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AVOIDING A SUBPRIME-LIKE CRISES IN MICROFINANCE: LESSONS FROM THE MEXICAN AND BOLIVIAN EXPERIENCE

Pamela Das*

ABSTRACT

Starting in 2007, the United States began feeling the effects of the “subprime mortgage crises,” which ultimately contributed to a devastating global recession. As governments and businesses reflect upon the causes and remedies of this crisis, one must ask whether the increasing commercialization of microfinance worldwide will cause a similar crisis. Because microfinance is the extension of credit to individuals who are considered unbankable by most commercial financial institutions, microfinance delivery inherently involves risky lending. The commercialization of microfinance begs the question whether the poor will ultimately be exploited by these businesses in order to maximize profits, a driving force that was clearly present in the collapse of the subprime credit market.

To shed light on this issue, this paper looks to at the evolution and current state of microfinance in Mexico and Bolivia. Both of these Latin American countries have extremely profitable MFIs within their borders that operate in drastically different business climates. Mexico has a highly deregulated and stratified microfinance market, where commercialized MFIs impose interest rates close to 100%. Bolivia, on the other hand, has a more regulated market with one of the lowest interest rates in Latin America.

By looking at Mexico and Bolivia’s experience with microfinance, this paper hopes to accomplish a number of things. First, through giving a snapshot of the evolution and organizational structure of microfinance, the reader should have a greater overall understanding of microfinance delivery in Latin America. Additionally, this paper also attempts to analyze whether the increasing commercialization in the field has made microfinance into a profit-making tool that comes at the expense of the poor. Ultimately, in using the Mexican and Bolivian example, this paper hopes to recommend a sustainable structure for microfinance that will not only continue to service the poor but will also avoid creating another subprime-like crises.

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I. AN INTRODUCTION TO THE MICROFINANCE
LANDSCAPE OF LATIN AMERICA

MICROFINANCE in Latin America has mushroomed over the past few decades into a booming industry. In fact, on a global scale, Latin American Microfinance Institutes (MFIs) “have more assets, leverage more equity, and attract more commercial invest-

ments than MFIs in other regions.”¹ Microfinance began in Latin America through the actions of grassroots organizations offering small-scale loans to the poor. The concept of offering financial services to low income individuals was heralded as a mechanism for not only alleviating poverty but also for increasing economic productivity for the country as a whole.

Microfinance quickly transformed from an informal network of non-governmental organizations (NGOs) and small moneylenders into an industry of large multinational MFIs. Currently, MFIs make up an undeniable segment of the Latin American financial markets. The growing commercialization of microfinance offers unique challenges and opportunities for the Latin American poor. While the growth of MFIs allows for the expansion of services and greater resources for the poor, the commercialization of microfinance also has allowed objectives of growth, efficacy, and profit to increasingly shape the current landscape.

This paper analyzes the growth and commercialization of microfinance in two different Latin American countries: Mexico and Bolivia. The Mexican example is illustrative of the transformation that the microfinance sector has experienced in Latin America. Over the past two decades, the Mexican microfinance industry has greatly expanded from small regional NGO lenders to large-scale for profit microfinance institutions. Currently, four microfinance institutions (Caja Popular, Compartamos, Independencia and FINCA) serve almost 1.2 million clients and “control eighty percent market-share of the Mexican microfinance market.”² Despite the global recession hitting Mexico’s banking industry, Compartamos, one of Mexico’s most successful MFIs, continues to grow rapidly.³ According to the Inter-American Development Bank, one major reason that Compartamos continues to grow is because of the high interest rates that it charges on its loans.⁴ In 2005, the interest rate yield was about eighty-six percent and the rate paid by borrowers was close to 100 %.⁵ The rapid and sustained growth of Compartamos has increased access and diversified financial services. But the high interest rates and increased profitability of Compartamos raises two important questions: (1) will success be sustainable, and (2) does the strategy employed by the company exploit the poor. Some critics of the commercialization warn that high interest rates will doom the microfinance industry to the same

1. MICROFINANCE INFORMATION EXCHANGE, *BENCHMARKING LATIN AMERICAN MICROFINANCE 1* (2003).

2. Roberto Valdez, *The Proliferation of Microfinance Institutions in Mexico and the Village Banking Experience* 12 (Dec. 6, 2006) (unpublished working paper, on file with the Univ. of Ariz.).

3. Adam Thomson, *Microfinancing Still Resilient in Mexico* Financial Times, Feb. 26, 2009, http://www.ft.com/cms/s/0/37adbce-0270-11de-b58b-000077b07658.html?nclink_check=1.

4. Lucy Conger, *The Compartamos IPO: Pushing the Envelope on Doing Well by Doing Good* (IADB April 16 2008), available at www.iadb.org/news.detail.cfm?language=English&id=4571.

5. *Id.*

fate as the U.S. subprime mortgage crises. Whether this is true or not is a question for debate.

While Mexican MFIs have the highest interest rates in Latin America, Bolivia, after Ecuador, has the second lowest interest rate for microfinance.⁶ In addition to low interest rates, the Inter-American Development Bank ranked Bolivia number one for the best microfinance business environment.⁷ The Economic Intelligence Unit (EIU) noted that compared to other Latin American countries, Bolivia has a regulatory environment that “reflects the proactive, gradualist posture towards fostering the development of microfinance of regulatory authorities.”⁸ The EIU also commented that Bolivia has strong institutional development that is symbolic of microfinance evolution in Bolivia from non-regulated NGOs “toward improved regulation and self-regulation of governance and transparency practices and toward successive innovations in the range of services.”⁹

Microfinance in Mexico and Bolivia occurs in very disparate business climates. This article, therefore, dissects the histories and microfinancing practices of both countries to give the reader a greater understanding of the different evolutionary paths that the microfinance industry can take. Additionally, this paper also generally addresses the effects of high interest rates and regulation of the microfinance industry both on a micro and macroeconomic level. Through this analysis, this paper hopes to shed light as to whether microfinance, with its increasing commercial presence, still remains a positive option for the Latin American poor.

In Part II, this paper will explore the general modalities of microfinance delivery and the relationship of microfinance to the alleviation of poverty. Part III and Part IV of this paper will look more specifically at microfinance in Mexico and Bolivia, respectively. In both these sections, the paper will explore the historical origins, growth, commercialization and regulation that exist in the microfinance sector for these countries. In Part V, the concluding remarks, this paper will reflect upon the U.S. subprime crises and use the Mexican and Bolivian experience with microfinance to recommend a sustainable structure for the industry. Ultimately this paper hopes to recommend strategies that will allow microfinance to withstand economic downturns and continue to service the poor in an increasingly commercialized market.

6. *Id.* In 2006, Bolivia’s annual interest rate for microfinancing was twenty-one percent. INTER-DEVELOPMENT BANK, MICROFINANCE IN LATIN AMERICA AND CARIBBEAN 2008 DATA UPDATE 1 (April 5, 2008). Ecuador’s interest rate was 15.5%. *Id.* at 5. On the other extreme, Mexico’s annual interest rate for microfinancing was 64.9%. *Id.*

7. *Id.* at 4. The measure for business environment scored thirteen different variables in three different categories: regulatory framework, institutional development and investment climate. *Id.* These three variables by percentage were forty percent, forty percent, and twenty percent respectively. *Id.*

8. ECONOMIST INTELLIGENCE UNIT, MICROSCOPE ON THE MICROFINANCE BUSINESS IN LATIN AMERICA 2007 8 (2007).

9. *Id.*

II. MODALITIES OF MICROFINANCE: THE IMPORTANCE OF MICROFINANCE TO THE POOR AND THE DIFFERENT METHODS OF MICROFINANCE DELIVERY

A. THE RELATIONSHIP BETWEEN MICROFINANCE AND THE ALLEVIATION OF POVERTY

Microfinance developed as a means for poor people to gain access to basic financial services because traditionally the banking sector deprived poor people of access to credit. Microfinance has been defined as “banking the unbankables, bringing credit, savings and other essential financial services within the reach of tens of-or rather hundreds of-millions of people who are too poor to be served by regular banks, in most cases because they are unable to offer sufficient collateral. . . . In general, banks are for people with money, not for people without.”¹⁰

Mohammad Yunus, who received the Nobel Prize in 2006 for his work in pioneering microfinance, described the role of microfinance in poverty alleviation as follows:

“[Microcredit] is based on the premise that the poor have skills which remain unutilized or underutilized. It is definitely not the lack of skills, which make poor people. . . . charity is not the answer to poverty. It only helps poverty to continue. It creates dependency and takes away the individual’s initiative to break through the wall of poverty. Unleashing of energy and creativity in each human being is the answer to poverty.”¹¹

Access to financial services is important to poverty alleviation because it increases income and reduces vulnerability. For example, individuals who are able to obtain microloans can use the money to explore entrepreneurial capabilities.¹² Moreover, financial resources allow for greater food security and increase access to sustainable housing, education, and health care.¹³ These actions in turn enable individuals to build up wealth and rise from poverty. Microfinance is a means for self-empowerment because it permits individuals to have greater control over their economic future. By encouraging economic freedom, microfinance enables individuals to successfully tackle issues of domestic violence, illness, and unforeseeable catastrophes.

10. GERT VAN MAANEN, MICROCREDIT: SOUND BUSINESS OR DEVELOPMENT INSTRUMENT 17 (2004).

11. See Muhammad Yunus, Founder Grameen Bank, Address at the International Seminar on Attacking Poverty with Microcredit (Jan. 8-9, 2003), *available at* http://www.microfinancegateway.org/files/3642_Yunus3.doc.

12. Global Trends in Microfinance and a Focus on Latin America: Public Hearing Before the European Parliament (2005) (statement of Brigit Helms, Consultative Group to Assist the Poor), *available at* www.europarl.europa.eu/hearings/20051011/femm/helms_en.pdf.

13. See *id.*

B. THE EVOLUTION OF MICROFINANCE IN LATIN AMERICA: FROM
INFORMAL NETWORKS TO LARGE FOR-PROFIT
MICROFINANCE INTUITIONS

Microfinance in Latin America, as in most other parts of the world, began small and simple. Some of the very first microfinance "organizations" were informal networks of individuals offering credit to individuals who had been turned away by banks for the lack of collateral.¹⁴ In some cases, these informal networks were groups of friends and neighbors, where the role of lender and borrower were interchangeable.¹⁵ In other circumstances, individuals relied on local moneylenders who would offer small loans on flexible but exorbitant terms.¹⁶

From these roots sprung microfinance in the nonprofit sector. Because the clients lacked collateral, non-profit organizations began relying on other measures to determine credit-worthiness and encourage repayment.¹⁷ For example, loans were often only given for entrepreneurial activities, and the decision to lend was based on personal characteristics and business cash flow.¹⁸ To determine reliability, microfinance organizations "would interview family, neighbors and business contacts."¹⁹ Second, to encourage repayment, they would reward reliable clients "with larger loans at lower interest rates."²⁰

By the 1990s, NGOs in Latin America became very successful at this mechanism of financing "and started to grow rapidly."²¹ The success of these organizations had two very important implications. First, commercial banks began paying serious attention to microfinance, realizing that they make a profit through this practice.²² Moreover, the growth of microfinance in the NGO sector, encouraged the transformation of many NGOs "into professional financial institutions that specialize in microfinance."²³ These organizations are former NGOs that have received license by the country to operate as regulated and supervised financial institutions. Today, the field of microfinance in Latin America has greatly evolved from providing services through small NGOs to commercial banks and large formal financial intermediaries. In 2000, banks and specialized financial intermediaries "serve[d] as many clients and provide[d] three times as much credit as the non-profit organizations."²⁴

14. TOR JANSSON, *MICROFINANCE: FROM VILLAGE TO WALL STREET* 1 (2001).

15. *Id.*

16. *Id.*

17. *Id.*

18. *Id.*

19. *Id.*

20. *Id.*

21. *Id.*

22. *Id.*

23. *Id.* at 1-2.

24. *Id.* at 2.

C. FINANCIAL SERVICES OFFERED TO THE POOR THROUGH MICROFINANCE: BEYOND MICROCREDIT

When microfinance was first introduced to Latin America, financial services were limited to microcredit, or the provision of small loans. However, as microfinance became more successful, the services offered greatly expanded. Today, microfinance institutions provide a wide array of services including: “deposit services, credit lines and term loans, crop and life insurance and money transfers.”²⁵ Moreover, some institutions have also allowed deposit services to allow individuals to save for important occasions.²⁶ Because many individuals in Latin America emigrate, MFIs introduced domestic transfers or international remittances that allow individuals to send money back to their home country.²⁷ For example, Banco Solidario, a MFI in Ecuador, offered a new product in 2002 called “mi familia, mi pais, mi regreso” which targeted Ecuadorians living in Spain or Italy who wanted to send money to Ecuador, save for a return, or buy a home in Ecuador.²⁸ Since 2002 “this product has allowed more than 62,000 clients access more than 19,000 sales locations in Spain and Italy to bank with Banco Solidario.”²⁹

D. THE CURRENT MODALITIES OF MICROFINANCE DELIVERY

1. *The Credit Union Approach*

The Credit Union approach is “one of the oldest modalities of microfinance delivery” used in Latin America.³⁰ Credit unions or financial cooperatives are much more informal than commercial banks, but they are still registered and subject to commercial law.³¹ Credit unions differ from commercial banks in that they are generally not regulated or supervised under banking law.³² Although credit unions were one of the earliest forms of delivery, even today, they serve an important function because they help households fill the gap left by commercial banks and formal microfinance institutions.³³ Credit unions are member owned non-profit institutions that provide financial services to members. In order to be a member, the individual may have to be affiliated with a certain employment group of the community. Because there are no external shareholders, funding primarily occurs through the members themselves. The financial services offered are usually limited to savings and loan ser-

25. Helm, *supra* note 12, at 2.

26. *Id.*

27. *Id.*

28. *Id.*

29. *Id.*

30. Heather Montgomery & John Weiss, *Modalities of Microfinance Delivery in Asia and Latin America: Lessons for the People's Republic of China*, 1 (Asian Dev. Bank Inst. Working Paper No. 29, 2004).

31. *Id.*

32. *Id.*

33. *Id.*

vices and insurance.³⁴

2. *The NGO Approach*

The NGO sector was the pioneer of modern microfinance. Because many NGOs experienced success in extending microcredit to individuals during the early 1990s, they transformed into formal financial intermediaries specializing in microfinance.³⁵ In Bolivia, for example, Prodem, a successful MFI, was the first microfinance NGO in Latin America to transform into a formal institution. Many NGO still exist in the microfinance industry. The success of these NGOs seems to depend on the size of the economy. LAEBA notes that outreach is greater for smaller economies such as Bolivia, rather than large economies like Mexico and Brazil.³⁶

3. *The Banking Approach*

Commercial banks are the newest players in microfinance delivery. The banking modality includes many different types of institutions: (1) transformed microfinance NGOs; (2) government owned development banks; (3) reformed state banks; (4) universal or commercial banks; and (5) specialized financial institutions.³⁷ Because most banks can easily access capital markets, these institutions are self-sustainable and usually very profitable. Large for profit MFIs typically have much higher returns than NGOs and credit unions. Notwithstanding their success, the presence of these for-profit institutions in microfinance is paradoxical because the initial motivation behind microfinance is to service the poor. As more and more NGOs transform into commercial banks, countries struggle with determining the best method of regulation and supervision.

III. MEXICAN MICROFINANCE: LESSONS REGARDING COMMERCIALIZATION, PROFITABILITY, AND ACCESS FOR THE POOR

A. MICROFINANCE DELIVERY: SERVICES THROUGH THE BANKING AND NON-BANKING SECTORS

The banking sector in Mexico as well as Mexico's large population makes microfinance within this country very unique. Mexico's size lends itself to greater stratification in microfinance delivery. The institutions involved in microfinance range from large banks such as Banamax, which has over forty billion dollars in assets, to small community based savings and credit associations with only a few thousands in assets.³⁸ The formal sources of microfinance in Mexico are savings and loans cooperatives,

34. *Id.*

35. *Id.*

36. *Id.*

37. *Id.*

38. Jacques T. Loubière, Patricia L. Devaney & Elisabeth Rhyne, *Supervising & Regulating Microfinance in the Context of the Financial Sector Liberalization: Lessons*

Popular Financial Partnerships (specialized financial institutions), and Bansefi, which is a government institution that provides saving services, infrastructure development, financial and technical support to micro banking institutions.³⁹ Semi-formal sources of microfinance delivery are NGOs that are sponsored under PRONAFIM. PRONAFIM, which stands for National Program for Financing the Microentrepreneur, is a government program that sponsors microfinance institutions and connects these institutions with poor entrepreneurs.⁴⁰ Through this arrangement, PRONAFIM “aims to contribute to the establishment and consolidation of the microfinancing institutions. . .”⁴¹

1. *The Banking Institutions*

The Banking sector has played a huge role in microfinance delivery. The banking institutions in Mexico have the largest value of assets; this makes their scope and reach in microfinance much more extensive. Mexico has two different types of banks involved in microfinance: universal or development banks. At the end of 2006, there were thirty-two universal banks and six development banks.⁴² Development banks are mainly owned by the government and are not driven by commercial purposes. Rather, they are created to promote the development of specific sectors such as transportation. In contrast to development banks, universal banks are operated for commercial purposes and traditionally target clients with more collateral. These banks provide a number of services, including savings, loans, and investment services. Universal banks in Mexico own approximately 255.6 billion (USD) in assets.⁴³

A unique aspect of Mexican microfinancing through the banking sector is the prevalence of foreign owned banks. Mexico's proximity to the United States and regulatory environment has attracted foreign banks into Mexico.⁴⁴ Many major U.S. and European banks have bought into the Mexican banking system. For example, the U.S. bank Citigroup owns Mexico's largest bank, Banamax.⁴⁵ Foreign ownership of banks in Latin America is not uncommon. However, foreign ownership in Mexico is quite pronounced.⁴⁶ In fact, Mexico has only one bank that is predominately locally owned. One concern with the foreign ownership is how these banks will weather international banking crises. The Wall Street

from *Bolivia, Columbia and Mexico*, Report to Tinker Foundation 20-23 (Aug 2004), available at <http://ssrn.com/abstract=776905>.

39. Janette Klaehn, Brigit Helms & Rani Deshpande, *Mexico, Country-Level Savings Assessment*, Mar. 2006, http://www.cgap.org/gm/document-1.9.2960/mexico_assessment.pdf.

40. PRONAFIM website, <http://www.pronafim.gob.mx/>.

41. *Id.*

42. Microfinance Gateway, Mexico: Country-Specific Analysis, http://microfinancegateway.com/resource_centers/reg_sup/micro_reg/country/28/?print=true.

43. *Id.*

44. *Id.*

45. *Id.*

46. *Id.*

Journal noted that Mexico has not been hard hit by the recent global economic slowdown because Mexican banks did not engage in risky business practices such as sub-prime lending.⁴⁷ However, if a foreign bank struggles, it may compromise the foreign ownership of the Mexican banks. For example, the Wall Street Journal notes that there were speculations that Citigroup was exploring selling Banamex as a result of the U.S. banking crises.⁴⁸

2. *Non Bank Financial Institutions*

Although the banking sector boasts more assets, the banking system has played a very limited role in microfinance. Non-bank financial institutions are very important in microfinance delivery because they fill the gap left by the banks. In fact, most microfinance delivery occurs through the non-banking sector. As a consequence, specialized MFIs and NGOs can serve as an important tool for the poor. The non-bank financial institutions include: (1) Financial Companies with limited corporate purpose (SOFELEs); (2) Regulated Financial Companies with multiple corporate Purpose (SOFOMEs); (3) Non-regulated Financial Companies with Multiple Corporate Purpose (SOFIPOs); (4) Savings and Loans Cooperatives; and (5) Popular Financial Partnerships.⁴⁹

SOFELEs are financially regulated institutions that obtain funding through the securities market and cannot receive funds from the public through deposits.⁵⁰ The services include direct loans, financial leasing, and factoring. These services, however, can only be rendered to specific authorized industries. One of the most notable SOFOLEs is Compartamos. Compartamos offers a wide range of services in rural Mexico and boasts over 220,000 clients, making it the largest MFI in Latin America.⁵¹ Compartamos began as an NGO but in 2000, it transformed into a for-profit SOFELE.

SOFEMEes are much newer entities than SOFELEs. They are financial institutions that were created by the government in 2006.⁵² Although SOFELEs can only extend credit to specific industries, SOFEMEes can extend credit to multiple sectors.⁵³ In the next seven years, it is expected that most if not all of the SOFELEs will be transformed into SOFEMEes.⁵⁴ Similar to SOFELEs, SOFEMEes cannot obtain funds through deposits, but they may obtain funds from loans, offering of eq-

47. Dan Wilchins, Tim Dobbyn & Carol Bishopric, *RTP-Update 2: Citigroup has Considered Selling Banamex Stake*, WALL ST. J., Feb. 14, 2009, available at <http://www.reuters.com/article/americasMergersNews/idUSN13121920090214>.

48. *Id.*

49. Microfinance Gateway, Mexico: Country Specific Analysis, http://microfinancegateway.com/resource_centers/reg_sup/micro_reg/country/28/?print=true.

50. *Id.*

51. Loubière, *supra* note 38, at 20.

52. Microfinance Gateway, Mexico, *supra* note 49.

53. *Id.*

54. *Id.*

uity stakes, and debt instruments.⁵⁵ Regulated SOFEMEs differ from unregulated SOFEMEs in that the regulated entities are partially or wholly owned by another credit institution; therefore they are subject to banking rules concerning supervision and prudential regulations.⁵⁶

Popular Financial Partnerships (SOFIPOs) are stock corporations with a public purpose mission.⁵⁷ These entities render financial services to members and non-members of the partnership. The services include savings and loans, facilitation of access to credit, provision of financing for small and medium enterprises, and promotion of the “social and economic well-being of their members in which they operate.”⁵⁸ Depending on the SOFIPOs assets and liabilities, these organizations can provide a wide range of services to their clients.⁵⁹ Savings and Loan Cooperatives differ from SOFIPOs in that the cooperatives only provide deposit taking and granting of credit.⁶⁰ In addition to the non-banking financial institutions, NGOs also play an important part in microfinance delivery. These organizations tend to be fairly small but they often service clients that have been turned away by other financial institutions. NGOs in Mexico only provide for deposit taking, and granting of credit among its members.⁶¹

B. REGULATION AND SUPERVISION IN THE MEXICAN MICROFINANCE INDUSTRY

In 2001, the microfinance sector in Mexico was reorganized. In order to consolidate microfinance delivery, in 2001, Mexico passed a law called *Ley de Ahorro y Credito Popular*. This law allowed NGOs, financial organizations, saving cooperatives, and private assistance institutions to transform into specialized MFIs.⁶² The law provided for the gradual incorporation of non-banking financial institutions into a regulatory and legal framework out of this law arose regulated institutions known as *Entidades de Ahorro y Credito Popular* (EACPs). These institutions were either cooperative owned or individually owned as SOFIPOs.⁶³

These entities are supervised by federations which have been authorized by the Mexican Banking authority, the *Comision Nacional Bancaria y de Valores* (CNBV).⁶⁴ In essence, these federations are various members of MFIs that engage in self-regulation. The federations are charged with the responsibility of creating prudential and non-prudential regula-

55. *Id.*

56. Microfinance Gateway, Mexico: Country-Specific Analysis, http://www.microfinanceregulationcenter.org/resource_centers/reg_sup/country_info/mexico (last visited July 14, 2008).

57. *Id.*

58. *Id.*

59. *Id.*

60. *Id.*

61. *Id.*

62. Loubière, *supra* note 38, at 20.

63. *Id.* at 21.

64. *Id.*

tions. Through this program, the CNBV was able to delegate its supervisory role, which resulted in major cost savings for the Government.

A major controversy with the federation system is with conflicts of interest. Because the federations are composed of members of the MFIs that it also supervises, there is a high likelihood that the federations cannot be unbiased. Furthermore, federations have the power to create and implement their own prudential regulations, which means that MFIs will have to comply both with the rules promulgated by the CNBV and the regulations instituted by the federations.⁶⁵

In addition to the federation system, the 2001 law also created Bansefi, a public savings bank which builds capacity for over 400 popular savings and credit institutions.⁶⁶ These institutions target poor and lower-income groups that generally have no access to the commercial banking sector. BANSEFI attempts to ensure that clients of savings and credit institutions have access to safe and efficient financial services through various expansion programs.⁶⁷ Moreover, because the 2001 law only applies to deposit taking institutions, the 2001 law attempted to create prudential norms that effectively protect deposit. In order to offer protection, the Mexican government requires minimum levels of assets and capitalization.⁶⁸

Although Mexico does not have interest rate caps, licensure requirements and minimum capitalization amounts for banks are quite stringent. This can result in high operational costs and cause an adverse incentive against microfinance delivery in the banking sector.

C. THE COMPARTAMOS EXAMPLE: PROFITABILITY IN MICROFINANCE, INTEREST RATES, AND EXPLOITATION OF THE POOR

The lack of interest rate limits and relatively relaxed governmental regulations in Mexico have allowed for-profit MFIs to impose annual interest from fifty to 120%.⁶⁹ These rates are extremely high when compared to the worldwide average of thirty one percent for non-profit micro-lending institutions or the twenty-nine percent interest rate charged to Americans with bad credit on credit card loans.⁷⁰ While economic justifications for high interest rates exist, some challenge these business practices as exploitative and ultimately harmful to the poor.

65. *Id.* at 22.

66. Lisa Taber, Carlos Cuevas, Juan Navarrete & Gabriela Zapata, *Integrating the Poor into the Mainstream Financial System: The BANSEFI and SAGARPA Program in Mexico* (World Bank 2004).

67. *Id.*

68. Loubière, *supra* note 38, at 23.

69. Keith Epstein & Geri Smith, *The Ugly Side of Microlending*, *BUSINESSWEEK* (Dec. 13, 2007).

70. *Id.*

1. *Pitfalls of the High Interest Rates*

One of the major criticisms of the high interest rates is that it exploits the poor because many of the clients of microfinance are unsophisticated borrowers, and therefore, the repayment terms may not be sufficiently explained. In fact, because Mexico does not require disclosure of interest rates, many borrowers take these loans with minimal information and without any clear understanding of the repayment terms. As one financial representative at Banco Azteca explained, "terms are explained to them, maybe not as clearly as they should, but many don't understand. . . . They take on financial commitments they can't meet."⁷¹

Even if clients initially take on impractical financial commitments, microfinance has been a profitable business because low-income clients tend to boast a fairly high repayment rate. This repayment, however, may come at a cost. Under terms that many would consider usurious, payment amounts can quickly double over a year or two. For example, one Mexican couple that took out a loan for \$920 from a large Mexican MFI owed approximately \$1485.00 for that loan by the next year.⁷² Because some may not be able to meet the demanding repayment terms, individuals may engage in informal borrowing from loan sharks.⁷³ Mexican law does not prohibit this type of informal lending despite the threat of violence often associated with this practice.⁷⁴

Moreover, low-income individuals without much collateral have very few options for paying back these loans if the expected return from their investment is not sufficient. For many, it may come down to the choice between having food or paying back the loan. In addition, if an individual struggles to pay back a loan, the bank will seize whatever goods the borrower owns. If the borrower has enough goods to cover the debt, the bank will consider the debt repaid, and will not consider the borrower defaulted.⁷⁵ This type of classification may be why the stated loan default rate for many microfinance institutions is only about one to two percent.⁷⁶

2. *Justifications for High Interest Rates and Increased Commercialization*

One of the major justifications for high interest rates is that the rates are necessary to cover the high operational costs of lending small value loans.⁷⁷ More specifically, many argue that high interest rates are necessary to cover "the cost of funds, the MFIs operating expenses, loan losses

71. *Id.*

72. *Id.*

73. *Id.*

74. *Id.*

75. *Id.*

76. *Id.*

77. Nimal Fernando, *Understanding and Dealing with High Interest Rates on Microcredit: A Note to Policy Makers in the Asian and Pacific Region*, ASIAN DEV. BANK (May 2006).

and profits.”⁷⁸ Moreover, interest rates also reflect inflation. Inflation can “add to the cost of microfinance by eroding microlender’s equity.”⁷⁹ While most of these justifications are reasonable, some take issue with interest rates being used to increase profits.⁸⁰

Notwithstanding the inherent skepticism with profit making in the microfinance sector, to many economists, commercialization and profit-making have been a positive force in the field. According to their view, commercialization allows greater access and diversity in service. By having shareholders and profits, it allows for greater self-sustainability and faster growth.⁸¹ As such, many have disagreed on the propriety of government regulation, namely interest rate caps on MFIs.⁸² It is argued that interest rate ceilings will discourage potential investors from supporting microfinance and lead to a contraction of services and access.⁸³ Moreover, rate ceilings may also decrease creditworthiness of MFI, making it harder for them to borrow to finance their operations.⁸⁴ Ultimately, it is argued, that rate ceilings or restrictions on profits will cause MFIs to desert the poor.⁸⁵

3. *Compartamos: Mexico’s Most Successful MFI*

Compartamos’ success as a MFI demonstrates how profitable microfinance delivery can be in Mexico. By the end of 2008, *Compartamos* reached one million borrowers and achieved almost eighty million dollars in profits.⁸⁶ The loan portfolio of *Compartamos* has grown to almost 400 million.⁸⁷ Currently, the MFI charges about a ninety percent interest rate.⁸⁸ The New York Times notes, however, that interest rates in both the for-profit and non-profit MFIs are higher in Mexico as compared to other microfinance interest rates around the world because of high costs, inefficiencies and limited competition.⁸⁹ Notwithstanding the generally high interest rates in Mexico, approximately 23.6% of *Compartamos’* interest income went to profits.⁹⁰ If *Compartamos* reduced its return on average equity to fifteen percent, which is the normal return for Mexican Banks, the interest rate would drop to approximately sixty-eight

78. *Id.*

79. *Id.*

80. *CGAP Reflections on the Compartamos Initial Public Offering: A Case Study on Microfinance Interest Rates and Profits*, FOCUS NOTE (Consultative Group to Assist the Poor (CGAP), Washington D.C.), June 2007 (hereinafter “*CGAP Case Study*”).

81. *Id.*

82. Fernando, *supra* note 77, at 5.

83. *Id.*

84. *Id.*

85. *Id.*

86. Elisabeth Malkin, *Microfinance Success Sets off Debate in Mexico*, N.Y. TIMES, Apr. 5 2008.

87. *Id.*

88. *Id.*

89. *Id.*

90. *Id.*

percent.⁹¹

The Consultative Group to Assist the Poor (CGAP) noted that when Compartamos was an NGO, the charging of high interest rates was defensible because it could “overcharge” clients for the sake of more outreach to the poor.⁹² The surplus amount made by the NGO remained in the NGO to service the poor.⁹³ When Compartamos transformed into a for-profit MFI in 2000, priorities of the institution may have also transformed. Because private shareholders entered into the picture, the surpluses made by the MFI no longer necessarily translated into direct benefits for the poor.⁹⁴ Rather, while most of the returns remained in the MFI for the expansion of services, some became modest dividends for individual shareholders.⁹⁵ The debate about Compartamos’ reached a pinnacle in 2006 when Compartamos went public.⁹⁶ Compartamos was the first MFI in Latin America to go public and will probably not be the last.⁹⁷ The IPO produced huge profits for private investors. Many of the investors, including the bank’s top executives pocketed about 150 million dollars from the sale.⁹⁸ In total, the IPO brought in about 458 million dollars.⁹⁹ The Nobel laureate Mohammad Yunus condemned the IPO as a perversion of the industry.¹⁰⁰

Profit making in microfinance is not a controversial concept in itself. Most microfinance specialists agree that profit allows for self-sustainability and the expansion of services. However the average return for self-sufficient organizations is about 5.5%.¹⁰¹ Compartamos makes almost four times that, with approximately 19.6% return on assets.¹⁰² There is no question that Compartamos’ success has led to a greater expansion of services. In 2000, the MFI was serving about 60,000 clients and at the end of 2008, Compartamos was providing financial access to over 840,000 “unbankable” individuals.¹⁰³ Despite Compartamos’ rapid growth, less than 1/3 of Mexico’s working poor have any access to financial services at all.¹⁰⁴ Therefore, whether Compartamos’ profitability is the answer, or even an answer to effective microfinance delivery is debatable.

91. CGAP Case Study, *supra* note 80.

92. *Id.*

93. *Id.*

94. *Id.*

95. *Id.*

96. Malkin, *supra* note 86.

97. *Id.*

98. *Id.*

99. *Id.*

100. *Id.*

101. *Id.*

102. *Id.*

103. *Id.*

104. Keith Epstein & Geri Smith, *supra* note 69.

IV. BOLIVIAN MICROFINANCE: LESSONS REGARDING SUSTAINABILITY OF MICROFINANCE DELIVERY

A. THE ORGANIZATION OF MICROFINANCE DELIVERY

Bolivia is known for its successful microfinance industry. Almost 100% of the urban poor have access to financial services.¹⁰⁵ Microfinance delivery to the rural poor, however, has not been as successful. Bolivia's experience with microfinance is a textbook example of the liberalization that was occurring all through Latin America. In its elementary phase, microfinance delivery in Bolivia mostly occurred through the NGO sector.¹⁰⁶ In the 1990s, however, microfinance regulations were greatly liberalized and many of these NGOs transformed into regulated MFIs.¹⁰⁷

Like Mexico, Bolivia's microfinance delivery is broken down into bank and non-bank financial institutions. Because Bolivia eliminated public sector banking in the mid-1980s all banks and financial institutions are privately owned.¹⁰⁸ Within the banking sector, Bolivia has thirteen commercial banks and two specialized banks involved in microfinance.¹⁰⁹ In total, these banking institutions owned about sixty-five billion dollars in assets.¹¹⁰ One of the most famous banks involved in microfinance lending is BancoSol.

As for non-bank financial institutions, there are approximately fifty-two of these institutions within Bolivia.¹¹¹ The five different types of non-bank financial institutions involved in microfinance delivery are: (1) Private Financial Funds (FFPs), (2) open cooperatives, (3) mutual benefit savings and home loan societies, (4) closed cooperatives and (5) NGOs.¹¹²

In 1995, the Bolivian government created FFPs, or Fondos Financieros Privados, to encourage NGOs with strong lending power to transform into specialized commercial financial institutions.¹¹³ The FFP business structure would allow organizations to take deposits, access wholesale funds and commercial capital more easily and encourage effective management.¹¹⁴ The principal objective of these FFPs is to channel resources to micro and small-scale borrowers both in rural and urban areas.¹¹⁵

Although FFPs can be run for profit, the other four types of non-bank financial institutions are non-profit organizations involved in microfinance delivery. For example, Mutual Benefit Savings and Home

105. Microfinanceregulationcenter.org, Regulation Home Page: Country Profiles: Bolivia, http://www.microfinanceregulationcenter.org/resource_centers/reg_sup/country_info/bolivia (last visited July 8, 2009).

106. Loubière, *supra* note 38, at 2.

107. *Id.* at 14.

108. Microfinanceregulationcenter.org, *supra* note 98.

109. *Id.*

110. *Id.*

111. *Id.*

112. *Id.*

113. *Id.*

114. *Id.*

115. *Id.*

Loans Societies (NFBIs) are set up as non-profit civil associations that are authorized to carry out financial intermediation operations and provide financial services to the public.¹¹⁶ Open cooperatives are limited liability NFBIs, and therefore provide services to the public.¹¹⁷ Closed cooperatives, on the other hand, only provide financial operations for members.¹¹⁸ The government does not require closed cooperatives to be licensed. NGOs, like closed cooperatives can also operate without a license.¹¹⁹

B. THE HISTORY AND REGULATION OF MICROFINANCE INSTITUTIONS

Before the 1990s, Bolivian banks were highly inefficient with high administrative costs because most of the banks were oligopolies. In order to address these inefficiencies, by the mid to late 1980s, the Bolivian Government began responding with financial reform to weaken the oligopolies and increase competition.¹²⁰ One of the first reforms that occurred was liquidating state banks and weak private banks.¹²¹ Secondly, the Bolivian Government modernized the legal framework by strengthening the Superintendency of Banks and Financial Institutions (SBEF) by giving this regulatory group more autonomy from political pressure.¹²² Moreover, the government also allowed institutions to accept foreign currency in deposits, which encouraged foreign banks to enter into the Bolivian market and increased competition.¹²³ The other significant reforms that occurred were liberalizing interest rates, eliminating directed credit, and reducing the levels of reserves required on deposits.¹²⁴

With these reforms came the expansion of the informal sector and new-found economic stability. Within a year of the policy reform, microfinance NGOs began springing up on the Bolivian financial landscape.¹²⁵ Since state banks and weak private banks had closed as a result of the financial reform, non-profit organizations began lending credit to microentrepreneurs.¹²⁶ The Bolivian financial sector continued to liberalize during the mid 1990s, and many of these NGOs transformed into formalized microfinance institutions. One of the most successful transformations was the evolution of the NGO Prodem into the commercial bank BancoSol.

116. *Id.*

117. *Id.*

118. *Id.*

119. *Id.*

120. ELISABETH RHYNE, *COMMERCIALIZATION AND CRISIS IN BOLIVIAN MICROFINANCE* 2-3 (2001), available at <http://66.102.1.104/scholar?q=cache:mo7boy2tefQJ:scholar.google.com/+Elisabeth+Rhyne,+Commercialization+and+Crisis+n+Bolivian+Microfinance&hl=en>.

121. *Id.*

122. *Id.*

123. *Id.*

124. Loubière, *supra* note 38, at 11-12.

125. *Id.* at 12.

126. *Id.*

The SBEF regulates formal financial institutions and supervises compliance with pertinent rules. At first, the only regulations that existed were commercial banking regulations.¹²⁷ This proved to be problematic to microfinance institutions since microfinance portfolios and organizational structure can be drastically different in commercial banks. Therefore, during the early years of the transformation, the SBEF overlooked some violations of commercial banking regulations. For example, Prodem's unconventional portfolio of unsecured loans violated the banking regulations that any portfolio made up of more than ten percent unsecured loans had to be provisioned at 100%.¹²⁸ The SBEF allowed microfinance institutions to continue to operate despite violations of some key commercial banking norms. This selective enforcement allowed administrative costs to remain relatively low for these institutions.

In 1995, NGOs worked with SBEF to create a new regulatory framework for microfinance delivery in order "to become licensed intermediaries without having to meet all the requirements to become a commercial bank, particularly requirements relating to minimum capital and some of the more sophisticated banking operations (current accounts and financial trade)."¹²⁹ During this time, SBEF developed the FFPs, which had significantly lower capital requirements. These FFPs could also mobilize savings and were subject to the same prudential and non-prudential norms as banks. Moreover, the SBEF also developed a regulatory and supervisory framework for open cooperatives that strengthened these organizations by giving these organizations incentives to be regulated by SBEF and gain access to deposits from the public.¹³⁰

The new regulatory framework and corresponding increased liberalization encouraged competition within the microfinance sector. This competition has driven down price and increased quality of services. Bolivia has one of the lowest interest rates on micro loans in Latin America. In addition to regulated MFIs, the NGO sector in Bolivia also remains extremely active in microfinance delivery and serves a large number of clients.¹³¹

C. THE BANCO SOL EXAMPLE: THE PROFITABILITY OF COMMERCIALIZATION

In 1992, Banco Solidario (BancoSol) became the first microfinance NGO to transform into a commercialized MFI. The commercialized of BancoSol allowed it to become financially independent and expand its loan portfolio to service more clients.¹³² From 1997-1999, BancoSol was considered the "best local financial entity" by most business newspapers

127. *Id.* at 12-13.

128. *Id.*

129. *Id.* at 13.

130. *Id.*

131. *Id.* at 14.

132. Counsel on Hemispheric Affairs, *BancoSol: Mission Drift in Microfinance Institutions*, available at <http://www.coha.org/2008/08/bancosol-mission-drift-in-microfinance-institutions/>.

in Latin America¹³³ While most Bolivian banks struggled to maintain the twelve percent capital adequacy requirement, BancoSol's twenty-nine percent return on equity in 1998 made it one of the top performing banks.¹³⁴ In 1992, when BancoSol was still an NGO called Prodem, the organization serviced about 17,000 clients and had approximately four million dollars in assets.¹³⁵ By the end of 2007, BancoSol services over 160,000 clients with over \$300 million in loan portfolios.¹³⁶ BancoSol's reputation as a profitable MFI became well known internationally, and its example has been imitated not only in Bolivia but throughout the world.¹³⁷

Although BancoSol has become an example for profitable microfinance, whether it remains committed to its mission of alleviating poverty is more questionable. For example, although BancoSol claims to still be committed to exclusively servicing the poor, twenty percent of its clients are not considered poor and eighty percent are not exclusively under the poverty line.¹³⁸ Moreover, BancoSol's increase in average loan size also indicates that the MFI has drifted away from financing the Bolivian poor. In 1992, when the Prodem first transformed into BancoSol, the average loan size was \$ 326 (USD).¹³⁹ However, by 1997, the average loan amount increased to \$904.¹⁴⁰ By the end of 2007, the average loan amount increased to \$1,200.¹⁴¹ The steady increase in loan amount indicates that borrowers are coming from higher income levels since poor clients cannot afford large loans. In addition, the interest rates also appear to be higher than the interest rates available at non-profit microfinance organizations.¹⁴² Notwithstanding this discrepancy, interest rates at BancoSol still tend to be relatively low due to competition within the Bolivian microfinance sector.¹⁴³

D. MICROFINANCE AND ECONOMIC CRISES IN BOLIVIA

By 1999, Bolivia became a victim of its own early success. The rise of profitable banking institutions in Bolivia led to aggressive competition and ultimately caused over-lending.¹⁴⁴ Clients began taking advantage of

133. Elisabeth Rhyne, *supra* note 120, at 4.

134. *Id.*

135. MIX Market, Profile for BancoSol, *available at* <http://www.mixmarket.org/en/demand/demand.show.profile.asp?ett=280>.

136. *Id.*

137. ELISABETH RHYNE, *supra* note 120, at 4.

138. Jenna Barzelay Counsel on Hemispheric Affairs, BancoSol: Mission Drift in Microfinance Institutions (Aug. 27, 2008), <http://www.coha.org/2008/08/bancosol-mission-drift-in-microfinance-institutions>.

139. *Id.*

140. *Id.*

141. MIX Market, Profile for BancoSol, <http://www.mixmarket.org/en/demand/demand.show.profile.asp?ett=280> (last visited July 14, 2009).

142. Jenna Barzelay Counsel on Hemispheric Affairs, *supra* note 138.

143. Interest rates at BancoSol were between twelve and twenty-two percent at the end of 2007. See MIX Market, Profile for BancoSol, *supra* note 141.

144. ELISABETH RHYNE, *supra* note 120, at 11.

offers for quick and easy credit, which resulted in individuals having multiple loans from various institutions. In fact, many individuals maintained two or more loans outstanding at one time. As a result, clients began borrowing more than they could handle which increased delinquency. Overindebtedness coupled with macroeconomic slowdown greatly curtailed progress in the financial arena. Banks that were once extremely prolific were experiencing economic setbacks for the first time in over a decade. The financial sector was not the only area affected by economic downturn. Rather, the overindebtedness mixed with growing Latin American recession caused upheaval throughout Bolivian society. Massive protests, dangerous demonstrations, and social backlash against formal financial institutions ensued.¹⁴⁵

By the end of 1999, the consumer credit movement had crashed. In order to revive some of the larger consumer lending institutions, the Superintendent intervened directly into those institutions by injecting money.¹⁴⁶ However, despite the Superintendent's attempts, the investors of these banks lost money and refused to make any new loans.¹⁴⁷ The collapse of consumer credit directly affected microenterprise lending, although to a lesser extent. Because MFIs also participated in the rush to lend more money, they also witnessed delinquency to an unprecedented level.¹⁴⁸

In order to respond to the delinquency, MFIs began using the credit bureau more vigorously to determine whether potential clients had outstanding loans or had delinquency in the past.¹⁴⁹ Moreover, the Superintendent passed tougher regulations regarding the securitization of loans. Microlenders began placing greater emphasis on repayment capacity relative to past performance.¹⁵⁰ Furthermore, the Superintendent and MFIs began placing more emphasis on tangible collateral. A new law was passed that allowed individuals to mortgage equipment in order to secure collateral.¹⁵¹ Although increasing collateral requirements decreases the possibility of delinquency, it also makes financial services less available for the poor.

These regulations have resuscitated the microfinance sector to a certain extent. However, the financial crises of 1999-2000 greatly weakened the industry to the point where pre-crises growth rates have become a remnant of the past. BancoSol lost twenty-five percent of its clients between 1999 and 2000 and its return on equity plummeted from twenty-nine percent in 1998 to four percent in 2000.¹⁵² Furthermore, delinquency in the regulated microfinance sector increased from 2.4% in 1997 to 11.2% by

145. *Id.* at 12.

146. *Id.* at 13.

147. *Id.*

148. *Id.* at 14.

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.* at 15-16.

the end of 1999.¹⁵³ Since the economic crises, microfinance has slowly regained strength. In order for Bolivian microfinance to continue to thrive, the MFIs will need to develop innovative strategies to maintain good performance and encourage growth.¹⁵⁴

V. LOOKING TO THE FUTURE: LESSONS AND RECOMMENDATIONS

The Mexican and Bolivian example has shown us that increased commercialization can have definite benefits for microfinance because it encourages financial independence, diversification of products and greater outreach. Commercialization in microfinance, however, is a double-edged sword. The idea that profit can be made while chipping away at poverty may not seem objectionable at first glance. In fact, this idea spurred the growth of microfinance throughout the world and captured the support of many international development organizations such as ACCION and the United Nations.

Although profit-making and poverty alleviation do not have to be inherently mutually exclusive, the emergence of profit-seeking players in the field raises the possibility that instead of being a poverty alleviation tool, microfinance is increasingly becoming a mechanism to exploit the poor for a quick profit.¹⁵⁵ For example, in Mexico, where the government does not require disclosure of interest rates, for-profit MFIs such as *Compartamos* are charging interest rates close to 100%. Although high interest rates can be attributable to high administrative costs and inflation, for profit institutions charge much higher rates than their NGO counterparts. The high interest rates and collateral requirements make it more and more difficult for the poor to gain access to financial services or to pay off their debt. Moreover, if MFIs began loaning larger amounts, which is a phenomenon that has been occurring in Bolivia since its last financial crisis, the extremely poor will be unable to borrow because of their lack of collateral. When shareholders enter the microfinance picture, priorities can easily shift from poverty alleviation to the maximization of profit. This shift in priority may not only be detrimental to the poor but also to the economy as a whole.

A. REFLECTIONS ON THE SUBPRIME CRISES: LESSONS FOR MICROFINANCE

In many ways, the subprime mortgage lending carries the same risk involved in microfinance. With increase pressure to turn around quick profits, lenders may engage in predatory practices and encourage over-

153. *Id.*

154. Ulrike Vogelgesang, *Microfinance in times of crises: the effects of competition, rising indebtedness and economic crises on repayment behavior*, 31 *WORLD DEV.* 2085, 2085 (2003).

155. Barbara Kiviat, *The Big Trouble in Small Loans*, *TIME*, June 5 2008, available at <http://www.time.com/time/magazine/article/0,9171,1812051,00.html>.

indebtedness. One of the major reasons why the subprime scandal occurred was because lenders were disproportionately targeting “lower-income people and places with higher priced products offered on inferior terms.”¹⁵⁶ Many of the subprime loans were complex, confusing, and deceptive to borrowers. Currently, microfinance instrument are relatively simple and very little evidence of widespread delinquency exists. Nevertheless, as more for profit institutions enter into the microfinance business and aggressive competition ensues, the possibility of predatory practices increases. To avoid such practices, countries should implement truth in lending laws for microfinance that require disclosures of key terms, increases transparency in the lending system, and standardizes methods of calculating costs.

Another contributing factor to the subprime crises was speculative thinking on the part of the buyers.¹⁵⁷ Many U.S. borrowers took out loans in good faith with the expectation that they would be able to pay back the debt through their “investment.” However, when the housing bubble burst and prices within the housing market plummeted, delinquencies increased. Speculative thinking in microfinance also exists. Similar to homebuyers, microentrepreneurs take out loans with the expectation that through their business ventures they will be able to pay back the loans. Nevertheless, microcredit is also very different from the U.S. subprime lending because microloans tend to be much smaller than the subprime home loans. Moreover, delinquency rates are low in microfinance. As witnessed in Mexico and Bolivia, further commercialization encourages the diversification and sophistication of financial instruments. These changes increase the possibility of default. Therefore, microfinance organizations must invest in researching consumer behavior, developing sustainable and responsive products and carefully selecting borrowers. Although this paper does not recommend increasing collateral requirements, as this would make microloans less accessible, this paper does recommend limiting lending to entrepreneurial activities. In Mexico, for example, MFIs are increasingly lending microloans for consumer activities that have very little expected return. To illustrate, *Compartamos*, has been known to grant small loans with very high interest rates to buy stereos or television sets. This type of lending is unsustainable and will contribute to overindebtedness.

In addition to the speculative thinking and predatory practices, the subprime crises also resulted from an over-reliance on credit scores and the failure of the underwriting processes. Instead of conducting an in-depth analysis of risk and performance of the various portfolios, investors relied heavily upon credit ratings. In essence, lenders failed to exercise due diligence and oversight.¹⁵⁸ For microfinance institutions, credit rating sys-

156. K. McKee, *Microfinance Gateway: Meditations on the U.S. Sub-Prime Crises*, available at www.microfinancegateway.org/content/article/detail/47886?print=1.

157. *Id.*

158. *Id.*

tems can be an invaluable tool. However, the subprime crises should show MFIs that credit scores alone are insufficient. MFIs must actively engage in careful analysis of borrowers and implement adequate controls to ensure high quality portfolios performance.¹⁵⁹ MFIs should reflect upon the early days of microfinance where NGOs would take the time to interview family, friends, neighbors, and business contacts to determine loan worthiness.

B. A NEED FOR BALANCED GOVERNMENT REGULATION

A way to address the negative effects of commercialization is through sufficient government regulation and supervision. Some microfinance advocates claim that government presence in microfinance is detrimental because regulations increase administrative costs and may cause banks and other for-profit institutions to exit the field. Notwithstanding, without sufficient oversight, microfinance delivery can become exploitative and detrimental to the poor.

One major area that microfinance can be exploitative is through charging egregious interest rates. This paper does not recommend imposing interest caps since administrative costs and inflation can vary and drastically affect interest rates. One mechanism for maintaining low interest rates is through encouraging competition. Governments should support microfinance NGOs in their non-profit form and allow them to grow. Moreover, governments should also provide incentives to businesses to keep interest rates low. For example, through tax rebates and other incentives, governments could reward companies that charge lower interest rates and forgo large profits in microfinance delivery.

To lower administrative costs and hence decrease interest rates, governments should apply a flexible and balanced approach to regulation. For instance, Bolivian microfinance greatly benefited when the Superintendent used unbiased judgment and employed selective enforcement of rules to lower administrative costs for NGOs when they were transitioning into specialized financial institutions. One very important mechanism for decreasing administrative costs and encouraging growth is to allow microfinance institutions to take deposits. While Bolivia allows this, Mexican SOFELEs and SOFEMEs cannot take deposits from the public, which may be contributing to the extremely high interest rates for these organizations.

Self-Regulation through regulatory boards may also decrease administrative costs. However, as seen with the Mexican federation system when the regulatory board is composed of members of the MFIs, it can lead to conflicts of interest. Therefore, while self-regulation may decrease costs, there must be sufficient government oversight to guarantee impartiality. Because of the possibility of partiality, the regulatory boards at the MFIs should only handle non-prudential regulations. Prudential regulations

159. *Id.*

should be handled by an independent government agency that is knowledgeable of the microfinance industry.

C. A NEED FOR GREATER INFRASTRUCTURE

Another lesson that both Bolivia and Mexico has demonstrated through their experience with microfinance is the need for better infrastructure. Greater investment must be made in infrastructure to give the poor better access to financial services. For example, in Bolivia rural penetration in microfinance remains relatively low with less than fifty percent of the rural poor having access to financial services. In contrast, 100% of the urban poor in Bolivia have access to microfinance services.

Better roads and transportation will allow the rural poor to access urban banks. Governments should also encourage MFIs to operate in rural areas. Movement into rural areas will not only increase access to the poor but will also avoid saturation in the urban market. In Bolivia, MFIs are slowly moving into rural services as a result of fierce competition and oversaturation. In countries where MFIs lack motivation to move into the rural market because of low profit incentives, governments may consider offering tax rebates and temporary subsidies for rural microfinance delivery.

In addition to roads and transportation, countries should make greater investments into community infrastructure such as water sanitation and sewage. These types of investments make it more likely that low-income entrepreneurs will be successful at their business ventures and decrease delinquency rates. Investments into community property, especially in rural areas, will allow for a better overall business environment not only for the poor but for the country as a whole.

D. RECOMMENDATIONS FOR MICROFINANCE INSTITUTIONS: BALANCING PROFITS WITH PURPOSE

In addition to government action, MFIs themselves must take a proactive role in maintaining their sustainability. By incorporating profit-motives into microfinance delivery, some MFIs have lost touch with their original purpose of servicing the poor, and instead engage in practices that will possibly exploit or neglect the poor. "Mission drift" has become a problem in microfinance and threatens the long-term viability of these institutions. Mission drift is apparent both in Mexico and Bolivia. In Mexico, although only one-third of the poor have access to financial services and face extremely high interest rates, shareholders of MFIs reap in millions in profits. The initial public offering of *Compartamos* allowed the top executives of the bank to gain over one hundred million in profit. Similarly, in Bolivia, the steadily increasing loan amounts and collateral requirements of for-profit MFIs make it increasingly more difficult for the poor to access financial services.

While these profit-seeking actions may allow investors to turn around quick profits, neglecting or exploiting the poor in microfinance delivery

dooms the industry to failure. In order to maintain sustainability and avoid greater mission drift, MFIs should use great care in choosing members of the board of directors. MFIs should choose members that have experience and knowledge in microfinance delivery and are committed to long-term viability rather than turning around quick profits. In addition to choosing board members, MFI should also exercise due diligence in choosing clients. MFIs should consider the prospective client's purported use of the loan, past repayment history, number of outstanding loans and community reputation. Moreover, MFIs should disclose all key provisions in financial documents to clients and implement programs that educate clients on the financial services and repayment responsibilities.

In times of economic downturns, MFIs should shift their focus from increasing scale to maintaining financial viability.¹⁶⁰ Instead of expanding the number of clients or services, MFIs should concentrate on managing and monitoring portfolio quality. Additionally, MFIs should conduct in depth cost analysis for the financial services offered. In doing so MFIs should ask themselves which customer segments are more or less costly to serve, which products are more or less financially viable and how can they streamline products to meet demand. Lastly, in saturated markets and slow economies, MFIs should consider consolidation. Consolidation can offer a solution to liquidity problems because it allows MFIs to merge pooled assets and increases attractiveness to capital investors. Furthermore, consolidation may encourage economies of scale and reduce operating expenses.

E. CONCLUDING REMARKS

Over the past two decades, microfinance has undergone a dramatic transformation, evolving from a grassroots movement to a booming commercial industry. Through greater commercial presence, microfinance delivery has not only become more sophisticated and formalized, but has also allowed for greater access to the poor. Commercial microfinance institutions serve millions of clients all over the world and do a great deal towards poverty alleviation. Latin America, in particular, has one of the oldest and most successful microfinance movements in the world.

The Mexican and Bolivian experience with microfinance illustrates both the positive and negative effects of commercialization. In both of these countries, microfinance delivery has transformed from small-scale NGOs to large for profit specialized microfinance institutions. This transformation has expanded access to the Latin American poor and encouraged diversification in financial products. Because these organization can operate without donations and grants, they are generally more sustainable than their non-profit predecessors. While profit making in microfinance has its positive effects, it can also lead to exploitation and

160. Yana Watson, *From Crises to Catharsis: How Microfinance Can Make it through the Global Recession* 11 MICROFINANCE INSIGHTS 13-15 (Apr. 2009), available at www.microfinanceinsights.com.

overindebtedness. Like the U.S. subprime credit market, microfinance is also susceptible to failure from too much greed and irresponsible lending. In Mexico and Bolivia the microfinance sector has experienced great success but has also been susceptible to mission drift.

The commercialization of microfinance necessitates a delicate balance of regulation and growth. In order to maintain a profitable and sustainable microfinance industry, the government must use a balanced and flexible approach to regulating and invest in infrastructure for the poor. MFIs must also do their part by maintaining focus on portfolio quality and using ethical and transparent lending practices. By balancing flexible government oversight with MFI self-regulation, microfinance will continue to be a positive force in our society both as a poverty alleviation tool and as a growth opportunity for commercial enterprises.

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Comments and Casenotes

