compensating balances, four trips back and forth to the offices of the credit union in order to process, receive and then service the loan. Factoring in some paperwork delays in line with current practice, the author demonstrated that the costs to the borrower of the moneylender is $40 (the direct financial costs and no transaction or accessibility costs, as disbursement is immediate and repayment is collected at the borrower’s location) versus $96 for the credit union, of which only $10 is the direct financial cost.\textsuperscript{49} Only when it understood this could ACCION realize that the tolerance for high interest rates at the base of the pyramid was directly affected by transaction and accessibility costs, and that it was completely rational for its clients to trade off one against the other. High interest rates were sustainable if efficiency and reliability were guaranteed.

While simple once understood, this insight was such a breakthrough because it was absolutely contrary to the mindset of the professionals engaged in microfinance, who invariably came from the top of the pyramid. There, the financial system on one hand and the clients on the other have been working literally for centuries to minimize and absorb transaction and accessibility costs. These have either been driven down to minimal levels (e.g. the density of branches and ATMs in high-income districts) or fully absorbed and standardized as the costs of doing business (e.g. lawyers, credit agreements, perfection of security). Hence, they are taken mostly for granted, with the result that attention is drawn to the one remaining dimension: interest rates. This explains why the level of interest rates have always been more controversial at international conferences than at the base of the pyramid.

The third factor that allows low income people to absorb high interest rates is the high marginal productivity of capital where capital is so scarce. When an electric saw is introduced by a carpenter making furniture with a hammer, nails and a handsaw in his one-room dwelling, his productivity increases, not by 20 or 30\%, but by various orders of

\textsuperscript{48} Robert P. Christen, \textit{What Microenterprise Credit Programs can Learn from the Moneylenders} (Boston, MA: ACCION International Discussion Paper Series Document No. 4, October 1989).

\textsuperscript{49} Idem, p.p. 16-19
magnitude. On the contrary, when one more electric saw is introduced in a furniture factory running various production lines fully equipped with electric saws, the increase in productivity may be barely noticeable. This was another insight acquired by ACCION in the field:

The smaller the microbusiness, the greater the return to assets … A … study conducted among 320 of the smallest businesses in 40 poor neighborhoods that participate in [an] ACCION affiliated program … demonstrated their capacity to generate returns. For businesses with an average US $833 in total assets, the gross return on assets was 700 percent annually… A similar study of small commerce in La Paz, Bolivia … revealed gross rates of return of over 100 percent a year for businesses with an average of $545 in assets. Rates of return for the very smallest approached 3,000 percent annually.  

Revisiting the basic conceptual breakthroughs that made commercial microfinance possible highlights the deep differences that separate the top from the bottom of the pyramid. A lesson from that experience is that commercial success in serving the poor must start with a fundamental understanding of the day-to-day realities of low-income lives. Most, if not all, protagonists that come from outside that world are likely to carry into the base of the pyramid deeply ingrained assumptions without realizing their inappropriateness when dealing with the poor. Accordingly, theory-down approaches have a dismal record in the history of microfinance; successes have always flowed street-up. In that process, initiatives driven by commercial considerations seem to have an advantage. Unlike philanthropy, which can measure itself on quality alone, given the small unit value of the products for the poor, commercial initiatives cannot define success without engaging sizable numbers of the target population. That, in turn, cannot be accomplished on a sustained basis without ultimately responding effectively to the fundamental needs of the people at the base of the pyramid, whether these have been understood from the start or had to be discovered in the crucible of the marketplace.

The Evolution of Commercial Microfinance

In its recent overview of the microfinance industry, The Economist noted the current strong interest in microfinance and then reflected that “What is now generating so much hope and excitement is less the discovery of some entirely new way to deliver financial services to the poor than the effect of the rapid innovation that has taken place in the past three decades.” Indeed, for practitioners in the field, dynamic change has been a constant and that characteristic may be a key difference between microfinance and other initiatives aimed at alleviating global poverty. The distance traveled by microfinance can be gauged by looking at its history in Latin America, where arguably the greatest transformation has taken place --- from its birth as a tentative experiment by fledgling NGOs to the current involvement of established local and international commercial banks. How fast this evolution has been is demonstrated by one fact: all these

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51 The Economist, Hidden Wealth, p. 2.
changes have taken place in less than the span of a person’s career. Many of today’s key protagonists actively driving the entry of conventional banking into microfinance were involved with NGOs and civil society organizations when they were launching their first microlending operations --- and these people still have plenty of productive years left. Why has innovation been so prevalent in microfinance? What does it have to teach us about commercial models serving the poor?

Modern microfinance began in the early 1970s at around the same time in Latin America and Asia. In 1971, Opportunity International started lending in Colombia; ACCION International issued its first microcredit loan in Recife, a poor area of Brazil in 1973; in 1970, an entrepreneur established Bank Dagang Bali in Indonesia to lend to and capture savings from people who had no access to the financial system; Grameen Bank was founded in 1976 to empower Bangladeshi women. None of these early pioneers knew each other nor did they realize the scope of what they were unleashing.

In Latin America, the evolution of commercial microfinance is reflected in the history of ACCION. Founded as a nonprofit in 1961, during its first 12 years, ACCION mobilized young men and women from the US and Europe to work among the low income populations of Latin America. Soon after its initial microcredit experience in Brazil, ACCION focused entirely on microfinance as the means to fulfill its mission of combating global poverty. ACCION’s key contributions to the creation of commercial microfinance can be summarized in four innovations:

- **Seeking Economic Viability (1973-1985):** Given the radical departure from convention that at the time characterized providing financial services to the poor, microfinance began as the exclusive province of NGOs. While ACCION itself was a nonprofit, from inception it believed in a model that could be financially self-sufficient, covering all expenses and generating a surplus from the income of the loan portfolio. As previously noted, this ran counter to the accepted views in development circles. ACCION proceeded to co-found various local NGOs with business leaders as champions. These, together with the few existing NGOs that bought into the ACCION concept, became the ACCION Network. A decade of intense experimentation and trial-and-error tests followed. By the mid 1980s, the leading NGOs had managed to crack the problem and cross break-even. During this period, the funding for the operating costs and the loan portfolio came from philanthropy and bilateral and multilateral development agencies (see Figure 1).

- **Connecting with the Banking System (1985-1990):** Once break-even was attained, scale ceased to be a challenge to become an ally. As the institutions began to meet the market demand, the bottleneck changed from donor sources for operating deficits to accessing pools of capital large enough to fuel the growth of operations. While economically-viable NGOs could now potentially borrow on a corporate basis, the challenge became to link them with the local banking systems. To do this, in 1986 ACCION established the Bridge Fund, a guarantee fund made up of assets solicited from foundations and socially responsible

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Figure 1. Seeking Economic Viability (1973 – 1985)

Figure 2. Connecting with the Banking System (1985 – 1990)

Source: Author
investors which it used as collateral for a program of letters of credit (L/C) from first tier global banks. It then used these L/Cs to guarantee credit lines extended by local banks to ACCION affiliated microcredit NGOs. The guarantee was never for the full risk. Typically, it might start at 90%. This provided local banks with an extremely attractive economic proposition: receiving 100% of the interest, while incurring only 10% of the risk. As the Bridge Fund enabled the connection to the local banking system, the loan portfolios grew dramatically. As the banks got to know the microfinance NGOs, their stellar performance allowed for a higher and higher leverage on the L/Cs, until these disappeared altogether (see Figure 2).

- **Becoming Regulated Microfinance Institutions (1992 on):** Effective as the Bridge Fund was to relieve the funding bottleneck for the successful microfinance NGOs, growth was so sustained that the capability of the local banking system to serve the NGOs as corporate clients was soon exhausted. This was the result of two factors. While the NGOs were excellent clients, they had no hard collateral, as their main asset remained IOUs from the base of the pyramid. Without hard assets, the local banks under prevailing regulations had to limit what they could lend to a single customer on an unsecured basis. Beyond that, the banks had to provision the loan (regardless of performance), making the cost prohibitive. ACCION concluded that the only way the successful NGOs could continue growing past that obstacle was to bypass the intermediary step and become banks (or regulated financial companies) themselves. The first of these “transformations” was BancoSol in 1992. The funding model gained in efficiency and power (see Figure 3).

- **Creating the Private Service Company Model (1999 on):** While the conversion of successful microfinance NGOs into regulated financial institutions was highly successful in opening another stage of high growth, the costs of such a process were also high in terms of time and financial and human resources. Simultaneously, conventional commercial banks had become aware of the financial attractiveness of serving clients at the base of the pyramid. As they began to explore how to do this, many concluded that they lacked the proper expertise. This led ACCION to design a model in which a joint venture is established between a commercial bank and ACCION. The joint venture takes on all contact with the microfinance market, from marketing the product through making the credit decision to collecting the payments. To do this, the joint venture recruits, trains and manages its own staff. But when it issues a loan, the loan is carried not on the balance sheet of the joint venture but on the books of the bank. This is a highly efficient model as it redefines two key levers: funding, which now benefits from the volume and the cost of a much larger commercial bank; and back office operations, eliminating the need to establish a new stand-alone processing center for microfinance (see Figure 4). The first of these was established in 1999 with Banco Pichincha, the largest Ecuadorian bank, under the name of Credife. It has since been followed by SogeSol (2000), a joint venture with Sogebank, the largest bank in Haiti and by RealMicrocredito (2003), a joint venture with Banco Real, the ABN-AMRO bank in Brazil. Through this model, ACCION has facilitated the entry of conventional banks into microfinance. At
Figure 3. Becoming Regulated Microfinance Institutions (1992 on)

Source: Author

Figure 4. Creating the Private Service Company Model (1999 on)

Source: Author
the same time, the efficiency of the model is resulting in levels of return significantly superior\textsuperscript{53} to those of the average regulated microfinance institutions in the ACCION Network, which include many of the most profitable entities in the industry.\textsuperscript{54}

Consistently producing radical innovations within one organization over three decades requires a constant questioning from the inside of the very models that have brought the institution success and acclaim. While no doubt this is attributable to more than one factor, it is notable that a principal driver of all the innovations at ACCION has been the urgent search for ways to break the bottlenecks to growth and efficiency. Another example of innovation driven by the same motivations is the current greenfields model developed by IPC of ProCredit banks created from scratch, wholly-owned, or at least controlled, by one single entity, extending economies of scale and knowledge over national borders. Since growth and efficiency are such natural outgrowths of a commercial concept, it raises the question whether such innovations would have occurred under a different view of microfinance. It suggests a possible explanation for why in the last three decades, the introduction of new concepts --- those subsequent to the original innovations responsible for the founding of organizations --- have come overwhelmingly from those institutions most committed to commercial microfinance. This link between innovation and commercial approaches is a consideration that perhaps can be extended to the entire field of business at the base of the pyramid.

A second observation derived from the evolution of microfinance is that low income markets are presently so underserved that it is likely that any killer concept that manages to open the field, even to great success, is unlikely to last for long without challenge. In the ACCION Network example described above, the NGOs responsible for the fundamental step of creating the methodologies that resulted in breakeven have all ceased to be at the head of the industry. Some have remained in the field as boutique players, examples of well-run operations that no longer seek to grow exponentially; others have contributed their operations to another form of organization with different financial and operating capabilities and turned to new social or developmental activities. The same evolution can be seen in all the products, delivery systems and infrastructure that at one time or another had been deemed to be the cutting edge. A consequence of tapping into the majority of the population is that the market in number of clients is so much larger that rapid growth can be sustained for far longer periods than previously conceived. Such continued waves of growth will constantly render obsolete all concepts and systems. Indeed, despite its explosive growth in the last decade, microfinance continues to be a high-margin, low-volume (in relation to total market) business. Yet its end-state will be as a low-margin high-volume business, with the concept of market size recalibrated to take into account not a portion but the whole of humankind.\textsuperscript{55}

\textsuperscript{53} Internal ACCION International documents.
\textsuperscript{54} Such as Financiera Compartamos, BancoSol, Mibanco, Banco Solidario, BanGente, Financiera El Comercio, UMU and PADME.
\textsuperscript{55} The author has benefited from discussions with Alvaro Rodriguez, CFO of Grupo Vitro and board director of ACCION International.
The Key Factors of Success

That commercial microfinance can be successful in every major region of the Third World, under the most varied cultures, ethnicities and religions, and within a spectrum of political circumstances suggests the existence of a set of factors so fundamental that it cuts across all these dimensions. While it is not within the parameters of this paper to address this issue in detail, the following five characteristics may belong in this category, based on a practitioner’s experience that has seen their presence in successful microfinance institutions:56

1. **Pricing is set by market forces alone.** In these cases, pricing reflects all costs related to microfinance and, at least for the most efficient operator in the market, a return commensurate to the risks of the business. Experience indicates that when interest rates for microfinance loans are capped, credit is forced inexorably towards larger initial loan sizes, as institutions cannot afford to wait for interest income to achieve breakeven solely on the growth of the average balance of the loan portfolio as a result of the success of their clients’ enterprises. This is significant, as initial loan size is an indicator of the socioeconomic outreach of a microfinance program: the lower it is, the poorer the population reached.57 One way to get around the drift towards higher initial loans is through subsidy, in effect capping the interest rate for the borrower but not for the lender. However, history shows that when the end-borrower’s rates are below market, sometimes even lower than the prevailing inflation rate, there is such value imbedded in the mere fact of receiving the loan that it is difficult to protect disbursement from political interference or fraud. Contrary to popular belief, the effective result of both interest rate caps and subsidies is the perverse transfer of capital away from the base and towards the top of the pyramid.

2. **Client selection is at the sole discretion of the microfinance institution and the criteria used are entirely economic.** This does not mean that the lender shies away from risk but that it only disburses funds when it has in place procedures and systems that can manage that risk appropriately. It also means that loans are disbursed only to borrowers who can repay. This helps to confine microfinance loans to those who can benefit from contracting debt --- men and women who have an income stream that will support repayment, especially if

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57 Instead of initial loans, for many years well-intentioned observers have insisted on using the average loan size of the entire portfolio as a proxy for the poverty outreach of a microfinance program. This represents a misunderstanding of the fundamentals of microfinance. Without any change at all in its outreach, the average loan size of a microfinance portfolio is bound to grow if the program is lending to clients whose enterprises benefit from the credit and the program does not abandon its clients but accompanies them in their growth. Given that organic expansion of the portfolio, if initial loan size remains constant, it rapidly becomes impossible for the intake of new clients to keep up with the growing loans of their successful predecessors. Accordingly, an increasing average loan size is a better indicator of a healthy microfinance program than in conveying anything meaningful regarding poverty outreach.
that income stream will increase as a result of the loan. It is no favor for the poor to end up saddled with debt obligations which they cannot repay, the unintended but disastrous consequences of poorly executed microfinance.

- **Risk is borne entirely by the microfinance institution.** There are no mechanisms to insulate the lender from the full consequences of its decisions. There are no grants to cover operating deficits or to make up negative net worth. Guarantees such as those backing the bonds issued by BancoSol, Mibanco and Compartamos do not violate this provision so long as the credit enhancement is provided on a commercial, arms-length basis. Shareholders, even those with deep pockets, respond only to the extent that it makes sense commercially.

- **Microfinance is the sole business focus.** The attention and energy of the entire organization is devoted to microfinance and is not diluted by other activities that require different success factors and skill sets. A corollary is that the careers of the people involved ride or fall with the microfinance operations. In the case of conventional banks, this must be made to apply to the unit within the bank that deploys microfinance, especially difficult as the microfinance segment is so different from the rest of the institution. It is precisely the ability to do this that constitutes one of the main attractions for conventional banks of ACCION’s “private service company” model.

- **Long term survival of the business unit is critically affected by the returns of microfinance.** This is regardless of the accomplishments of the activity in other areas, such as fulfilling social goals or the positive contribution made to corporate objectives such as image and brand name.

These five factors alone do not guarantee the success of a microfinance institution. Indeed, all the usual requirements of a successful business also need to be in place: strong management and sound business model; robust control, accounting and information systems; well-aligned promotion and compensation policies; great products and good customer service, and so on. But the absence of even one of the five considerations identified above weakens the chances of success of the microfinance project. This may explain why microfinance has not taken off in China yet despite a multitude of pilot projects and why it is beginning to do so in India today. In any other commercial enterprise, the five factors would be so basic as to make their enumeration clearly redundant. Yet because it is a business serving the poor, this perspective of microfinance has caused controversy in the past and may continue to do so for some time still.
THE CREATION OF SOCIAL VALUE

How Does Microfinance Create Social Value?

Were microfinance just a business capable of earning superior returns, its novelty would be limited. Business is full of examples of high returns to first movers that manage to introduce killer concepts that open up a new market. That it is doing so by bringing to the poor products and services that have long been staples in the lives of the affluent is notable, given that for centuries conventional business wisdom considered the notion an absurdity. But being the subject of global summits with the presence of heads of state, ministers and royalty\textsuperscript{58} and having a year dedicated to it by the United Nations is due to the promise of microfinance as an effective response to global poverty.

The increasing attention that microfinance is receiving in policy-making circles is beginning to find support in macroeconomic studies. As reported in \textit{The Economist},

A Word Bank report by Thorsten Beck, Asli Demirguc-Kunt and Soledad Martinez published [in October 2005] shows strong correlation between lack of financial access and low incomes… Earlier research by the first two authors and Ross Levine concluded that a sound financial system boosts economic growth and particularly benefits people at the bottom end of the income league. A long-term study in Thailand by Robert Townsend of the University of Chicago and Joe Kaboski of Ohio State University showed that families with access to credit invested more, consumed more and saved less than those without such access.\textsuperscript{59}

But why does this happen? What occurs at the microeconomic level that ends up producing such macroeconomic results? What is the view of microfinance, not from the institution that provides it, but from the eyes of the men and women who pay for it?

Most of the world lives under conditions where all the essentials that are associated with basic survival and dignity are lacking or deficient: food, education, healthcare, shelter, clothing, safety, respect. While countless factors affect the access of the poor to those essentials, from physical properties like climate and geography to social and cultural institutions such as religion, history and political systems, disposable income remains the single most direct and powerful lever to overcome the barriers to that access. No matter the hurdles or their origin, one fact stands out: if the people in the world that survive on $365 a year were suddenly to have the annual U.S. average disposable income of $28,000\textsuperscript{60}, few would doubt that the world would mobilize rapidly to provide them with all those missing essentials --- regardless of race, caste, religion or national origin. While money, as the proverbial saying goes, cannot buy happiness, it is the essential building block on which are built equal life-chances. One more dollar of disposable

\textsuperscript{58} Microcredit Summit, held on February 2-4, 1997 in Washington, D.C.
\textsuperscript{59} \textit{The Economist}, \textit{Hidden Wealth}, p. 2.
\textsuperscript{60} The disposable personal income per person in the United States in 2003 was $28,227. Source: U.S. Census Bureau, www.census.gov.
income in the hands of the poor is one dollar closer to accessing all the essentials the lack of which defines poverty.

Accordingly, whenever business intersects with the base of the pyramid, the fundamental social question is its impact on the disposable income of the poor. This can be viewed along three dimensions:

- **It stretches the disposable income of the poor:** The business makes available goods and services currently used by the people at the base of the pyramid at a lower price, allowing the poor to do more with the same amount of disposable income. Microfinance has reduced the interest rate paid on the streets from levels in the thousands of percent per annum to double-digits, with the lowest rates now in the low 20s%. While transaction costs and accessibility costs have increased relative to the moneylender, the best microfinance institutions have kept these at a minimum, many having organized themselves, for example, to disburse the next loan at the same time that the last installment of the current loan is being repaid. In any case, the drop in interest rate has been so dramatic that the difference has easily absorbed any increased transaction and accessibility costs. Once the moneylender is displaced, in markets characterized by commercial microfinance, costs (finance, transaction and access) have continued to drop as a result of competition.

- **It expands the reach of the disposable income of the poor:** The business introduces goods and services that were unavailable to the base of the pyramid, extending in this way the purchasing power of the disposable income of the poor. In microfinance, institutions have usually penetrated the market on the strength of a basic product. In Asia, that has often been savings instruments. In Latin America, it has been loans. But once the infrastructure is laid, microfinance institutions are capable of delivering other products and services. In Asia, savings products have grown to cover the entire range of needs of an individual or family: liquidity accounts to safeguard monies that are earmarked for constant use; accounts to accumulate capital for specific religious or family obligations, such as religious festivals, coming-of-age parties, weddings and funerals; school uniform savings accounts to prepare for the passage into secondary school of the family’s children; retirement accounts to take care of old age. In Latin America, from basic working capital loans, products have expanded to take into account equipment financing, housing improvements, insurance and remittances. In addition, Latin American microfinance banks are increasingly funding their balance sheet with savings mobilized from the base of the pyramid. These products and services have helped increase the efficiency with which the poor can manage their lives. It is literally exchanging saving by purchasing a few bricks a month for a passbook account earning interest.

- **It increases the disposable income of the poor:** The business, directly or indirectly, sets in motion a process in which new sources of income are created at the base of the pyramid. This occurs when a microentrepreneur, relieved of the need to meet the moneylender’s high interest rates, is left with
additional income that can be used to increase the business itself --- additional flour to bake more bread, greater variety of fruits and vegetables for a roadside stall, a bench saw to speed production. This in turn leads to further growth. The increased level of the microenterprise’s activity leads to more employees. In addition, microfinance institutions themselves, operating physically at the base of the pyramid, often draw personnel from the same population base.

The impact of any business serving the poor can be evaluated along these lines. For instance, consider Ajegroup, the Peruvian-born soft-drink company now headquartered in Mexico whose sweetspot is the base of the pyramid. It first made its mark making Kola Real and presently is giving Coke and Pepsi a run for their money in four Latin American markets. The company, like microfinance, can be assessed along these three dimensions. In the case of Ajegroup, particular attention should be paid to the new distribution infrastructures created by the firm that come from within the same communities it sells to and the resulting increase in disposable income.

This framework also provides a way to eventually compare the relative social impact of businesses engaged at the base of the pyramid. Businesses can be evaluated based on two considerations. The first one is how the entry of the business directly stretches, expands and increases the disposable income of the poor. The second consideration is to what degree the entry of the business sets in motion a sequence of events that will continuously contribute to the growth of disposable income among the poor, i.e. does the business cause a one-time effect or does it launch a self-sustaining cycle of value-creation that stretches, expands and increases disposable income on a continuing basis? The macroeconomic studies cited earlier suggest that effective financial services at the base of the pyramid may be an activity which, like construction, has a broad multiplier effect.

Maintaining the focus on disposable income has a further benefit: it protects the analysis of social impact from the imposition of the values of the analyst over the values of the men and women at the base of the pyramid. Focusing the measure on disposable income puts the poor squarely at the center. It is they who will vote where their next dollar will go --- more inventory for their business, an antibiotic for a sick parent, school supplies for a child, tiles for a leaking roof, a T-shirt for a spouse or Kola Real for the whole family. People who have worked at the base of the pyramid in Third World countries are often struck by how rational decision-making is among the poor and how universal family priorities are. This is far from saying that the decisions of the poor will not benefit from better information and knowledge. It is an affirmation that, ceteris paribus, decisions, imperfect as they may be, are best made by those most cognizant of the circumstances under which those decisions must be carried out.

Increasing disposable income is not the only benefit provided by microfinance. A common theme is the sense of empowerment and self-respect that often comes with the loans, and few observers fail to notice it. This has particular value among people who have suffered from not only the economic but also the cultural consequences of living at
the base of the pyramid. However, the social capital that flows from the microfinance transaction, while not being captured in a calculation of disposable income, is inseparable from it. Without the effect microfinance has on a poor person’s disposable income, it is doubtful whether much of its qualitative impact would be preserved.

Businesses create value, but they can also destroy it. In fact, models of wealth creation which are centered on entrepreneurialism, as microfinance and business itself, have at their core the Schumpeterian notion of creative destruction --- progress is a messy proposition in which the birth of the new comes at the expense of the old. Accordingly, a review of the social value created by microfinance should also take into account some of the costs incurred along the way.

A natural outgrowth of commerce in open markets is competition. Bolivia, home to one of the earliest examples of commercial success, was also the location of what is likely one of the first shakeouts of the microfinance industry.61 In 1996, attracted by the performance of BancoSol and Caja Los Andes, and making use of a recently-approved financial company structure for micro specialists that required only $1 million of equity capital,62 a group of Bolivian investors formed FASSIL FFP. Their strategy was to start with consumer lending to rapidly build volume and profits while developing a microfinance portfolio. In short order, FASSIL was followed by three Bolivian commercial banks, each establishing separate divisions to deploy both consumer lending and microcredit63. The largest consumer lender in Bolivia, Acceso FFP owned by a prominent Chilean holding company,64 also aggressively entered the field. While superficially similar in loan size and approach, Acceso inserted into the base of the pyramid a totally different business model. While the microfinance practitioners had deployed a methodology that was knowledge-intensive with regards to each borrower, extremely disciplined in terms of loan size and intolerant with delinquency, the consumer credit model was a factory approach, built on high volume and automated credit scoring, with delinquency rates shocking for microfinance factored into the pricing. The lack of an appropriate database to build a microfinance credit scoring system did not deter the new entrants. When possible, they went after the existing clients of the established microfinance players and if not, they took on new borrowers.

This mixture of badly-designed consumer lending for the base of the pyramid and microfinance proved lethal. The first few years produced extraordinary reported earnings, but in 2000, with the onset of a deep economic crisis in Bolivia, the portfolio of the new entrants imploded. Acceso FP went from a portfolio of $93 million in 1998 to $5.4 million in 2000, with the difference a complete write-off.65 It then withdrew from Bolivia. Of the new entrants, only FASSIL FFP remains active in microfinance today. In

62 Fondo Financiero Privado, or FFP
63 Banco Económico and the Presto Division; Banco de Santa Cruz and Solución; Banco Unión and CrediAgil.
64 Empresas ConoSur.
this one instance in which unsuccessful competitors actually withdrew from microfinance, it is interesting to note that all were commercial organizations, unsupported by donor funds.

In addition to the destruction of economic value, there was also a high social cost, as the bubble of easy credit led to a wave of overindebtedness among the poor of Bolivia. As Rhyne notes,

Clients took advantage of the offer of quick and easy credit from so many institutions, maintaining two or more loans at a time. In an increasing number of cases, clients borrowed more than they could handle. Some let repayments slip or, in worst cases, began “bicycling” loans --- using the proceeds of one loan to pay off another. Such behavior seriously damaged the carefully constructed culture of repayments in microcredit.66

BancoSol clients that had maintained a perfect repayment record for six years or more, in the space of two were cut off from the financial system, this time not for being poor but for not honoring commercial obligations. Their enterprises, once the growing asset base taking them out of poverty, were now saddled with debts that might never be repaid.

The Bolivian microfinance crisis of 1999-2000 shows that business at the base of the pyramid is subject to all the trials and tribulations of business anywhere. Just because the poor are involved, there is no exemption from economic realities or basic human nature. In fact, the behavior of Bolivian microentrepreneurs was identical to that of U.S consumers when deluged with easy credit: they borrowed above their means and they rushed to the lender that provided the largest credit with the least requirements and at the lowest rate. Once the market was flooded by new entrants with new terms, the experienced microfinance players were confronted with the classic dilemma familiar to bankers everywhere: relax the definitions of imprudence or lose the business.

Another lesson of the Bolivian crisis is that, at the intersection of business and the base of the pyramid, there is a role for responsible government. In Rhyne’s words, “The market dynamics associated with overlending require a collective response, supported by regulatory standards. In such a situation, only a central body, like the Superintendency of Banks, can stop the spiral…”67 Indeed, the role of the Bolivian banking authorities was critical in containing the crisis and paving the way to recovery. It established tight credit profiles for the clients that the consumer lending FFPs were allowed to take on and forced them to make good on the deterioration of their portfolios. At the same time, the Superintendent of Banks worked with the experienced microfinance institutions to establish practical ground rules under which their ailing portfolios could be restructured and nursed back to health.

66 Idem, p. 123.
How Effective is Microfinance as a Response to Poverty?

Definitive impact studies in microfinance are hard to find. Many reasons account for this. In the first place, studies that have tried to survey clients directly must overcome the challenge of obtaining reliable information from people across multiple barriers of language, culture and class, and without the presence of accurate record-keeping. To be effective under such circumstances often requires extensive time and training which has usually been lacking. Limited studies undertaken by development agencies such as USAID and some microfinance entities are well regarded but, in the words of one of the most knowledgeable students of microfinance, “Overall, however, the microfinance industry has little systematic, reliable information on the impact of its services on its clients and their households.”68 Accordingly, the bulk of the information is anecdotal. As can be expected, there is no shortage of that, and it varies in quality, rigor and credibility.69

This situation may be about to change. On one hand, with the maturing of the leading microfinance institutions, there are now data banks that are extensive both in number of clients and length of history, with information integrity and relative ease of electronic access. This is a far cry from the early days of the field when microfinance NGOs, in their parsimony, would lose historical records as staff members used the same computer diskettes over and over again. At the same time, the group of serious academicians interested in microfinance is growing, including some whose training and disposition make them well-suited to unlock the information contained in the industry’s data banks. The results of their data-mining will no doubt enrich the macroeconomic evidence that others are compiling with regards to the link between access to financial services and economic and social development.

The lack of hard impact studies raises the issue of how to approach the effectiveness of microfinance. The answer depends critically on the context. If what drives the inquiry is academic rigor, then the response has to be that, despite much anecdotal evidence supporting the positive impact of microfinance on the poor, the jury is really still out. To what degree are the poor of Bolivia better off now thanks to microfinance, which has basically been available by and large to everybody at the base of the urban pyramid since 2000? To what extent has microfinance stabilized incomes during economic recessions? How much of the GDP growth of Bolivia is due to microfinance? Similar questions can be posed for every country that has a significant microfinance industry. Currently, there are no answers. Providing them is a major contribution that academia can make to the field of microfinance.

In the meantime, practitioners must continue to make decisions. For a minister of state, the question may be whether to include microfinance as a priority in the nation’s development plan. For a Bank Superintendent, it may be whether devote scarce resources to design a regulatory framework for microfinance. For the CEO of a microfinance bank

69 For a particularly useful collection of microfinance client interviews, see Idem, pp. 104-122.
it may be whether to continue in the field or return to traditional banking. While the hard impact studies are being conducted, is there anything in addition to anecdotal evidence that might be helpful?

In business, it is a given that decisions must be made under uncertainty. Accordingly, managers are trained to identify the key assumptions on which a decision is based and to evaluate the integrity behind those assumptions. Good decision making does not call for knowing with precision the exact weight that each assumption should carry, but it does require a sense of their relative weights --- what is trivial and what is fundamental. The quality of the decision is then determined by the robustness of the thinking that ties all the assumptions together.

Perhaps in the case of microfinance, practitioners can follow a similar approach. Poverty is a complex condition, affected by a myriad of factors. No single variable can fully explain it or is capable of solving it. The claims made of microfinance as the eradicator of poverty belongs to the world of public relations and sound bytes. But it is possible to identify some variables on which most reasonable analysts would agree, such as education, nutrition and healthcare. The question is whether in the short list of the fundamental variables that can meaningfully affect poverty, microfinance should be included. In the absence of hard impact studies, this must necessarily be an educated guess.

Under these circumstances, assessing microfinance’s contribution to combating global poverty requires examining the underlying theory of change. Simply put, it can be expressed as follows:

- Poverty is defined by the shortage of the essentials for survival and dignity: food, education, healthcare, shelter, clothing, safety, respect.
- Regardless of the barriers that block access to these essentials, including non-material ones, they are made more accessible by an increase in disposable income.
- The vast majority of the poor of the world survive on the disposable income generated by some type of economic activity.
- In most cases, that economic activity will benefit from access to microfinance: working capital loans, equipment financing, savings instruments, and so on. Financial products and services, if well deployed, will increase the economic activity in excess of the costs incurred, leading to an increase in disposable income for the client. Any additional disposable income increases access to the essentials required to emerge from poverty.
- In the case of wage earners, access to financial services, including personal credit and savings, will leverage their disposable income so as to gain faster access to those essentials that are missing.
- The increase in economic activity of the client will have a multiplier effect in the community, leading to a cycle of additional increases in disposable income for others.
For the practitioners in the field, the acid test of the effectiveness of microfinance has always been the market. Working at the base of the pyramid, their response, incomplete as it is for academia, is to point to the reception of their products and services by the client. Every day more and more low-income people vote for microfinance with their wallet, they like to point out, and every one of those millions of daily transactions in commercial microfinance comes from a willing buyer, who returns time and time again.\(^70\)

**COMMERCIAL RETURNS AND SOCIAL VALUE COMBINED**

*The Role of Profit in the Creation of Social Value*

Even accepting that future rigorous research will confirm the impact of microfinance on poverty, the fact that it is a *bona fide* business capable of generating outstanding returns raises the issue of the appropriate level of profitability when commerce intersects with poverty. After all, every cent of the net incomes and the ROAs and ROEs in microfinance is earned off the sweat of hard-working men and women at the base of the pyramid. While interest rates may not be the only factor to consider in the financing of the poor, they remain a major element and it is difficult to ignore that some of the institutions earning the highest financial returns are also the ones charging the highest prices. At the top of the pyramid, relying on the market to determine pricing may make perfect sense, but is it good policy to extend that to the base? Even if market forces will eventually bring the price down, in poor communities the elapsed time is measured not in pleasure deferred but in hardships suffered and life-chances lost.

The history of microfinance points to a basic insight in responding to global poverty: effectiveness ultimately rests on two fundamentals, the ability to reach large numbers and the capability to maintain that reach for however long it is necessary. The need for scale is determined by the enormity of the problem. As Jim Wolfenson said during his tenure as President of the World Bank, “across the world, 1.3 billion people live on less than one dollar a day; 3 billion live on under two dollars a day; 1.3 billion have no access to clean water; 3 billion have no access to sanitation; 2 billion have no access to electricity.”\(^71\) No matter how effective an initiative is by itself in changing poverty, it will not matter much unless it reaches sufficient numbers of the poor to make a difference in the aggregate. Nor will it really be consequential if it does not have staying power. Eradicating today’s levels of poverty will take more than one generation. Accordingly, an effective initiative must have a permanence that can survive the finite attention span and lives of individuals, whether they are at the helm of government, NGOs, philanthropy, think tanks or academia.

\(^70\) At July 2005, the average client retention compared to prior year of the ACCION Network was 85.9% (Source, Elisabeth Rhynne, Senior Vice President, ACCION International).

The power of microfinance in terms of global poverty lies in its ability to meet these two key requirements of scale and sustainability. It does so by turning an activity that can create social value into a business. The value of a commercial approach is that once the delivery of a good or service makes sound economic sense, the seeds are sown for the eventual complete penetration of that market. To use a prosaic example, few would doubt that the last person on earth that can afford a soft drink will eventually have one offered. The reason is because if Coke will not deliver it, Pepsi will, or Wahaha, or Kola Real or some other competitor. Behind them are capital markets ready to provide the resources to make that possible. And sometime in the future, when those brands and formulations are no longer effective, a beverage industry stands ready to provide a product better suited to the evolving needs of the client. Industries have life cycles that transcend those of individuals. From the beginning of recorded history, chefs have come and gone, but the restaurant industry continues; realtors open and close offices, but the real estate industry is always there when people need homes.

Microfinance is standing at the threshold of that world. Because the BancoSols and the BRIs have proven that it is economically rational to serve the poor, it is now possible to believe that the day will come when the last woman with a stall by the side of the road who needs a loan and is without one, will get it. What type of institution will offer it to her is less clear --- a local single-purpose bank, a regional financial institution or the branch of a global megabank --- perhaps all three, if she is lucky. Linked to these institutions are the capital markets of the world. This last fact is of enormous consequence. Given the scale of poverty, where else could sufficient resources be marshaled that are commensurate to the problem?

In accomplishing all this, profits have been a must, and outstanding profits have been critical. Precisely because microfinance works with the poor, it has had to push hard to gain legitimacy in the world of business. Emerging from a sector that is so closely associated with social work and philanthropy, it has had to overcome strong prejudices, both regarding the poor and those that work with them. This has been further clouded by the large number of entities in microfinance, with an enormous variability in their performance and information characterized by a lack of transparency. Added to this has been the coexistence of two ultimately contradictory conceptions of microfinance: at one end, the view that it is a “human right” and at the other, that it is a component of the financial system. Given all this, it is not surprising that until the late 1990s, business by and large ignored microfinance. Where it was known, as in Third World banking, it was viewed with great skepticism. To pierce through, microfinance had to perform like business, only more so. It had to not only generate market rates of return --- it had to beat them. The opening of the bond markets and the entry of conventional commercial banking would not have been possible without that.

The acceptance of microfinance as a legitimate business and its connection to the capital markets has had a fundamental impact on outreach. One place where this can be
clearly seen is in the history of the ACCION Network. Figure 5 shows the evolution since 1986 of the network in terms of annual disbursement of loans and the number of active clients at year-end. On this chart, the establishment of the Bridge Fund (1986) marks the point where the Network, then comprised of NGOs, connected to the local banking sector. BancoSol (1992) indicates the establishment of the first regulated commercial bank focused solely on microfinance. Profund and Gateway (1995) identifies the creation of equity investment funds in microfinance. The private service company (PSC) model bringing in conventional banks as partners was introduced in 1999. ACCION Investments, the successor to the Gateway Fund, was capitalized in 2003. Accordingly, the chart tracks the effect of linking microfinance to the capital markets, first indirectly as a corporate client of banks (1986-1992) and subsequently, as an integral part of the financial system, with ever-wider access to capital markets. While Figure 5 omits the prior 13 years of microfinance activity (1973-1986), a key stage that led to achieving commercial breakeven, the volume attained by the Network in loans and active clients while operating as NGOs would have barely registered on the chart. Connecting to the local banks allowed the network to increase active clients from 18,000 to almost 100,000 and to lend $100 million, but the real jump comes after connecting to the capital markets, enabling the ACCION Network to reach 1.5 million active clients and disburse over $1.7 billion in loans in the course of 2004.

Figure 5. Impact of Commercial Microfinance

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72 The ACCION Network in 2005 operated in 22 countries in Latin America, the Caribbean, Asia and sub-Saharan Africa, and in the U.S. Since 1992, ACCION affiliated programs have made $7.6 billion in microloans to more than 4.7 million people. (Source: ACCION website, www.accion.org).
When Profit is Good and When it is Bad

But has this outreach come at too high a price for the poor, despite the repeat customers and the growing number of clients? The answer to that lies in the realization that, from a social perspective, the real success of microfinance in Latin America is not financial institutions dedicated to the poor that earn rates of return matching or surpassing traditional banks. It is that these profit leaders were able to attract the entrants to create an entire industry dedicated to the base of the pyramid. Following the displacement of the moneylender, it has been this competition that has driven the continuous improvement of the terms under which financial services reach the poor. When BancoSol opened its doors in 1992, it charged an effective interest rate of 35%.\textsuperscript{73} The rate was such a bargain compared to the moneylender that the bank enjoyed a virtual monopoly. Caja Los Andes was formed in 1995 as an FFP.\textsuperscript{74} At that time, market penetration was still low and growth was possible for both institutions without having to fight each other for clients. As previously noted, the competitive scene changed radically with the crisis of 1999-2000. While the wave of overindebtedness exacted a social cost, the end result of the intense competition was to provide several new benefits to the poor.

Figure 6. Average Microfinance Interest Rate, Bolivia 1998 – 2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Annual Effective Interest Rate</th>
</tr>
</thead>
<tbody>
<tr>
<td>Dec-98</td>
<td>29.61%</td>
</tr>
<tr>
<td>Dec-99</td>
<td>29.03%</td>
</tr>
<tr>
<td>Dec-00</td>
<td>25.92%</td>
</tr>
<tr>
<td>Dec-01</td>
<td>24.67%</td>
</tr>
<tr>
<td>Dec-02</td>
<td>24.01%</td>
</tr>
<tr>
<td>Dec-03</td>
<td>22.64%</td>
</tr>
<tr>
<td>Dec-04</td>
<td>21.66%</td>
</tr>
<tr>
<td>Dec-05</td>
<td>21.23%</td>
</tr>
</tbody>
</table>

Source: ASOFIN

Ever since the crisis, the Bolivian microfinance industry has remained intensely competitive. This has had a fundamental impact on pricing. Figure 6 shows that effective interest rates\textsuperscript{75} in Bolivia have dropped constantly, with apparently no end in sight. Since 1998, the price paid by the poor for credit has gone from just under 30% to 21.2%, the lowest in Latin America. Together with lower prices, the variety of credit products available to the poor has also blossomed. When it first started, BancoSol was characterized by one single product, solidarity loans, where people with no collateral and

\textsuperscript{73} For dollar loans. Given the “dollarization” of the Bolivian economy, the bulk of BancoSol’s loans are dollar-denominated. (Source: BancoSol).

\textsuperscript{74} Now licensed as a bank, operating as Banco Los Andes ProCredit.

\textsuperscript{75} Calculated as the ratio of financial income to loan portfolio (Source: ASOFIN).
no ascertainable credit history could borrow from the bank if they got together in a self-selected group of 3 to 5 people that cross-guaranteed each other. This was a highly effective mechanism to bring in new borrowers to the bank while preserving asset quality, but the high transaction costs of forming groups made it vulnerable to individual loans, which the competition was quick to introduce. Figure 7, tracing the evolution of loan products at BancoSol from 1997 to 2001, shows it went from effectively being a monoproduct bank to offering nine different credit options by the end of the competitive crisis. As Rhyne states, “Unquestionably, most microfinance clients benefit from the advent of competition. More people have access to financial services, they can choose their supplier, and they can demand favorable terms. … it is important to reiterate the effects of commercialization on service quality, methodology, and new product development and to emphasize that these emerged independent of the crisis.” Since then, the Bolivian competitive experience has played out in several other countries, with the resulting drop in prices and the increase in product variety. In Mexico, where pricing remains high relative to the rest of the region, serious competition is emerging for the first time and this will accelerate the downward evolution of pricing and the introduction of changes to lending products and methodologies. The beneficiaries of this process will be Mexico’s poor.

Figure 7. BancoSol: From monopoly/monoproduct to multiproduct

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held constant, profitability improved as market penetration produced growth that leveraged on the economies of scale of the bank’s infrastructure. Eventually, in 1998 this model produced an ROE just under 30%. This was significant, as it solidified the image of BancoSol in the business community and strengthened its links to the capital markets. Meanwhile, the creation of social value was limited to the gains in the outreach of the bank --- new clients and larger loans for existing clients. With the onset of competition (and the crisis of 1999-2000), the bank’s profitability was decimated. In an intensely competitive market, arguably what BancoSol was losing in profitability was what the poor were gaining, via better pricing, more products and improved service. Competitive pressures have remained intense in Bolivia and BancoSol’s recent return to attractive levels of profitability has been achieved in a declining price environment. Now, profitability improvements are the result of management skills applied diligently to obtain efficiencies in the cost structure at a faster rate than the drop in prices. As a result, achieving a ROE of 26.3% in 2004 was consistent with the creation of social value (see Table 8 for the financial returns of BancoSol since inception).

Table 8 Banco Solidario S.A.: BancoSol Financial Returns Since Inception

<table>
<thead>
<tr>
<th>Year</th>
<th>ROA</th>
<th>ROE</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td>1.1</td>
<td>2.6</td>
</tr>
<tr>
<td>1993</td>
<td>0.8</td>
<td>4.4</td>
</tr>
<tr>
<td>1994</td>
<td>2.1</td>
<td>13.3</td>
</tr>
<tr>
<td>1995</td>
<td>1.3</td>
<td>9.2</td>
</tr>
<tr>
<td>1996</td>
<td>2.3</td>
<td>14.4</td>
</tr>
<tr>
<td>1997</td>
<td>3.4</td>
<td>23.8</td>
</tr>
<tr>
<td>1998</td>
<td>4.2</td>
<td>28.9</td>
</tr>
<tr>
<td>1999</td>
<td>1.4</td>
<td>9.0</td>
</tr>
<tr>
<td>2000</td>
<td>0.6</td>
<td>3.9</td>
</tr>
<tr>
<td>2001</td>
<td>0.1</td>
<td>0.5</td>
</tr>
<tr>
<td>2002</td>
<td>0.3</td>
<td>1.8</td>
</tr>
<tr>
<td>2003</td>
<td>1.9</td>
<td>13.4</td>
</tr>
<tr>
<td>2004</td>
<td>3.7</td>
<td>26.3</td>
</tr>
</tbody>
</table>

Source: BancoSol, ACCION International

At the base of the pyramid, in an environment in which competition is weak or not present, the link between profitability and social value may range from benign, (where the issue may be whether the potential of creating social value is being maximized), to harmful (where financial return is exacted while creating little or no social return.) An example of the latter may be an open air market strategically located at the intersection of two important roads, but where all the financing is provided by one moneylender in complicity with the local police chief, who will not allow anybody else to compete. It follows that one of the key variables to examine at the intersection of business and poverty is the barriers to competition --- their origins and the ease with which they can be overcome.

When barriers to entry are not artificial, and competition is not yet significant, whether profitability and social returns are complementary or antagonistic may depend on the use given to earnings. In the last six years, Compartamos in Mexico has been
earning an average annual ROE of 50.6%\textsuperscript{77} but it has used this to fuel an extraordinary growth, going from 48,835 active clients in 1999 to 309,637 in 2004, an average annual increase of 44.9%, making it the largest microfinance bank in Latin America (see Table 9). Compartamos made dividend payments of $2.50 million in 2004 and $1.95 million in 2005. However, given its shareholding, more than half of those funds went to nonprofit organizations (36.6% to Compartamos A.C., a leading Mexican nonprofit recognized for its educational and healthcare work, 17.1% to ACCION International, dedicated to microfinance); another 10.0% went to the World Bank’s IFC and 5.8% went to Profund, the world’s first microfinance equity fund. Only 30.5% of the dividends went to Mexican private shareholders, and these were the 18 individuals who came together when the notion of a regulated finance company to serve the poor in Mexico still required a stretch of the imagination (See Table 10).


<table>
<thead>
<tr>
<th>Year</th>
<th>ROA</th>
<th>ROE</th>
<th>Active Clients</th>
<th>% Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>42.0%</td>
<td>47.6%</td>
<td>48,835</td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td>51.9%</td>
<td>61.6%</td>
<td>64,141</td>
<td>31.3%</td>
</tr>
<tr>
<td>2001</td>
<td>18.4%</td>
<td>39.5%</td>
<td>92,773</td>
<td>44.6%</td>
</tr>
<tr>
<td>2002</td>
<td>17.8%</td>
<td>53.7%</td>
<td>144,991</td>
<td>56.3%</td>
</tr>
<tr>
<td>2003</td>
<td>18.3%</td>
<td>52.8%</td>
<td>215,267</td>
<td>48.5%</td>
</tr>
<tr>
<td>2004</td>
<td>18.3%</td>
<td>48.5%</td>
<td>309,637</td>
<td>43.8%</td>
</tr>
</tbody>
</table>

Source: MIX Market

Table 10. Financiera Compartamos: Dividend Payments

| Shareholder                  | Shares   | Dividends ($ '000) | | |
|------------------------------|----------|--------------------|---|
| Compartamos AC               | 36.60%   | $915 $714          | $1,629 |
| ACCION Gateway Fund, LLC    | 17.08%   | $427 $333          | $760 |
| IFC                          | 10.00%   | $250 $195          | $445 |
| Profund International        | 5.80%    | $145 $113          | $258 |
| Private Individuals          | 30.52%   | $763 $595          | $1,358 |
| Total                        | 100.00%  | $2,500 $1,950      | $4,450 |

Source: ACCION International

Conclusions

The experience of the last 30 years of microfinance illustrates the power of harnessing the markets to disseminate interventions that affect the productivity of the poor. The ability to turn these interventions into \textit{bona fide} businesses opens the door to the global capital markets. By linking the savings of the world to the poor, it makes it realistic to conceive reaching the entire base of the population pyramid, and to sustain that effort across generations. Because this can only be done through business, scale and sustainability are the signal contributions of commerce to the eradication of global poverty.

\textsuperscript{77} Average of the annual ROEs in 1999-2004.
In the process of establishing a social enterprise as a legitimate part of business, market rates of return, and superior profitability if possible, are vital. In this regard, any cap on business returns at the base of the pyramid, despite best intentions, appears misguided and short-sighted, so long as market conditions allow for the entry of competition. Support, if any, should go towards accelerating the onset of competition. It is competition that is most effective in maximizing the social returns on business, as it drives down cost, maximizes choice and improves service.

Modern microfinance has emerged as a leading example of how a social initiative can turn into an attractive business. However, thirty odd years ago, it seemed an absurdity. This suggests that other high impact activities for the base of the pyramid, seldom considered commercial or being in the province of the private sector, may have the potential to be reinvented, much as microfinance was. Primary healthcare and education may fall into this category. At the same time, understanding how social value is created by microfinance suggests ways in which the social impact of any business at the base of the pyramid may be evaluated and compared.

After hundreds of years focused on the top 30% of the population pyramid, the success of microfinance is solid evidence that business is at the threshold of moving towards its last frontier, the 4 billion people that live on an annual purchasing power of $1,500 or less. These are still uncharted seas, and as business and social enterprise sail into these waters, both can refer to the experience of microfinance, one of the first industries born solely to respond to the needs of the less-advantaged, and which has grown and prospered while it has sought to be an effective fulcrum for the poor as they strive to unlock the potential of their lives.

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78 Pralahad, *Bottom of the Pyramid*, p. 4.
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