

The Microfinance Movement
in Mexico: Revolutionary or
Institutional?

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Providing assistance to the world's poor has long been seen more as a work of charity than as a business model, yet contemporary trends strongly indicate that the face of traditional aid organizations are undergoing a major transformation, especially in Latin America. The microfinance¹ industry, which has traditionally been viewed as an entity that operates under the umbrella of an aid organization or government department, is becoming increasingly commercialized. Major controversy has followed this marked shift in methodology from charity to business. The origin of this schism is founded in one question: As the microfinance industry grows, should it take the path of commercialization² and profitability, or should it remain an institution that operates under a charitable model whose goal of serving the poor is undistracted by the pursuit of profits?

Ninety percent of the world's poor have no access to formal credit or savings.³ Microfinance carries great potential in helping the poor in developing countries, but there is still much progress to be made. It is estimated that the world demand for microloans is \$250 billion; approximately \$25 billion has been dispersed.⁴ It is widely believed that a non-profit approach is globally affordable because the demand cannot be met through donations and government-based programs.⁵ As Figure 1 illustrates, less than two million people in Latin America received microfinance services in 2006. It is imperative that the microfinance industry expand so that its services reach more people. Many of the world's poor have been excluded from participating in the traditional banking sector. Due to a lack of viable options many are forced to engage in

¹ The provision of financial services to low-income clients, including the self-employed. Joanna Ledgerwood, Microfinance Handbook (World Bank 1999) 1.

² To develop commerce in; to manage on a business basis; a market approach; a financial-systems approach. Robert Peck Christen and Deborah Drake, "Commercialization: The New Reality of Microfinance," The Commercialization of Microfinance: Balancing Business and Development, eds. Deborah Drake and Elisabeth Rhyne (Kumarian, 2002) 3.

³ Marguerite S. Robinson, The Microfinance Revolution: Sustainable Banking for the Poor (World Bank, 2001) 9.

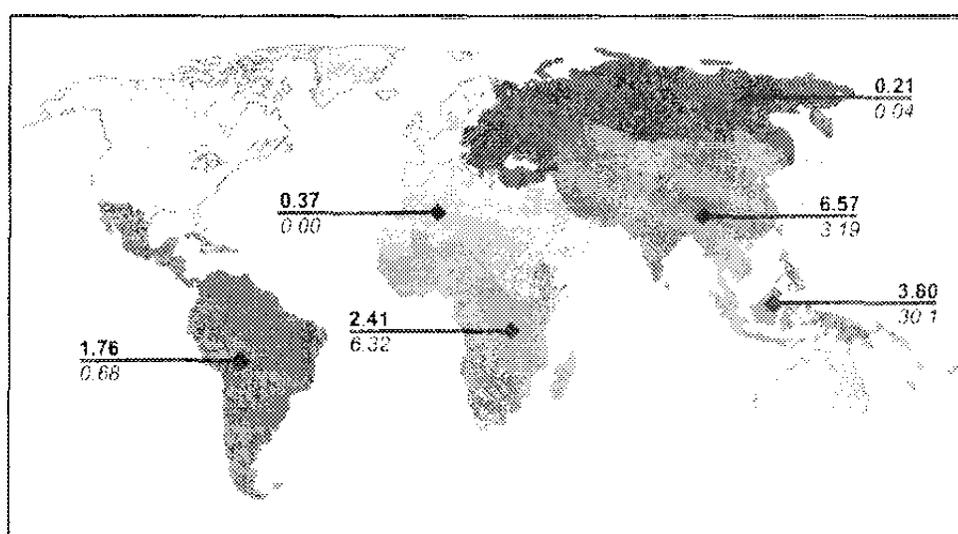
⁴ Elisabeth Malkin, "After Success, Problems for Microfinancing in Mexico," New York Times 5 April 2008.

⁵ Robinson 8.

transactions with informal moneylenders, which carries both high interest rates and high risks. A legitimate and stable microfinance industry can provide economic opportunities for a population that has traditionally been excluded from formal channels of finance. In order to provide microfinance services to the largest amount of people, a commercial approach to microfinance must be undertaken.

Figure 1 - Total Microfinance Outreach by Global Region (2006)

(**bold**=borrowers, *italics*=savers; in millions)



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In Latin America, a large segment of the poor population currently participates in the informal economy.⁷ Within the last thirty years most Latin American governments have come to recognize that informal economic activities can impact a nation's macroeconomic success.⁸ The fact that the microfinance industry distributes a great majority of its services to informal workers

⁶ Anne-Lucie Lafourcade, Jennifer Isern, Patricia Mwangi, and Matthew Brown, "Overview of the Outreach and Financial Performance of Microfinance Institutions," *Microbanking Bulletin*, 12 (Apr. 2006) 4.

⁷ Refers to economic activities in which workers or entrepreneurs do not fulfill the legal obligations that correspond with the production or distribution of a good or service. Juan Froilán and Martínez Pérez, "El sector informal in Mexico," *El Cotidiano*, (Mar/Apr 2005) 31.

⁸ Maria Otero, "The Role of Governments and Private Institutions in Addressing the Informal Sector in Latin America," *Contrapunto: The Informal Sector Debate in Latin America*, ed. Cathy Rakowski (Univ. of NY Press, 1994) 186.

and microentrepreneurs⁹ indicates that a healthy, expansive microfinance industry can have positive effects on the well-being and security of Latin American economies at local, regional, national, and continental levels.

A strong microfinance industry would be capable of delivering much needed financial services to a massive informal sector that has traditionally lacked access to legitimate channels of credit. A commercial, for-profit approach would be the most feasible way to deeply impact this population on a long-term basis. Non-profit organizations would not cease to play an important role, as their non-financial, social services would complement existing microfinance services. Yet, a commercialized microfinance industry would lead to more expansive outreach, increased stability, and the availability of more diverse financial products such as savings, microinsurance¹⁰, and remittance services.

In order to demonstrate that commercialized microfinance will actually produce more benefits than damages for the poor, I will first show how the poor of Latin America have been marginalized by traditional lending theories and banking practices. Following this, I will explain how the informal economy emerged as a channel through which the poor adapted to a formal economy that failed to absorb and integrate them. I will then illustrate how microfinance institutions (MFIs) originated as a response to inattentiveness from governments and banks towards a marginalized sector that was actually becoming increasingly integral to macroeconomic success. I will then address what the principal differences are between commercial and non-profit approaches to microfinance. Following this, I will discuss the growth

⁹ Owners of microenterprises.

¹⁰ The protection of low-income people against specific perils in exchange for regular premium payments proportionate to the likelihood and cost of the risk involved. Jim Roth, Michael J. McCord, and Dominic Liber, "The Landscape of Microinsurance in the World's Poorest Countries," Microbanking Bulletin, 15 (Apr. 2006) 9.

of Compartamos, how its success embodies the commercialization debate, and how its practices, however imperfect, still present a good banking option for a marginalized population.

In order to comprehend the importance of microfinance institutions in the Latin American we must first understand two important 20th Century developments. First, traditional banking methods consistently failed to provide access to financial services to poor segments of the population. Secondly, the massive rural-to-urban migration that occurred following World War II dramatically changed the demography of Latin American cities. Many migrants were forced into informal employment because the rate at which rural migrants populated the cities was higher than the rate at which the formal economy could absorb them. The combination of being eschewed by traditional banks and their inability to find formal employment meant that many migrants had to find ways to adapt to their new urban environment without access to formal channels of finance or employment. Many survived by finding informal employment or by establishing their own informal microenterprise.¹¹ Throughout Latin America many microenterprises receive credit from both non-profit and commercial MFIs.

The inability to access formal financial services has retarded the social and economic growth of Latin America's poor. In theory, credit is theoretically viewed as a lubricant that allows for the smoother flow of commercial and business transactions, but the reality is that credit represents socioeconomic capital that can empower its recipients. In terms of access to formal financial services, the rich have received disproportionately high levels in comparison to the poor. As the rich consistently exercised their credit privileges, poor populations were unable to maintain an equivalent rate of social and economic capital acquisition, thus creating a

¹¹ Businesses whose owner or employees produces, recycles, repairs, or sells goods; who provide services; who work for wages or commissions; who gain income from renting out small amounts of land, vehicle, draft animals, or machinery and tools, and to other individuals and groups at the local levels of developing countries, both rural and urban. Many of these households have multiple sources of income (Robinson, 9).

permanent gap that traditional banks were never able to close.¹² This disparity was exacerbated by the fact that many migrants found it difficult to participate in formal economic activities and acquire the official income documentation that formal banks required for gaining access to their services.¹³

In terms of economic activity, formality and informality are distinguished by varying degrees of legality. The principal difference between formal and informal economic activities pertains to *how* the business is operated, not necessarily what the type of business is. These business operations must be viewed through a scope of legality in which businesses can exist within realms of both formality and informality. There are two basic determinants for these criteria: initial legal recognition and the continued maintenance of this legality.

The initial legal recognition requires that the enterprise officially register with local and national bodies, providing a legal gateway into the formal economy. Registration gives the business legitimacy and authorization in the eyes of law enforcement.¹⁴ Concurrently, it cements the business's obligations to meet standards of health and product quality, categorizes the business as an economic unit that may belong to appropriate trade groups or associations, and, perhaps most importantly, obliges the business to pay taxes.¹⁵

The second stage involves the maintenance of legality, which requires that microentrepreneurs fulfill all legal obligations in every stage of their business operations. Unfortunately for many small businesses, maintaining legality, or permanence, can consume an

¹² Muhammad Yunus, Banker to the Poor: Micro-Lending and the Battle Against World Poverty (Public Affairs, 2003) 150.

¹³ Ricardo A. Lagos, "Barriers to Legality and Their Costs for the Informal Sector," Beyond Regulation: The Informal Economy in Latin America, ed. Victor E. Tokman (Lynne Rienner, 1992) 102.

¹⁴ Victor K. Tokman, "The Informal Sector in Latin America," Beyond Regulation: The Informal Economy in Latin America ed. Victor E. Tokman (Lynne Rienner, 1992) 5.

¹⁵ Lagos 88.

extremely large portion of their operating costs.¹⁶ However miniscule their level of economic activity and output may be, legal businesses are required to accurately pay municipal, state, and federal taxes, which generally means that accounting must be maintained and a declaration of profits must be submitted annually. For those microbusinesses that employ workers, costs associated with labor obligations such as official minimum wages, social security requirements, and overtime pay, can absorb much needed revenue.¹⁷

When looking at the shades of legality it becomes clear that there is “no clear-cut division between a formal and an informal sector and that the complex reality could be better described as a continuum with sliding transitions.”¹⁸ It is important to note that the largest group of informal businesses falls in an intermediary category that combines all forms of legality. Mexico can serve as an example due the strong and established role that the informal sector has played throughout the 20th Century. Based on several case studies, 27% of all microenterprises are unregistered (not having paid any entry costs or taxes), 18% are fully legal (having paid all entry and permanence fees; which would therefore pass them into the formal sector), and 55% fall in the middle somewhere (having paid entry costs, but not all of the permanence fees).¹⁹ With more than 80% of all Mexican microenterprises operating in either full or partial informality, the potential impact of microfinance activity demands that the microfinance industry grow and become firmly rooted in Latin America’s domestic economic agendas.

Today’s expansive informal employment initially resulted from the massive rural-to-urban migration caused by import-substitution-industrialization economic policies. The process of industrialization was slower than the rate at which major Latin American cities became

¹⁶ Tokman 5.

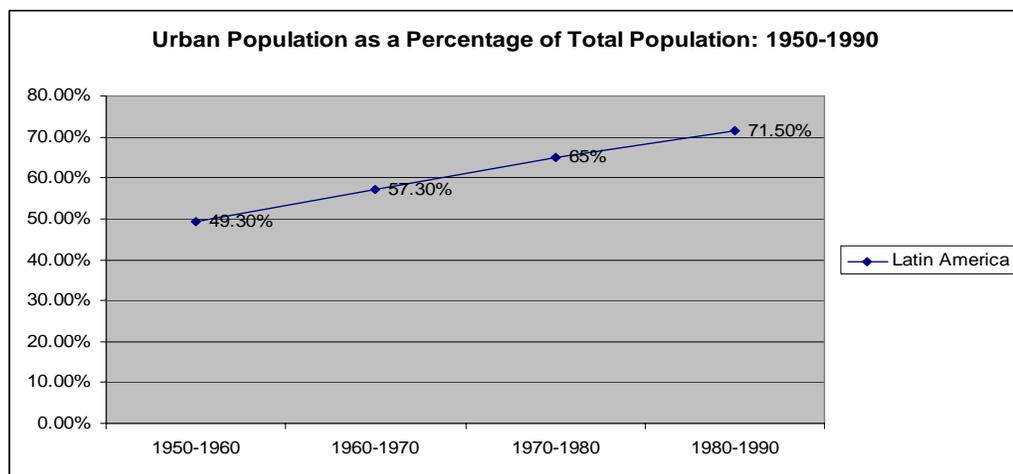
¹⁷ Lagos 103.

¹⁸ Robinson 11.

¹⁹ Tokman 5.

urbanized by rural migrants. In turn, major industries were unable to absorb the newly arrived migrants into the formal economic system, creating enormous pockets of impoverished rural workers with little education or skill throughout urban Latin America.²⁰ Many new migrants found that they were unable to participate in formal economic activities²¹ and were forced to create wage-earning activities in an alternative sphere, displaying survival characteristics that are still prevalent in today's informal workers.

Figure 2



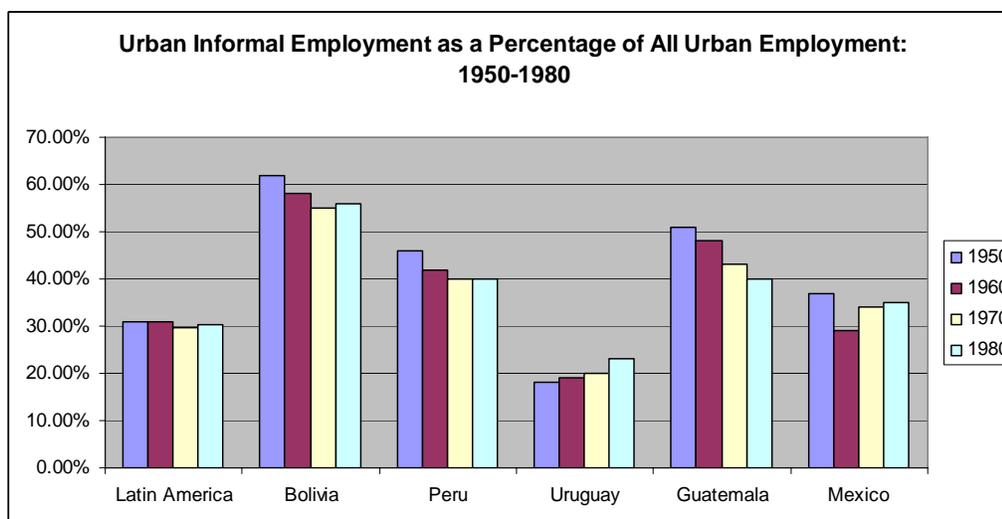
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Figure 3

²⁰ Carolin O.N. Moser, "The Informal Sector Debate, Part 1: 1970-1983," *Contrapunto: The Informal Sector Debate in Latin America*, ed. Cathy A Rakowski (Univ. of NY Press, 1994) 13.

²¹ J.J. Thomas, *Surviving in the City: The Urban Informal Sector in Latin America* (Pluto, 1995) 27.

²² 1950-1980 (Thomas 44); 1980-1990. Alejandro Portes and Richard Schauffler, "Competing Perspectives on the Latin American Informal Sector," *Population and Development Review*, 19.1 (Mar. 1993): 4.



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As the two graphs above illustrate, the second half of the 20th Century saw steady urban population growth that was accompanied by increasing informal labor activity in urban areas. The first microfinance institutions emerged in urban Latin America due to the large informal populations there, but rural Latin America remained largely ignored because of a longstanding belief that an informal economy was more natural for rural areas.²⁴ Although the percentage of urban informal employment often fluctuated between five or ten percentage points within individual countries, the urban populations of the entire region grew dramatically, which resulted in continually increasing informal urban activity. As a region, Latin America's percentage of urban informal employment may have only slightly exceeded 30%, but the fact that its total urban employment saw consistent and substantial increases, the actual number of urban informal workers and microentrepreneurial activity continued escalating. This decades-long growth established informal economic activities as a common characteristic in urban Latin America.

During the economic crises of the 1980s and the neo-liberal economic reforms of the 1990s, a dramatic rise in informality took place on a continental level, with rates of informal

²³ Portes and Schauffler 37.

²⁴ Robinson 13.

activity rising throughout Latin America from 40% in 1980 to 54% in 1992.²⁵ As formal sector employment decreased throughout the neo-liberal era, the informal sector served as a sanctuary for the newly unemployed that still needed to earn money. Many people began operating microenterprises in order to alleviate their economic struggles. Between 1990 and 1998, nearly 60% of all new urban employment came from these small, informal enterprises.²⁶ The parallel rise of the “invisible” economy and the decline of the formal economy forced most Latin American governments to assume a role of direct collaboration in an effort to integrate the success of informal economic activities with national macroeconomic goals.²⁷ At times this meant funding public or private microfinance organizations and even transforming national banking regulations.²⁸

Various reasons exist for the recent shift in government policy towards the informal sector. Governments eventually began to comprehend the full depth and impact of the informal sector on domestic economies due to important academic- and NGO²⁹-conducted studies in the 1960s and 1970s.³⁰ Furthermore, following the economic crises of the 1980s, governments began to view informal economic units as mechanisms that could reduce external dependence and could serve as reliable sources for tax revenue, if properly administered.³¹ For many of these governments, cooperating with or assisting the informal sector carried the same weight as a social service.

²⁵ Thomas 44.

²⁶ Alejandro Portes and Kelly Hoffman, “Latin American Class Structures: Their Composition and Change during the Neo-Liberal Era,” *Latin American Research Review* 38.1 (2003): 48.

²⁷ Otero, 187.

²⁸ Ramon Rosales, “Regulation and Supervision of Microcredit in Latin America,” *An Inside View of Latin American Microfinance*, eds. Marguerite Berger, Lara Goldmark, and Tomas Miller-Sanabria (Inter-American Development Bank, 2006) 117.

²⁹ Non-Governmental Organization.

³⁰ Otero 180.

³¹ Otero 178.

This cooperation has proven to be extremely important given the current demography of Latin America. A majority of the continent is young, unskilled or minimally skilled, and currently lives in urban areas, indicating that the informal market will likely be a source of employment for much of the population. From the government's point of view, the informal economy can absorb a portion of the workforce that has been marginalized by the formal economy.³² Importantly, during economic difficulties or restructuring, the informal sector can also serve as a cushion against disturbance or turmoil among a recently displaced or marginalized population.³³ Under these circumstances it would be imperative that a legitimate, alternative source of financing exist so that the informal workers can continue to generate money and informal businesses can find ways to grow and diversify.

Recent changes in government attitudes have translated into an increased level of stability for informal workers. Microfinance institutions have become more equipped and prepared in providing financial services to a population that has been excluded by the traditional banking sector. Due to the fact that traditional banking institutions avoided transactions with informal workers, these workers had no choice but to turn to informal moneylenders in order to attain credit. Borrowing from informal moneylender usually involved high transaction costs, high interest rates, and low security.³⁴ The entrance of both non-profit and commercialized microfinance institutions into the informal market provided some much needed legitimacy and security.

Despite the fact that much of the poor throughout Latin America participate in the informal economy, the traditional banking sector has believed that offering credit to them would be unprofitable and therefore have kept all channels to credit closed. Lending to the informal

³² Otero, 180.

³³ John C. Cross, Informal Politics: Street Vendors and the State in Mexico City (Stanford, 1998) 22.

³⁴ Robinson 16.

economy was not recommended because the small transactions led to higher costs per customer. Plus, the businesses lacked legal status, did not keep official financial records, and did not have any collateral.³⁵ In reality, many of these perceived risks were not actually true; informal moneylenders found that offering credit could be a very lucrative business.³⁶ Yet, the high interest rates charged by informal moneylenders, combined with exclusion from official financial institutions, have still marginalized a large portion of Latin America's working poor. Within the last 35 years, microfinance institutions have begun to fill this economic vacuum.

As microenterprises have become increasingly influential in macroeconomic success, microfinance institutions have also shown themselves to be significant in informal business activities and personal income. In reality, microbusiness finances often intermix with family income and, at times, the finances of additional microenterprises in which the family may be involved. So, it can easily be said that the financial needs of the microbusiness may mirror the needs of the family, especially if the microentrepreneur is female.³⁷ Despite the fact that the mission of many microfinance institutions is to provide services to microenterprises, many of the funds inevitably assist the family unit.

Open channels to savings and credit services help microeconomic units to expand their activities, increase efficiency and profits, and improve their day-to-day well-being. Additionally, access to affordable credit and reliable savings services can contribute to the diversification and growth of a microenterprise. Despite the fact that much of Latin America's poor has been excluded from formal savings institutions, they do in fact save in a variety of ways, many times in a nonfinancial matter. For those that are economically active, saving is often implemented in

³⁵ Robinson, 9.

³⁶ Robinson 17.

³⁷ Elisabeth Rhyne and Maria Otero, "Financial Services for Microenterprises: Principles and Institutions," The New World of Microenterprise Finance: Building Healthy Financial Institutions for the Poor, eds. Maria Otero and Elisabeth Rhyne (Kumarian, 1994) 13.

order to restock after emergencies, invest in capital, diversify activities, meet household expenses, and finance cultural events such as weddings and funerals.³⁸ The poor will definitely save if an appropriate savings institution exists. Many commercial MFIs offer microsavings³⁹ services, which allow poor clients to earn interest on financial savings rather than mortgaging presently-owned assets or prospective assets.⁴⁰ Although savings services are often more appropriate than credit for the working poor, this aspect of microfinance is often underemphasized.

Within a region whose traditional and formal institutions tend to serve as platforms that allow the financially and socially rich to perpetuate their elite status, it should be of no surprise that much of the population has not been allowed to participate. Due to this exclusion from formal banking and employment, an informal, parallel society developed alongside formality. These correlative institutions have come to carry great significance in their communities and countries and their growth must be encouraged. Microfinance has emerged as a medium that supplies much needed services to a marginalized population while operating on a level of legitimacy that serves to benefit both small communities and nations at large.

HISTORY AND DEVELOPMENT OF LATIN AMERICAN MICROFINANCE

Before moving into the debate between commercialization and subsidization, it is important to understand the historical context in which the microfinance industry developed and how government opinion evolved from ambivalence to active cooperation. This industry transformation coincided with shifting government attitudes towards the informal sector, economic crises, and continued rural-to-urban migration throughout Latin America.

³⁸ Hege Gulli, Microfinance and Poverty: Questioning the Conventional Wisdom (Inter-American Development Bank, 1998) 10.

³⁹ Savings accounts that have a very low required minimum balance

⁴⁰ Robinson 38.

The prevailing governmental attitude towards microenterprises and the informal sector had been one of indifference until the 1980s. However, this shift in thought was influenced by external forces that pushed for change. Academic- and NGO-sponsored studies implemented throughout the late 1960s and 1970s led to the foundation of a body of information and literature that documented the work of informal businesses and their economic contribution, which made the indifferent attitude by the government difficult to maintain.⁴¹ Most importantly, the founding and subsequent success of the Grameen Bank⁴² in Bangladesh showed that large-scale lending to the poor could be a practical venture. Throughout the 1980s, non-governmental agencies, with the help of governments for the first time, began founding institutions that mirrored Grameen. Some of these non-profit MFIs experienced a level of success that was sufficient enough for further expansion. By the 1990s, agencies were ready to test the microfinance model in the commercial banking industry, revolutionizing microfinance methodology at its foundations.

Appropriately, the country at the center of the microfinance commercialization movement was the poorest country in South America: Bolivia. More so than any other Latin American countries, Bolivia's informal economy has always occupied a disproportionately large position in the country's economic activities. While the percentage of the Urban Informal Workforce in relation to the total Urban Labor Force throughout Latin America hovered at 30% from 1950 to 1970, the Urban Informal Workforce for Bolivia occupied 56% of the total Urban Labor Force in the same time period.⁴³ As Bolivia confronted the economic crises of the 1980s and the structural adjustments of the 1990s, 75% of the population came to depend on income

⁴¹ Otero 180.

⁴² Stemming from a 1976 project at the University of Chittagong in Bangladesh, Dr. Muhammad Yunus started a program called the Grameen Bank Project that sought to break the cycle of poverty among the Banladeshi poor, especially women. The project was successful and slowly expanded into additional regions. In 1983 Grameen ("rural" in Bangla) became an independent bank that was majority-owned by its borrowers. [A Short History of Grameen Bank](#). 1998. Grameen Communications. 13 May 2008 <www.grameen-info.org>.

⁴³ Thomas 44.

generated within the informal economy.⁴⁴ As of 2007, 80% of all workers were either partially or fully employed in Bolivia's informal sector.⁴⁵ The important role played by informal businesses in the overall economy indicates that Bolivia would have an ideal climate for a competitive and profitable microfinance industry. Fittingly, that is precisely what Bolivia has.

In Bolivia the move towards commercialization was started with a NGO called PRODEM (*Fundación para la Promoción y Desarrollo de la Microempresa*). Founded in 1986, PRODEM sought to channel credit to local microentrepreneurs. After several years of successful operations, PRODEM realized that they were only meeting 2% of the demand for microcredit, yet constraints on capital and funding prevented the organization from expanding. Due to its status as a NGO, federal banking regulations prohibited PRODEM from collecting savings from its clients and from taking out loans from formal banking institutions. In order to expand outreach and increase mobility, the board of directors decided to transform PRODEM from a NGO into a commercial bank that offered microfinance services.

The new commercial MFI, BancoSol, opened its first four branches in 1992 and distributed \$21.7 million in loans. By 1998 it had disbursed \$135.9 million in loans, offered services to over 81,000 clients, and opened its 40th branch office. Additionally, BancoSol's portfolio at risk⁴⁶ was extremely low and its outstanding loan portfolio⁴⁷ had reached US \$74 million. Within ten years this commercialized MFI had become the most profitable bank in Bolivia.⁴⁸ In an effort to emulate the success of BancoSol, numerous competitors sprouted up

⁴⁴ Otero 178.

⁴⁵ "Friends, Not Clones," *The Economist* 7 Jun. 2007: 42.

⁴⁶ The outstanding value of loans with payments past due as a percentage of the total portfolio.

⁴⁷ The amount of money that a MFI has disbursed in loans.

⁴⁸ Robinson 67-9.

throughout Bolivia, which increased efficiency, decreased interest rates, and greatly expanded outreach and access for Bolivia's enormous informal workforce.⁴⁹

Although the industry growth that followed commercialization was remarkable, Bolivia had to quickly accept the reality is that the microfinance industry still had to operate within realistic parameters. As commercial MFIs began competing for profits, they began irresponsibly dispersing excessive amounts of small loans to poor Bolivians. This negative business tactic led to client over-indebtedness and caused massive amounts of loans to default. Were it not for strong federal banking regulations, Bolivia would have faced deep economic turmoil. This error in judgment helped fuel additional charges by critics of commercialization. According to the critics, this over-lending crisis would not have been as severe had the element of profitability not been present.⁵⁰

On an international scale, Latin America is a leader in microfinance. As of this writing, the region has at least 231 microfinance institutions⁵¹ reporting more than \$12 billion in total assets and almost \$10 billion in outstanding loans.⁵² The industry has developed into a formidable entity that can spark development in the region. Still, fewer than two million customers, less than one-half of 1% of Latin America's population, had been served by MFIs in 2006.⁵³ With this largely untapped market base, there is much potential in the future of Latin American microfinance, commercial or non-commercial. Through a combination of government

⁴⁹ Berger, Otero, and Schor 61.

⁵⁰ Armando Muriel, Victoria Muriel, Giulissa Franco, and Elsa Martin, "Microfinance Institutions in Time of Crisis: Impact, Actions, and Lessons Learned," An Inside View of Latin American Microfinance, eds. Marguerite Berger, Lara Goldmark, and Tomas Miller-Sanabria (Inter-American Development Bank, 2006) 149.

⁵¹ Matthew Gehrke and Renso Martinez, "First Look: The Diverse Latin American Microfinance Market," Microbanking Bulletin, 15 (Autumn 2007): 20.

⁵² Blaine Stephens, "Large MFIs Dominate Investor Portfolios and Client Services," Microbanking Bulletin, 15 (Autumn 2007): 31.

⁵³ Lafourcade, Isern, Mwangi, and Brown 4.

cooperation, economic stabilization, and investment, the Latin American microfinance industry can continue expanding and impacting the lives of more people.

COMPARING COMMERCIAL MFIs AND NOT-FOR-PROFIT MFIs

Returning to the central debate in this paper: What is the most effective methodology for microfinance in serving the marginalized population of Latin America? Can a commercial approach better assist the impoverished and indigent than a subsidized, donor-based approach? My response would be a measured yes. I hesitate to fully endorse the commercialization approach because non-profit MFIs still contribute necessary services that can never be financially viable. Comparing commercial and non-commercial MFIs can be difficult because their approaches are fundamentally different. Yet, outreach, efficiency, and portfolio quality are solid indicators of how well a MFI effectively serves its purpose and reaches its target audience.

Figure 3 - Commercialized MFIs: Advantages and Disadvantages

| Advantages | Disadvantages |
|---------------------------|---|
| Sustainable and long-term | Temptation to focus on profits |
| High Mobility | Over-lending |
| Offer Diverse Products | Need for Strong Supervisory and Regulatory Bodies |
| High Financial Efficiency | |
| High Outreach | |

Figure 4 - Non-profit MFIs: Advantages and Disadvantages

| Advantages | Disadvantages |
|---|----------------------|
| Commitment to Poverty Reduction | Low Outreach |
| Offer skill training, medical services, and education | High Losses |
| High Social Efficiency | Capital-constrained |

Outreach: An Institution's Ability to Impact the Most People in Need

Outreach refers to a MFI's effectiveness in reaching its target market. Depending on the purpose of the institution, the target market can change. Some non-profit MFIs focus strictly on serving the poorest of the poor, others may focus on serving moderately poor businesses, and others may concentrate on helping poor women. Within the commercialization debate some argue that the introduction of profitability into microfinance will cause the outreach of for-profit MFIs to stray from the marginalized to the more financially prosperous. This phenomenon is called mission drift.⁵⁴

Figure 5 - Top 5 MFIs with Greatest Depth in Outreach (2006)

| MFI Name | Adjusted Average Loan Balance/GNI per capita | Adjusted Average Loan Balance |
|-----------------|---|----------------------------------|
| Finca – Mexico | 3.8% | \$239 |
| Compartamos | 4.6% | \$99 |
| ProMujer – Peru | 5.0% | \$309 |
| Finca – Peru | 6.8% | \$146 |
| ADRA | 7.8% | \$168 |

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In the graph above, the outreach of a MFI is measured by taking the average loan amount as a percentage of GNI per capita. If the percentage is low, then it is determined that the institution has deep outreach and is distributing small loans to poor sectors of the population,

⁵⁴ Refers to a MFI's "drifting" away from its initial mission, the professed desire to use microfinance only improve the well-being of the poor, and towards providing financial services to a more financially stable population that has traditionally always had access to formal banking and is generally more profitable and stable for formal banks.

⁵⁵ Jared Miller and Renso Martinez, "Championship League: An Overview of 80 Latin American Providers of Microfinance," Microbanking Bulletin, (April 2004): 18.

thus fulfilling its mission by targeting the disenfranchised.⁵⁶ Of the five MFIs in the graph, the only for-profit institution is Mexico's Compartamos. This indicates that non-commercial MFIs have succeeded in consistently providing access to credit to the poor in the markets in which they operate. It also illustrates that Compartamos has done well in implementing a financial-systems approach and still successfully maintaining its target market.⁵⁷

Since commercial MFIs generally average higher loan amounts some argue that mission drift is already occurring. It is true that loans from commercial MFIs are consistently higher than non-profit MFIs, but this does not necessarily indicate mission drift. Uninhibited by the constraints placed on not-for-profit MFIs, commercialized MFIs exercise greater mobility within the market and are able to offer their services to a more diverse client base. For example, many small- and medium-sized enterprises⁵⁸ (SMEs) operate in the informal economy and are excluded from formal banking services. Unfortunately many of these SMEs are also ineligible to receive credit from non-commercial MFIs due to the fact that their operations exceed the preferred size of business that the MFI is professed to serve. Therefore many SMEs are marginalized by both the traditional banking industry and the not-for-profit microfinance industry. Supporters of commercialization believe that "lending to SMEs can be a key part of a business strategy where reputation and providing access to low-income workers – that is, SME employees – are also important in building a deposit base, and in markets where the existing formal sector does not serve this market adequately."⁵⁹ The fact that commercialized MFIs are capable of serving both the extremely poor sector of the market and the SME sector signifies that

⁵⁶ Miller and Martinez 18.

⁵⁷ Jared Miller, "Enabling Growth: An Analysis of Compartamos' Expansion," *Microbanking Bulletin*, 10 (Mar. 2005): 10.

⁵⁸ Enterprises that typically employ between ten and two hundred fifty workers. Marguerite Berger, Maria Otero, and Gabriel Schor, "Pioneers in the Commercialization of Microfinance: The Significance and Future of Upgraded Microfinance Institutions," *An Inside View of Latin American Microfinance*, eds. Marguerite Berger, Lara Goldmark, and Tomas Miller-Sanabria (Inter-American Development Bank, 2006) 51.

⁵⁹ Berger, Otero, and Schor 56.

mobility and outreach elasticity exists due to commercialization and that the non-commercial microfinance industry lacks the ability to reach multiple markets that need access to credit and savings.⁶⁰

While successful non-profit MFIs can effectively reach their target market, a lack of mobility prevents them from expanding their services to untouched markets in which an absence of financial access persists. This element of constraint due to immobility and minimal funds does not generally exist for commercial MFIs, who are free to expand and diversify to the extent that its assets allow. The performance of CrediAmigo, a microfinance branch of Banco do Nordeste in Brazil, illustrates that the ability to grow and reach farther into the market can have significant impacts. CrediAmigo was founded in 1998 and began to achieve growth quickly, expanding by 40% each year. In May of 2003, CrediAmigo had more than 120,000 active clients, 70% of whom were first-time bank users.⁶¹

Both commercial and non-commercial methodologies have shown that they are capable of serving poor clients and reaching deep into the market, yet non-commercial MFIs are distinct because they have proven their ability to consistently serve the poorest of the poor. On the other hand, commercial MFIs have also shown that their mobility and ability to expand allows them to offer services to a much larger segment of the population than non-profit institutions are capable. Additionally, the ability of commercial MFIs to serve SMEs is an aspect that should not be underemphasized. What is important is that the microfinance industry as a whole recognizes that specific segments of the population require different services and that the industry is striving to meet these distinct needs.

⁶⁰ David de Ferranti and Anthony J. Ody, Beyond Microfinance: Getting Capital to Small and Medium Enterprises to Fuel Faster Development, (Brookings Institute, 2007) 6.

⁶¹ Yerina Mugica, A Development Bank's Success with Microfinance: Banco do Nordeste's Crediamigo (Univ. of North Carolina, 2003) 10.

Efficiency: An Institution's Ability to Maximize its Limited Resources

Depending on the institution, operational efficiency⁶² can represent a multitude of outcomes. For example, an institution with a poverty-lending approach that has 100% efficiency in production would generate outcomes that are vastly different from a MFI with a financial-systems approach to lending. Some institutions may perform extremely well in terms of social returns, but fail to yield any significant financial returns. In the era of commercialization there is now the fear that MFIs will begin excelling in financial efficiency while shirking their responsibility to create social returns.⁶³ However, there are important fields in which the efficiency of commercial and non-commercial operations differs: operating costs, staff productivity and corruption. These are important determinants of efficiency because they can impact outreach, a customer's confidence in an institution, and the institution's opportunity for sustainability.

For commercialized MFIs with high rates of financial efficiency, operating costs are consistently low in comparison to the overall portfolio. This allows for an increase in portfolio quality and a decrease in loan interest rates, which benefits the customers. In order to achieve such efficiency it is imperative that the market in question be competitive. A lack of competition will prevent increases in efficiency and will undoubtedly prevent any substantial decrease in interest rates.⁶⁴ For example, Bolivia's commercial microfinance industry is the most competitive in Latin America. Due to competition between commercial MFIs, maximized operating costs have caused interest rates to drop to levels that were once thought unattainable.⁶⁵

⁶² A determinant of how well a MFI does in allocating inputs (assets, staff, subsidies, etc.) to produce the maximum output (number of loans, financial self-sufficiency, poverty outreach, etc.). Bernd Balkenhol, "Microfinance, Efficiency Return and Public Policy," *Microbanking Bulletin*, 14 (Spring 2007): 18.

⁶³ Balkenhol 18.

⁶⁴ Berger, Otero, and Schor 60.

⁶⁵ Berger, Otero, and Schor 60-1.

The operating costs of non-commercial MFIs have traditionally been higher. The fact that the ratio of employee per customer in non-commercial MFIs is much lower than the commercial sector indicates that the costs associated with individual transactions consumes higher amounts of limited resources. This low employee-to-customer ratio can also translate into poor customer service. For customers, the cost-per-transaction can be unnecessarily high due to inconvenient branch locations that may require repeat visits for a single transaction.⁶⁶

Staff productivity in non-profit MFIs can generally suffer from problems that do not exist in commercial institutions. Employees can unproductively use their time and energy by monitoring the end-use of the loan, which neither impacts the ability of the MFI to collect the loan nor the ability of the customer to repay it. While certain non-financial training can help customers become more self-sufficient, non-profit MFIs have the tendency to make inappropriate training, such as training for a job they already know how to do well, a requirement for loan acceptance. In the minds of the customers, the training is nothing more than another time-consuming act that must be obliged in order to receive a loan. Additionally, staff can spend much of their time filling out excessive paperwork, much of which provides information to donor groups and government bodies and is pertinent to neither the clients nor loan repayment.⁶⁷

Corruption can foster quite easily within the non-commercial microfinance industry. Due to the below-market interest rates attached to subsidized microcredit, local political leaders and other elite factions learn how to funnel the credit to their favor, which wastes precious funds. Subsidization and corruption can also reduce the outreach of non-profit institutions because artificially low interest rates force institutions to ration credit and tend to create incentives for better-off borrowers to try to capture the benefits of any subsidy used to support the low rates.

⁶⁶ Robinson 144, 146.

⁶⁷ Robinson 144, 146.

This has the effect of excluding microentrepreneurs.⁶⁸ At times, these elites will on-lend⁶⁹ the money to the poor of the community, but at an interest rate higher than the original. Additionally, there is a possibility that the staff of the institution will demand bribes in order to fulfill requests.⁷⁰

Operating costs, staff productivity and corruption would be important concerns for any functioning financial institution, but the differing operational practices within sustainability and subsidization approaches change the dynamics of the relationship substantially. Operating in a competitive market demands that an institution be efficient or lose customers to another institution. Commercialized microfinance is not free from institutional problems however. Corruption within non-profit MFIs generally results in the exclusion of poor customers. This can also occur in the commercial microfinance industry, but in the form of mission drift. Depending on one's perspective, mission drift is nothing more than legitimized corruption that channels finance in a way that perpetuates the wealth of a select few and deprives others of economic opportunities.

Portfolio Quality: An Institution's Ability to Foster Security and Stability in its Funds

The quality of a portfolio⁷¹ is an excellent indicator as to whether or not an institution can remain commercially viable. For the most part, commercial MFIs in Latin America have portfolios of a very high quality, which indirectly brings stability to their borrowers, the surrounding communities, and the greater economic well-being. In order for a portfolio to maintain a high quality, the institution must have a low rate of write-offs⁷² and portfolio-at-risk. For commercial MFIs these indicators of portfolio quality are generally competitive; non-

⁶⁸ Gulli, 63

⁶⁹ To disperse a loan to a third party; in this context it is generally informal and exploitative.

⁷⁰ Robinson, 144, 146.

⁷¹ The collective amount of funds that a banking institution holds.

⁷² Delinquent loans that are taken as a loss.

commercial, subsidized MFIs have been known to control their portfolios poorly. This puts at risk both their borrowers, the economic stability of the community in which they operate, and decreases the integrity of the institution in the eyes of the customers.

While write-offs are a concern for every banking institution, rates among commercial MFIs have traditionally been low. In fact, these institutions remain extremely competitive in this aspect of banking, with write-off rates having generally been generally lower than or equal to the traditional banking sector. BancoSol in Bolivia, for example, in its lifetime has only taken a loss on \$11 million of the \$1.1 billion that it has dispersed, a rate of 1%. The rate for Banco Los Andes ProCredit in its lifetime has been 2% and Banco ProCredit of El Salvador has only written off 0.5% of its lifetime disbursements.⁷³

Much like their write-offs, the percentage of portfolio-at-risk of commercial MFIs is impressive in comparison to the percentage of the overall banking industry. The PaR30, which measures the percentage of portfolio-at-risk in a thirty-day period, differs very little between commercial MFIs and traditional banking institutions. Generally, regulation for late payments in commercial microfinance is stricter than that of the traditional banking sector because an over-disbursement of loans or a lack of collection can lead to client over-indebtedness, which can easily cause a financial crisis for the microfinance industry.⁷⁴ This type of stability gives customers confidence their institutions and encourages them to invest and save, which increases a nation's macroeconomic stability.

On the other hand, subsidized MFIs tend to suffer from unstable portfolios and can risk destabilizing the economy of the region in which they operate. High default rates in non-commercial MFIs generally stem from the fact that subsidized loans are viewed as an entitlement

⁷³ Berger, Otero, and Schor 59.

⁷⁴ Berger, Otero, and Schor 58.

rather than a loan that is to be repaid. Conversely, lenders do not attempt to collect payment because the loan is seen as a political favor or social service instead of a business transaction.⁷⁵

At times high default rates on subsidized loans can be extremely damaging to the greater economic security. In Mexico in the late 1980s, BANRURAL's loan recovery rate of 25%, the decreasing value of the *peso*, and the abuse of on-lending caused significant damage to the agricultural industry. The federal government of Mexico was forced to bail out the agricultural industry with subsidies that totaled 1.7% of its GDP. In 1980, a similar crisis with agricultural microcredit occurred in Brazil which resulted in a loss of 2.2% of GDP.⁷⁶

In order for microfinance to truly reach those in need, it is important that MFIs maintain sight of who their primary customers are. Some institutions may falter due to misguided pursuits of high profit or through systematic corrupt practices. What we can see through an analysis of write-off rates and portfolio quality is that simultaneous institutional integrity and customer confidence is necessary in order for MFIs to remain sound. If one or both of these elements are missing, economic destabilization or institutional failure will likely occur.

Relevancy of Not-for-Profit MFIs in an Era of Commercialization

The presence of commercialization in microfinance should never threaten the relevancy of not-for-profit organizations. Commercialized MFIs can provide access to credit, savings, microinsurance, and remittance services to a wide range of people because these activities are financially viable. However, many impoverished communities lack important non-financial services that generally are not financially viable and require frequent subsidization.⁷⁷ Any commercial organization that pursues a financial-systems approach to microcredit would doubtfully implement services that continuously absorb funds and reduce efficiency. Non-

⁷⁵ Robinson 72.

⁷⁶ Robinson 144.

⁷⁷ Rhyne and Otero 19.

Governmental Organizations, however, should provide necessary social services as long as donations and funding remain available.

For many impoverished communities, access to credit is unnecessary and inappropriate because it would only be invested in activities that do not create income, such as food or home repair. In this instance it could be said that access to credit is just access to debt and an exacerbation of problems.⁷⁸ For this population non-profit organizations provide social services such as skills training, literacy, health, and family planning.⁷⁹ Additionally, services such as financial training and community organization⁸⁰ can serve to complement the availability of commercial microfinance services.⁸¹

The social services offered by non-profit organizations and microfinance institutions will never be made redundant due to the necessity of their existence and that they are generally not financially viable. Commercialized microfinance may continue to expand and expose greater populations to financial access, but some important social services simply cannot be provided by a market approach alone. For these reasons we can hope that governments and donor organizations continue to fund non-profit organizations that provide important non-financial services to poor communities.

A CASE STUDY: COMPARTAMOS

For proponents of the commercialization approach, Mexico's Compartamos has epitomized the potential that a financial-systems approach possesses. Plus, its path to success fit in well with the way in which commercialization is advertised: originating as a non-profit MFI, transforming into a commercial MFI, and then achieving impressive success in the formal

⁷⁸ Robinson 8.

⁷⁹ Robinson 22.

⁸⁰ Rhyne and Otero 19.

⁸¹ Robinson 73.

banking sector while still servicing its target clients. Success for Compartamos has translated into unbridled profit margins, raising red flags from critics that claim the bank is achieving exorbitant earnings at the expense of the poor. Even within the for-profit industry there is fear that the continued presence of excessively high profit margins could damage the already delicate public image of commercial MFIs and possibly impede any advancement of the commercialization approach.

Figure 6 – Growth of Compartamos: 2002-2007

| Year | Active Portfolio | Amount Dispersed | Active Clients |
|--------------------------------|-------------------------|-------------------------|-----------------------|
| 2002 | \$43,030,870 | \$179,124,272 | 144,991 |
| 2003 | \$64,213,016 | \$285,256,214 | 215,267 |
| 2004 | \$102,033,717 | \$457,529,651 | 309,637 |
| 2005 | \$183,271,404 | \$795,799,010 | 453,131 |
| 2006 | \$275,198,000 | \$1,190,122,000 | 616,528 |
| 2007 (3 rd Quarter) | \$316,455,000 | \$1,167,725,000 | 765,362 |

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For Compartamos, a dramatic amount of growth has occurred in just over a decade. Founded as an NGO in the early 1990s, Compartamos began dispersing subsidized loans that promoted microenterprise development with a focus on women in rural areas. From 1995 to 2002, Compartamos' customer base grew from 15,000 customers to over 140,000.⁸³ Much of its growth is owed to the fact that it is one of the only MFIs in Mexico that focuses almost completely on microenterprise credit. This allowed Compartamos to expand rapidly.⁸⁴ Similar to the funding restrictions that PRODEM faced, the board of directors of Compartamos decided

⁸² "Compartamos." 2008. ACCION International. 5 May 2008 <www.accion.org>.

⁸³ History. 2008. Compartamos. 26 April 2008 <www.compartamos.com>.

⁸⁴ Miller 10.

to upscale to a *Sociedad Financiera de Objeto Limitado* (a private intermediary institution in the Mexican financial system) in 2001.⁸⁵ Compartamos continued expanding and *Microenterprise Americas* considered named it the most profitable microfinance bank in 2005.⁸⁶ In 2007 Compartamos decided that it would act as a bridge between public investors and the marginalized poor and became the first microfinance institution to enter into the stock market.⁸⁷ In 2007, Compartamos' shares were sold for \$467 million⁸⁸ and it brought in \$80 million in profits.⁸⁹

During its meteoric ascent, Compartamos quickly became the focal point in the argument supporting commercialization. For those that opposed the institution's methodology, Compartamos became synonymous with the dangers inherent in a for-profit microfinance model. Numerous authors, researchers, and leading microfinance advisers from the Inter-American Development Bank, the World Bank, ACCION International, the Multilateral Investment Fund, and the International Finance Corporation viewed Compartamos as a microfinance institution that could simultaneously expand, earn profits, and still maintain profound influence within their target community of poor clients. However, its entrance into the stock market and subsequent high profit margins marked a distinct shift in the debate.⁹⁰ Critics actively expressed their dissatisfaction and there was now valid reason to fear that rampant pursuit of profits could now harm the industry as a whole.

Even those who had traditionally supported the commercialization process felt that Compartamos' profit margins and methodology had ventured too far into the realm of the

⁸⁵ Making a Difference: Financial Markets, 2005. International Finance Corporation. 26 April 2008 <www.ifc.org>.

⁸⁶ Matthew Gehrke, Renso Martinez, and Blaine Stephens, "Championship League: The Top 100 MFIs in Latin America and the Caribbean," Microenterprise Americas (Fall 2005). 30 Dec. 2007 <www.iadb.org>.

⁸⁷ History.

⁸⁸ Mexican Microfinancing Bank Banco Compartamos Places Shares for USD 467 Million, *Noticias Financieras*. 20 April, 2007.

⁸⁹ Malkin.

⁹⁰ Malkin.

business world and had ignored the second constant in the double bottom line of commercial microfinance: financial returns and social returns. Muhammad Yunus⁹¹ has charged that Compartamos is putting the industry at risk by placing too much emphasis on investor returns. The founder of ProMujer, a microfinance NGO that operates throughout Latin America, said that it was the customers that generate profits, therefore the profits ought to be reinvested in serving the customers rather than the investors. According to one outspoken critic, “Not only are they making obscene profits off poor people, they are in danger of tarnishing the rest of the industry. Compartamos is the first but they won’t be the last.”⁹² The recent growth of Banco Azteca⁹³ confirms this critic’s prediction.

A principal criticism of Compartamos at this juncture is that their interest rates on loans have not dropped in proportion to their rise in profits. These interest rates, combined with the conspicuously high taxes in Mexico, have meant that Compartamos charges some of the highest interest rates of any Latin American microfinance institution. Their 90% annual interest rate on loans compares poorly with the 25%-45% annual interest rates charged throughout much of the developing world.⁹⁴ While this gap is significant, the informal moneylender alternative is not promising for prospective borrowers as these moneylenders can often charge upwards of 300% annual interest on loans.⁹⁵ When placed alongside this informal alternative, the Compartamos product seems convenient, cheaper, and more legitimate. Although it is rarely discussed by industry insiders, it is believed that microentrepreneurs actually care more about convenient

⁹¹ Founder of Grameen Bank, Nobel Prize Winner, and major figure in microfinance theory and practice

⁹² Malkin.

⁹³ A commercial MFI founded by Grupo Elektra, a Mexican institution very similar to Wal-Mart. Its billionaire owner, Ricardo B. Salinas Piego, famously recalls advice given to him by his grandfather: “If you want to become rich, sell to the poor.” Keith Epstein and Geri Smith, “The Ugly Side of Micro-Lending: How Big Mexican Banks Profit as many Poor Borrowers Get Trapped in a Maze of Debt,” *Business Week*, 24 Dec. 2007: 39.

⁹⁴ Malkin.

⁹⁵ Robinson 17.

access to credit than market-price interest rates.⁹⁶ If this turns out to be true, then much of the argument against commercialization will be deflated.

More importantly, two characteristics of Mexico's microfinance system might explain the high interest rates of Compartamos: poor regulation and supervision, and a lack of competition. A glance at Bolivia's microfinance infrastructure indicates that once the proper conditions and parameters (strong regulation and competition) are in place, both the customers and the microfinance industry can prosper. Mexico's commercial microfinance industry needs to develop one or both of these elements in order to reduce their interest rates and continue strengthening their position in the greater economic agenda. Still, the fact that Compartamos continues to serve its initial client base indicates that it is fulfilling two key goals of commercialization: outreach and sustainability. Although multiple variables exist that could cause the pendulum to swing either way, there is a slim likelihood that a dramatic ascent into the upper echelons of profitability will cause Compartamos and the commercialized microfinance industry to fall from grace.

CONCLUSION

Traditional financial institutions have largely been a disappointment for Latin America's working poor. The recent emergence of microfinance institutions has provided stable and cheap financial opportunities that have historically been unavailable. Combined with the fact that informal workers, microenterprises, and small- and medium-size enterprises encompass a large majority of the economically active population, microfinance institutions have the potential to play an integral role in the development of communities.

The wide variety of demands that exist in the developing regions of Latin America can be separately met by non-profit and commercial MFIs due to the fact that each institution excels in

⁹⁶ Berger, Otero, and Schor 42.

different areas. For non-profit MFIs, these demands may be pre-loan financial training, skill training, medical exams, or community organization. For commercial MFIs, the demands might be credit, savings, or microinsurance. When approaching microfinance from a sustainability and efficiency standpoint, the commercialization methodology stands out as the most practical and realistic due to the fact that the demand for microfinance cannot be met through donor funds or government programs. Additionally, it is widely believed that more people want access to savings services than access to more credit and that savings services create a more profound impact on specific communities. Since the banking regulations in most countries prohibit non-profit MFIs from mobilizings, it would be difficult to believe that the non-profit methodology could achieve the same impact as the commercial pursuit.

At this juncture in the development of the commercial microfinance industry, what was considered to be the threshold for acceptable profits by industry insiders has been crossed. Still, what remains in on the periphery of the debate is the argument that most poor borrowers prefer convenience, good terms, and security rather than extremely low interest rates. This aspect of microfinance, the customer's point of view, has been overlooked and deserves much study. Once we understand more about what the customer is willing to pay in interest rates, we will be able to gauge more accurately the lengths to which a commercialized microfinance industry can expand.

Importantly for the commercialized microfinance industry, the biggest hurdle has already been conquered: proving to the world that loaning to the poor can be profitable and sustainable. From this point, commercialized microfinance institutions will continue refining their methods and strategies while simultaneously allowing previously marginalized poor workers to confidently engage in the improvement of their personal well-being and that of their family.

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