The microfinance industry is rapidly changing as increasing numbers of profit-seeking firms enter the market. Based on field interviews from Bangladesh, this paper investigates why profit-seeking microfinance firms are likely to be more efficient, financially sustainable, and lend to poorer households than their non-profit counterparts.
Do Profit Incentives Matter in Social Lending Programs?

Amidst the metallic clattering of scissors and frantic barbers pacing between clients, Rukaiya Azam, a Bangladeshi climate-refugee-turned-entrepreneur, showed me her latest purchase- a Nokia cell phone that she bought with her salon’s monthly profit of $300. Her’s is not the traditional microfinance story. Homeless and destitute after the 2008 Nargis cyclone in Bangladesh, she fled to Dhaka where, despite several attempts, she was refused a loan from the non-profit pioneer Grameen Bank. The messiah, much to Grameen’s chagrin, was its for-profit competitor, BRAC Bank, that lent $150 to Rukaiya’s salon.

However, even five years ago Rukaiya’s was not the common showcase story at global microfinance summits, which were dictated by non-profit firms. So much was the hype about non-profits leading microfinance initiatives that in 2006, Dr. Muhammad Yunus, founder of Nobel-Prize winning Grameen Bank challenged capitalists to enter this market and pursue “social business.” Much to his surprise, businesses took the hint: 40 percent of microfinance lenders today are private, profit-seeking firms\(^1\) who are more sustainable in the long run, more efficient and can reach a wider clientele including high risk poor communities than their non-profit counterparts. What is puzzling is that the for-profits have higher profitability, efficiency and can reach poorer clientele, but the non-profits tend to get all the press attention and high accolades.

What explains this influx of private, profit-seeking entities into the microfinance market? And more importantly, despite similar interest and loan repayment rates\(^2\), why are profit-seeking firms more sustainable and efficient than their donor-subsidized non-profit counterparts?

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\(^1\) Analysis of the Microfinance Information Exchange (MIX) database (www.mixmarket.org) categorized by for-profit status suggests that 40 percent of microfinance firms are solely profit-seeking or have profit-seeking arm

In the next sections, I will argue that despite having similar interest and loan repayment rates, profit-seeking firms are more sustainable and efficient than non-profit microfinance firms because of the profit-incentives that stimulate reinvestment of profits into the business and therefore enable for-profit firms to extend credit to larger markets including poor borrowers in the high risk category.

The purpose of this paper is to provide a political and econometric framework, which is grounded in theoretical understanding and explanations of why for-profit microfinance firms are more sustainable and efficient than their non-profit peer groups.

To advance my argument and research purpose, I will proceed in the following ways: first, I will review existing literature; second, I will construct an econometric model to factor risk probabilities, risk indices and interest rates to assess impact on sustainability and operational efficiency of lending to a largely high risk market. Key variables of interest that I will test are: i) access to financial capital for non-profit and for-profit firms; ii) perceived risk of borrower group, which will be measured through debt-income ratio of borrowers and then categorized by for-profit and non-profit borrowing status, and iii) consumption-to-income ratio of borrower groups categorized by for-profit and non-profit firms to evaluate improvements in living standards. Finally, I will acknowledge limitations of my model and conclude on how further empirical analyses can be conducted in this field.

**Microfinance’s Evolving Business Model**

The rationale behind microfinance’s existence lies within the successful demonstrations that poor households can be reliable bank customers. Microfinance extends credit to poor individuals who have been underserved traditionally by the formal banking mechanism (Yunus, 1997; Morduch, 1998).
However, within the school of thought that claims that microfinance works in favor of poor communities, there are differences between those who advocate the more exclusive use of non-profit organizations and those who find more value-added in shifting to for-profit firms. The social and financial success of for-profit firms in developing and developed countries have shifted scholarly debates from whether microfinance helps poor people” to whether for-profit microfinance firms are more sustainable and efficient than non-profits.

In no other country than poverty-stricken Bangladesh has this debate been more contentious. The Mecca of microfinance, Bangladesh boasts two of microfinance’s prized organizations- the founding non-profit, Grameen Bank and the social business BRAC Bank that initially began operations as a profit-making arm of the non-profit BRAC Foundation. However in subsequent years, growth in credit demand among Bangladesh’s small and medium business entrepreneurs led BRAC Bank to separate itself from BRAC Foundation and become a commercial entity to launch its IPO. BRAC Bank’s offering in July 2006 created national headlines, as the first microfinance bank to raise $13 million through an IPO which would be used for the expansion of the bank’s operation throughout Bangladesh. BRAC’s stock had increased by 619 percent within a two-year period, making it the prized share in leading analysts’ portfolios. BRAC’s entry into the capital markets inspired more than 3,000 Bangladeshi NGOs to launch profit-seeking microfinance entities between 2006 and 2008, stimulating competition by creating a fragmented market of microfinance providers. Beyond Bangladesh, this trend has transcended into other developing countries where the entry of for-profit microfinance firms

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3 IPOs are Initial Public Offerings that are instruments through which the general public can buy stakes in BRAC Bank in the form of “shares” or “stocks” of shares.
4 Microfinance and Capital Markets: the Initial Listing/Public Offering of Four Leading Institutions. Ira Lieberman, Anne Anderson, Zach Grafe, Bruce Campbell and Daniel Kopf, Council of Microfinance Equity Funds
5 Khandkar, Shamim, “Reviewing the evidence: Microfinance’s social mission”
have increased by 1,200 percent between 2005 and 2010. One such success story is of Mexican Banco Compartamos that in 2007 held a public offering of its stock that was over-subscribed by 13 times, making the company worth $1.6 billion. Unlike BRAC Bank, Banco Compartamos in April 2007 sold 30 percent shares through the secondary market, providing liquidity to existing investors. The offering opened at 12.8 times the book value and within six months saw a 48 percent increase over the initial price. (Lieberman, Anderson, Grafe, Campell and Kopf, 2008). A testimony to the power of profit incentives, these institutions’ expansion into the microfinance market indicates the potential of the microfinance market, which the World Bank estimates to be at $1.5 trillion by 2015 with the entry of for-profits and only $110 billion without for-profits.

The World Bank’s speculation reflects current growth rates among for-profits around the world. Compartamos grew from 60,000 customers to over 800,000 between 2000 and 2007. During the same period, BRAC’s customer base grew by 700 percent and Banco Credito’s increased by 300 percent. These impressive accomplishments indicate that microlenders can and should compete with mainstream commercial banks, vying for billions of dollars in global capital markets. (Morduch, Cull, Demirguc-Kunt, 2008).

The success of BRAC and Compartamos reflects the theoretical framework, which suggests that organizations such as BRAC that combine profit-incentives with social missions can better enhance poor people’s access to microcredit than non-profit entities.

This framework developed during the 1980s when donor-agencies, cash-starved during the Latin American crisis begun pushing non-profit entities into profit-making institutions. They argued that if microfinance firms were to lend money to other people on the basis of reinvesting it into “business projects” then microfinance firms have a responsibility to lead by example and

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6 Morduch, Microfinance Meets the Market. For-profit firms are defined as any organization, public or private that aims to make a profit from its microfinance operations.
show that they can become financially solvent and sustainable entities as well. The logic that proponents of this school of thought have put forward is simple: if microfinance firms expect their clients to make a profit using their money, then they themselves should also be able to make a profit or at least become financially independent. Otherwise, microfinance firms would exist only as an extension of a charitable entity that forces its borrowers to pay for a loan that has been obtained at zero marginal costs. Microfinance firms, if anything, would cause further inefficiencies in the market by being a redundant “middleman” between the donor agency and the poor borrower.

This premise that microfinance should become self-sustainable unfolded in three steps, as Morduch et al (2008) notes. First, it holds that small loans are costly for banks to administer and poor households can pay high interest rates. Moneylenders, it is often pointed out, routinely charge (annualized) interest rates of over 100 percent per year, so, charging anything lower must be a benefit and would attract more market share by undercutting the traditional moneylender who is labeled as the “loan shark” in this case. Access to finance may be more important than its price (CGAP, 1996).

The second part of the argument holds that subsidies are the root of major problems in state banks and that even in non-governmental institutions, ongoing subsidization can weaken incentives for innovation and cost-cutting (Morduch et al).

The third argument put forward in favor of for-profit microfinance firms is that subsidies are not available in the quantities necessary to fuel the growing sector, so that if the goal is to spread microfinance widely, no practical alternative exists to pursuing profitability and ultimately, full commercial status (Morduch et al). Bhagwati (1996) extended this argument to further suggest that as long as subsidies were prevalent in the microfinance market, non-profit
entities would be risk-averse and inefficient in their management of the business. Subsidies allow non-profit firms to take risks that may not fully materialize and that may further reduce the possibilities to be a going concern. Bhagwati (1996) and further point to failed education and training facilities in Kathmandu, Nepal, where for example, the non-profit firm “Jagoron” received a World Bank grant to lend out $50,000 to reinvest in youth ventures. Jagoron organized training and education facilities and spent a huge proportion of its grant money in organizing workshops and bringing facilitators from the United States and other countries who were experts in enhancing human capital. In the end, however, only six of the 450 youth leaders attended all of the required six-week workshops. Due to their absences, they became ineligible automatically to receive the micro-credit. The sunk costs incurred were never recovered and the project failed to reach its goals even before it had lent out the micro loans. The lack of profit-incentives poses the greatest threat to non-profit microfinance firms’ long-run sustainability (Bhagwati, 1996).

Building on this argument, donors and scholars alike have experimented with a “venture capitalist” approach towards funding microfinance initiatives. At the 2003 World Economic Forum in Davos, Jeffrey Sachs argued for subsiding microfinance firms only in the start-up phase. The idea he put forward resonated with other private investors: use subsidies sparingly and only in the start-up periods; earn ample profits and expand as rapidly as profits allow (Morduch et al, 2008). This venture-capitalist approach has been celebrated in an emerging field of literature led by C.K. Prahalad (2004) who, in his book, The Fortune at the Bottom of the Pyramid: Eradicating Poverty through Profit, explains how profit incentives can enable entrepreneurs to invest in firms that have huge growth potential but cannot find credit in the formal market.
However, critics of for-profit microfinance firms remain unconvinced. They argue that the purpose of microfinance firms is to extend credit to poor communities and the integration of profit incentives undermines the goals of these businesses. Profit incentives send negative signals to investors as they begin lending money to individuals without regarding the financial conditions of their clientele and whether the borrowers are would be able to pay back the loans. These scholars point to the vast number of villagers’ experiences with for-profit firms, where firms had lent money to poor borrowers without accounting for their prevailing financial conditions or monitoring whether they reinvested the borrowed money into.

This debate has gained most prominence due to the involvement of the founder of the Grameen Bank, Dr. Muhammad Yunus, who has been the staunchest supporter of non-profit microfinance firms. The non-profit rebuttal is that the end goal of profit-seeking investors is to make profit. They are not interested in investing in human capital or entrepreneurial spirits. While profit-incentives definitely help in expanding the market, it also risks very fast expansion, eventually destabilizing the system.

Yunus’s case is helped by plenty of real-life examples across the world, where rogue profit-seeking microfinance entrepreneurs have lent out money to poor individuals without providing them with any kind of financial training or in most cases without any kind of business plan. The latest culprit is SKS Microfinance in India’s Andhra Pradesh state, whose recent initial public offering was overshadowed by news of ten women committing suicide due to alleged harassment by loan collectors.⁷ The accused criminals are small microfinance banks who bought shares of SKS Microfinance upon its entry into the stock market. For many scholars, this is the biggest threat to the continuity of microfinance initiatives. One profit-seeking firm spurs another

and that in turn attracts another, until all other firms become for-profit enterprises and desperate in their attempts to lend. Opponents of for-profits further contend that, if anything, for-profit firms should be held responsible for the very bubble that they are creating in India right now and will succumb to the market when such a bubble bursts.

These opposing viewpoints and opinions seem to be widely reflected in several news articles since the suicide incident in Andhra Pradesh. In an article titled “India Microcredit Faces Collapse from Defaults,” the New York Times reports, “India’s rapidly growing private microcredit industry faces imminent collapse as almost all borrowers in one of India’s largest states have stopped repaying their loans, egged on by politicians who accuse the industry of earning outsized profits on the backs of the poor.” The Indian government, for example, is now reconsidering microfinance investments in India, fearing an American sub-prime-mortgage-default kind of debacle in India’s credit market.

**A Theoretical Econometric Framework**

To advance my argument, I create a universal model that can be applied to both non-profit and for-profit microfinance institutions. I begin with the assumptions that both non-profit and profit-seeking entities are willing to provide loans (L) to three categories of poor communities: i) least-risky (α), ii) moderately risky (β) and iii) most risky (γ), where α, β and γ represent the social weight index scores assigned to each type of borrower. The Social Weight Index consists of three separate weights, α, β and γ that measures the magnitude of the borrower’s risk of not repaying the money back. All three indicators α, β and γ are such that 0 < α, β, γ > 1. According to my index, a high risk individual has a high score and a low risk individual has a low score. The expectation is that higher-risk investments (borrowers) would yield higher returns.

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8 This model is not a development of existing models. It has been constructed for the purposes of this paper and is open to further revision and discussion.
due to higher payment extraction from them while low risk investments (borrowers) would yield low returns. This expectation is consistent with general investment and economic theories.

For the purposes of this paper, risk profiles of borrowers are defined by the amount of loan that they borrowed (average loan size) as a percentage of their income. This measure is helpful as it does not use income as the defining factor between high risk and low risk groups. This point needs clarification because in the current literature, many scholars have automatically “downgraded” individuals with low-incomes into high risk groups and “upgraded” individuals with high-incomes into low risk groups. Intuitively this may seem right because those who have higher incomes may be less likely to default than those who have lower incomes.

However, the major problem with this assumption is that it assigns a default bias against poorer clients, mislabeling them as “high risk” clients. Income status is not a good proxy for measuring risk profiles of borrowers. A better measure would be to incorporate the ratio of the loan size as a percentage of a borrower’s income. This is further illustrated in the following example. Let’s say that borrower A has an income of $5,000 and has borrowed $50,000 (1000 percent), the total amount of which is the outstanding balance and that borrower B has an income of $1,000 but has borrowed $2,000 (100 percent), which is also the total amount of the outstanding balance. In the bank’s books, borrower A will be considered a higher-risk individual than borrower B, even though borrower B has a lower income. In risk-probability terms, borrower A has a higher probability of defaulting than borrower B because of his high income-leverage on borrowing funds. This means that borrower B has highly leveraged his relatively low income to borrow (and hence owe) a large loan amount relative to his income. Thus, contrary to popular perception, high risk groups do not consist of “the poorest people” in society, but rather
those who have higher probabilities of defaulting, a good measure of which is the loan amount borrowed as a percentage of income.

Furthermore, interest rates charged to borrowers by non-profits and for-profit organizations are held constant to investigate the central research question of why, given similar interest rates between non-profit and for-profit entities, for-profit firms tend to be more sustainable and efficient than non-profit organizations. In answering this question, I am not arguing that for-profits and non-profits do not charge high interest rates to account for high risk groups. In fact, the rational expectation is that all organizations regardless of their legal status would charge higher interest rates (risk premiums) for higher risk groups. My argument suggests that, although the interest rate spread might be higher for high risk groups, the interest rates themselves are similar for non-profit and for-profit organizations for borrowers with similar risk profiles. Thus hypothetically if Grameen Bank charges 20 percent and 50 percent interest rates to its low risk and high risk groups, BRAC would also charge similar (any number close to 20 percent and 50 percent) interest rate for its low and high risk groups respectively.

It’s important to clarify this point as interest rates are often perceived as the key element of financial sustainability of microfinance firms. The rationale is that, firms that charge higher interest rates are more likely to earn higher returns than firms that charge lower interest rates. While such a relationship is rational it is certainly not the driving factor for financial sustainability of different firms.

Although the interest rate varies depending on the risk group of the borrower for a particular firm, the interest rates between BRAC and Grameen are fairly similar for all three risk groups. This means that the interest rates charged to low risk, medium risk and high risk groups vary for each of these groups but the rates charged to each group are fairly consistent between
for-profits and non-profits. The reason this point merits further clarification is because for-profit entities can achieve financial sustainability *without* having to increase their interest rates significantly higher than the rate that non-profits charge for each risk groups.

To advance the econometric model, I construct a Social Weight Index that assigns different weights depending on the borrowers’ risk profiles. Here, I factor into the probability of high, moderate, and low risk individuals paying back the loan. Such risk probabilities can be ascertained through historical trends that indicate the probability of bad debt and loan repayment rates from different borrower groups. I assume that high, moderate and low risk borrowers carry a probability of 0.5, 0.8 and 0.9 in repaying the interest payments. To allow comparison between non-profit and for-profit firms, I hold the following variables constant: i) interest rates and ii) loan repayment rates. This means that given, constant and shorter loan repayment rates and interest rates between non-profit and for-profit firms, we would expect profit-seeking firms to make profits while non-profit firms will not?

Thus net returns (Y) is a function of money lent out (L), a constant social weight index (α, β and γ), a constant risk probability depending on risk group of borrower, constant interest rates (r₁) and the only variable in the model, borrowers’ debt amount as percentage of personal income (s). Debt risk is measured as the average loan size owed by a borrower as percentage of his or her personal income which is measured by GNI/per capita. This is measured as a percentage and helps us to understand the magnitude of debt-leverage against a borrower’s personal income. For example, if the variable is 10 percent for borrower A and 250 percent for borrower B, we can ascertain that borrower A is less risky than borrower B, because for every $100 of borrower A’s income, he owes only $10, whereas borrower B owes $250 for every $100 of personal income.
\[ Y = L(\alpha r_i^n x 0.9 + \beta r_i^n x 0.8 + \gamma r_i^n x 0.5) \] 

(1)

From equation 1, we can determine the rate of change of total income, or profits (Y) from changes in the variable debt risk, assuming the social weight index and risk probabilities remain constant. Therefore, the point at which microfinance firms can reach net returns maximization is:

\[ \frac{dY}{ds} = a x 0.9 x r_i^n x \frac{dL}{ds} + \beta x r_i^n x 0.8 (\frac{dL}{ds}) + \gamma x r_i^n x 0.5 (\frac{dL}{ds}) \] 

(2)

Equation 2, which is the change in income returns (dY/ds) as a function of change in debt risks will help us to understand the point at which income returns are maximized. In other words, equation 2 would give us the point at which net returns would be maximized with marginal changes in the amount of loan borrowed as a percentage of the borrower’s income.

The theoretical framework therefore proceeds as follows: microfinance institutions would extend loan facilities to three groups, low, medium, and high risk individuals at progressively increasing interest rates. As financial institutions raise interest rates for each group, I expect marginal income from lending money to increase initially, reach a maximum point (at which income levels are optimized at its peak), and then fall.

It’s important to clarify that like all other revenue-based models, the income of a non-profit or a for-profit microfinance firm is also a diminishing marginal returns model. The emphasis needs to be placed on the word “marginal,” because marginal income (the addition to total income from an additional dollar lent) diminishes in the long run, largely due to diseconomies of scale that lead to inefficiencies in the long run. While the “long-run” has no pre-ascertainable fixed time parameter, it may range from anywhere between 50 and 100 years for a particular microfinance firm. Thus in the long run, marginal income for the microfinance firm
may diminish due to pervasive diseconomies of scale resulting from, for example, poor management coordination of a large clientele that becomes too difficult to control and monitor.

**HOW DOES THIS FRAMEWORK APPLY TO NON-PROFIT AND PROFIT-SEEKING FIRMS?**

I argue that profit-seeking firms are able to expand and tap into a larger market, extending credit to a high risk clientele and earn higher returns to become financially sustainable than their non-profit counterparts. This is achieved, as my model suggests, at similar rates of interest and loan repayment rates, which are given constants in my model.

Figures 1.1 and 1.2 illustrate the argument under my model’s framework. Both figures are consistent with the general expectation that net marginal returns are diminishing over various risk groups and over time. In other words, as the level of debt as a percentage of client’s income increases, marginal returns (profit) at first rise, reach maximization point and then decline.

Figure 1.1 shows the marginal returns (income) of a profit-seeking firm. As risk level of borrowers increases, marginal returns from each risk group increases, reaches a maximum and then decreases. However, returns are higher at each and every level from high risk borrowers ($\gamma r^n$) than medium risk ($\beta r^n$) and low risk ($\alpha r^n$) borrowers. Figure 1.2 shows similar expectations for non-profit seeking firms.

The key difference between both groups is the point at which returns-optimization occurs for profit-seeking and non-profit microfinance firms. As figures 1.1 and 1.2 show, non-profit firms reach their return/income-optimization point (A, B, C) much earlier at a point where they have only lent out to a relatively low risk debtor group than profit-seeking firms who reach return-optimization points (D,E,F) much later, being able to fully capitalize on high-returns by lending to high risk groups. Thus, it is clear that for each and every level of borrower-risk groups,
non-profit firms reach return-optimization peak much more quickly than profit-seeking firms. In income or net return (Y) terms, \( Y(A) < Y(D) \), \( Y(B) < Y(E) \), \( Y(C) < Y(F) \) meaning incomes are lower for non-profit firms at each and every level, because they are either unwilling or unable to reach a more-risky portfolio of borrower-groups.

Non-profits have a lower-risk tolerance than for-profit firms because for-profits can reinvest their profits into the business for purposes of further lending, thus optimizing the resources available for extending credit, while non-profits are less able to do so because of their inability to raise sufficient capital to tap into a larger market and hence make bigger loans to a high risk clientele. Cash and capital starved, non-profits cannot afford to take risks using donor-subsidies to lend out to a high risk group and thus miss out on the opportunity to earn higher returns.
revenues from a largely untapped high risk market. Thus, at each and every comparable interest rate for different risk profiles of borrowing groups, for-profit firms can use their ploughed-back and other capital raised from the market (such as capital from private investors within and without selling stocks in the capital market) to offer credit to a high risk borrowing group. Thus, despite both non-profits and for-profits having similar interest and loan repayment rates, for-profits are able to expand into a larger market, while non-profits lag behind.

Profit-seeking firms, as my model depicts, seem to achieve both income sustainability and social objectives of extending credit to high risk communities. They reach their returns optimization peak at a much later stage than non-profits do and therefore have more opportunities to capitalize on high returns from more high, medium, and low risk borrowers. However, more importantly, profit-seeking firms seem to be more efficient in extending credit facilities to a more diverse and larger group of the poorest communities who need access to credit more than their relatively wealthier peer groups.

**Data**

In this section I will build on the theoretical econometric model that I have explained in the above section. At the beginning of this paper, I outlined the three dependent variables of interest for this paper: i) entry of for-profit firms into the market, ii) financial sustainability, and iii) efficiency of for profit and non-profit firms.

To advance my analysis, I conducted a series of qualitative observational interviews (in the form of household surveys) in Dhaka city and Gopalganj district in Bangladesh. For the purposes of my survey, I interviewed 19 women borrowers of for-profit (BRAC) and non-profit (Grameen Bank) organizations. The main objective of the survey was to find patterns in income, consumption, and household welfare changes. Questions such as “Did you have a new television
set for your business or personal use after the loan” or “were you able to send your child to school after taking the loan” were treated as direct benefits of the microloan on the borrowers’ living standards.

In addition to conducting qualitative interviews with women borrowers, I also analyzed secondary data to test whether my hypothesis holds for a larger sample of organizations around the world. To advance my analysis, I collected secondary data of approximately 2,000 organizations from the Microfinance Information Exchange (MIX) database. MIX is a free database that has been created with the aim of promoting information exchange in the microfinance industry. These data include outreach and impact data, financial data, audited financial statements, and general information on specific microfinance institutions for 346 microfinance institutions in 67 developing countries. Participation in MIX is voluntary and participation may be skewed towards non-profit microfinance firms who benefit highly from MIX’s free-of-charge information-sharing products and services. However, this benefits my study as it corrects for any bias in case selection towards for-profit firms.

After collecting the data, I aggregate them on a national level and categorize them by their profit status. For example, Bangladesh has 5 microfinance firms and India has 10, etc. Then each unit of analysis is coded as for-profit and non-profit. Additional data on profitability, loan term, financial capital, etc., are added according to their respective categories.

Second, I collected data on profitability of for-profit and non-profit microfinance firms. Profitability is measured by the general accounting formula: profits = revenues - expenses. For the purposes of this paper, profit is defined as net income. For-profits are likely to distribute a portion of their profits among shareholders, while non-profits, by the virtue of their profit status
have to re-distribute any profits generated into the general capital pool available for disbursement to clients.

Third, I collected data on efficiency of non-profit and for-profit microfinance firms. Efficiency is a measure of how productively a microfinance firm manages its existing resources relative to its loan portfolio. The first formula to measure efficiency is adjusted operating expenses divided by the gross loan portfolio. This is consistent with current literature in its expectations that organizations that have lower adjusted operating expenses for each additional dollar of loan portfolio should be considered more efficient than organizations that have high adjusted expenses over gross loan portfolio. Operating expenses are adjusted for administration, monitoring, and loan-disbursement costs, with higher weights assigned to loan disbursement (40 percent) and monitoring expenses (40 percent) than administration (20 percent) in order to fully capture the direct expenses associated with lending to borrowers. The second measure comprises operating expenses over average loan size divided by income per capita. The expectation is that the higher the average loan size standardized by income of borrower, the lower should be the operating expenses for microfinance firms since the total costs are distributed over larger loan sizes relative to the borrowers’ income.

In the next sections, I will detail the stories of Asha, Razia and Aisha, three women borrowers of non-profit and for-profit microfinance firms in Bangladesh that I had interviewed for this study. Next, I will build on the results of my household sample survey to highlight some key differences between standard of living of non-profit and for-profit borrowers. Finally, I will criticize my arguments and conclude the paper, arguing the case for for-profit microfinance firms.
A TALE OF TWO TALES

“Oi Jabbar bhai, fix the camera on this side,” shouted one of the TV news camera men, exasperated by the increasing number of people who had gathered around the thatched-roof house made of clay. The house was dilapidated and barely worthy of attracting a crowd that included the local council chairman, women commissioners and a massive village crowd that seemed overwhelmed by the media attention and the shiny video equipment that was being installed at the spot. An entourage of private security forces created a human barricade against the burgeoning crowd, shielding the news reporters from the exuberant crowd.

“Today, we have gathered here to showcase how Aisha Khanam has escaped poverty; in this small village of Bangladesh, Aisha has made a substantial difference with a small microloan from Grameen Bank,” announced the reporter.

Aisha Khanam sat on a small tool under her thatched roof, ready to explain how even five years ago, she was being exploited by local loan sharks who threatened to take away all her properties if she failed to comply with their terms and conditions. If it had not been for Grameen, which she called a messiah, she would have been on the streets today.

Aisha Khanam wanted to start a business and was privileged enough to have access to relatives who were planning to apply for a group loan from Grameen Bank. With Aisha’s eighth-grade education background, she was an asset to the group for her math, reading, and writing skills were better than the rest of the group.

Aisha is the prized case for innumerable media productions. She represents the face of a “poverty graduate” who now lives independently in a thatched-roof house and who self-admittedly, would not have been able to succeed without a loan from Grameen Bank.
However, just a few miles away from where Aisha lives, Razia Amin sat down with her calculator and notepad to figure out how much more sugar and tea bags she would need for next month. Sitting under her tin-roofed tea stall, she pressed numbers on her casio calculator, while simultaneously checking on the boiling tea that was being freshly brewed as the local city council chairman came with his team of workers to discuss the day’s politics.

Over the last three years, Razia’s tea stall has changed from a one-chair stall with a thatched roof to one, that now has four rows of tables and chairs, employs one assistant to serve tea and clean-up, a color television to engage the crowd with city-oriented politics, and bakery items that did not exist when she had initially started with a Tk. 1,000 loan from a for-profit microfinance institution.

Razia’s parents forced her to get married at the age of 18, when she had just finished high school and was planning to enter college. In exchange for a Tk. 1 lac (US$ 1200) dowry, Razia, was sent away from her parents’ household to her new home in Barisal, about 460 miles from her hometown Gopalganj district. Soon after arriving at her husband’s house, she was met with severe difficulties, the worst of which, as she described, was meeting her husband’s first wife, who also lived in the house.

“I was unaware that my husband had another wife. When my parents wanted me to get married to that hoodlum, I told them no. I wanted to study and pursue a college degree. I had excellent grades in the local school and the school headmistress said that she would help me get into college. However, my parents did not want to be burdened by me anymore. All my uncles and aunts came and hurled slangs at me for wanting to study. They said I am a girl and I should remember that. But when I went to my husband’s house, I quickly realized that he got married to me only for the dowry.”
When Razia fled her husband’s house to return to her village home, her parents disowned her and sent her away. From being one of the smartest girls in her high school class, Razia became an object of public ridicule.

“Other women looked at me with disgust. They saw me as a curse for my family. I was the one who brought my parents down. However, the man who had married an 18 year old girl only for dowry remained unscathed. At that point, no one wanted to help me out. So I told myself that I would start my own business and show these men and women the mistakes they had made.”

Razia’s path to finding microloans was not easy. She didn’t have any resources that she could keep as security. She did not have contacts who could help her and, worst of all, she was refused by all the women’s groups she had contacted to take her as part of their borrowing group. Traditionally, organizations such as Grameen Bank, have operated under the principle of group lending. Under group microfinance lending schemes, individuals are allowed to apply for loans only after they have formed a group that bears responsibility for the risk of default by any particular borrower.

Eschewed by the non-profit microfinance community, Razia was ever-determined to secure a loan from either a private individual or a for-profit organization. To her rescue, one of Razia’s closest friends, who was studying in a city-based college, referred her to a for-profit microfinance bank that had just started a new program targeted towards small-scale women entrepreneurs. After several interview processes and formal document processing, Razia had finally managed to secure a loan for her tea stall.

“When I started the business, I expected everyone to neglect my store. Knowing this, one of the first things I did was purchase a radio that everyone could listen to. Gradually, people
started coming to my store, and as they listened to the latest news and movie songs on the radio, they began ordering *chai* and other items.”

**Asha’s story**

“Apa, can I bring you a cup of tea? Would you care for some biscuits along with it?” Asha politely asked, wiping her sweating forehead with the pair of her cotton Sari. The decade-old ceiling fan hanging from the paint scraped roof muffled Asha’s voice in the thick, dense air of Dhaka. Just outside of Asha’s 250 square-feet store in Chowkbazar, a teenage Jhalmuriwalla yelled, “Oi Jhalmuri, Jhalmuri” and peered through Asha’s store to ask her lady client whether she would buy some. “Madam, only Tk.5 for one packet,” the boy smiled, shooting a flirtatious glance at 21 year old Asha, who stood at her feet, eager to please her first customer of the day.

“Ja, ja. Madam is not here to take your cheap jhalmuri,” Asha shot back a hard, rebuking glare at the teenage Jhalmuriwalla. In fact, the glamorous madam sitting in chagrine on Asha’s age-old leather chair could not have been least bothered by either Asha’s tea offerings or the jhalmuriwalla who would make fresh chancahur for her. Already sweating, madam wanted to get out of the small store as soon as she had walked in, but it had been Asha’s persistence that had convinced her to check her products.

Asha is one of the ten retailers who sell hand-knit quilts to a mostly middle-class clientele that cannot yet afford the premium ones sold at the high-street retailers. Like Asha, her competitors are mostly poor migrants who had fled their flooded village. Like Asha, many of her peer for-profit microfinance firms’ women borrowers have come from a zero-point; many of them had lost their properties or families.

“As the flood worsened, my mother and I realized that we would lose our house pretty soon. You could see the water level rising outside of your house and our floor was already
drenched in knee-deep water. I was going to take my high school exams in a few weeks when the flood struck our village; as the eldest of my five sisters, I was hoping that I would be able to finish my exams and then apply to a good college in the city and then support our family. However, everything changed when the flood hit us. Over the course of three weeks, we were forced to leave our house and seek refuge in a local makeshift tin-roofed shelter that housed at least forty families. Once there, we realized that we could no longer go back to our village. Everything was gone…everything. My father had already left us long before the flood, and so, my four sisters and I, along with our mother, ventured towards the capital city,” tiny drops of salty tears stung Asha’s soft tanned cheeks as she recalled her horrific experiences with floods.  

“When we first came to the city, we sought shelter in a shanty slum in Mirpur area in the city. The five of us shared a tiny bed and a common bathroom that was shared by more than seventy-five other men and women who lived in the slum. My mother found work as a maid in a big house, and I was left with the responsibility of taking care of my siblings. Every morning, we would go to the streets and beg to the madams sitting comfortably inside their luxurious cars. Somedays, we would make enough money to buy ourselves rice and eggs, but most days, we didn’t have enough money.”

**For-Profit vs. Non-Profit**

Asha, Aisha, and Razia are three of the nineteen women borrowers I interviewed for this study. Although each of them have their own unique stories, what became strikingly clear from the individual interviews were the similarities that women borrowers of for-profits and non-profits shared. Borrowers of for-profits, at least based on my observations, often came with a strong sense of future achievement. Their backgrounds also tend to strikingly resonate with each other in terms of their adaptability and business acumen. These women borrowers lost a lot -
sometimes their personal dignity (as in the case of Razia) or their properties (as in the case of Asha). Many of them have never had strong acceptance by other groups in society, mostly because of their social class.

Results from qualitative interviews in Bangladesh

<table>
<thead>
<tr>
<th>Social Indicator</th>
<th>Non-Profit</th>
<th>Percentage</th>
<th>For-Profit</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bought new TV</td>
<td>1</td>
<td>10</td>
<td>6</td>
<td>67</td>
</tr>
<tr>
<td>Bought new Radio</td>
<td>3</td>
<td>30</td>
<td>2</td>
<td>22</td>
</tr>
<tr>
<td>Bought new furniture</td>
<td>1</td>
<td>10</td>
<td>4</td>
<td>44</td>
</tr>
<tr>
<td>Paid loan on time</td>
<td>8</td>
<td>80</td>
<td>7</td>
<td>78</td>
</tr>
<tr>
<td>Missed repayment deadline once</td>
<td>2</td>
<td>20</td>
<td>3</td>
<td>33</td>
</tr>
<tr>
<td>Missed repayment deadline &gt;1</td>
<td>2</td>
<td>20</td>
<td>3</td>
<td>33</td>
</tr>
<tr>
<td>Send children to school</td>
<td>8</td>
<td>80</td>
<td>6</td>
<td>67</td>
</tr>
<tr>
<td>Business customers increased in last 2 years</td>
<td>3</td>
<td>30</td>
<td>8</td>
<td>89</td>
</tr>
<tr>
<td>Business customers increased in last 3 years</td>
<td>3</td>
<td>30</td>
<td>8</td>
<td>89</td>
</tr>
<tr>
<td>Business customers increased in last 5 years</td>
<td>3</td>
<td>30</td>
<td>8</td>
<td>89</td>
</tr>
<tr>
<td>Felt harassed to payback loan</td>
<td>4</td>
<td>40</td>
<td>3</td>
<td>33</td>
</tr>
<tr>
<td>Sought new loan after first one</td>
<td>5</td>
<td>50</td>
<td>5</td>
<td>56</td>
</tr>
<tr>
<td>Denied new loan after first one</td>
<td>2</td>
<td>20</td>
<td>5</td>
<td>56</td>
</tr>
<tr>
<td>Total surveyed</td>
<td>10</td>
<td>100</td>
<td>9</td>
<td>100</td>
</tr>
</tbody>
</table>

Table 1.1: Social indicators and borrowers of non-profit and for-profit MFIs

All women borrowers of for-profit organizations in my sample come from a point where they have lost everything or many things in life and are therefore ever-more determined to achieve their goals. These women were not accepted into any of the “social groups” that are necessary pre requisites for non-profit microfinance lending. As Table 1.1 shows, women borrowers of for-profit firms in my sample placed more value on buying new television or new furniture (items that increase their social status or directly improve their living standards), whereas place relatively less value on sending their children to school compared to women borrowers of non-profit microfinance firms.
Reaching out to the poorest of the poor and expanding their clientele base have led for-profit microfinance firms to earn higher profit margins than their non-profit counterparts. Expanding the client base means more for-profit microfinance firms are able to distribute the net expenses on a larger number of borrowers, while gaining increased additional revenues from a bigger client pool.

Although figure 1.3 shows that the median for-profit microfinance firms earn higher profit margins than their non-profit counterparts, it also reveals that neither the median non-profit nor for-profit firms have made a net loss in the period 2000-2010, which is good news for the microfinance industry in general.

Higher profit margins of for-profit microfinance firms can be explained by the relatively larger loan balances relative to the income level that borrowers of for-profits are able to attain compared to non-profits.

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9 Profit margins is defined as profit=income-expenses (for-profits) and net income=income-expenses (for non-profits). For the latter, the net income or (net loss) is channeled back into the total pool of loans available for distribution.
In 2000, the median loan balance was approximately 50 percent of the GNI per capita, which is used as a proxy for average income level of the borrower. On the other hand, non-profit microfinance institutions were ready to risk only 20 percent of the GNI per capita as the loan balance relative to income per capita.

Loan balance per borrower relative to the income-per-capita is used to indicate the level of risk-carrying by for-profits compared to non-profits. Although figure 1.4 shows that median loan balances of for-profits are higher than non-profits at each and every period in time and for each and every level of income, the loan balance trend of for-profits seems to be coming down, whereas for non-profits, the trend has been relatively constant. While many scholars may term this as a downward shift of risk-perception and risk-carrying by for-profits compared to non-profit microfinance firms, figure 1.4 also illustrates how quickly for-profit firms can adapt to market changes. During peak recessionary times (2007-2010), for-profit microfinance firms cut down their loan balances relative to income levels much more sharply than non-profit
microfinance firms. This may be possible for non-profits because their financial health can be buoyed by donor agencies and governments, who do not respond to cuts in aid and grants as quickly as for-profits do to changes in underlying market economics.

<table>
<thead>
<tr>
<th>Profit Status</th>
<th>Number of MFIs</th>
<th>Amount (USD), total</th>
<th>Amount (USD), median</th>
<th>Rate, weighted average</th>
<th>Term (months), weighted average</th>
</tr>
</thead>
<tbody>
<tr>
<td>Non-profit</td>
<td>640</td>
<td>17,936,110,654</td>
<td>249,282</td>
<td>0.087052044</td>
<td>54</td>
</tr>
<tr>
<td>Profit</td>
<td>416</td>
<td>35,506,558,513</td>
<td>500,281</td>
<td>0.084903914</td>
<td>63</td>
</tr>
</tbody>
</table>

*Table 1.2: Loan disbursements and capital pool of for-profits and non-profits*

Although for-profits constitute only one-third of the total number of microfinance institutions (Table 1.2), their loan disbursement capital is almost *double* that of non-profit microfinance firms (figure 1.5). For-profits also have higher loan-term periods than non-profit microfinance firms (figure 1.6).

*Figure 1.5: Financial capital distributed by for-profits compared to non-profit*

*Figure 1.6: Loan terms of for-profit and non-profit microfinance institutions*
Across all specifications and measurement standards, for-profit firms are more self-sustainable and efficient than non-profit microfinance organizations. For-profit microfinance firms have higher return-on-equity at each and every level of loan sizes relative to the borrower’s income. This has important implications in terms of lending capacities, because a high return on equities over loan sizes relative to borrowers’ income levels suggest that for-profit firms are more risk-prone than non-profit firms and may be willing to invest more in investing or reinvesting additional loans to existing or new borrowers in its attempt to increase financial returns. This is consistent with my theoretical framework that indicates market expansion as the primary reason for profit-seeking microfinance firms to earn higher financial returns than non-profit organizations.

An important clarification is necessary here as one may question whether the return on equity trend increases with high loan balances relative to the borrowers’ income levels because of differing appetites for risk or simply due to the natural weight of debt loads on household

*Figure 1.7: Efficiency for Non-Profits vs. For-Profits*
incomes. In this context, natural weight of debt-loads may be a measure of how much debt naturally falls on household incomes without the individuals having to borrow any additional debt from microfinance organizations. Thus a contending explanation of this kind of trend would be that the natural debt loads that persist on household incomes without any kind of additional microfinance loans can explain such a relationship.

The response to these points is that, natural debt loads on household incomes are generally classified as “endogenous” variables that persist across the board on all borrowers’ household incomes and have significant diversity. Two problems arise: one, endogenous factors such as this is difficult to measure and explain and second natural debt-loads vary not only between high risk and low risk groups, but also within such groups. However, one of the possible ways that endogenous factors such as this can be controlled for lies in the general assumption that the effect of such factors cancel out by themselves due to large natural variations. So, for example, even if natural debt loads on household incomes were to convolute the expected relationship, one would assume that the significant differences between the “natural” weights would cancel each other out, so that the endogenousity problem can be averted.

In terms of efficiency, as figure 1.7 illustrates, for-profit firms have lower average costs per dollar lent than non-profit firms relative to their assets. Operating expenses also fall more significantly for profit-seeking than non-profit firms as the average loan size relative to borrowers’ income increases as well as the asset pool increases. This has two implications: first, lower weighted average costs for each additional dollar lent means that profit-seeking firms provide them with more incentives to lend out to a bigger clientele and reduce costs to optimize profits. Second, profit-seeking firms benefit from economies of scale as average loan sizes become bigger. Thus in terms of productivity of average costs with respect to average loan sizes,
profit-seeking firms have strong incentives to continue lending more money to each borrower since average costs fall with rising loan-sizes relative to borrowers’ income. Why do we observe such a relationship between average costs and loan sizes? The explanation may be found in two areas: first in the ways that weights are assigned to average costs, such as the assignment of 40 percent weight to monitoring and 20 percent to administrative costs.

Furthermore, the nature of diminishing average fixed transaction costs for higher loan sizes gives for-profits a comparative advantage in enhancing their efficiency by increasing the loan sizes. The theory behind this is that, fixed transaction costs incurred on lending money to a particular borrower remains relatively constant throughout the lifetime of the loan. For example, if person A borrows $100, then the fixed transaction costs incurred may not grow more than 10 percent over the loan’s lifetime. However, if person A decided to borrow $100,000, then transaction costs would still rationally be expected to also not grow with the same proportion as the increase in loan size. Thus fairly constant transaction costs create incentives for profit-seeking firms to expand their loan sizes as well as their markets and reduce average costs in as many ways as possible. Unfortunately, for non-profit firms, such average costs remain relatively expensive due to their lack of capital that is required to expand into other markets as well as increase the loan sizes for individual borrowers. Reliant on subsidies, non-profit firms cannot simply afford to increase their clients’ loan sizes significantly enough that it would have a substantial effect on lowering of average costs.

**RESPONSES TO MY MODEL & CONCLUSIONS**

Bleak as it may seem, the field of non-profit microfinance is drenched in some serious challenges from all sides. On one hand, unhappy and sometimes over-bearing donors push for decreased dependence on subsidization and, on the other, aggressive expansion of a burgeoning
class of rich, capital-flush, for-profit banks makes it even more difficult for non-profit organizations to continue their operations. The parallel that becomes most relevant here is one that resonates with aggressive development policies of large, profit-seeking enterprises such as the multinational Starbucks and the riveting old-school coffee-shop that was the major socialization spot for generations. The advent of Starbucks in the coffee-shop market and Walmart in the retail market has taken jobs and profits from a once-thrivent but currently-weakened market of small-town businesses. The irony lies in the fact that large multinational for-profit microfinance firms such as SKS and BRAC are perhaps expanding so aggressively that their growth style may almost demean the very small businesses that they are helping to start-up. Like the non-profit entities, these small businesses may be out of the market as globalization grips the world and macroeconomic trends around the world intensify aggressive price competitions between large multinationals. In such a situation, which may not be far away, profit-seeking microfinance firms may have no other option but curse their super-normal growth.

This super-normal growth has begun to challenge for-profit firms already. In India, for example, governments are asking people not to return money even if they have the capacity to do so. Consistent with the current literature, my study suggests that profit-seeking firms have huge incentives to increase their market sizes as well as loan sizes relative to borrowers’ income levels in order to increase long-run sustainability and operational efficiencies. Strong as they may be, these incentives have been proven to be perverse in the case of the American financial crisis that hit the banking industry in 2008. Hungry for profits, some banks went on a lending-spree giving loans to any living blood that came to their banks. Such perverse profit-incentives were too late in signaling bankers and investors when to stop lending and for consumers to realize their mistakes and stop lending.
In the end however, profit-seeking microfinance entities seem to have achieved their dual missions of attaining financial sustainability and social goals of extending credit to some of the poorest and riskiest individuals around the world. So far, the track record has been impressive: rapid entry of increasing numbers of for-profit microfinance firms have signaled the growing importance of microfinance as a global capital market and additionally, long-run sustainability and increased efficiencies of profit-seeking firms have continued to testify to the power of profit-incentives in stimulating growth and access to credit for some of the poorest millions in the world. The challenge has been thrown back at the other side now, creating a struggling class of capital-starved non-profit microfinance firms.

However, only time can and will tell what is in store for the aggressive expansion and potentially perverse incentives that for-profit firms are generating and whether such adverse incentives may lead to the collapse of the global microfinance market which banks on some of the poorest, hungriest and perhaps possibly helpless “under-class.” Only then, the effects would be more severe and drastic, forcing millions into a poverty trap, the scale of which remains beyond our imagination.
Bibliography


