

The Changing Role of Non-Profit Microfinance: An analysis of the changes in aspects of microfinance outreach over the last decade.

Adam Krauland
December 2012

Senior thesis submitted in partial fulfillment
of the requirements for a
Bachelor of Science in Economics
at the University of Puget Sound

Introduction.

Defeating extreme poverty is one of the greatest global challenges today. The World Bank defines extreme poverty as people living with an income at or below \$1.25(US) a day. Conservative estimates place the number of people living in extreme poverty at around 1.3 billion. If the income threshold is increased to \$2.00(US) a day, the number of people living in poverty approaches 2.5 billion or 35.7% of the world's population. Combating poverty is of vital importance and in the last century microfinance has risen as the primary tool for poverty reduction. Aliya Khawari (2004) defines microfinance as an institution that provides one or many different banking services, such as loans, insurance, and deposits to people who do not have access to formal banking institutions. People who take advantage of these services are generally members of poor and low income households or enterprises. These people are able to use these loans to create opportunities previously unavailable to them and potentially increase their status in life. These loans can be used to invest in businesses, to buy technology to better communicate, or simply allow a person to buy clothes to be able to be able to work a job. In this way, the services of microfinance translate directly into increased social welfare for its clients that would otherwise be unattainable.

The microfinance sector began in the 1970's and initially was comprised of non-profit organizations (Khawari 2004). However, in the last forty years microfinance institutions (MFI's) have undergone many changes, the most significant occurring in the last decade. In 1992, Prodem, a non-profit microfinance organization in Bolivia joined with local banks to become Banco Sol, the first commercial microfinance enterprise in the world (Schriener 2002). After this venture proved successful, for-profit enterprises became increasingly common in microfinance, innovating and changing the industry significantly. The commercialization of microfinance, spectacular growth in technology, and growing political awareness of microfinance as an effective poverty reduction tool has changed the way the world views microfinance from simply another charity delivery mechanism to a viable commercial opportunity with profit potential.

While the original goal of microfinance was to help alleviate poverty and increase social welfare, much has changed in the industry over the last decade, making it increasingly pertinent to analyze the shifts in microfinance and their impact on the impoverished. As a sector of the financial industry, there is much analysis of microfinance and the trends that are occurring within the sector in order to study the effects of microfinance on the impoverished and evaluate microfinance's efficiency and outcome for its clients. To date, there is little research looking into the effect of the changes in microfinance on the social welfare of the clients that are consuming its service. It is important to know how the changes in microfinance are effecting the impoverished, whether it is beneficial, and what these changes mean for the role of non-profits in a sector that is increasingly being penetrated by for-profit microfinance ventures.

In this paper I will use a framework for evaluating the effectiveness of outreach by microfinance organizations in order to analyze how the impact of drivers of change such as increased competition, technological progress, entry of for-profit firms and a change in political climate have affected the social welfare delivered by non-profit microfinance. Due to these forces there has been a marked mission drift in the delivery of microfinance which has resulted in much less emphasis on lending to the poorest persons. In addition these forces have caused a change in the role of non-profit microfinance from that of the innovator and entrepreneur of microfinance to being one part of a greater sector delivering finance services to the impoverished.

Review of Literature.

Rhynne and Otero (2006) have determined that the changes in microfinance can be distilled to four different forces; competition, commercial entry, technology, and an enabling political environment. They found that increases in competition between lenders in Latin American countries resulted in increased productivity, reduced operational cost and a lower interest rate to the borrowers. Figure 1 shows the interest rates on microfinance loans in Bolivia from 1998 to 2005.

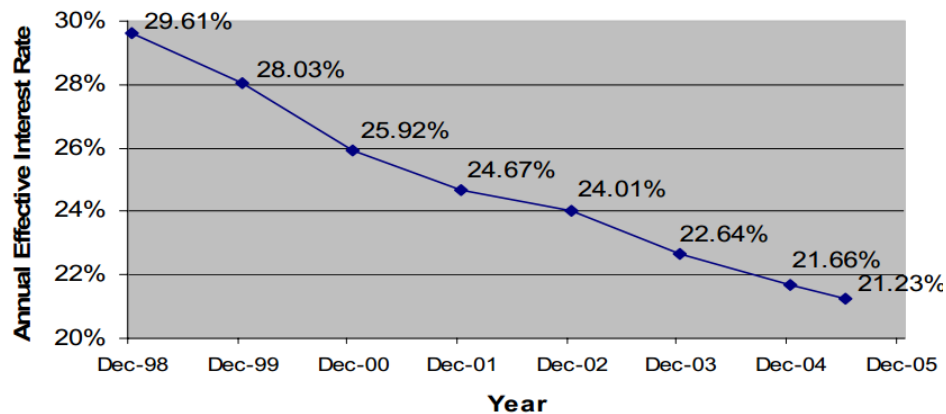


Figure 1 (Rhyne and Otero, 2006, pg. 15)

In the last 20 years commercial entry into microfinance has considerably increased after the first few commercial microfinance organizations’ “demonstrated profitability, business models that can be copied, and competencies for working with low income populations” (Rhyne and Otero, 2006). The entry of the commercial sector into microfinance has resulted in many more firms and thus increased competition. The commercial sector has also introduced much greater efficiencies into microfinance through the drive for greater profit.

Technology has been the greatest driver of change over the last two decades. With the popularization and proliferation of internet information, sharing and processing has never been easier. Access to microfinance services has become much easier as physical transactions are no longer needed. MFIs have classically relied on a great deal of personal interaction which has high associated costs, however, technology is allowing this to change, creating a new more efficient and cost effective relationship between borrower and lending institution. Rhyne and Otero also point out that microfinance is beginning to use technology not just to manage and enhance information, but on the front end with clients, utilizing ATM’s, smart credit cards, satellite communication, cell phones, etc. Caudill Gropper and Hartarska (2009) present a mixture model that suggests that the overall costs of microfinance organizations are decreasing and relate this to, among other factors, technological progress.

Throughout the history of microfinance organizations, governments have for the most part been adopting policies that lead to more liberal financial markets. Rhyne and Otero found that microfinance does well in “settings where the government did not follow directed credit policies, allowed interest rates to be market-determined, kept credit allocation separate from politics, and was not itself involved in direct lending” (pg. 19). In a case study focused on regulatory frameworks, Gallardo (2002) found that in Ghana and the Philippines, a tiered regulatory framework that clearly identifies pathways for lending institutions to become legitimate can lead to greater realization of outreach potential for non-profit microfinance organizations.

Schriener asserts that the main objective of microfinance is to improve the welfare of the poor. In addressing whether poverty-focused MFIs or sustainability-focused MFIs improve social welfare the most, Schriener created a framework for outreach to evaluate the impacts of microfinance on society. Schriener’s framework consists of six different aspects in which a microfinance organization enhances social welfare: worth, cost, depth, breadth, length, and scope. This framework, while being highly conceptual, allows one to measure, however rudimentarily, the social benefit of a MFI.

Schriener defines the *worth of outreach to clients* as the client’s willingness to pay for the lender’s services. These costs depend on the financial contract as well as the tastes, constraints, and opportunities of the client. The *cost to the client of welfare* is defined as the sum of the price costs and the transaction costs, where price costs are direct cash payments for interest and fees while transaction costs are measured by non-cash opportunity costs as well as indirect cash expenses. *The depth of outreach* is the value that society attaches to the net gain of a client. Assuming, for example, that society would rather give a gain to a poverty stricken individual rather than a wealthy person, one can infer that the worse off someone is, the greater the depth that is attributed to lending to them. Some examples of this would be lending to females as opposed to males, in rural locations versus urban ones, to people with less education rather than more, to people with less access to public resources rather than more. *Breadth* is the number of clients reached. As breadth increases more people in society are receiving financial services, and

assuming they wouldn't engage in the services unless there was some benefit to it, one can say that the greater the breadth, the greater the outreach. *Length of outreach* is defined as the time frame of supply of microfinance. Finally, *scope of outreach* is defined as the number of types of financial contracts supplied. The greater the scope, the more services one can access at a single institution, allowing for lower transaction costs for the various social welfare services.

Analysis.

The last ten years has seen a great deal of change on a global scale. The internet has come into prominence, as well as the mobile industry has boomed, resulting in more than 2 billion mobile phones currently in use (Donner 2005). For the first time recently the microfinance industry is comprised of both non-profit and for-profit organizations. The critical question that arises is what effects do these changes have on non-profit microfinance, and more specifically, on the different aspects of its outreach?

The amount of services provided by a non-profit firm differ in a fundamental way from a for-profit firm. As shown in Figure 2, due to the non-distribution constraint, a welfare maximizing non-profit will not serve at the traditional profit maximizing point where a for profit firm will choose to operate. Instead the non-profit firm will produce where marginal revenue is equal to average cost (Q^*). This maximizes the services provided by a non-profit organization, and therefore maximizes the welfare the MFI delivers to its clients, all else held equal. The important result from this is that any increases in technology or lower costs for a non-profit firm should be turned completely into greater output, or greater welfare delivered to the organization's clients (Q'). As average cost decreases, quantity produced will increase. This relationship indicates that the amount of social welfare a microfinance firm delivers is directly affected by any changes in non-profit microfinance's costs.

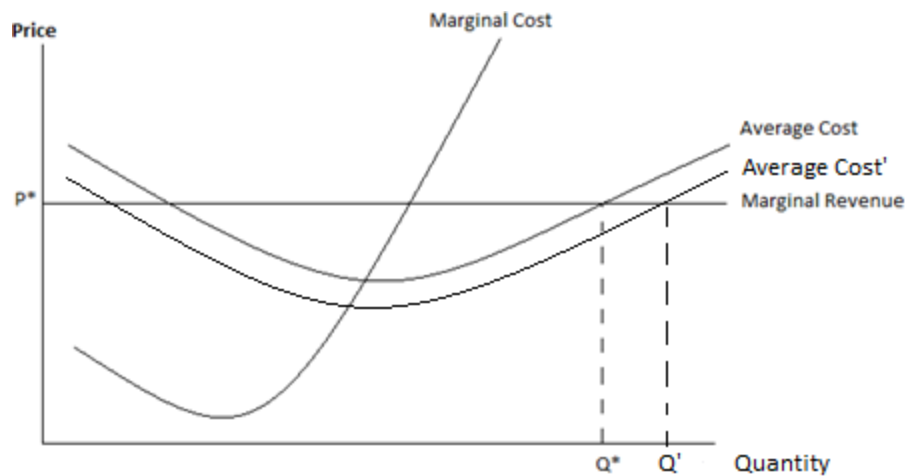


Figure 2

Using Schriener's framework, one can analyze how outreach is changing in microfinance due to Rhyne and Otero's four main components of change. Conclusions may then be drawn as to why microfinance outreach has been changing as it has, and what the implications of this change are for the industry. The aspects analyzed will be Cost, Depth, Breadth, Scope and Length, excluding the worth to clients. The value a client derives from a service is highly subjective and any attempt to measure this value would surely be subjective and conjectural and thus will be excluded from this analysis.

The data provided for the analysis comes from Mix Market (accessed at www.Mixmarket.org) which provides a free dataset on both for-profit and non-profit microfinance organizations. The data includes over 12,000 observations from 1997 to 2011, 7350 observations from non-profit microfinance firms and 4733 from for-profit firms. It comprises firms from all six continents and every major region in the world. The data provided by Mix Market is not self-reported; rather it is taken from audits, financial statements, and other documents. It has multiple year information on over 2000 different microfinance organizations from all over the globe. This, paired with the nature of the information retrieval, makes it a reliable source of information for the various aspects of a microfinance firms finances.

Governmental effect on the aspects of outreach

The effects of governmental policy, while surely important for each of the aspects of outreach, are extremely varied and specific from region to region making it difficult to determine what the overall effects of individual countries are on the entirety of microfinance outreach. While governments have for the most part accepted and tried to incorporate microfinance into their policies, the effects of governmental intervention on certain aspects of outreach are too specific for any general claim to be made. Some governmental policies are restrictive, putting caps on the rates MFI's can charge as well as what types of services they may provide, severely limiting their abilities. In contrast, other governmental policies have done the opposite, creating protectionist policies and helpful frameworks which give microfinance an environment in which it can thrive, experiment, and grow.

Breadth of outreach

Breadth of outreach is simply the number of clients using the micro lender's services. The more people able to engage in micro financing, the greater the social benefit and outreach an organization is able to contribute to society.

As technology makes back-end computations faster and cheaper, organizations are able to manage their clients more efficiently. Information sharing between firms allows the MFIs to have better information on clients, resulting in better decision making regarding borrowers and lending terms. Improvements in communications allows for better contact with clients, which can create a greater sense of responsibility for the client to repay their loan. As informational efficiencies increase one would expect the rate of arrears to decrease. Firms can better align their assets, and lend to more clients, increasing breadth. In addition, the increased availability of communications allows the MFIs to reach a greater client base as travel becomes less of a necessity.

Competition forces MFIs to expand their client base. More competition in a market incentivizes firms to lower costs in order to be competitive. Lower costs make the firm's services attractive to more clients. Similarly, the pressure of competition on cost will allow the firm to accept more clients. The

substantial increase in breadth is shown in Figure 3 which depicts the increase in number of clients for the largest 20 MFI firms from 1996 to 2007. This figure shows the effect of competition increase on the breadth of outreach in the MFIs.

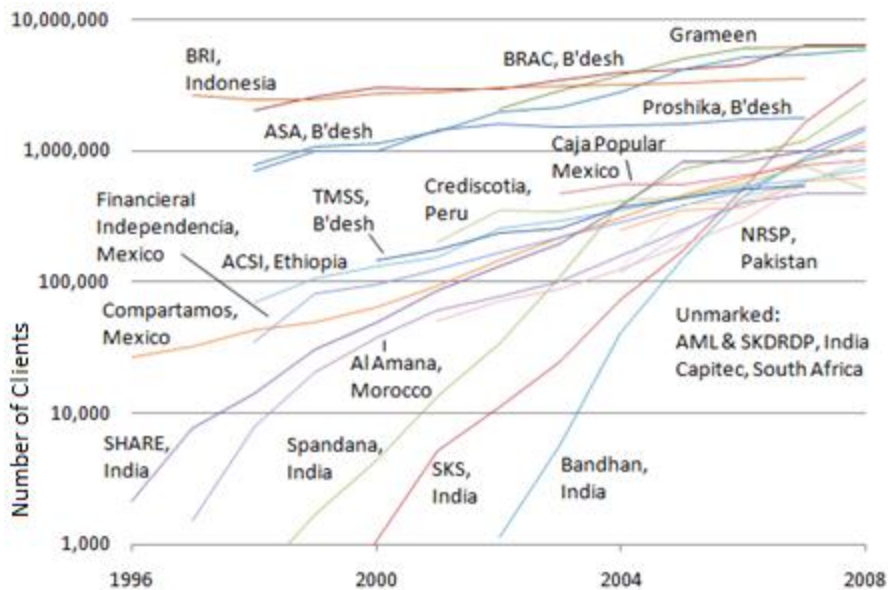


Figure 3 (Mix Market, 2012)

The recent surge in commercial microfinance has increased breadth of outreach greatly. Using new and creative lending models to cut costs and increase profitability per loan, for-profit organizations have created a profit focused approach to microfinance which puts emphasis on increasing number of clients. These models are being copied by non-profit firms who hope to also become financially sustainable.

The breadth of outreach is the simplest aspect of outreach to measure as it is just the number of people receiving microfinance services. Figure 4 shows the increase in total clients receiving MFI services over the last decade. This can be attributed to lower costs and prices in microfinance. Similarly, this increase can be attributed to a greater desire to offer these services as the model of microfinance becomes more sustainable. The two declines on the graph are seen in 2001 as well as around 2008. These correspond to the two financial market crashes, one being the tech bubble and the other the more recent

housing bubble. This allows insight into how important financial expectations are in the delivery of microfinance services to non-profit MFIs. These numbers show that the breadth of outreach is indeed increasing, as microfinance services are being delivered to greater and greater numbers of people around the globe.

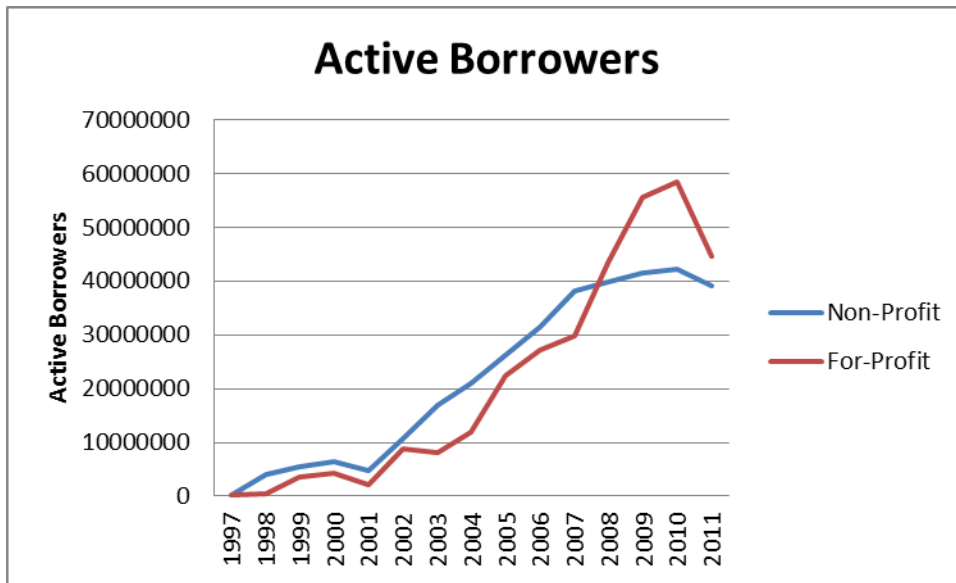


Figure 4. (Mix Market 2012)

Cost to Clients of Outreach

The cost to clients of outreach is the amount of money that is necessary for a client to access and participate in microfinance. This manifests itself in such things as payments for fees and interest on loans. The costs of outreach to clients also includes opportunity costs. An example of this is time spent applying for and utilizing the microfinance's services as well as the cost of gas and paper and any other expense incurred to be able to use the service.

The increase in technology has had a pronounced effect on the cost to clients of outreach. Donner reports that in 2005 over 80% of the world lived within range of a cell phone network (pg. 2). Small businesses and social entrepreneurs have been making increasing use of this technology. Mobile phones

are a low cost way to communicate with a borrower to share information that would otherwise require a trip to the offices of the microfinance institution. In addition to cell phones, technologies such as ATM's, the internet, and credit cards, allow for the basic functions of an MFI to be used remotely. These technologies can be used to access one's account and even allows for repayment, minimizing both time and travel costs to the client

Competition decreases the cost of outreach. As more firms enter the market, clients have more choice of where to borrow and so they can choose a firm that can provide the lending services for the lowest cost. Knowing this, firms will do their best to lower the costs to their clients, so as to attract the optimal amount. Secondly, having more than one firm in the market will inspire creativity for firms to come up with more cost-effective ways of operating in order to lower their operating costs, prices, and increase output.

Commercial entry in microfinance has caused lower costs. Using the profit motive to structure its processes differently; commercial organizations have found many ways of reducing MFI's costs. These business models can and are being copied by the non-profit MFIs, and being used to reduce costs across the board.

Directly measuring the cost to clients of outreach is difficult due to the methods of financial record keeping. Focusing on monetary costs as proposed by Mersland and Strom (2008), one can look at different aspects of the income yield of microfinance as it makes up the revenue ratio of monetary costs to clients. Figure 5 shows the trend of the Average Operating Expense Ratio of non-profit and for-profit organizations. The trend is downward signifying reduced operating expenses which allow the cost to clients to decrease, increasing clients' welfare. However, when looking at the firms Average Portfolio at Risk in Figure 6 as well as the Average Write off Ratio in Figure 7, these diagrams show an increase in risk and write-offs over the last decade. When looking at the Average Cost of Funds Ratio an increasing trend is again observed (Figure 8). This leads to the conclusion that lower operating expenses are allowing non-profits to increase their lending. When lending increases so does the amount of risk taken

on by a firm. This is due to the fact that as a firm expands their number of clients they must relax their risk threshold to include a greater population to lend to. This causes their overall risk to increase as a result of lowered operating expenses and increased lending. The ability to lend to more clients indicates an overall decrease in the cost to clients.

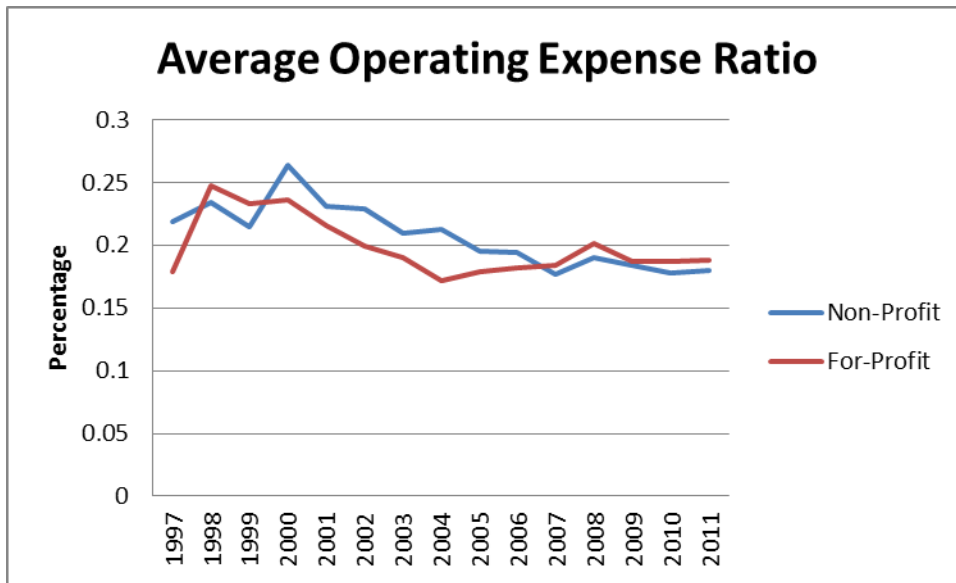


Figure 5. (Mix Market 2012)

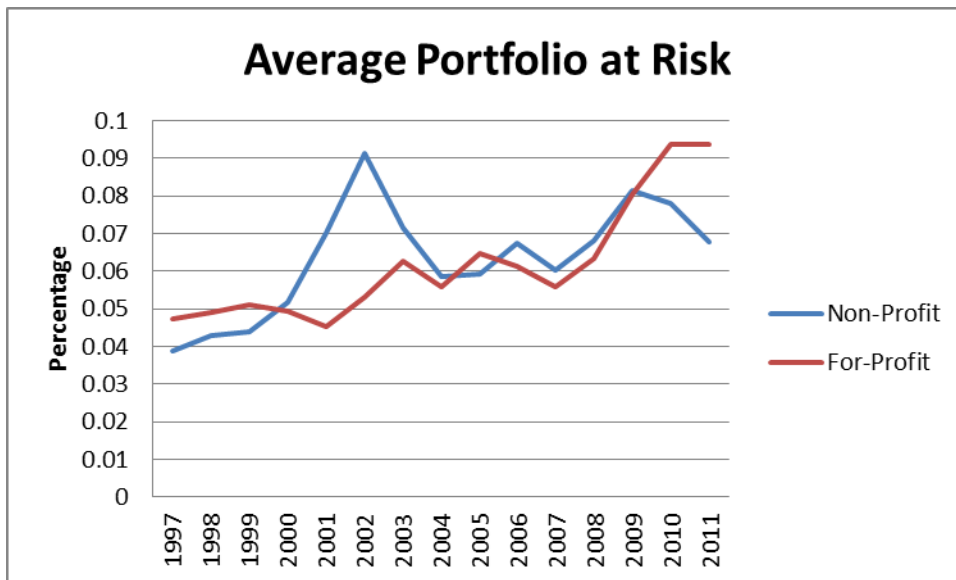


Figure 6. (Mix Market 2012)

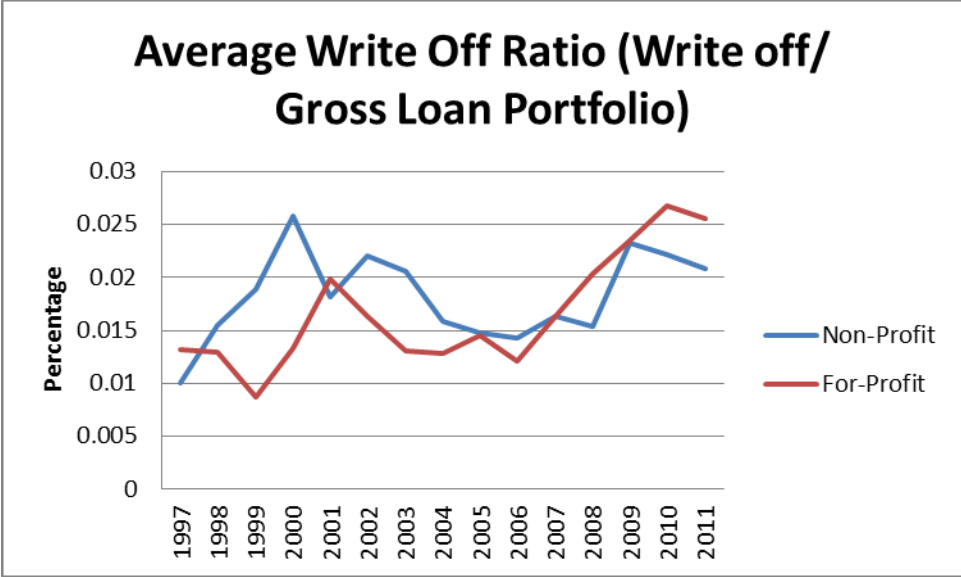


Figure 7. (Mix Market 2012)

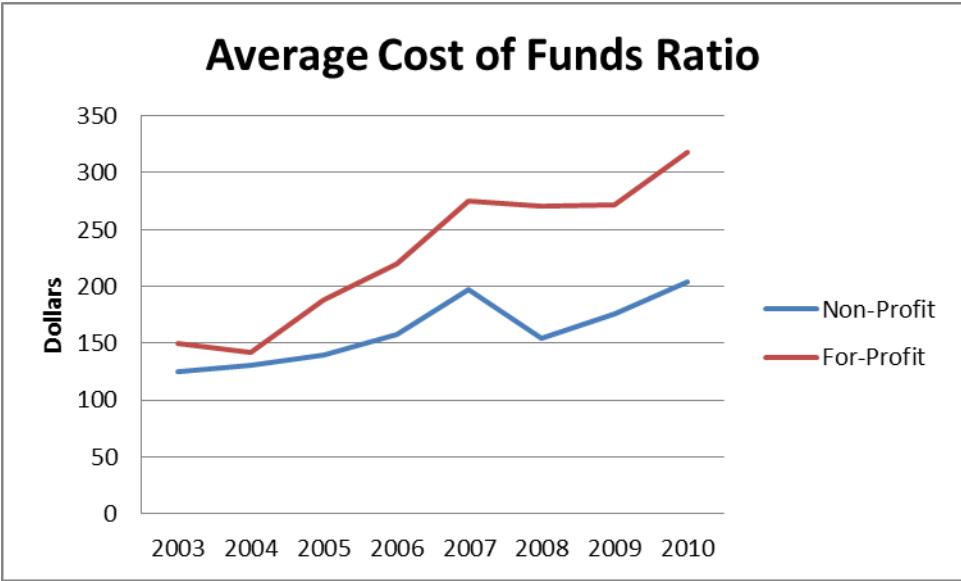


Figure 8. (Mix Market 2012)

Depth of outreach

The depth of outreach is the value that society places on the gain of a client. In the case of non-profit microfinance, whose goal is to reduce poverty, value is increased by helping people who are worse off in society. Basic proxies for this are income, education, area, ethnicity and sex. The less income and

education a client possesses; the more depth of outreach. Similarly, if a client is female, a minority, or living in a more rural area, depth is increased relatively. These demographics and thus depth of outreach, equate to how well microfinance reaches those people in society with the greatest need. Therefore, by definition, an increase in depth of outreach leads to an increase in overall outreach.

The technologies that facilitate changes in depth almost entirely revolve around the communications revolution. This effect is two-sided. The proliferation of cell phones and the internet allow more rural populations to communicate with and utilize the services of microfinance organizations which are likely to be located in more populated centers. Similarly, this technology allows the reverse as well. With better communication the MFI's are better able to seek out the socially disadvantaged, whether it be women, the poor, or those in rural communities. Better technology provides increased information. MFIs can utilize technology to determine where their services are needed and provide them to those markets. One potential negative consequence is that an increase in reliance on these technologies can make borrowing prohibitively expensive for the poor who cannot afford mobile technology or internet services.

As more institutions enter the microfinance market, the number of clients able to utilize the services will increase. This is due to a firm's physical ability to lend to more clients, but due to the effects of competition, these firms will need to lower their costs and have more money to lend in order to attract business. Firms will also expand their financial services in order to better meet the needs of a larger number of people. These actions will cause organizations to seek out clients beyond their original scope. This includes clients who are not located near the MFI, clients who could not originally afford the services and clients who would not have been accepted previously for other socially undesirable traits, such as being women or minorities.

The entry of commercial organizations has put more emphasis on financial sustainability in the microfinance sector. With this focus on increased financial sustainability comes a de-emphasis on the depth of lending. This is due to a general shift in opinion that lending to the less poor and thus lowering

arrears rates, or overdue money, is more socially beneficial because the organization can be more financially sustainable. Khawari reports that average income impact of borrowers near poverty line is greater than those below the poverty line or in other words, borrowers near the poverty line get more financial improvement from using MFI's services. This focus has steered the sector away from the more socially disenfranchised.

The depth of outreach is most easily ascertained by looking at two different values. The first is the Percentage of Female Borrowers (Figure 9). While relatively high to begin with, non-profit microfinance has not increased the percent of female borrowers by significant amounts over the past decade. Given the already high percentage, this could be due to the fact that they are already reaching a large amount of female borrowers and so are not concentrating any extra efforts to this cause. Another proxy measure, though not as useful, is the Average Outstanding Loan per Client (Figure 10). The greater the average outstanding loan, the less impoverished the client base as poorer people cannot afford to take out larger loans. This value has also not changed much, yet increased slowly and steadily over the last decade. The conclusion can only be that the depth of outreach is slightly decreasing. The recent emphasis on loan sustainability versus lending to the lowest classes has resulted in non-profit firms decreasing their total depth of outreach to their clients. This trend is more prevalent in for-profit microfinance, which has seen a huge increase in Average Outstanding Loan per Client, showing the focus on greater revenue versus greater social welfare for these organizations.

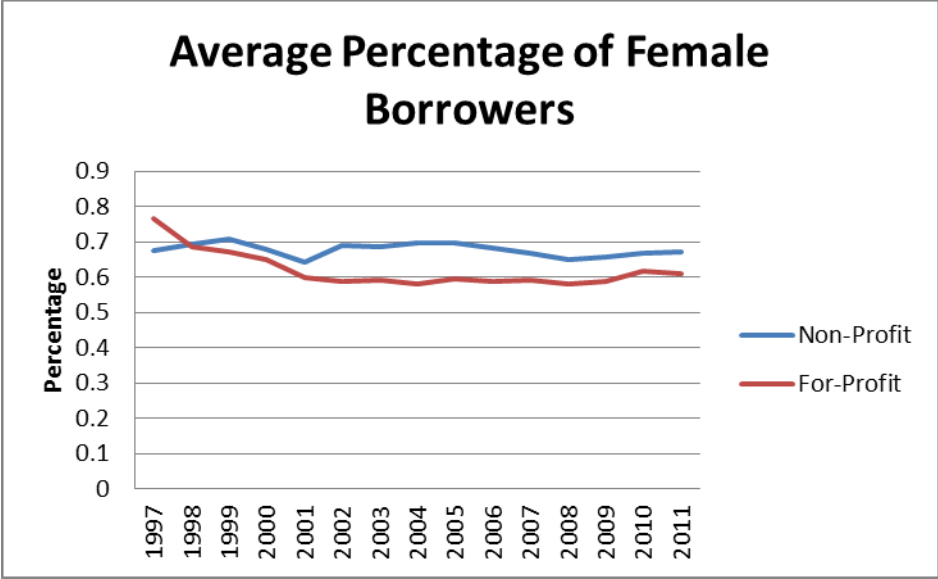


Figure 9. (Mix Market 2012)

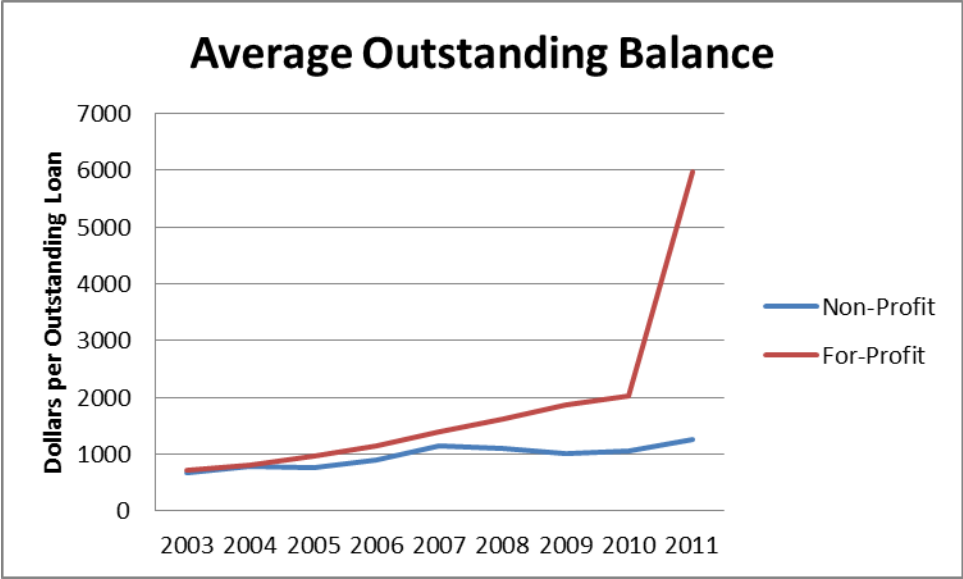


Figure 10. (Mix Market 2012)

Length of outreach:

Length of outreach refers to the amount of time a specific microfinance firm is able to deliver its services, or in other words, how long the firm is able to operate in a given location. This analysis will focus on lenders leaving markets solely due to lack of funds to continue operations. If the organization ceases to exist, so does its welfare enhancing benefits. When a client uses an organization more than once, there is a reduction in transaction costs as some trust and information has already been established. The longer an organization exists, the greater the outreach it is able to provide.

Technology's role in determining length of outreach is less salient than other aspects. The length of outreach of an MFI is mostly determined by how profitable the firm is, allowing it to continue its operations. While technology helps by reaching clients and lowering arrear rates, it doesn't do much to directly contribute to the lengthening of the presence of an MFI, though it does allow it to be more sustainable. The direct effect of technology on length is unclear at best, though it is more likely to increase length than reduce it.

Competition's effect on length is similarly unclear. As more firms enter a market, increases in competition will cause the revenue per unit of loan or total revenue for each individual MFI to decrease. This means that if a firm does not increase its efficiency enough to be able to reduce its loan rates to remain competitive with other firms; it will be forced to leave the market.

The more firms entering the market, the more competition a MFI has in obtaining donations. Donations can be vital for non-profits as their social focus generally makes them less financially sustainable due to inefficiencies and arrear rates associated with lending to the most poor. The firms that are able to stay in the market will thus be more sustainable.

Profit seeking firms have revolutionized microfinance with the realization that microfinance services can be delivered to the poor profitably. Driven by big banks and investors, the focus of the commercial sector to create revenue has produced a model where microfinance does not need to rely on donations. While donations allow non-profits to operate longer, donations are not a very reliable source of

income. As non-profits mimic the for-profit model of financial sustainability they too become less reliant on donations. This allows them to deliver their services for a greater length of time.

The length of outreach is best determined by using the firm's returns as a proxy. A non-profit microfinance organization will stay around until its services are not needed or until they are unable to fund their services. Since the number of impoverished is high we can assume length is only affected by whether or not a non-profit MFI is able to continue operations. A reliable method of determining this is by looking at the firm's revenue in excess of costs. Since these organizations are subject to the non-distribution constraint, any revenue earned exceeding costs can go back into the business, and towards maintaining their services. Figure 11 shows the Average Profit Margin made by non-profits over the last decade. It is clear these values are increasing as non-profits put more emphasis on financial sustainability. In the last year non-profits have averaged a positive profit margin, and thus the longevity of these institutions has increased as they are not forced to look for donations or drop out of the market due to losses. This permits much greater length of outreach.

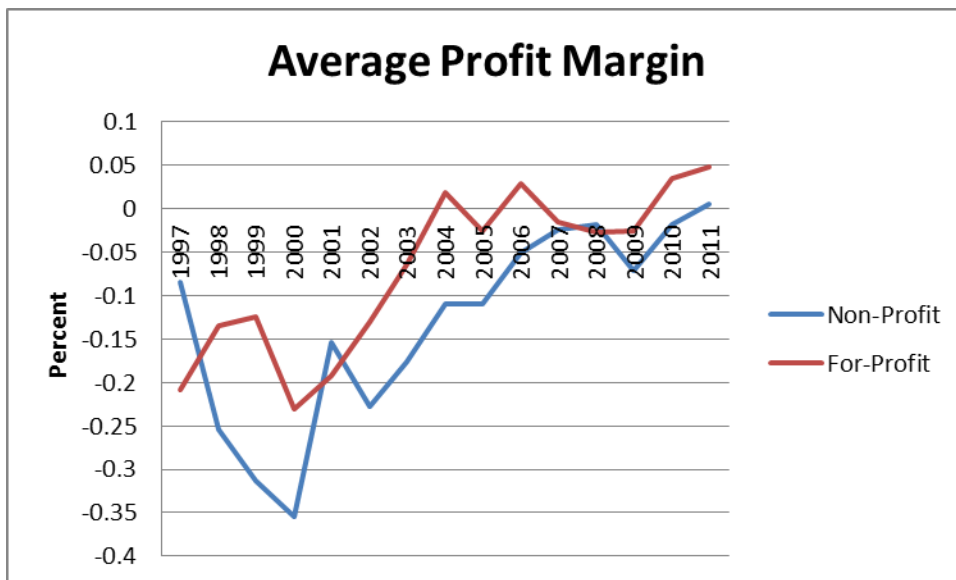


Figure 11. (Mix Market 2012)

Scope of outreach:

Scope of outreach is the number of types of financial services provided. There can be scope between products, such as having savings accounts as well as loans, and scope within products, such as loan contracts for many different amounts (\$100 loan, \$200 loan, etc.). The greater the scope an organization offers, the more clients it can satisfy through greater specialization. Therefore, as scope of outreach increases, the overall outreach and social benefit of the organization increases.

Technology has had a profound effect on the scope of outreach. The internet has allowed MFIs to require less human capital in the production of their services, so offering an additional service does not require the number of skilled workers it would have previously to carry out transactions for its services. This allows microfinance firms to provide many different services to its clients at a low cost. Similarly, new computing technologies allow MFIs to be much more flexible in their financial contracts, allowing for a spectrum of loan values. Due to this flexibility MFIs are able to more easily customize their services for each client.

Competition is probably the biggest driver of change when it comes to a firm's scope. As more firms enter a market, each firm will seek to differentiate itself from the others, offering more customized and unique services to attract potential clients. Also, competition causes firms to reduce the cost of offering each service, making it less costly and therefore more desirable for a firm to increase the range of products they have available.

The innovations of the commercial market have shown that microfinance can do more than just offer loans in order to help their clients. With the introduction of other financial services, market entry has spurred growth in the scope of outreach among MFIs.

Data on the increases in scope of outreach is difficult to gather on a global scale, but anecdotally the evidence does point to greater provision of unique financial services in microfinance organizations. Figure 12 shows the diversification of financial services offered by the for-profit firm BancoSol from 1997 to 2006. All of microfinance, non- and for- profit, has much incentive to increase their product

offerings as it will increase their customer base as well as providing plans that better suit customer needs, thus decreasing the rate of arrears.

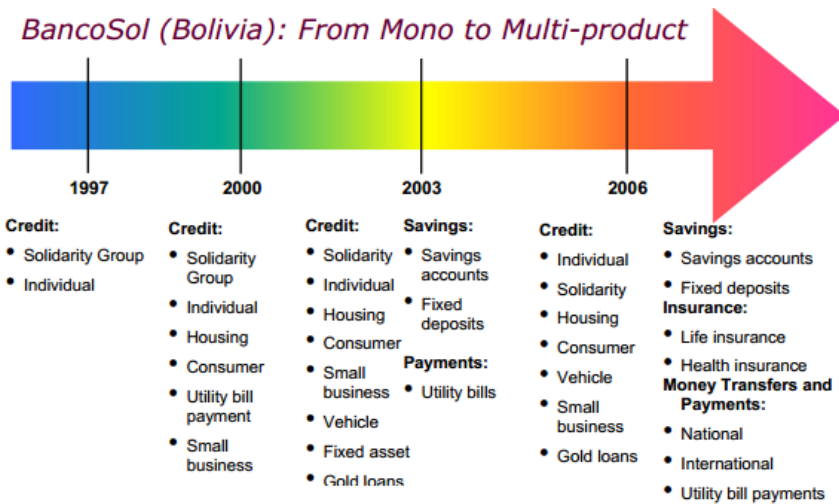


Figure 12. (Rhyne and Otero 2006)

Over the last decade microfinance has become much more prevalent and more effective due to changes in technology, the increase in competition, and the entry of for-profit firms and their new approach to lending. The culmination in these processes has impacted non-profit microfinance and has altered the way it approaches the delivery of financial services to the poor. The next section will go into more detail on what has changed and what it signifies for the non-profit microfinance industry.

Implications

The outreach of non-profit microfinance organizations has changed dramatically in the last decade. The focus on greater depth and reduced costs to the client has been de-emphasized. In its place, these organizations have instead put their efforts into increasing their longevity and have focused on increasing clients and revenue. The result is a marked mission drift in the non-profit microfinance industry.

Non-profit microfinance was created in order to bring financial opportunities to those without access to formal lending solutions. This led to a goal that is best described as “increasing the welfare of

the poor”, implicitly referring to the poorest. Yet in the last decade, while different forces have created an industry that is much more efficient and effective, lending to female clients has remained stagnant (Figure 9), and the average size of loans has increased; an indicator that the non-profit MFIs are lending to clients who are less impoverished (Figure 10). These facts point to either a stagnation or reduction in the depth of outreach as delivered by non-profit MFIs. This trend is contrary to the original goal of microfinance to help those who are financially the worst off.

This mission drift is due to a shift in the climate of opinion in microfinance surrounding the best way to deliver its services. The new focus on sustainability has come out of a series of papers by Mosley, Hulme, and others who have found that, ” MFIs are likely to produce a higher income impact by focusing their lending on clients just above the poverty line who would also invest in technology to improve the efficiency of their activities helping them earn higher returns on their investments” (Khawari 2004).

While this mission drift has caused non-profit MFIs to stray from reaching the most impoverished, there are a couple things worth noting. Firstly, the move towards self-sustainability and lending to clients at or above poverty line has been proven to have a greater impact. This increase in impact is due to the fact the less impoverished can borrow greater amounts, allowing them to use the finances to fund more viable or profitable business ventures. The small amounts of money available to the most impoverished are less likely to be used for capital purchase, and thus have less effect on the overall incomes of the borrowers. The result is a larger welfare increase for the same amount of money lent per loan. Even though mission drift has occurred, it has been in a direction that has increased societal benefits. It is also important to understand that poverty is defined as peoples who make an average income of \$1.25(US) a day. Keeping this in mind, lending at or just above poverty level is still reaching extremely poor people.

This shift towards greater sustainability is pushing non-profit microfinance organizations towards operating in ways similar to for-profit microfinance organizations. In almost all aspects of outreach, non-profits have converged with for-profits over the last decade. As for-profits focused their efforts and

innovations on becoming profitable, non-profit microfinance copied these innovations and as a result Figure 11 shows the gradual increase that both non-profit and for-profit microfinance sectors enjoyed in their profit margins. Similar trends are found in the breadth of outreach (Figure 6) as well as in risk taken on by the firms (Figures 6 and 7). Non-profits and for-profits are building off each other's ideas creating a sector that is more homogenous.

Despite the increasing homogeneity between the two sectors, there are two aspects where non-profit and for-profit microfinance organizations are increasingly different. The Cost of Funds Ratio (Figure 8) is increasing for both sectors, yet the rate at which it is increasing for for-profits is much greater. The same trend is seen in the Average Outstanding Balance (Figure 10), which while increasing steadily for non-profits, has begun to climb sharply in the last couple of years for for-profit MFIs. These two trends highlight the defining differences between the non-profit and the for-profit microfinance sector today.

The cost of funds ratio for a lending institution is the cost incurred by the institution to raise the funds necessary to lend to borrowers. People who invest in microfinance do so because of the high returns that are generated by the high risk of non-collateral lending to the impoverished. This leads to for-profits lending on average much greater sums and undertaking much more risk than non-profit MFIs (Figures 6 and 7). Due to this for-profit microfinance organizations will have greater costs to clients of outreach when compared to non-profit organizations.

The increasing popularity of microfinance has resulted in the number of firms investing in these financial products increasing, leading to greater competition. In order to increase profits, for-profit microfinance has not only increased its risk, but has also increased the average amount it lends to borrowers (Figure 10). Larger loans mean greater interest payments and profits which draws more investors to the for-profit firms. The effect of this, though, is to decrease the depth of outreach delivered by for-profit microfinance. This is because the more impoverished cannot afford to borrow increasingly

greater sums of money. Non-profit microfinance, however, has not experienced such a marked increase in its Average Outstanding Balance.

The result is a microfinance sector comprised of two types of organizations, non-profit and for-profit. These organizations are becoming increasingly similar in outlook and mission, delivering microfinance services to the poor, but in such a way that the organizations can make a profit and so be sustainable. Both are creating new and innovative lending methods using recent technological advances to reach and meet the needs of a broader range of clients. While costs overall are greatly reduced, for-profit firms are delivering larger loans at a slightly greater cost per dollar. This reflects their need to meet their shareholders' desires of greater profit through risky financial products. Non-profits, however, are loaning smaller amounts to clients, at a slightly lower cost. Apart from these differences, these organizations are offering comparable loans as well as outreach, creating an increasingly predictable and consistent microfinance sector.

As non-profit and for-profit MFIs become more similar it becomes increasingly pertinent to ask what the role non-profits play in the microfinance industry. Initially non-profits played the role of social entrepreneur in the microfinance industry, innovating by developing and applying new technology (Frumkin, 2002). They used their lower costs and donations to provide a service that was prohibitively costly for commercial firms. Due to increases in innovations, technology, and efficiency this is no longer the case. The microfinance sector now more closely approximates other mixed sectors such as hospitals, nursing homes, and daycares in that roughly the same services are available from both for-profit and non-profit providers. This is because changes led to a great enough increase in profit and decrease in costs that entry began to take place. While one might believe the for-profit's ability to provide a comparable service more efficiently and competitively would put pressure on non-profits forcing them out of the industry, this has not been the case; for hospitals or microfinance organizations. Rather the ratio of non-profit to for-profit microfinance organizations has stayed largely the same over the last ten years (Figure 13).

The theory that non-profits step in to alleviate contract failure, as proposed by Hansmann (1980), provides a framework for describing the current relationship between for-profit and non-profit microfinance. Being non-profit allows microfinance organizations to enjoy greater trust from their borrowers, differentiating themselves from the more competitive for-profit organizations. In this way the less efficient non-profits are able to retain their position in the microfinance industry because some borrowers will prefer to use the services of a firm that is not motivated by profits while other clients may prefer the greater infrastructure and efficiencies that come with profit focused microfinance.

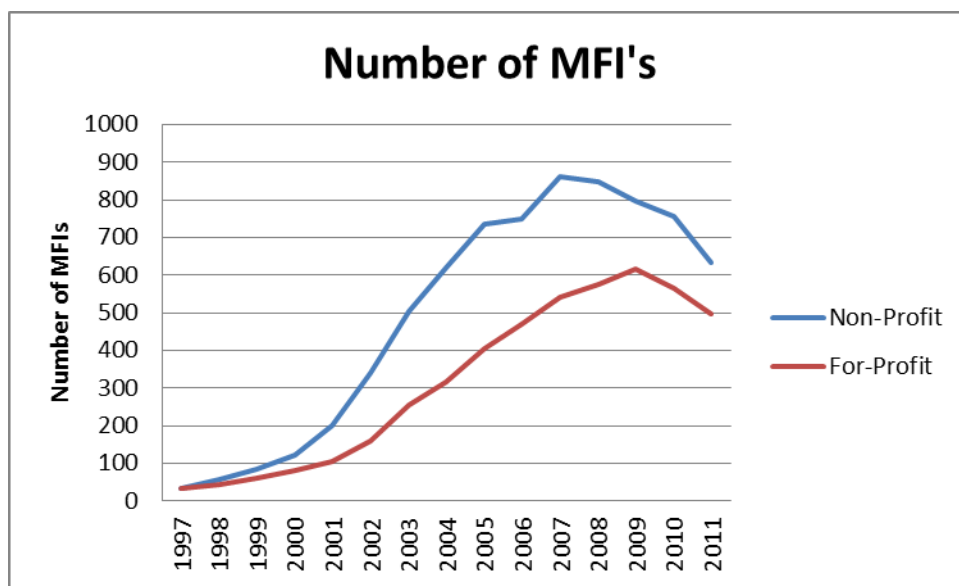


Figure 13. (Mix Market 2012)

Conclusion.

Over the last decade the landscape of microfinance has shifted dramatically. Due to changes in technology, competition, policy, as well as the entry of for-profit firms, microfinance is much more efficient, profitable, and effective. The number of organizations providing microfinance services has increased exceptionally, as well as the number of people receiving these services. Using Schriener's framework for analysis of microfinance outreach it becomes clear that social welfare generated by microfinance today dwarfs that of a decade ago. The way in which microfinance improved this welfare

led to a change in the ways it delivers its outreach. Due to competitive forces and mission drift of non-profits towards focusing on self-sustainability and thus increased revenue, microfinance organizations are lending to less impoverished people as well as slightly increasing the cost to the clients. This has allowed non-profit MFIs to increase the number of people it lends to as well as increasing the length of time the firms operate, allowing for repeated lending in the community. These changes are making non-profits more similar to for-profit MFIs, reflecting a shift in the role of non-profit microfinance from that of the entrepreneur proving the feasibility of microfinance to one part of the larger and more demanded microfinance sector of today. There is very little literature on the negative impacts of the recent changes in microfinance, and that is reflected in the arguments presented in this paper, which are surely skewed in a positive direction. Further research should be directed towards the possible negative effects of the changes in microfinance, and specifically, the impact of a more homogenous microfinance industry on the most impoverished borrowers. As the microfinance industry becomes more homogenous and focused on financial sustainability, the ability for the most impoverished to borrow is negatively affected.

References:

Al-Mamun, A., Malarvizhi, C. A., Hossain, S., & Siow-Hooi, T. (2012). Examining the Effect of Microcredit on Poverty in Malaysia. *ASEAN Economic Bulletin*, 29(1), 15-28. doi:10.1355/ae29-1b

Caudill, S. B., Gropper, D. M., & Hartarska, V. (2009). Which microfinance institutions are becoming more cost effective with time? Evidence from a mixture model. *Journal of Money, Credit and Banking*, 41(4), 651-672.

Cull, Robert J., Asli Demirgüç-Kunt, and Jonathan Morduch. *Microfinance tradeoffs: regulation, competition, and financing*. World Bank, 2009.

Dichter, T. W. (1996). Questioning The Future Of NGOs In Microfinance. *Journal Of International Development*, 8(2), 259-269.

Donner, J. (2005). The use of mobile phones by microentrepreneurs in Kigali, Rwanda: Changes to social and business networks. *Information Technologies and International Development*, 3(2), 3.

Frumkin (2002). *On Being Nonprofit*. Cambridge, Massachusetts. Harvard University Press.

Gallardo, J. (2002). A framework for regulating microfinance institutions: the experience in Ghana and the Philippines. *World Bank Policy Research Working Paper*, (2755).

Hansmann, H. B. (1980). The role of nonprofit enterprise. *The Yale law journal*, 89(5), 835-901.

Hermes, Niels, and Robert Lensink. "The empirics of microfinance: what do we know?." *The Economic Journal* 117.517 (2007): F1-F10.

Hermes, Niels, Robert Lensink, and Aljar Meesters. "Outreach and efficiency of microfinance institutions." *World Development* 39.6 (2011): 938-948.

Khawari, A. (2004). *Microfinance: Does it hold its promises? A survey of recent literature*.

McIntosh, C., & Wydick, B.(2005). Competition and microfinance. *Journal of Development Economics*, 78(2), 271-298

Mersland, Roy, and Strøm, Reidar Øystein. "Performance and trade-offs in Microfinance Organisations—Does ownership matter?." *Journal of International Development* 20.5 (2008): 598-612.

Mix Market (2012). Trends for Microfinance. Retrieved from http://www.mixmarket.org/mfi/trends/products_and_clients.number_of_depositors/2005-2009

Rhyne, Elisabeth, and Maria Otero. *Microfinance through the next decade: Visioning the who, what, where, when and how*. ACCION International, 2006.

Schreiner, Mark. "Aspects of outreach: A framework for discussion of the social benefits of microfinance." *Journal of International Development* 14.5 (2002): 591-603.

World Bank (2012).Poverty Overview. Retrieved from
<http://www.worldbank.org/en/topic/poverty/overview>