

MICRO-FINANCE AND INCLUSIVE FINANCIAL SYSTEMS
IN LATIN AMERICA

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ABSTRACT

The search for the best way to create opportunity and sustainable development in the less privileged parts of the world has brought about initiatives to overcome poverty and marginalization, and to build more inclusive social, economic and financial systems. Among a multitude of initiatives, micro-finance, by now a familiar concept, has only recently come to the attention of the development field. The contemporary version of micro-finance traces its origins to 1974, via the innovative initiative of Dr. Muhammad Yunus in starting the Grameen Bank in Bangladesh, for which he went on to win the Nobel Prize for Peace in 2006. Yunus showed that micro-finance held the promise of providing financial services for those individuals otherwise considered unworthy and unprofitable by the traditional financial sector. The introduction of micro-finance in Latin America, where poverty has grown to reach over fifty percent of the population in multiple nations, has developed in varying stages among countries of the region. The question then is whether micro-finance is a viable option to reduce such levels of poverty. The goal of this paper is to show that micro-finance *can* be an effective element in poverty reduction efforts, but it must be accompanied by an enabling political environment and regulatory framework. An analysis of the Argentine experience in micro-credit serves to elucidate this point. Moreover, the paper analyzes the recent formalization trend in the micro-credit field, arguing for the importance of maintaining micro-finance's social mission in the face of increasing expansion and commercialization, if micro-finance is to have a true impact on poverty reduction. The research for this thesis, based on two years of field work in the *villas miserias* of the Buenos Aires province in Argentina, aims finally to explore the role of micro-credit in building more inclusive financial systems, in order to evaluate its impact on the goal to decrease marginalization and poverty.

PREFACE AND ACKNOWLEDGEMENTS

This thesis attempts to contribute to the discussion of micro-finance as an element of poverty reduction through its provision of access to financial services to the poor who are excluded from financial systems worldwide. My interest in the topic arose during my two years of field work with Fundacion Franco Mattiello, collaborating in Project CIC, a micro-credit program serving 200 low-income women entrepreneurs in José León Suárez, in the province of Buenos Aires, Argentina.

After a brief introduction, the paper is organized as follows: the first chapter describes the relevance of the topic, objectives, hypothesis and methodology. Chapter two establishes the theoretical framework, discussing the role of micro-finance in the development agenda and in particular the goal of creating inclusive financial systems. It emphasizes the necessity of a conducive political environment along with an enabling regulatory framework as fundamental for micro-finance to be effective in poverty reduction.

Chapter three presents a case study of micro-finance in Argentina to support the argument for an enabling political environment, showing that on its own micro-finance faces significant obstacles to growth. It provides an example of the potential challenges and benefits of micro-finance formalization on an underdeveloped micro-finance sector in the context of high financial marginalization. Chapter four builds upon the case study of Argentina examining the commercialization of the sector as an option to stimulate growth and expand micro-finance outreach. To do this, it analyzes two trends: upscaling by NGOs into formal financial institutions and downscaling by banks into the micro-finance sector.

Chapter five returns to the role of micro-finance in poverty reduction and shows that attempts to expand micro-finance can lead to a trade-off between the social

and market functions of micro-finance, which policymakers have not recognized sufficiently. It stresses the double goal of MFIs to achieve both economic and social returns, and the role of the policy in promoting this aim. As a conclusion, ideas are suggested for micro-finance to provide increased access to financial services and to contribute to lasting and effective poverty reduction.

Finally, I would like to thank all the patient and kind individuals who helped and supported me during the entire Masters program and thesis-writing process. In particular, the dedication, support and hard work of my Thesis Director, Barak Hoffman, Thesis Committee, Dra. María L. Fago Fontana and Gabriel Bezchinsky, and the people at Universidad Nacional San Martín and Georgetown University who helped me along the way. To all I owe an enormous and sincere thank you.

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INTRODUCTION

“The difficult truth is that the majority of the poor in the world still lack access to sustainable financial services, whether its savings, credit or insurance. The great challenge, then, that awaits us is to face the limitations that impede these persons to fully participate in the financial system. Together we can and we should create inclusive financial sectors that help people to improve their lives.”¹ Kofi Annan, UN Secretary General, 2003.

Micro-finance, although it has been around in its contemporary form since 1974, is a relatively young industry. The recent surge of interest in micro-finance of the past decade has attracted the interest of banks, governments, financial regulators, non-governmental organizations (NGOs), multilaterals, donors, municipalities and foundations, which have at some point held micro-credit to be an almost legendary solution to poverty in the developing world. The United Nations General Assembly designated 2005 as the International Year of Micro-credit and the industry gained notable recognition worldwide when Muhammad Yunus won Nobel Prize in Peace in 2006.

Why should we care about micro-finance? It is by now clear in the international development world that micro-finance, from its simple yet important objective – providing financial services to unbanked people – has become big business. The sector is home to over 10,000 institutions with an annual turnover of around \$12 billion. And this is only the beginning; the demand for micro-credit appears to be growing as more and more nations are faced with the reality of increasing

¹ Annan, Kofi. United Nations General Assembly Address; New York: June 2003.

poverty and inequality around the world. In fact, half of the 2.2 billion adults in Africa, Asia and Latin America are not able to save with or borrow from a bank.² It is within this framework of the increasing impact of micro-finance on poverty on a global scale that initiated the ideas for this investigation. Does micro-finance truly have an impact on poverty reduction? If so, what kind of environment is necessary for micro-finance to be effective and to grow to reach increasingly more poor? Further, what can be learned from the experience of Argentina, where micro-finance has had limited growth and consequently limited effects on reducing poverty? Lastly, given Argentina has grown little, would the formalization of the sector enable micro-finance to reach more people. This paper has attempted to answer these questions as they relate to why micro-finance matters for development and how it contributes to poverty reduction. To begin to address these questions, a working definition of micro-finance is in order.

What exactly do we mean by 'micro-finance'? The definition of micro-finance has evolved over time, and still varies between countries and contexts. However, in general *micro-finance* refers to the provision of financial services to low-income clients, including the self-employed. As defined by the Inter American Development Bank (IADB), micro-finance is "the provision of a broad range of financial services such as deposits, loans, payment services, money transfers

² Annan, pg. 1.

and insurance to poor and low-income households and their micro-enterprises.”

³ In this analysis *micro-finance* will cover any non-traditional financial product to customers whose access to financial services or traditional banking services is hindered by an underprivileged position in the community. Micro-finance encompasses a diverse range of institutional formats, ranging from individual money-lenders to more formal institutions such as village banks, credit unions, financial cooperatives, state-owned banks for small enterprises and social venture capitals funds.

Because MFIs do more than simply provide access to affordable credit, a distinction must be made between *micro-finance* and *micro-credit*, although the two terms are often used interchangeably. *Micro-credit* specifically deals with the provision of small loans and falls under the broader definition of micro-finance. Micro-credit is described in one of two ways, “either by the characteristics of the loan, or by the characteristics of the client.”⁴ In the case of the former, the definition speaks to the size of the loan; in the case of the latter, it focuses on the assets of the borrower’s business. Either way, it is important to recognize the difference between micro-credit in developed world compared to developing world contexts. In the United States, the Small Business Loan Administration considers loans of up to \$35,000 to be micro-loans and the average loan size is \$13,000; meanwhile Grameen Bank in Bangladesh the

³ Inter-American Development Bank. *Micro-finance Basics*. IADB. Web. September 2009.

⁴ Consultative Group to Assist the Poor. *Micro-finance Today*. CGAP Public Relations Office. Washington DC: 2002.

threshold the average loan is \$130, one percent of that amount.⁵ It is within this framework, of small-scale micro-loans in the developing world and their consequent impact on poverty reduction, that his investigation was developed.

Part I: Theoretical Framework

Chapter I. Micro-finance role in development

Relevance of the topic

The words of Kofi Annan at the beginning of the Introduction convey the importance of financial inclusion on poverty reduction. The levels of poverty throughout the world are not only due to the lack of wealth distribution or merely to a lack of credit, which was established as a “universal right” according to the 2005 UN Millennium Development Goals.⁶ Yet due to the underlying financial and economic systems that run the global economy, today there are millions of “potential bank clients” made up of the so-called *poor*, low-income individuals with micro enterprises who could potentially benefit from a micro-loan, but who also require a variety of services in a comprehensive development framework to be able to escape poverty.

⁵CGAP, pg 4.

⁶ UN Millennium Development Goals. Accessed 13 Sept 2008: www.un.org/mdg/2005.

Until recently this group of poor pertained to a stable and growing middle class, which in the developing world over past few decades has consistently seen its jobs lost through inadequate policy, combined with an ever-increasing tendency towards wealth and opportunity being distributed among fewer hands. In light of this reality of increasing poverty worldwide, the objective of this thesis is to analyze how micro-credit fits into the goal of reducing poverty through building inclusive financial systems. A comprehensive review of all aspects of micro-finance related to poverty reduction is beyond the reach of this paper, which instead focuses on three areas: analyzing micro-finance as a technical solution to a political problem; presenting Argentina as case study for the importance of policy; and exploring the trends of commercialization of the sector and its impact on social mission, as a response to underdeveloped cases such as Argentina.

Finally, the idea to explore this topic arose from firsthand experience working with Fundacion Franco Mattiello (Fundvis), a micro-credit organization modeled after the Grameen methodology, which operates in the province of Buenos Aires, Argentina. While doing fieldwork for Fundvis from 2007 to 2009, I had the opportunity to learn about the regular challenges faced by low-income entrepreneurs and the daily consequences of their financial and economic marginalization. I became interested in the role of micro-credit in poverty alleviation and the importance of the political environment in order for micro-finance to have a poverty reduction impact.

Objective

To analyze the role of micro-finance in poverty reduction via exploring three aspects of micro-finance: government policy, the Argentine experience with micro-credit, and the dual mission of both economic and social returns.

Hypothesis

Even in considering micro-finance as a key component of constructing more inclusive financial systems to reduce poverty and financial marginalization, the hypothesis is that micro-credit alone will not solve poverty, and that, without being rooted in comprehensive development policy, especially in Latin America, it will continue to grow. Furthermore, micro-credit must capitalize on the formalization trend in order to increase outreach and to become sustainable in the long run. At the same time, its original mission of delivering both economic and social returns must be fervently maintained in the face of increasing bank involvement in micro-finance, which is where enabling policy is imperative development-oriented State.

Methodology

As methodology, the paper opens with an overview of micro-finance in Latin America, its social mission to alleviate poverty and the prerequisite political climate for micro-finance to operate successfully. An analysis of this sort requires methodology organized into three phases: first, Antecedents, or reviewing previous studies and literature; second, Prospection, or exploring present and

future possibilities based on current indicators; third, Prolepsis, or anticipated understanding of the subject.

Antecedents

This phase was comprised of conducting interviews, reading and research. It consisted in revising background bibliography of books, journal articles, scholarly publications, newspaper articles, third-party interviews and presentations on topics related to my investigation: financial systems and poverty, financial exclusion and micro-credit, micro-finance in Argentina, formalization of micro-finance. To provide a theoretical framework and background for my fieldwork, secondary research included revision and analysis of books, papers, documents and presentations on micro-finance-related literature. To further explore themes touched upon in my structured interviews and conferences, I consulted publications on social investing and economic development policy from various sources. This phase of the investigation established the theoretical framework of this thesis, which is based on the fact that 75 percent of the world's population⁷ is excluded from access to any financial system. This led to the subsequent question for analysis of how do we understand the role of micro-finance – and in particular the tendency towards the formalization of the sector – as part of the objective to create more inclusive financial systems in order to reduce poverty?

⁷ According to data collected by the United Nacional Millenium Development Goals, 1999.

Exploration of actual and future possibilities

The analysis of the Argentine case was based on my internship with the Fundación Franco Mattiello (Fundvis) from 2007 to 2009 in the province of Buenos Aires, during which I collaborated with Project CIC (stands for Training, Innovation and Credit in Spanish). In brief, my fieldwork consisted of the following research methods described below:

- Conduct structured interviews with 17 experts in micro-finance and related development and NGO fields.
- Conduct impact analysis surveys with five Project CIC loan recipients to create case studies to be used by Fundvis.
- Participation in weekly group meetings of multiple loan centers with 15 to 20 members each.
- Visits to business sites and homes of multiple loan recipients.
- Travel to two other Grameen Argentina replicas in Mendoza and Rosario Argentina to realize comparative study with Fundvis.
- Attend regular meetings with the Argentine National Social Development Ministry, regarding their Micro-credit Law, of which Fundvis is a recipient of state subsidy.
- Participation in group meetings of the Argentina Micro-finance Network (*Red de Microfinanzas* in Spanish), of which Fundvis is a member.

Through participating in weekly center meetings with loan recipients, I learned about the daily functioning of their micro-enterprises, collected weekly payments, reviewed business plans and assisted with basic accounting and loan portfolio reconciliation. I had the chance to attend meetings held by the Argentine Social Development Ministry, as they held meetings to receive feedback from NGOs receiving funding from their new financing initiative, supported by the Argentine National Government by the National Micro-credit Law (*Ley de Micro-creditos 26.117* in Spanish) passed by the National Congress in 2006. This was an invaluable experience for a graduate student in public policy, seeing firsthand the merits and challenges of a new policy initiative being discussed, re-worked and implemented.

Prolepsis / Anticipated Understanding

This point is developed in the Conclusion, which analyzes future possibilities for micro-finance and ways in which it may be more inclusive and comprehensive in order to contribute to poverty reduction.

Research Activities related to thesis

Along with fieldwork and structured interviews, I attended various conferences and seminars from 2007 to 2009 in Argentina, Paraguay and New York, held by the organizations listed below.

- Central Bank of Argentina

- Inter-American Development Bank (IADB)
- United Nations Development Programme (UNDP)
- UN Consultative Group to Assist the Poor (CGAP)
- Women's World Banking
- Universidad Catolica Argentina (Argentine Catholic University)
- Fundacion Grameen Argentina
- Argentine Ministry of Social Development Capital Fund (FONCAP)
- ANDARES & Radim (Argentina Micro-finance Network)
- Citigroup Micro-finance for Development
- Columbia University Working Micro-finance Group

I presented working research papers in two of these conferences, held by the Argentine Catholic University (UCA) and by the National Fund for Social Capital (FONCAP). This allowed me to gain a firsthand perspective on the recent debates on progress and challenges made in micro-finance in both the Latin America region and in Argentina in particular. Gaining international experience in micro-finance and development issues sparked my interest in learning about investment in micro-finance, the trend towards formalization, and its consequences on the social goals of micro-finance, three main areas explored in this paper.

Chapter II. Micro-finance and Poverty Reduction

Marginalization and poverty

United Nations Development Program (UNDP) estimates that of the 3 billion poor worldwide, about half or 1.5 billion could be considered *working poor* or potentially eligible for a micro-credit loan or other types of small-scale financial products.⁸ According to the World Bank, there are more than one billion persons worldwide that live on less than two dollars per day, 150 million of which live in Latin America. In the region it is estimated that some 360 million live on the margin of the economy with subsistence-level income and lack basic services such as running water, electricity, medical care and housing. Such poverty is manifested in a wide variety of channels: conditions of minimal survival, lack of education, lack of social integration, lack of access to basic goods and services. In essence, the poor have few alternatives to protect themselves from risk or to manage risks they face daily. According to Amartya Sen, winner of the Nobel Prize in Economics in 1998, the poor continue to be poor because they lack autonomy and power. Sen states, “once empowered, through greater inclusion and access to traditional systems, they become able to change their lives and overcome obstacles that previously were considered insurmountable.”⁹ However, individuals cannot transform their lives by their efforts alone, or without a society and financial system which allows them the opportunity for development and progress. Sen claims that the first step is to change the way poor are viewed; he explains, “instead of being seen as needy and incapable, society must change its

⁸ United Nations Development Program –UNDP- (2005). “Microfinanzas en la Argentina”. Economic Sciences Faculty at the University of Buenos Aires (UBA) by Marta Bekerman, Santiago Rodríguez, Sabina Ozomek.

⁹ Sen, Amartya. Development as Freedom. London: Oxford University Press, 1999.

paradigm to consider this group as potential architects of their own personal and socioeconomic development.”¹⁰ In addressing the challenge of poverty reduction and the impact of access to financial services in this goal, a recent report by FELABAN (Latin American Bank Federation) reveals the important relationship between access to the financial system – defined as the percentage of the population that can freely use financial services – and the reduction of poverty and inequality.¹¹ Understanding the problem of the lack of access to financial services is particularly important in Latin America, as the levels of poverty continue to be alarmingly high and it is the region with the most income disparity in the world,¹² despite the many reforms that have been implemented in the region over the past half century.

In Latin America banks constitute the most important source for the provision of financial services. Banks provide financial services through a variety of mechanisms including bank accounts, branches, ATMs, internet and telephone banking. However, even today commercial banks in developing countries still are inaccessible to the majority of the population. For example, in Mexico, Colombia and Brazil studies show that between 65 percent and 85 percent of urban households lack a deposit account in a formal financial institution, compared to

¹⁰ Sen, pg. 139.

¹¹ Rojas-Suarez, Liliana. *Promoting Access to Financial Services*. FELABAN, Bogota: 2006.

¹² Rojas Suarez, pg 46.

10 percent in the United States and 2 percent in Spain.¹³ Although the activities of other non-banking financial intermediaries, especially those oriented towards micro-credit, have been increasing recently in a significant way, their participation in the financial system is still limited. In Latin America, access to basic services by the adult population, such as having a bank account, stands at an average of 30 percent, which contrasts significantly with the industrialized nations where access by the population is close to 100 percent.¹⁴ Numbers are even lower when the percentage of the adult population with access to bank credit is analyzed. For a general idea of relative access in countries in Latin America, below is a chart comparing countries of the region measuring access to credit in each country as a ratio to GDP. Note Argentina is shown at the bottom of the figure, as it falls below the average. This signals a low level of access to credit within the traditional banking sector, as well as the micro-finance sector, which will be later discussed.

¹³ The Economist Intelligence Unit. *Microscope on the Micro-finance Business Environment in Latin America and the Caribbean*. London: The Economist Press, 2008.

¹⁴ FELABAN, pg. 47.

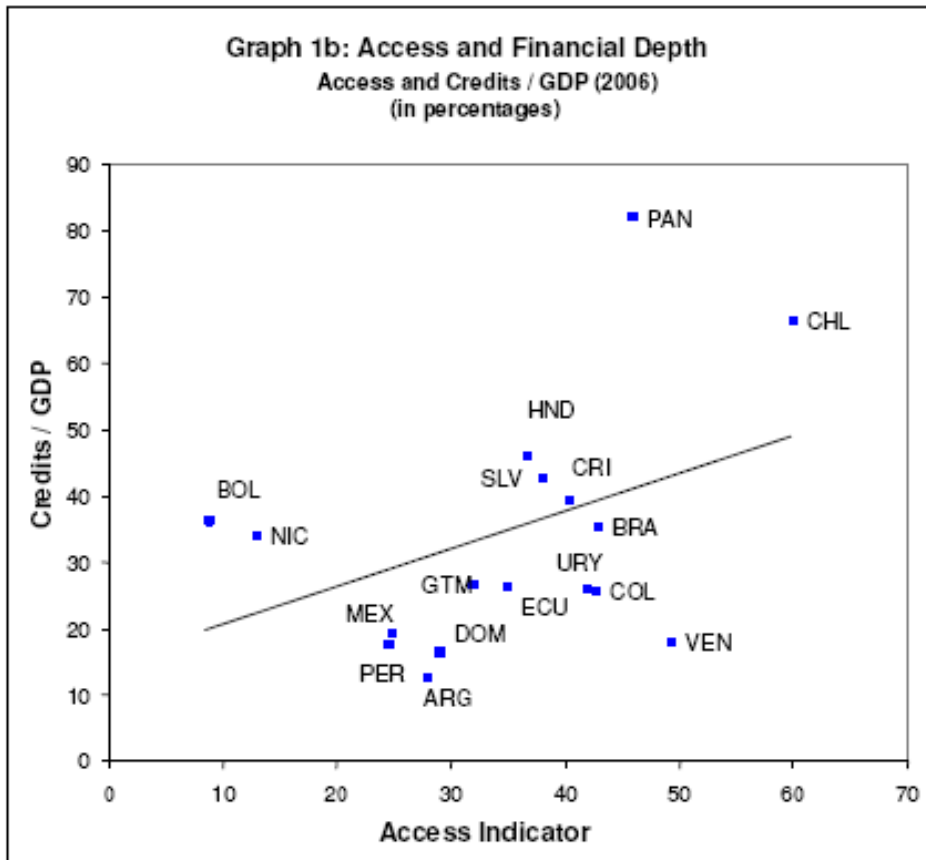


Figure 1: Compares Latin American countries with a ratio of access to credit as a percentage of GDP. Source: Federation of Latin American Banks.

In analyzing the degree of financial exclusion, it is important to consider ratios of available credit to GDP and deposits to GDP to analyze relationship between *financial access* and *financial depth*, which looks at not only the percentage of the total adult population accessing banks, but at the income level as well.

Another factor to consider is the provision of financial services by private versus public banks. In the region, one extreme is Bolivia where there are no commercial public banks, on the other hand in Costa Rica over 60 percent of banks are public entities. In Argentina and Brazil, in comparison, this share is

between 30 and 40 percent.¹⁵ It is important to point out that the problem of access to financial services is not generalized across all income levels or to all types of businesses, rather individuals with high incomes and large businesses in the region tend to not have problems of accessing financing. Moreover, many large companies, especially exporters and public utility providers, are financed both locally and internationally at costs that do not provide any significant obstacle of access.

Obstacles to bancarization

As defined by the World Bank, *bancarization* is access to and use of financial services within traditional financial systems. In an interview with Jane Bieneman of Blue Orchard Finance,¹⁶ a social investment firm, she commented that many obstacles confront banks and their clients in the process of bancarization. First, social factors related to poverty and informality limit access to credit; low income, informality and the lack of financial literacy obstruct both the demand for financial services, as well as the supply of such services. The same social factors that limit access to financial services are also obstacles to the expansion of channels for the provision of these services. Second, in addition to social issues, deficiencies within the banking system itself contribute to low levels of bancarization. This stems from the lack of market infrastructure, which to function at a most basic level requires elements such as a payment and

¹⁵ FELABAN, pg. 45.

¹⁶ Interview with Jane Bienemen, Director, Blue Orchard Finance, New York: December 22, 2008.

compensation system, information infrastructure made up of evaluation agencies and auditors that encourage transparency and enhanced performance; technical support and education services, associations and networks of financial service providers, financial infrastructure.¹⁷ Furthermore insufficient mechanisms of risk evaluation¹⁸ are the result of low levels of technology implementation, especially when compared to banking systems in the developed world. Third, regulatory obstacles in the form of bureaucratic inefficiencies, excessive tax on the banking system, lack of transparency and lack of creditor and property rights protection are all factors that cause banks to distrust the value of the collateral presented by potential debtors. All these are among the areas that, if improved, could improve access. The below is a chart showing the most frequently cited institutional obstacles to bancarization , according to a survey of countries in Latin America taken from a recent CGAP study. Note that institutional barriers, such as inefficient bureaucracy and insufficient property rights protection, rank above factors such as corruption and deficient sub-par credit methodology, suggesting the importance of institution-building.

¹⁷ CGAP, pg. 32.

¹⁸ FELABAN, pg. 61.

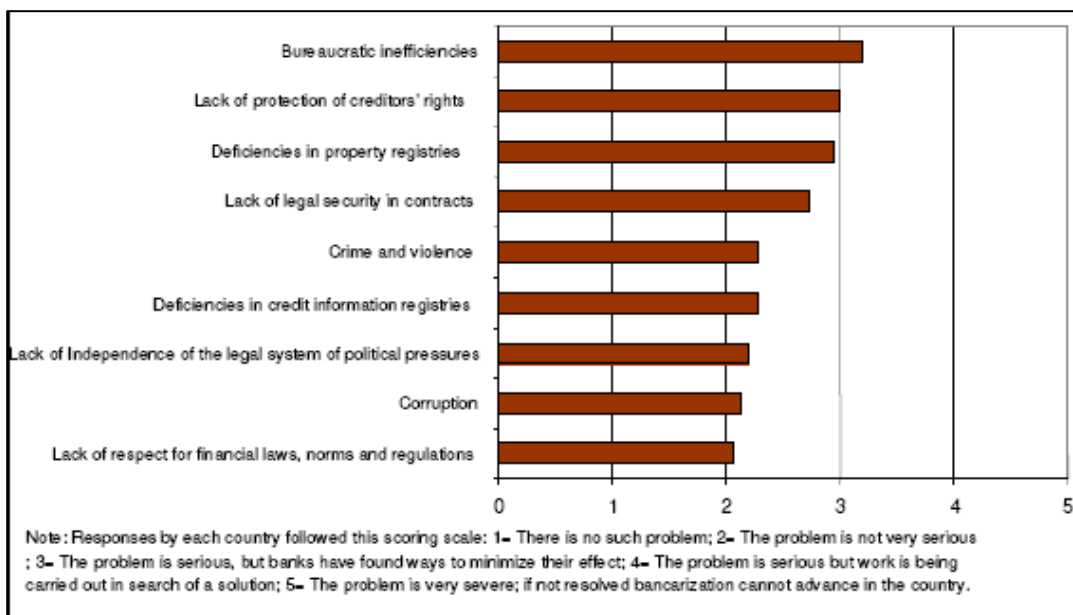


Figure II: Average responses of countries on effects of institutional problems on bancarization. Source: CGAP.

In the absence of a meaningful social security system in most developing countries, it is critical to ensure that poor people can use the banking system to save money and access credit. In the absence of national identification such as a social security number, a large percentage of the population does not meet the required documentation to even consider opening a bank account. Since poor people cannot use the banking system, they often find it difficult to access most other financial products as well. The undersupply of solid and competent institutions continues to be a significant barrier to increasing provision of financial services for the poor. Economic and social marginalization is a serious problem that requires coordinated effort to create a sustainable long-term solution in the form of inclusive financial systems. Unilateral effort by government, the private sector, or civil society alone is insufficient to develop more inclusive financial

systems and decrease marginalization; instead it needs to be a collaborative effort among all sectors.

Poverty reduction and inclusive finance

*"You cannot solve the problem of poverty with the institutions and concepts that created the problem in the first place."*¹⁹ Muhammad Yunus, founder of Grameen Bank, 1999.

As established by the United Nations Millennium Development Goals,²⁰ the access to financial services among low income populations *can* contribute to poverty reduction; therefore micro-finance is increasingly being viewed as an essential – rather than marginal – element of the financial system. UN Millennium Development Goals (UN MDG) defines inclusive financial system as “a continuum of financial institutions that together offer appropriate financial products and services to all segments of the population.”²¹ This envisions a world in which the poor have “continual and unhindered access to a wide range of financial services offered by a variety of institutions via appropriate and fair mechanisms.”²² To improve their financial situation, UN MDG states, low-income clients need financial services that serve their needs beyond micro-credit and provide deposit services, transfers, insurance and savings. Financial service access is not the best nor the only solution for the poor, yet it is an integral piece

¹⁹ Yunus, Muhamad. Hacia un mundo sin pobreza. Madrid: Andres Bello Publishers, 1999.

²⁰ Millenium Development goals are eight goals to achieve by 2015 that respond to the main challenges of development worldwide. It has been approved by 189 countries and signed by 147 state leaders during the UN Millenium Summit in the year 2000.

²¹ Yunus, pg. 49.

²² UNMDG, pg. 2.

in a multi-faceted and complex continuum of services, access and rights.

According to criteria established by the UNDP, inclusive financial systems are characterized by:²³

- Access at a reasonable cost of all households and enterprises to a broad range of financial services including savings, short and long-term credit, leasing and factoring, mortgages, insurance, pensions, payments, local money transfers and international remittances;
- Sound institutions guided by appropriate internal management systems, industry performance standards, performance monitoring, institutional transparency, accountability and sound prudential regulation;
- Financial and institutional sustainability as a means of providing access to financial services over time; and multiple providers of financial services, wherever feasible, so as to bring cost-effective and a wide variety of alternatives to customers.

Building upon UNDP criteria, the Consultative Gap to Assist the Poor (CGAP)²⁴ of the World Bank proposes a three-tiered approach to building inclusive financial systems that includes a Micro, Meso and Macro level. The figure below shows the three tiers to conceptualize inclusive finance, along with the elements of each tier; always keeping in mind the clients at the center of the model.

²³ UNDP Pink Book for Regulation, Washington DC: 2001.

²⁴ CGAP. "Regulacion y Supervision de las instituciones microfinancieras para estabilizar el nuevo Mercado financiero" Washington DC: Agosto de 1996.

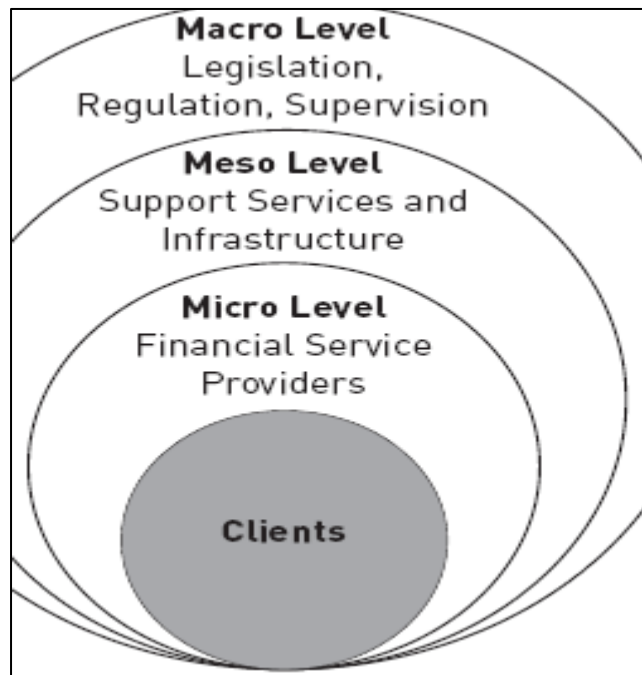


Figure III: Three-tiered approach to inclusive financial systems. Source: CGAP.

- **Micro** – comprised of a wide variety of financial and non-financial institutions such as NGOs, credit and savings cooperatives, private banks, state banks, non-bank intermediaries such as finance and insurance companies.
- **Meso** – made up of local market infrastructure and services including auditors, ratings agencies, networks and associations, risk centers, transfer and payment systems, technology providers and technical services.

- Macro – entails a favorable macroeconomic and political framework provided by appropriate government entities (further discussed in the following section).

These levels make up the informal financial sector, which comprises micro-finance institutions (MFIs), cooperatives, consumer finance companies and public sector banks that offer savings accounts and credit. Below is a chart by the UNDP showing the interplay of various institutions on each of the three levels – micro, meso and macro – in creating inclusive financial systems. Note the paradigm presented below includes regulated commercial institutions as well as NGOs and non-profits; the interplay of these will be discussed in chapter four.

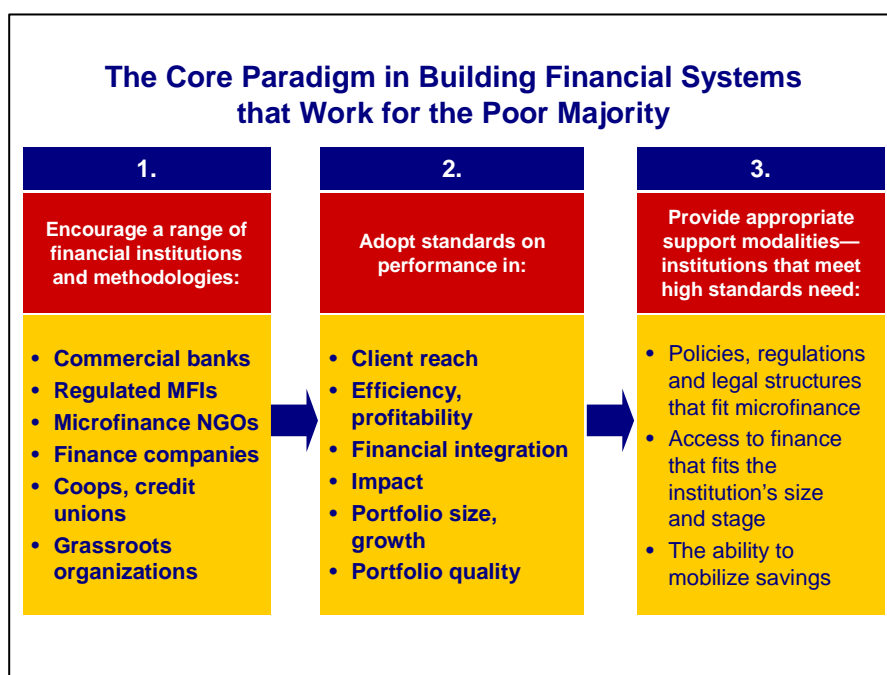


Figure IV: Three-tiered approach to understand comprehensive financial systems, according to the UNDP. Source: UNDP.

If the goal is to create financial systems with a more equal distribution of resources and price formation, *stable* and *competitive* markets are essential; furthermore, competition must be encouraged in the financial sector, as it favors lower interest rates and increased diversity of products. A recent book “Portfolios of the Poor: How the World’s Poor Live on \$2 a Day,” presents the results of year-long financial diaries collected twice monthly from hundreds of rural and urban households in India, Bangladesh and South Africa.²⁵ These diaries reveal that financial instruments are indeed critical survival tools for poor households; in fact, these tools are even more important for the poor than they are for higher income levels.²⁶ Poverty is not just a matter of low income, but also of irregular and uncertain income. To put food on the table every day, and to meet other basic consumption needs, poor households have to be able to save and borrow constantly. At following is a graph which compares what FELABAN identifies as “necessary bank improvements per country” to show a relative ranking of countries and development of their respective financial systems. These improvements provide the framework for responding to poverty through bancarization. Note Argentina figures among one of the better performers, requiring fewer improvements per client, according to the study.

²⁵ Rosenberg, Richard. Does Micro-finance Really Help the Poor? CGAP Focus Note No. 59, January 2010.

²⁶ Rosenberg, pg. 2.

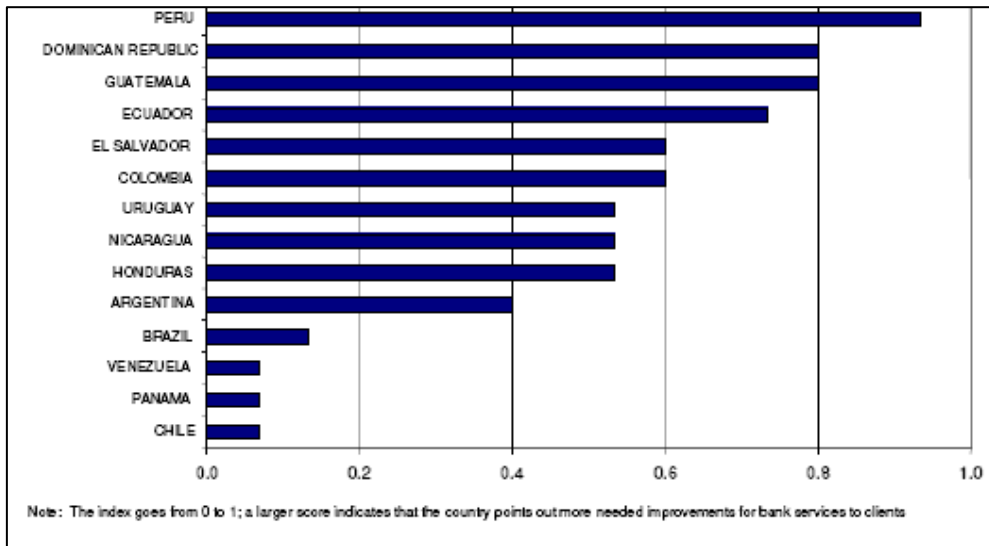


Figure V: Necessary improvements in bank services in relation to amount of clients per country. Source: FELABAN.

Whether or not financial services *lift people out of poverty*, they are vital tools in helping them to *cope with poverty*. The poor use credit and savings not only to smooth consumption, but also to deal with emergencies like health problems and to accumulate larger sums they need to seize opportunities (occasionally including business opportunities) and pay for important expenses like education, weddings, or funerals. Developing inclusive financial systems takes time, and slow, consistent progress via appropriate regulation and institutional development cannot be substituted by a quick fix government intervention or subsidy, which sacrifices development of the sector for short term political gain. Building upon the concept that financial inclusion implies ensuring open and equal access to the financial system to all segments of society, the next step is to look into is the State's responsibility in ensuring this access to its citizens.

Inclusive financial systems and policy

In building financial systems, the most important factor, arguably, is the State, which is the only actor that can guarantee a legal framework that promotes competition among a large variety of financial service providers, while at the same time protecting consumers. In envisioning an inclusive financial system, the UN MDG advise that the government's role is one of facilitator and regulator and *not* of a direct provider of financial services.²⁷ The UN MDG states that governments should not try to fulfill the role of creditor or provider of micro-loans, but rather should focus its energies to establish a supportive political framework for micro-finance. According to the UN Economic & Social Council, "the state cannot abrogate its role in the area of social provision, but must be a major player in the design and operation of an inclusive financial sector to cater to the needs of the 'missing' middle in the informal and non-banked sectors."²⁸ This is crucial to ensure that growth is employment-intensive and sustainable to maximize its impact on poverty reduction. For public policy aimed at reducing poverty and social fragmentation to be successful over the long term, it must not aim only to increase income in the poorest sectors, but also increase their assets to generate processes of transformation. This implies tying income transfer policies to measurable improvements in the following three areas:

²⁷ United Nations Development Program –UNDP- (2005). "*Microfinanzas en la Argentina*". Economic Sciences Faculty at the University of Buenos Aires (UBA) team coordinated by Marta Bekerman together with Santiago Rodríguez, Sabina Ozomek and Florencia Iglesias.

²⁸ Chowdhury, Anis. "Micro-finance as a Poverty Reduction Tool – A critical assessment" UN Economic & Social Affairs Council. DESA Working Paper No. 89: ST/ESA/2009/DWP/89, December 2009.

- Human capital – through education and training;
- Physical capital – through access to credit;
- Social capital – through developing social networks.

Transferring *assets* is indeed much more complex and multidimensional than simply transferring *income* and the challenge is to provide the framework of necessary capital in all three aforementioned dimensions, so that income transfers may become generators of assets. To accomplish this, it is necessary for the State to implement proactive and enabling government policy that increases the demand of these assets through comprehensive and inclusive development planning.

Introduction to micro-finance

*“The UN’s 2005 Year of Micro-credit marked the long journey of micro-credit from an obscure experiment in the mid 1970s to the status of a worldwide movement. Micro-credit has captivated not just a large portion development aid industry, but journalists, editorial writers, policy makers and the general public in both the North and the South. Virtually every development project I see these days, from maternal and child health, to women’s education, to soil conservation, to social forestry, to old fashioned integrated rural development, as a ‘micro-credit component.’”*²⁹ Robert Zoellick, President of the World Bank, 2008.

International micro-finance has grown exponentially from its humble beginnings for the simple reason that in many – but not in all – cases it has proven to be an

²⁹ Zoellick, Robert. World Bank, Office of the President, July 25, 2008.

effective way of meeting the tremendous demand for affordable capital in the developing world. According to the World Bank, there are an estimated “500 million economically active poor people in the world operating micro-enterprises and small businesses,” most of whom “do not have access to adequate financial services.”³⁰ Arguably one of the most important contributions of micro-finance to the development field is that it brought to light the *creditworthiness of the poor*.

The UNDP calculates that in 2009 over 150 million persons worldwide were served by 100,000 MFIs.³¹ As previously mentioned and defined by the UNDP, the term ‘micro-finance’ entails the creation of financial systems that attend to the necessity of low-income individuals. A primary benefactor of micro-finance products is the micro-enterprise, which is defined as *economic activity characterized by its informality, small-scale, self-generating employment, family-based, intensive use of labor to capital, low organization and labor division, limited use of technology, low fixed assets and lack of regular access to credit*³². Micro-enterprises tend to employ less than five persons and to start with under \$20,000 of seed capital.³³ Micro entrepreneurial activity is generally considered a last resource for the unemployed that lack access to employment through formal channels and are excluded from the formal labor market.

³⁰ Zoellick, pg. 1.

³¹ UNDP, pg. 31.

³² UNDP, pg. 29.

³³ CGAP. *Guía Sobre Buenas Prácticas para los Financiadores de las Microfinanzas*. Segunda Edición, World Bank Press; Washington DC: June 2006.

While micro-finance in various forms has existed since the origins of financial systems, the contemporary understanding of micro-finance, previously described, started in 1974 when Dr. Muhammad Yunus provided a loan of \$27 to a group of poor Bangladeshi basket-weavers. Dr. Yunus went on to establish the Grameen Bank, which to date has reached people in 80,000 villages of Bangladesh. The Grameen origins have by now become familiar to the development world, having brought to light the notion that unconventional solutions to poverty can be not only viable, but also highly successful. What's more, because the money was lent out rather than given away, Grameen Bank was able to become self-sufficient and, eventually, become profitable. Whereas aid programs might provide the women with free meals, clothes or shelter, Dr. Yunus' micro-credit model allowed them to increase their income and decide for themselves what they wanted or needed to purchase.

Dr. Yunus along with the Grameen Bank were awarded the Nobel Prize in recognition of their efforts to “create economic and social development from below.”³⁴ Grameen Bank has gone on to found nearly 20 other companies, ranging from enterprises that provide health care and clean energy to affordable eye care hospitals, to the largest cellular provider in Bangladesh. The majority of these enterprises use micro-loans from Grameen Bank to finance the purchase of the product or service. Grameen now has 7.2 million borrowers, 96 percent of

³⁴ Yunus, pg xii.

whom are women. As of 2009, it has loaned over \$6.5 billion, has a repayment record that exceed 98 percent and employs 24,000 people. While its subsidiary Grameen phone, a mobile phone provider that serves more than 15 million subscribers, is the largest corporate taxpayer in Bangladesh.³⁵ Expanding beyond Bangladesh, micro-credit has grown to a worldwide reach and has spread the following concepts important for economic development:

- The poor are credit worthy;
- Given the chance, people are capable of bringing themselves out of poverty;
- The provision of small-scale financial services to disadvantaged people can serve as a platform for providing other products and services that are empowering and beneficial to the recipients.³⁶

Poor households seek micro-finance products because they are beneficial in dealing with their vulnerability, even though the benefit may differ substantially from the widespread claim that micro-loans strictly go towards investment in micro-enterprises, instead often times covering basic consumption needs. For evidence of the demand of micro-finance by the poor, one need only to recognize the behavior of hundreds of millions of clients who demonstrate their demand for micro-finance by “voting with their feet.” Across the world, an estimated 154 million people have received a micro-loan.³⁷ Often it has been asked why they are lent to when the lender holds no collateral. The strongest

³⁵ Chowdhury, pg. 7.

³⁶ Chowdhury, pg. 7.

³⁷ Consultative Gap to Assist the Poor. Micro-finance is Big Business. www.CGAP.org accessed June 2008.

incentive to repay the loan is usually not group pressure, but rather the borrowers' desire to keep access to a valued service, one whose future availability they can count on as long as they keep their end of the bargain (loan repayment).³⁸ Below is a chart by CGAP showing key micro-finance products and services as elements of financial inclusion. Contrary to common belief, the micro-finance field comprises a diverse range of services and products, which must be kept in mind when laying out the framework for increasing financial access. The goal is that a wide-reaching offer of financial services to the sectors of the population previously excluded will promote poverty reduction by removing barriers to economic advancement. Note in the chart below the focus is on income and assets, rather than handouts or direct subsidy.

³⁸ Based on 23 interviews conducted with micro-loan recipients in Jose Leon Suarez, Provincia of Buenos Aires, Argentina on June 18, 2009.

Building Core Microfinance Services— Focus on Income and Assets		
Core Offerings		Other Non-core Offerings in Inclusive Financial Systems
Flexible Working Capital Loans	Education Loans	Consumer Finance
Housing Finance	Insurance	Transfer Payments
Savings	Remittances for Microfinance	Debit and Credit Card Facilities

Figure VI: *Components of micro-finance for financial inclusion.* Source: CGAP.

Conclusion: Micro-finance and political context

To reach its full potential for poverty reduction, micro-finance must be integrated into local financial institutions that can mobilize national savings and recycle them in the form of loans, as well as offer other complementary financial services. By now there is consensus in development that the responsibility of supporting micro-enterprise requires the coordination of activities among a multitude of actors internationally: most importantly the State, via the national, provincial and municipal government; as well as bilateral and multilateral development organizations, regional development banks, foundations, social and commercial investors, NGOs, universities and think tanks. Instead of focusing

solely on micro-finance, poverty reduction should be centered on designing efficient State-run specialized financial institutions as part of developing an inclusive financial sector. The micro-finance industry would benefit from being integrated into the traditional financial system, enhancing its ability to offer innovative solutions for problems of information asymmetry from both the demand side (potential micro-finance clients), and the supply side, (financial institutions). The potential clients lack access to financial institutions, while banks lack accurate information regarding credit risk and repayment capability of the poor. Management and operational lessons learned from successful MFIs can provide valuable inputs into the design of specialized financial institutions for small and medium-sized enterprise. The hope is that access to financial services can provide opportunity for low-income individuals, allowing them to go from subsistence and daily survival to be able to plan for the future, acquiring physical and financial assets and investing in better nutrition, improving health and living conditions and perhaps even creating the possibility for better education for their children. The following section, based on field work in Argentina, builds upon these notions and highlights the importance of adequate poverty reduction policy and an enabling political context for micro-finance to contribute to poverty reduction.

Part II. Field Research

Chapter III. Micro-finance in Argentina: Case Study

Regional context: Latin America

Building on the investigation into the role of micro-finance in creating inclusive financial systems to reduce poverty, the micro-finance sector in Argentina is an appropriate case study because it is one of the least developed in Latin America. In fact, *The Economist Intelligence Unit* recently published the “2008 Microscope on Latin American Micro-finance” in which it ranked Argentina as one of the worst-performing countries in the region. *The Economist* ranked Argentina number 17 out of 20 countries in Latin America, in between the notoriously problematic economies of Haiti and Venezuela.³⁹ Argentina’s ranking in the lowest 15 percent, especially when considering it is the third biggest economy in the region, behind Brazil and Mexico. This led me to consider why Argentina has been such an underperformer and earned this ranking. My goal was to capitalize on the past two years I spent doing fieldwork in micro-finance in Argentina to analyze the Argentine case in order to explore factors that contribute to the development of micro-finance, others that hinder growth of the sector, and what might be done to promote growth so that more poor have access to micro-credit. I found that the challenges faced by the micro-finance sector in Argentina supported my findings for the first section, which stresses the importance of

³⁹ The Economist Intelligence Unit. *Microscope on the Micro-finance Business Environment in Latin America and the Caribbean*. London: The Economist Press, 2008.

political climate on micro-finance effectiveness. Below is *The Economist* 2008 country ranking chart showing Argentina in the 17th position out of 20 countries regionally, based on a composite indicator evaluating each country in three areas: Regulatory Framework, Investment Climate and Institutional Stability.

Microscope 2008 score and rank results			
Overall score			
Rank	Country	2008 Score	Score Change
1	Peru	76.6	+2.5
2	Bolivia	74.4	-5.0
3	Ecuador	69.7	+1.4
4	El Salvador	59.0	-2.5
5	Colombia	58.6	+12.5
6	Nicaragua	58.0	+4.2
7	Guatemala	54.0	+10.0
8	Paraguay	49.6	-3.3
9	Dominican Rep	48.0	-9.5
=10	Mexico	47.5	-0.8
=10	Panama	47.5	new
12	Honduras	47.1	new
13	Chile	43.2	-5.1
14	Brazil	41.6	-1.7
15	Costa Rica	40.3	new
16	Haiti	30.2	new
17	Argentina	28.5	+1.7
18	Uruguay	28.3	-7.5
19	Venezuela	24.9	-2.5
20	Jamaica	21.2	new

Figure VII. Ranking of select regional countries micro-finance performance based on three macro indicators. Source: The Economist Intelligence Unit. The Economist report, presented in 2008 at the Inter-American Development

Bank conference I attended in Paraguay, finds that the micro-finance industry in Latin America is in “permanent expansion;” in 2001 micro-finance was present in 17 countries and served a client base of 1.8 million and in 2007 it had expanded

to reach 23 countries and a client base of 8.04 million.⁴⁰ Correspondingly, the portfolio value of the micro-finance market increased more than seven times during this period, from \$1.19 million to \$9.25 million.⁴¹ Furthermore, both the 2007 and the 2008 results underline the disassociation between a country's size and wealth and the quality of its micro-finance environment. Indeed, five of the top seven positions in the index are held by smaller, generally less developed economies: Bolivia, Ecuador, El Salvador, Peru and Nicaragua. Some of the larger and/or more prosperous countries that attract most attention from international investors for their overall business environment—such as Brazil, Chile and Argentina—continue to exhibit less favorable micro-finance business environments.

The chart below shows four select countries in the region and compares them in four factors: Market Penetration, Regulatory Framework, Investment Climate and Institutional Development. Market Penetration analyzes the percentage of demand for micro-credit met by current supply (as of 2008). Regulatory Framework is based on the following criteria: regulation of micro-credit operations, operation of regulated MFIs, operation of non-regulated MFIs and regulatory capacity. Investment climate measures political stability, capital market stability, judicial system, accounting standards and MFI transparency.

⁴⁰ The Economist, pg 27.

⁴¹ Valazza, Ana Laura. "La pobreza sigue aumentando en la Argentina: Informe Especial" La Nacion, 19/11/2009.

Institutional Development contemplates range of MFI services, credit bureaus and level of competition.

	Market Penetration (percentage)	Regulatory Framework	Investment Climate	Institutional Quality
Argentina	0.5	18.8	38.3	33-3
Peru	79	87.5	58.0	75.0
Bolivia	160	87.5	46.9	75.0
Haiti	33	43.8	30.0	16.7

Table VIII. Comparison of select regional countries micro-finance performance based on four macro indicators. Source: The Economist Intelligence Unit.

Based on a report by FELABAN, in Argentina 28 percent of adult population has access to banking services, meanwhile the other large economies in the region, Brazil and Mexico, have 43 and 25 percent access respectively.⁴² In Argentina public banks make up 30 percent of total banking services. While Argentina's indicators are more or less on par with similar data in developing countries, Argentina's micro-credit sector, which should theoretically grow in relation to degree of financial exclusion, has not done so. There is ample room for the sector to grow, as informal financial services comprise 48 percent of the

⁴² Rojas-Suarez, Liliana. *Promoting Access to Financial Services*. FELABAN, Bogota: 2006, pg. 15.

country's financial resources and only five percent of businesses are granted 91 percent of total credit.⁴³ A brief look back at Argentina's economic performance over the past few decades helps understand these trends.

Micro-finance in Argentina

While a full review of Argentina's economic history is out of the scope of this analysis, a few remarks on the country's economic past are in order to provide a background to understand the beginnings of micro-finance in Argentina. Since gaining independence from Spain in 1810, the country has had an uneven and tumultuous path to development. Over the past 50 years Argentina has seen 17 years of recession and another 17 of hyperinflation, according to a recent Deutsche Bank Report.⁴⁴ Between 1950 and 2003, Argentina's per capita GDP (gross domestic product) contracted 19 percent to \$3760 USD, while in the same period neighbor Chile's GDP rose 173 percent, Mexico's 201 percent and Brazil's 269 percent.⁴⁵ Likewise, since 1990 poverty has diminished in Argentina's regional counterparts; 19 percent in Chile, 18.3 percent in Brazil and has held stable in Uruguay. Argentina, in contrast, has seen an increase in poverty by 8.2 percent. According to the country's leading newspaper *La Nacion*, despite a recent period of strong economic growth from 2003 to 2007, one in

⁴³ Fundacion Banco Provincia. Informe Sobre Desarrollo Humano en la Provincia de Buenos Aires. Buenos Aires: Eudeba Universidad de Buenos Aires, 2006.

⁴⁴ Quiroga, Carla. Deutsche Bank: "Nos cuesta poner de vuelta a la Argentina en el radar" Buenos Aires: Revista Apertura, February 10, 2010.

⁴⁵ Quiroga, pg.1.

three Argentines today are considered to be living below the poverty line.⁴⁶ This often comes as a surprise, keeping in mind Argentina is the third largest economy in the region, behind Brazil and Mexico.

In many Latin American countries, micro-finance development began in the 1960s, resulting from previous experiences with credit cooperatives and communal banks during the 1950s. Yet until the 1970s Argentina had a relatively low poverty rate and was considered to be one of the more promising economies of the region. The demand for micro-credit was scarce because medium-sized businesses and high employment levels were the norm, while gaping inequality and impoverished neighborhoods were infrequent, unlike today. The first MFI in Argentina emerged in 1987, *Fundacion Juntos* (in Spanish, Together Foundation), whose activity only lasted three years due to the extreme hyperinflation of 1990. Structural economic changes and privatizations during the 1990s greatly increased the informal economy, causing a dramatic swell in inequality, while increasing unemployment and poverty created a newly emergent sector of the population with potential demand for micro-credit. This trend towards economic vulnerability culminated with the massive economic crisis of 2001, in which Argentina experienced the largest sovereign debt default in history. This caused a further increase in demand from a captive market demanding non-institutionalized and small-scale, accessible financial products,

⁴⁶ INDEC, pg. 3.

which motivated the gradual emergence of MFIs, with the goal of responding to this new “social urgency.” In the crisis aftermath, Argentina micro-finance doubled in size, shown in table below.⁴⁷

Growth of Micro-finance in Argentina

Year	2001	2006
Loan recipients	15,000	38,000
Total Amount Loaned	7 million u\$d	16 million u\$d

Figure IX. Increase in micro-finance clients and total amount loaned pre-financial crisis and four years post-crisis. Source: Wharton University Knowledge Series.

While the outreach has certainly increased, it is still severely lacking to meet demand, as it is estimated that microentrepreneurs represent 20 percent of the active workforce population in Argentina, according to the INDEC (National Institute for Economic Statics and Census).⁴⁸ With such a large percentage of the economically active in the underground economy, it is clear that there is indeed a large demand for micro-credit; and the question is how to incentivize the supply via more agile and development-enhancing policy. Given that microentrepreneurs comprise one-fifth of the active workforce in Argentina, the percentage of micro-credit clients in relation to total economically-active

⁴⁷ Wharton University Knowledge Series. “Los Micro-creditos Avanzan en Argentina, pero a paso lento” Accessed through www.formapyme.com on 12/19/2008.

⁴⁸ Wharton, pg. 47

population is less than 2 percent. In developing countries with a large informal economy and a well-developed micro-finance sector (Bolivia, India, Ecuador, for example) this falls between 4 and 8 percent.⁴⁹ Why has micro-finance grown so little in Argentina in relation to other relatively similar countries with large informal economies? It is estimated that in 2012 micro-credit in Argentina will amount \$230 million in loans to 540,000 low-income business owners.⁵⁰ What changes are necessary, especially in the realm of government policy, to allow the sector reach this potential demand level? To start, the current policy towards micro-finance (discussed in the following section) needs to be revised and made more favorable towards NGOs and non-regulated financial institutions, so they may be sustainable in the long term, favorable policy combined with formalization of the sector (discussed in Chapter IV) would help the current supply of micro-finance expand to reach projected demand.

Factors influencing the Argentine case

The following section provides a brief introduction of factors (for which a separate analysis, beyond the scope of this work, is recommended) both State-related and independent, exploring why micro-finance in Argentina has not developed on par with its regional counterparts. To this end, interviews realized with micro-finance and multilateral development professionals in Argentina,

⁴⁹ ANDARES, pg 19

⁵⁰ ANDARES, pg. 23.

Washington DC and New York, as well as recent literature on the subject, have provided a preliminary glance of the situation.

Economic – Among the most frequently cited economic factors limiting the development of micro-finance in Argentina is the recurring financial crisis the country has experienced over the past few decades, which cause a climate of economic instability and tight restrictions on access to credit from banking sector. Because of instability, the Argentine financial system lacks long term financing and stable capital markets. Only 20 percent of total national savings are kept in the national banking system and the rest is held overseas.⁵¹ Argentina has one of the highest country risk ratings and the local currency the peso is referred to by bankers as a “weak currency” used only for transactions but not as a reserve currency.⁵² According to various interviews, there is an overall distrust of banks from frequent crisis that has caused an aversion to debt in Argentine society.⁵³ When faced with choosing between a government-run bank and a private bank, two thirds of low-income clients prefer government-run because they tend to be untrusting of the banking system in general.⁵⁴

⁵¹ Quiroga, Carla. Deutsche Bank: "Nos cuesta poner de vuelta a la Argentina en el radar" Buenos Aires: Revista Apertura, February 10, 2010.

⁵² Crouzel, Roberto H. *Por que las Microfinanzas no se desarrollan con mas éxito en Argentina*. IDLO Micro-finance Research Paper, May 2009.

⁵³ Platteau, Stefan & Ribbink, Gerrit. *Microfinanzas en Argentina: situacion y oportunidades de Desarrollo*. The Netherlands: Facet BV, 2006.

⁵⁴ Bukstein, Gabriela. Personal INTERVIEW. Fundacion Banco Provincia. Buenos Aires, Argentina; 25 June 2008.

Institutional – Based on data from interviews, the most significant institutional barriers to MFI growth are lack of professionally trained personnel, the need to implement new software and technology to increase scale and sophistication of operations, the ability to track and follow-up with clients, transparency of operations and weak institutionally in all levels of management. In addition to internal factors, MFIs also face considerable competition from external factors such as informal financiers, moneylenders and local credit card companies. Consensus among interviewees revealed that Argentines view micro-enterprise as a last resort activity and look down upon working “informally,” associating micro-enterprise with informality, instability and insecurity and preferring to work as a salaried employee.⁵⁵ Another interesting observation is that Argentine society does not view itself and fellow citizens as poor,⁵⁶ therefore have been reluctant to implement public policy that could promote the development of progressive social and economic changes and enhance micro-finance.

Legal – According to Standard & Poor's,⁵⁷ Argentina is a typical incipient micro-finance market, where MFIs operate as NGOs or are launched via State initiatives. Particular regulatory framework has not yet been developed; rather regulation is based on type of organization (bank, NGO, non-profit) rather than activity (micro-finance). The legal and tax framework is unfavorable; a high

⁵⁵ Renaud, Juliette & Iglesias, Maria Florencia. *El Impacto Social de las Microfinanzas. El caso de Avanzar*. CENES, UBA: documento de trabajo Nro 18, 2008.

⁵⁶ Bukstein Interview.

⁵⁷ Standard & Poors. *Microfinancieras: Afinándose en los mercados globales de capital*. New York: June 2007.

value-added tax (VAT) of 21 percent is charged on interest, national taxes are levied on earnings and provincial taxes charged on income, which creates a significant barrier for small start-up MFIs from growing and becoming profitable.⁵⁸ Accounting and governance standards have worsened since 2007 and according to *The Economist* governance is one of the weakest aspects of Argentine micro-finance.⁵⁹ Requirements for Argentine corporations (SAs) are mostly limited to publication of charters in the Public Commercial Registry (Registro Público de Comercio), there is little regulation of corporate governance and some firms have de-listed to avoid what rules exist. Enforcement through the judicial system remains lengthy and cumbersome. NGOs and SAs in practice face only minimal regulation and supervision, the principal requirement being to submit financial statements and reports to the General Inspectorate of Justice and Provincial Directorate of Juridical Persons (ICJ). Awareness by MFIs of the importance of improving governance practices is still incipient.

Political – In addition to the factors just presented, the most-often recurring culprit, frequently mentioned in both interviews and publications, is government policy, in particular regulatory framework. According to an interview with Ruth Munoz of Universidad Nacional Sarmiento, “Argentina’s greatest weakness lies in the lack of capacity to regulate and examine MFIs. The difficulty that regulated and non-regulated MFIs encounter when forming and operating highlight the

⁵⁸ Davico, Gisela. Personal INTERVIEW. Director, Cordial Negocios. Buenos Aires, Argentina 30 July 2008.

⁵⁹ The Economist Intelligence Unit. *Microscope on Latin American Micro-finance*. New York: EIU Press, 2008

impact of this shortcoming. Specialized regulatory expertise and methodologies for micro-finance are completely lacking. The only efforts to promote best practice come from groups of institutions engaged in micro-finance themselves, not from regulators.”⁶⁰

As specified by CGAP⁶¹ regulatory framework refers to a combination of principles, norms and legal specifications that contribute to an MFI’s financial stability and efficiency. MFIs require special regulation apart from commercial banks because they have different institutional and loan portfolio structures. As outlined by the World Bank, three options most widely discussed for supervisory framework for MFIs are the following:⁶²

- Regulate and supervise MFIs within the formal financial sector;
- Create a new and MFI-specific regulation and supervision;
- Establish norms for auto-regulation or peer-regulation of the MFI sector.

Accordingly, aspects to take into consideration when constructing a legal framework include quality of assets, minimum required capital, financial performance, liquidity levels, fraud prevention and transparency.⁶³ Regulation began to appear in micro-finance discussion in the mid- 1990s, in Argentina and

⁶⁰ Munoz, Ruth Personal INTERVIEW. Universidad Nacional Sarmiento; Buenos Aires, Argentina. 15 February 2010.

⁶¹ CGAP. Regulation and Norms for Microfinance. Lessons from 10 years of Experience. Washington DC: 2003.

⁶² World Bank, Micro-finance Norms for Prudent Regulation. Geneva, World Bank Press, 1998.

⁶³ Robinson, Marguerite. “The Micro-finance Revolution: Sustainable Finance for the Poor” Washington, D.C. World Bank Press, 2005.

globally. The Central Bank of the Argentine Republic identifies two types of regulation: prudential and non-prudential.⁶⁴ Non-prudential regulation refers to general requirements such as the legal register of institutions, publication of financial statements, pre-fixed interest rate regulations and external audits. It regulates business conduct, not its viability, is consequently related to business management and its actions do not compromise the supervisory authority. Prudential regulation, on the other hand, has the final goal of protecting depositors and the stability of the overall financial system, so if one bank fails it does not affect the credibility of the others. Argentina, similar to most developing countries, lacks consensus regarding MFI regulation and supervision and practitioners agree⁶⁵ that generating consensus would be an important advancement for the sector.

Four government bodies in Argentina compete to influence the sector: the Central Bank, the Economy Ministry, the Social Development Ministry and the Superintendent of Financial Entities (*Inspector General de Justicia* in Spanish). While none has clear superiority, the in-fighting between the organizations creates a lack of capacity to regulate and inspect MFIs, and confusion leads to the default policy being direct subsidies to MFI loan portfolios, which encourages unsustainable lending and thwarts institutional development, and creates difficulty for the MFIs in qualifying for funding. Furthermore, the National Micro-

⁶⁴ Banco Central Republica Argentina. Aspectos para una regulación microfinanciera. UNDP Press: enero de 2007.

⁶⁵ Banco Central de la Republica Argentina, pg. 3

credit Law (*Ley de Micro-creditos 26.117* in Spanish) mandates that the government provide funding for local MFIs, and according to government reports, covers an estimated 90 percent of MFIs in the country.⁶⁶ The law stipulates that MFIs fix their micro-loan interest rates at 6 percent annually. This is counterproductive to promoting the institutional sustainability of the MFIs themselves and the financial stability of their loan portfolios. To do so, the rate would have to be upwards of 30 percent⁶⁷ in order to cover interest alone. The National Micro-credit Law requires NGOs to form consortiums with municipalities or other government entities if they do not have micro-finance experience. This ties NGOs and MFIs to the government, not allowing them to act independently if they wish to receive funding. In an interview with Marta Beckerman, founder of Avanzar, one of the largest MFIs in Buenos Aires,⁶⁸ she states that at first glance the law appears positive in its intent; however, problems have arisen because many organizations do not have experience in micro-credit and the mere fact that they work with a municipality or other governmental entity does not make up for this lack of experience. She also says that many other MFIs were granted government funding for political ties and not necessarily because they were eligible organizations, of which of course this would not be the only example.⁶⁹

⁶⁶ Banco Central de la Republica Argentina. Informe Regular, diciembre 2006.

⁶⁷ Beckerman, Marta. Micro-creditos: Una estrategia contra la exclusión. Buenos Aires: Editorial Norma, 1999.

⁶⁸ Beckerman, pg. 71.

⁶⁹ Biondi, Ricardo. Personal INTERVIEW. Permanent Commission to the Law of Micro-credit; 4 October 2008.

Other government programs related to micro-credit are *Manos a la Obra* (*Working Hands* in English) the National Plan for Local Development administered by the Social Development Ministry, through which it provides financing, training, technical assistance for low-income entrepreneurs. The Ministry also directs a program called *Banco de la Buena Fe* a network of state-run organizations that work with local NGOs to offer micro-credit based on Grameen Bank methodology. There have been various initiatives in Congress since 2005 aimed at promoting micro-credit on a national level. These include the following:

- To create a special type of micro-credit banks called *bancos solidarios* or “solidarity banks” with a special fiscal framework to facilitate micro-lending;
- To implement an initiative to create a micro-credit bank unit within the national government-run Bank of Argentina;
- To impose a special tax exemption for MFIs.

In analyzing options for regulation it is important to keep in mind that the government should put its efforts into creating a regulatory and legal environment in which more individuals have access to micro-loans, instead of focusing on the organizational structure of the entity offering credit, whether it is for-profit or non-profit, private or public.

Field Experience

To provide an example of the scope and operations of a local microfinance organization and how it has managed in the context analyzed in the previous section, it is relevant to briefly mention my field work with Fundvis.⁷⁰ With Fundvis I worked in Project CIC, which since 2003 has been providing micro-loans to low-income microentrepreneurs in *villas miserias* (shantytowns in Spanish) in José León Suárez, province of Buenos Aires. At the time of writing, Project CIC was working with approximately 200 entrepreneurs, providing micro-loans ranging from 500 to 800 pesos (equivalent to \$125 to \$205). These loans are to be used towards micro-enterprise investment or expense, repaid over six months and automatically renewable once entirely repaid. Among CIC's 200 borrowers, 85 percent are women, compared with a countrywide average in Argentina of 61 percent. CIC's loans, as with the average micro-loan in the country, tend to be destined towards the working poor with a low education level; 75 percent of loan recipients have not completed a high school-level education.⁷¹ In July 2008, I collaborated in an impact analysis survey done by FUNDVIS that surveyed 75 loan recipients to portray how they used their micro-loans from CIC. Clients were asked how they investment in their micro-enterprise, how they

⁷⁰ www.fundvis.org

⁷¹ Palomino, Héctor "La debilidad de las microfinanzas en la Argentina : entre las restricciones del sistema financiero y la conducta de los pobres." Universidad de Buenos Aires, Facultad de Ciencias Económicas, CESPA 2004.

distribute the loan among investment in tools, merchandise and work material, and how household income level and sales revenue were influenced by the CIC micro-loan. As shown in the chart below, 53 percent of interviewees (40 total) purchased work tools and/or a cell phone to facilitate business, 29 percent invested in their workplace and 18 percent bought merchandise for resale.

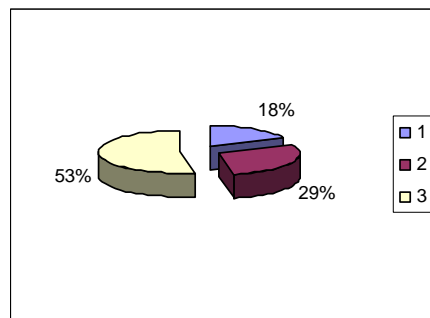


Figure X: Purchase of work tools and/or cell phone (group 3 / yellow), investment in workplace (group 2 / red) merchandise purchase (group 1 / blue). Date of Survey: July 2008, Buenos Aires, Argentina. Source: FUNDVIS.

Based on interview responses, the survey concluded that the growth of micro-enterprises is restricted by a lack of operating income, and that even the smallest loan amount of 500\$ pesos has an immediate impact in increasing the short-term cash flow and allowing small-scale investment in the micro-enterprise to increase and thus business revenue to expand.

A second research project during my field experience was the effect of the access to capital on Fundvis growth potential. Fundvis has been receiving low-interest funding from a Swiss foundation ECLOF (Ecumenical Church Loan

Fund)⁷² since 2005, as well as from the Argentine National Ministry for Social Development⁷³ since 2007. With funding from these two organizations, along with its own funding, from private donations and an active loan portfolio of approximately 180 borrowers, Fundvis has made 1,400 micro-loans through 2009 for a total of 200,000\$ pesos (\$52,630 dollars) in 2009.⁷⁴ The graph below shows how Project CIC's loan portfolio has grown due to low-interest loans from ECLOF and subsidies from the Argentine Social Development Ministry. The drastic increase in loan portfolio capital from the contributions of ECLOF and the Social Development Ministry shows the importance of external funding for non-profit MFIs like Fundvis, legally unable to capture borrowers' deposits. This is an important issue in the current debate regarding regulatory framework and appropriate policy for micro-finance in Argentina.

⁷² ECLOF Argentina: <http://www.eclofargentina.org.ar/> Accessed March 1, 2010.

⁷³ Argentina National Social Development Ministry (Ministerio de Desarrollo Social) <http://www.desarrollosocial.gov.ar/> Accessed March 1, 2010.

⁷⁴ FRAMAF www.framaf.org. Accessed February 11, 2010.

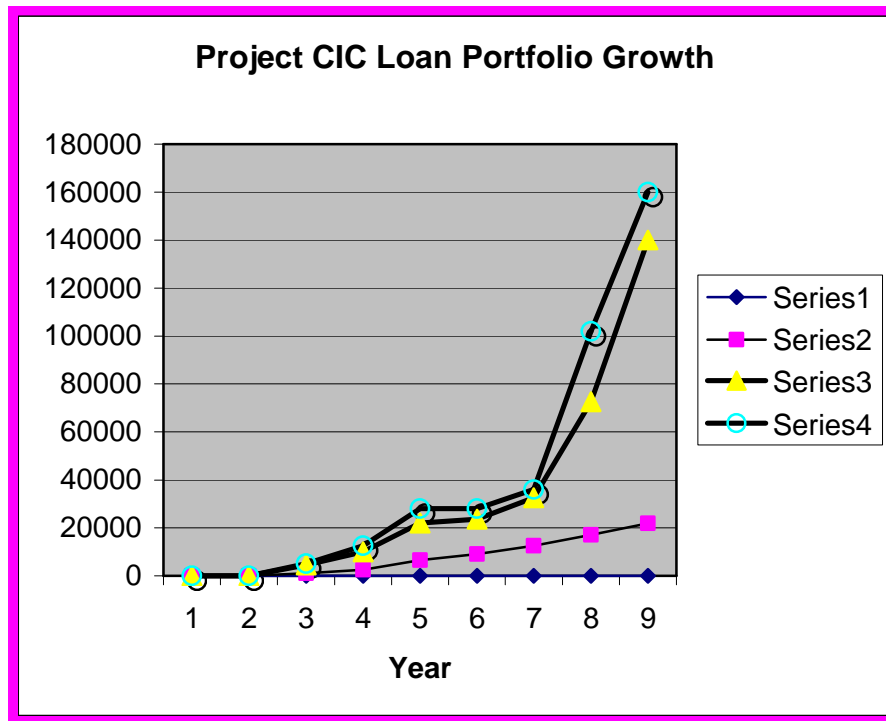


Figure XI. Project CIC's loan portfolio growth. The years 1 to 9 should be read as 2001, 2002, 2003, etc. Series 4 represents total loans in pesos. Series 3 represents recovered capital. Series 2 amount collected in interest. Series 1 is the baseline. Source. FRAMAF.

The graph shows performance through September 2009. At the time of writing, Series 1 and 2 have shown a steady and marked decrease, in both capital recovered and baseline loan portfolio, since the significant growth period from 2007-09. This decrease is illustrative of how the performance of a microfinance portfolio can depend largely on the greater macroeconomic context of the country. In this case, the portfolio grew from 2007 to 2009, during which the Argentine economy experienced an overall expansion period, with on average 8

percent GDP growth per year.⁷⁵ Correspondingly, micro-enterprise in general experienced a boom period, in which sales were high, micro-enterprise activity grew significantly, and loans were incrementally greater, reflecting higher profitability and demand. The subsequent decrease experienced in 2009 and 2010 reflects a decline in overall economic activity in the country due to the global economic slowdown.

Conclusion: microfinance and policy

In investigating the Argentine case, the most interesting insights into the effects of policy on micro-finance's impact on poverty reduction came from interviews with micro-finance practitioners. The following is a brief synthesis of points raised during interviews on possible policy measures to improve micro-finance in Argentina. These suggestions are meant to add to the discussion of the necessity of an enabling political climate for microfinance to grow and flourish.

In an interview with Ricardo Biondi, Advisor to the Permanent Committee on Micro-credit of the Argentine National Government,⁷⁶ he identified two general types of entrepreneurs: those that start businesses out of necessity and those that do so out of opportunity. This distinction, he maintained, is important because each sector requires different types of government policy and

⁷⁵ CIA World Factbook. Argentina. website accessed April 5, 2010.

⁷⁶ Biondi Interview.

regulation, and the State must customize its solutions to effectively meet the needs of both groups. For example, the first category itself can be divided into moderately poor and structurally poor, and undertake micro-enterprise activity as a last resort. Direct subsidy and assistance, rather than micro-credit, is more appropriate for the structurally poor in this category. Meanwhile, the second category, those with micro-enterprises out of opportunity, tends to have access to financial products through traditional channels. Micro-credit innovations, such as small-scale savings and insurance, are more apt for this group.

Gisela Davico, Development Director of Cordial Negocios,⁷⁷ stated in an interview that the Argentine government subsidies to MFIs are counterproductive to creating incentives to institutional sustainability and in turn are a short-term boost that will undermine long-run success. Based on her experience running Cordial Negocios, one of the first commercial MFIs in Argentina, Davico observes that micro-credit faces a formidable challenge in that it has low immediate satisfaction compared to direct government handouts, since micro-credit requires sustained effort and investment in the micro-enterprise over the long run, while a subsidy is an immediate cash injection, boosting consumption and household income in the short run. The government would be wise, she adds, to incentivize investment in business via renewable micro-loans offered at

⁷⁷ Davico interview.

a sustainable rate to counteract reliance on unreliable government handouts, subject to disappear with a change of party in power.

In an interview with Ruth Munoz, Coordinator of the Masters in Social Economy at Universidad Sarmiento, she explains that the State has an important role in financing the initial development stage of MFIs and in providing technical training and advisory.⁷⁸ She maintains that this can be accomplished by re-directing State support of MFIs towards promoting efficiency, linking government subsidies of MFIs to verifiable performance indicators in terms of efficiency, promoting better ratings and indicators to encourage investment in MFIs. Munoz stresses the importance of forming policy based on the goal of *improving local financial markets* in order to provide marginalized with greater choice and access to financial services.

⁷⁸ Munoz interview.

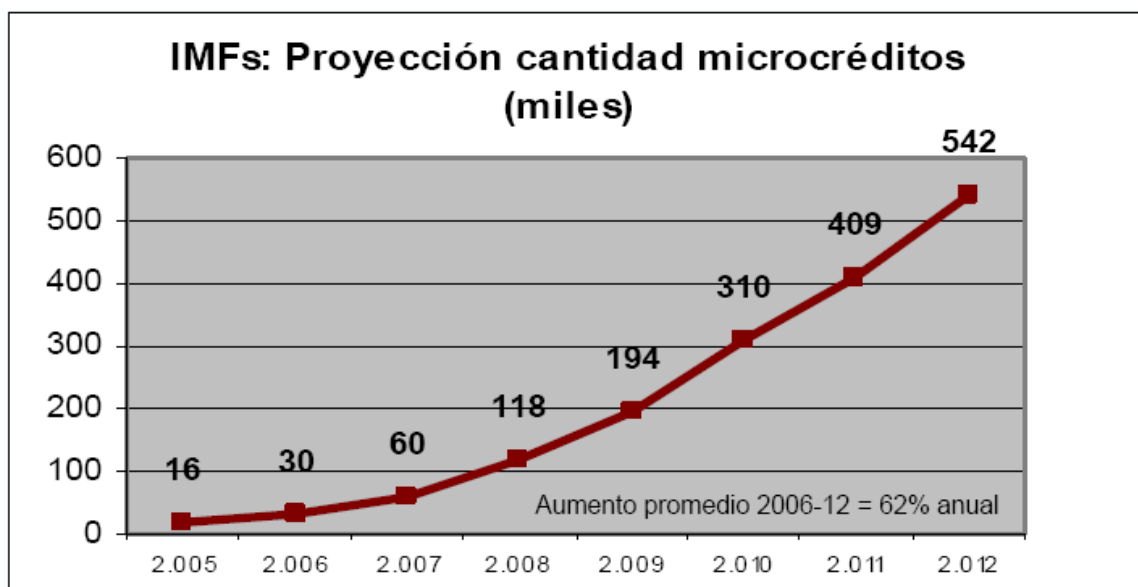


Figure: XII. MFI's projected amount of micro-loans per year in thousands. Source: ANDARES.

The chart above shows the estimated growth in micro-loans by MFIs in Argentina, projecting an average growth rate of 62 percent per year. Faced with the probability of significant growth, it is even more imperative for State policy to be re-worked in order to facilitate, rather than hinder, the potential for micro-credit to reach those who stand to benefit. Analysis of micro-finance regulatory framework must take into account the recent and wide-reaching impact of the trend of formalization in the micro-finance sector, which is discussed in the upcoming section. As a final remark for this section, at the time of writing, a newspaper article was published in *Clarín* that found 48 percent of the working population in Argentina does not have stable, formal employment and that underemployment, as well as unemployment has grown by 27 percent since

2002, although GDP has expanded by 63 percent during this time.⁷⁹ Such figures highlight the immediacy of the issue of poverty reduction through financial inclusion and the urgency to re-think development policy.

PART III. Micro-finance social & market functions

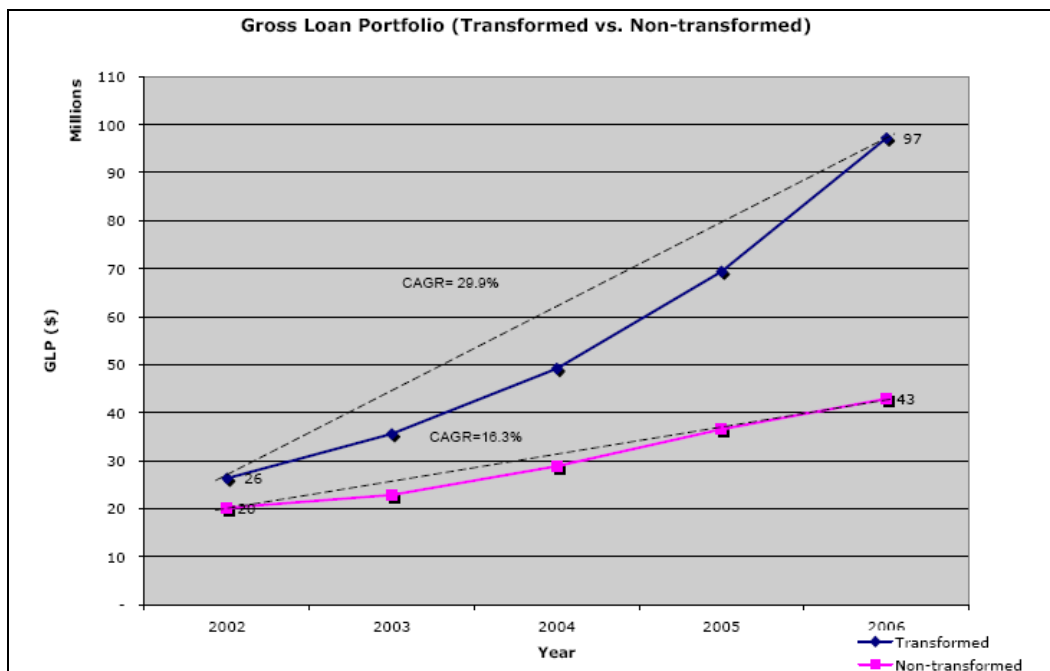
Chapter IV. Micro-finance formalization

Increasing formalization

Building upon the analysis of the importance of micro-finance to be accompanied by structural changes to address poverty reduction, and then using the Argentine case to highlight this argument, the discussion now turns to the current trend of formalization of the micro-finance sector to consider whether this trend is a potential solution to cases such as Argentina, whose micro-finance growth is hindered by policy and political factors. Whether one views it as going in a positive direction to grow the sector, or a case of “mission drift” from its original goal, formalization and commercialization have undoubtedly marked the direction of micro-finance for the future, so the issue becomes how to capitalize on these trends and how to understand their potential to deliver financial services to the poor. Why should we care about formalization? The relationship between MFIs and global financial institutions, through formalization, is producing a more professional and innovative environment, where new aspects of micro-finance

⁷⁹ La mitad de la población no tiene un empleo decente. Clarín iECO. 5 de Marzo de 2010.

are being developed and implemented. Recent data shows that this dynamic has been operating in sums worth considering for development agendas. In Latin America from 2001 to 2008, commercial banks provided 29 percent of loans to microentrepreneurs and NGOs formalized into RFIs contributed 45 percent, combining for 75 percent of total micro-loans coming from commercial regulated institutions.⁸⁰ By the end of 2007, the sum of global banks' outstanding loans to MFIs had doubled to \$ 1.5 billion, up from \$550 million just one year prior.⁸¹ The following chart shows the total loan portfolios of transformed (via upscaling or downscaling) MFIs in the upper line, compared to non-transformed (NGO) MFIs in the lower line.



⁸⁰ The Economist Intelligence Unit. *Microscope on the Micro-finance Business Environment in Latin America and the Caribbean*. London: The Economist Press, 2008.

⁸¹ Bouuert, Martin. *A Billion to Gain: A study on Global Finance Institutions and Micro-finance*. ING Publications, 2009.

Figure XIII: Variation in loan portfolio between formalized RFIs and non-formalized Ngo MFIs. Source: Women's World Banking.

This trend is a reversal of the past, as historically the demand for micro-finance services has been attributed to the *inability* and *unwillingness* of the formal financial sector to provide financial products to low income clients. In its earliest stages in the 1970s until the 1990s micro-finance operated in the realm of NGOs, non-profits and multilaterals primarily with a social mission, supported by donors and heavily subsidized by grants. The only purely commercial enterprise involved was the Grameen Bank in Bangladesh, operating under a special charter from the Bangladeshi government. In other words, in the beginning micro-finance was far from the conventional practices of the financial markets. Since the 1990s, however, this first version of micro-finance has undergone a drastic transformation towards *formalization* and it is now considered *the* method to deliver credit to poor people.

Formalization, as defined by CGAP,⁸² is the process by which an NGO MFI converts into a “formalized” or regulated financial institution (RFI). This usually requires fresh capital from outside investors, regulatory approval by local banking authorities and improved governance and internal controls. The transformation process typically allows an MFI to mobilize client deposits and to offer additional non-credit products. In this current second version, MFIs have

⁸² Women's World Banking. *Stemming the Tide of Mission Drift*. WWB Focus Note. New York, 2008.

evolved to include a wide range of legal structures, including a growing number of RFIs that must comply with the financial regulations of the countries in which they operate. Along with formalization, frequently appearing in micro-finance discussion is the concept *commercialization*; defined by CGAP as a term used to refer to the application of market-based business principles to micro-finance.⁸³ It is usually associated with an MFIs progression away from donor or subsidized funding toward commercial borrowing of debt and equity. As a result of these processes, currently there are 225 RFIs operating in micro-finance, the majority with profit margins larger than those of traditional banks.⁸⁴

Despite the historical perception that making business loans to poor people is an unprofitable venture, returns to MFIs rival those of commercial banks and often exceed them. Studies conducted in India, Kenya and the Philippines found that the average annual return on investments by micro businesses ranged from 117 to 847 percent, according to the United Nations.⁸⁵ In contrast, returns in the traditional banking sector average 5 to 12 percent.⁸⁶ Returns of these levels have driven the push towards micro-finance formalization and commercialization of the past decade, so it is important to examine the dynamic of the commercial bank – MFI relationship and its implications for the development of an inclusive financial sector.

⁸³ Jackelen, Henry and Elisabeth Rhyne. *Towards a More Market-Oriented Approach to Credit and Savings for the Poor.. Micro-finance- Evolution, Achievements and Challenges.* Ed. Malcolm Harper. London: ITDG, 2003. 52-71.

⁸⁴ Women's World Banking. *Stemming the Tide of Mission Drift.* WWB Focus Note. New York, 2008.

⁸⁵ Women's World Banking, pg. 31.

⁸⁶ Federal Reserve Bank. *Macroeconomic Trends*, 2007.

Both MFIs and private sector banks stand to benefit from the partnership. MFIs partner with banks to increase their funding, improve their financial structures and delivery channels, and expand the services they can offer clients, such as savings accounts, remittances and micro insurance. MFIs can benefit from the wide variety of wholesale products provided by global banks and the accompanying financial know-how to significantly contribute to their professionalization and formalization. In order to meet potential micro-finance clients' special demands, designing suitable retail and wholesale products, such as micro loans, micro saving products and equity stakes in MFIs demands great adaptability and willingness to learn-as-you-go, for which MFIs can leverage their relationship with banks to become more agile and implement bank technologies and best practices. The following graph shows the increase in amount of borrowers in formalized MFIs compared to non-formalized NGO MFIs. The formalized MFIs growth trajectory in amount of clients depicted by the grey line, while non-formalized NGO MFIs is shown by the black line.

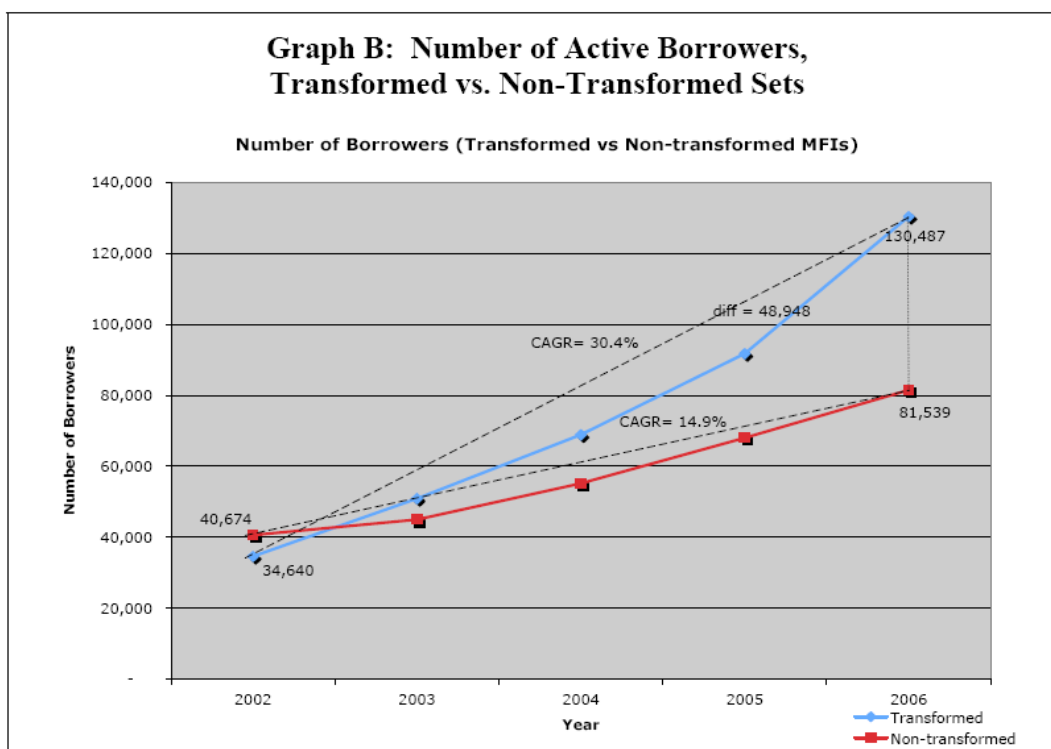


Figure XV: Difference in number of active micro-loan recipients in formalized vs. non-formalized MFIs. Source: Women’s World Banking.

What have been the effects of commercialization and formalization on micro-finance? The \$1.5 billion currently invested in formalized MFIs⁸⁷ have brought about marked changes in micro-finance practice, each one an investigation in itself and beyond the scope of this analysis. The most important formalization effects are the following:

- Professionalization of the sector
- Implementation of technology
- Diversification of services and products
- Expanded outreach to more clients

⁸⁷ Mixmarket.org. Investment reaches record levels in 2008. Mix Market publications in partnership with ACCION International. Boston: 2009.

- Tendency towards individual rather than group loans
- Increasingly large loan amounts
- Decreased accessibility to micro-loans for rural clients
- Higher interest rates
- Wider profit margins
- Debate of mission drift

The formalization of an IMF can occur through two processes: upscaling and downscaling. *Upscaling* occurs when a non-profit, foundation, charity, or NGO becomes a regulated financial entity, often in the form of a commercial bank or similar legal structure. In comparison, *downscaling* is the form in which traditional banks enter micro-finance, and occurs when a bank extends its commercial operations to include micro-finance, often adding a special micro-finance area within existing operations, or creating a separate micro-finance branch. What follows is an analysis of these two processes and their impact on micro-finance's social mission.

Upscaling of MFIs into RFIs

As banks and traditional financial institutions enter micro-finance, there is increasing competition among NGO MFIs to grow the number of clients, size of credit portfolio and operating income in order to become sustainable. As an NGO, MFI is constrained to financing by donations, state subsidies and private investment, all limited resources. Recent research by Jonathan Morduch of Colombia University suggests that not more than 5 per cent of micro-credit

programs worldwide could become financially viable without subsidy.⁸⁸ Financial sustainability is essential to achieve long term sustained growth and expand client outreach. When an MFI becomes an RFI and is legally allowed to take client deposits and offer savings accounts, if it has access to more permanent and ample sources of funding, both internally and externally. The most feasible way for an NGO to become an RFI, and thus sustainable in the long run, is via upscaling. Studies show that on average MFIs that have upscaled take between five and ten years to become sustainable, although this varies greatly depending on country, institution size, banking structure, legal framework, client demand and sector competition.⁸⁹ As estimated by Standard & Poors, a total of 250 to 300 MFIs are considered self-sustainable and do not need external financing.⁹⁰ However, this only accounts for 5 percent of total MFIs worldwide, while 95 percent must rely on donations, subsidies and external financing.

The question of whether to transform from an NGO to an RFI is one of the most important decisions that an MFI will undertake. It depends on a wide range of factors; among internal factors are capital structure, costs, interest rate and capital recovery rate; while external factors are country context, local market

⁸⁸ Chang, Ha-Joon. "The Micro-finance Illusion" London: University of Cambridge, 2007.

⁸⁹ Chan, pg 18.

⁹⁰ Standard & Poors. "Ratings and Sustainability in Micro-finance". New York: Focus Note XXII, 2005.

conditions and market segment in which the MFI operates. As identified by Jane Binerman,⁹¹ the decision to transform is frequently motivated by three goals.

- NGO MFI leaders hope that as an RFI the institution will benefit from improved and increased access to funding from commercial sources. Many NGO MFIs find that the single largest constraint to growth is the inability to access sufficient funding, and are reliant on private donors and multilaterals. This scenario improves significantly after transformation, as RFIs appear to be more “credit-worthy” in the eyes of local and international investors, thus gain access to new and more extensive sources of funding. Furthermore, local and international capital markets investors – increasingly an important source of funding for MFIs – favor the governance, risk management and regulatory oversight features associated with RFIs.
- NGO MFIs seek to offer non-credit products, especially savings, to their clients. Although many MFIs require compulsory savings as part of their loan program, in most countries MFI NGOs do not have the legal authority to mobilize voluntary deposits. MFIs that formalize into RFIs can mobilize savings and are less vulnerable to negative market conditions, which increases their potential to offer other products such as insurance, remittances, transfers and institutional deposits.
- NGO MFI leaders understand that the transformation process will result in the generation of economy of scale. Achieving an economy of scale allows the MFI to cover operating costs via an increased quantity of clients, a larger loan portfolio and higher operating income, all of which

⁹¹ Binerman interview.

lead to better financial performance and lower interest rates. Additionally, to create an economy of scale within the MFI it must rely on an improved management and governance structure, which requires a greater degree of institutional transparency and yields greater organizational sustainability.

Compartamos case

Perhaps the most controversial case to date of NGO formalization via upscaling into an RFI is that of Mexican MFI Compartamos, Spanish for "Let us Share." Compartamos was founded in 1990 as a classic micro-lending organization, funded entirely by donations. In 2006, Compartamos upscaled into a commercial bank and the following year went public with an initial public offering (IPO) that brought in \$512 million in fresh capital, and had shares oversubscribed by a factor of thirteen.⁹² Today Compartamos is Mexico's most profitable bank, and it still specializes in issuing micro-loans to those that do not qualify for loans from traditional banks, while charging annual interest rates of close to 90 percent.⁹³ The bank, which has attracted an unending stream of investors, boasts returns on investment (ROI) of 55 percent. These returns, unimaginable in the traditional financial sector, have stirred a controversial debate over the place of and limitations to the commercialization of micro-finance. Compartamos' two CEOs say that their bank's growth would not have been possible without the

⁹² CGAP, *Compartamos: case study for micro-finance trend?* World Bank Press, 2007.

⁹³ CGAP, pg. 6.

commercialization of their business or the IPO.⁹⁴ They justify their profit margin by noting that they serve both sides, investors and the poor, and that both sides benefit. Since Compartamos went public, a heated discussion has emerged in the micro-lending industry over the limits of decency and profit in a sector born with the goal of providing services and opportunity for the poor and intense skepticism as to whether MFIs, especially once they abandon their NGO roots, truly contribute to development.

Downscaling of banks into micro-finance

A parallel trend to upscaling, banks and financial enterprises are becoming increasingly eager to form partnerships with micro-finance institutions – via downscaling – to capitalize on the latter’s already established client base. Banks view MFIs as a beneficial partner because they offer portals to the market via their huge “bottom of the market” client base. Although each participating bank is involved in micro-finance in a different way, most follow a dual strategy for their involvement, looking to balance their business targets – later defined as economic returns – with their corporate citizenship vision – later defined as social returns.

As previously specified, *downscaling* refers to the process by which commercial banks incorporate micro-finance into their repertoire of products and their

⁹⁴ CGAP, pg.6.

operations become financed entirely by deposit taking, retained earnings and commercial debt, rather than by subsidies or donations. Downscaling can be direct or indirect, depending on the nature of the relationship with the client. Direct downscaling is generally realized by expansion of retail operations to small clients, while indirect downscaling occurs through financing or offering banking services to other micro-finance providers. In direct downscaling banks can create operations for micro-lending through a variety of structures, ranging from internal divisions to separate financial subsidiaries. The most frequent downscaling model is internal, where the bank establishes a micro-finance division within its normal structure. In another model banks establish a micro-finance service company, creating a separate space within the existing bank's own structure, sharing employees, funding, operating systems and corporate governance.

The decision to downscale is often dictated by factors such as the bank's risk appetite, corporate image, branding, involvement in other sectors, infrastructure, as well as the regulatory environment. Regulatory changes such as removal of interest rate caps and financial sector liberalization often create conditions that promote profitably in the low income segment, thus inducing banks to initiate micro-finance operations. In some cases, increased competition in the mainstream corporate sector has pushed banks towards underserved markets and in various instances banks have sought to improve their image by serving

the poor via micro-finance.⁹⁵ In entering micro-finance, banks have advantages over NGOs in areas such as physical and human infrastructure, market presence, brand recognition, access to plentiful and low-cost funds from client deposits and a relatively low cost structure. Another advantage, according to a study by ING in 2008,⁹⁶ is that clients tend to trust banks with their assets more than they trust NGOs. On the other hand, banks confront significant barriers in downscaling; they have little market knowledge on the low-income sector, often viewing it as risky and unprofitable. Micro-finance clients in general do not have documentation that banks require, such as credit records, official documents, paystubs, proof of income and previous bank statements. Banks lack of micro-finance experience and their traditional credit methodology does not transfer easily to MFI credit practice, which is more integral, small-scale and customer-oriented. Traditional banks tend to maintain a conservative corporate culture and lack capacity within existing human resources that are adept for working with poor clients in the informal economy, precisely the clients they previously avoided.

Citibank case

A prominent case of downscaling is that of Citibank, in establishing Citi Micro-finance in 2005 via indirect downscaling. Citi offers wholesale finance, risk-sharing financing programs and local currency structured bond issuances to

⁹⁵ ING, pg. 14.

⁹⁶ ING, pg. 7

MFI's worldwide. Citi is also a leader in retail finance products such as micro insurance, savings and remittances. In one of the largest micro-finance transactions to date, Citi purchased \$44 million of loans and shares of an Indian MFI, providing limited guarantee loan collateral. Additionally, Citi arranged the first local currency loan syndication for a Romanian MFI, a 5 year facility worth \$63 million to increase the MFI's loan portfolio.⁹⁷

Interest rate debate

No discussion of microfinance formalization is complete without briefly addressing the current debate over appropriate interest rates as part of a poverty reduction agenda. Although it is certain that micro-finance has been praised for providing much-needed capital to millions businesses and households in Latin America, it has also created contentious debate over the interest rates lenders charge in the region. Interest rates are often a focal point in micro-finance formalization discussions, often charged with being excessively high in a sector whose original goal was to provide financial opportunity to the poor. In 2009, the average interest rate on a micro-loan in Latin America is between 20 and 40 percent, according to data from *The Economist*.⁹⁸ In comparison, the average interest rate on a loan from a traditional bank in the region ranges from 5 to 12 percent.⁹⁹ The micro-finance sector can charge higher rates because it faces

⁹⁷ Citi Micro-finance. "Building Domestic Markets in Developing Countries" Annual Report, 2007.

⁹⁸ *The Economist*, pg. 18.

⁹⁹ *The Economist*, pg. 20.

less competition than the traditional financial sector. Competition is the best guarantee that loans, including those for micro-finance, will be priced appropriately, but that has not calmed the debate over interest rates.

Comparing absolute loan rates or the spreads between conventional and micro-finance loans can be misleading. MFIs procure finance at least indirectly from the mainstream financial system, so in this sense they are “rate-takers” and must charge a premium on mainstream market rates in order to be profitable. Yet the cost of capital varies considerably across economies, and countries differ in their ability to access concessionary international funding streams, which is in part based on the hugely differing levels of per capita income that affect international perceptions of country need. The second influential factor for interest rates is the quality and cost of accessing available banking and information technology. Here micro-finance institutions are partially at the mercy of the larger banking and financial system in which they operate. Country scale is a third factor; interest rates will be lower in those with high population density or with the option of spreading costs over a wider variety of permissible micro-finance services. High costs can also be due to operational expenses, especially influential in Latin America because of the relative newness of micro-finance in the region. This can negatively impact operating efficiency; such is a finding of a recent international study by Adrián González of Micro-finance Information Exchange (MIX) based

on data from 2005 and 2006.¹⁰⁰ The study found an inverse correlation between MFI age and relative operating costs; the older the institution, the lower its ratio of operating costs to total loan portfolio, a common measure of operational efficiency. As the micro-finance industries of the region mature, operating efficiency may improve and motivate interest rate cuts.

According to a 2008 FELABAN report, the finance of small enterprise, compared to large companies, has two distinctive characteristics. First, the costs of monitoring as a percentage of loan value are much higher than for large companies. This is due to two factors: banks have fixed costs for projects that do not depend on the size of the loan, and the variable costs of monitoring smaller companies are greater than those for monitoring large companies. Second, credit risk is greater due to lack of collateral and inconsistent income flow. These two characteristics, greater costs in monitoring combined with greater credit risk; make it necessary for banks following “prudent banking practices” to charge higher costs. In order to extend credit, these higher costs are passed on through higher interest rates to small enterprise than to large companies. This is often identified as a “micro-finance premium” and is the differential between what mainstream banks charge and what the micro-finance industry charges. The

¹⁰⁰ Gonzalez, Adrian. MIX Information Exchange. Interest rate and operating efficiency. Washington DC. www.mix.org, 2008.

IADB created a chart, shown below, to illustrate this point. In the right hand column it offers a rough estimate of the micro-finance premium in each country.

Nominal Financial Revenues/Average Loan Portfolio ¹
Selected Countries Circa 2007

Country	Microfinance ratio - % ^a	Bank ratio - % ^b	Microfinance Premium - % ^{a-b}
Argentina	48.1	21.7	26.4
Bolivia	20.5	13.3	7.2
Colombia	30.3	29.7	0.6
Ecuador	16.8	11.7	5.1
El Salvador	23.5	14.6	8.9
Guatemala	25.1	18.5	6.6
Haiti	49.4	n.a.	-
Honduras	33.7	16.8	16.9
Jamaica	20.8	n.a.	-
México	66.6	31.2	35.4
Nicaragua	32.4	20.3	12.1
Panamá	41.1	10.3	30.8
Paraguay	41.5	n.a.	-
Peru	30.8	16.7	14.1
Dominican Republic	35.7	18.6	17.1
Venezuela	30.0	23.3	6.7
- All countries ²	27.7 ³		

Figure XVI. Comparison of micro-finance interest rate and bank rate for selected countries. Source: MIX Market Exchange.

To provide an example of the micro-finance premium, the average loan officer working at affiliates of one of the largest micro-finance networks, Women's World Banking (WWB) manages 600 clients at a time. According to WWB, administrative costs are 10 cents to lend each dollar, or 10 percent of loan capital. These high costs combined with inflation drive real interest rates above

30 percent.¹⁰¹ In contrast, administration costs in the traditional banking sector average 0.05 percent of loan capital.¹⁰² Yet poor clients are willing to pay these rates because the moneylenders charge even more, often in the range of 80 to 120 percent.¹⁰³ While regulation of interest rates is essential to a certain extent, it is also necessary that regulators do not to overextend to creating excessive and hindering regulation that could impede MFIs in achieving sustainability. As their client base rapidly expands, many MFIs undertake the process of becoming regulated institutions similar to banks. At the same time, commercial banks, realizing the huge micro-finance demand, are moving into providing micro-finance to income levels they previously overlooked. There are two primary instruments that can respond to correct excessively high interest rates: State regulation by imposing rate limits and enhanced competition in the sector, which makes MFIs compete for clients by bringing down micro-loan product prices. In the next section, the second option, competition, will be analyzed through considering the process of micro-finance formalization, which increases competition and brings down interest rates, as studies have shown there is a direct relation between higher market penetration of MFIs and reduced interest rates.¹⁰⁴

¹⁰¹ WWB Red Global Para la Innovación Bancaria en Microfinanzas de WWB. “Bancolombia Adopta las Microfinanzas” 2005.

¹⁰² CGAP, pg. 3.

¹⁰³ CGAP, pg. 3.

¹⁰⁴ Womens World Banking, pg. 12.

Conclusion: Microfinance and social context

Commercialization of micro-finance through investment, a form of indirect downscaling, reached \$6 billion in 2007. One year later, by the end of 2008, investment in MFIs nearly doubled to \$11.7 billion. *Investment in micro-finance* refers to the flows of capital worldwide – from governments, institutional investors, multilaterals, banks, financial institutions, private sources and development agencies – to regulated financial institutions, upscaled NGO MFIs or downscaled banks. In determining the destination of global investment flows a key factor is the return on investment (ROI). MFIs in Latin America have an average ROI of 10 to 12 percent, while on average MFIs worldwide average an ROI of 7.5 percent.¹⁰⁵ This could partially explain why approximately 75 percent of international investment in MFIs goes to Latin America and Eastern Europe,¹⁰⁶ regions with relatively highly developed economies and a more commercially-oriented approach to micro-finance, compared to Southeast Asia and Africa, where MFIs are considered more development-oriented. The chart below shows large international financial institutions investment in local MFIs and the amount of clients each MFIs serves. The chart clearly shows that international investment allows MFIs to drastically increase client outreach. The average amount of clients served among the five MFIs listed below with commercial

¹⁰⁵ MicroRate. "Micro-finance Investment Vehicles: An Emerging Asset Class" November 2006.

¹⁰⁶ ING, pg. 2

investment is 973,000,¹⁰⁷ compared to the average MFI without investment, relying on donations and subsidies is 1,100.

Bank	Local Bank	Country	Products	Amount involved (in US\$m)	Number of people reached
ABN AMRO	Real Microcrédito	Brazil	Credit	6	8,800
ING	ING Vysya	India	Credit	74	112,000
			Savings	2.7	
Citigroup	Banamex	Mexico	Insurance	-	600,000
			Savings		40,000
Barclays	ABSA	South Africa	Credit	190	
			Savings		4,037,000
Banco Santander	Santander Banefe	Chile	Credit, savings	125	68,000

Figure XVII: Major investments in MFIs from international banks, to finance product lines of micro-credit, micro insurance and micro savings. Source: The ING Group Report.

By 2015 it is estimated that \$20 billion in investment in MFIs will be needed for MFIs to sustain current levels of operation.¹⁰⁸ For investment to reach the \$20 billion mark, according to Standard & Poor's, the sector must increase its capacity to absorb large capital flows of financing.¹⁰⁹ Challenges remain to develop intermediaries to channel these large flows from capital markets and from other sources of financing, to lower transaction costs and to develop prudent and enabling regulation. International investors need transparent and globally accepted standards for credit analysis and performance measurement of

¹⁰⁷ ING, pg. 7.

¹⁰⁸ Microrate, pg. 19.

¹⁰⁹ Micro-finance at a Crossroads: How Best to Create Value for the World's Poorest Citizens Published : October 18, 2006 in Knowledge@Wharton.

MFIs, as well as indicators to allow them to compare MFI investment opportunities internationally.

An important step in this direction is the development of benchmarking and underwriting standards evaluated by micro-finance ratings, which are in high demand by investors looking for criteria with which to base their MFI investment decisions. Ratings evaluate MFIs on a wide range of indicators including performance, profitability, financial solvency risk, portfolio quality, liquidity, internal operations, efficiency and last but not least, social impact. One of the most widely-used ratings tools is CAMEL, created originally by the U.S. Federal Reserve to evaluate U.S. banks.¹¹⁰ CAMEL stands for capital adequacy, asset quality, management, earnings and liquidity. Investors are not the only benefactors of ratings; MFIs also benefit because a favorable rating encourages investment, thus increasing their working capital and loan portfolio. While the increasingly widespread practice of ratings is not the same as regulation, it is a step towards institutional solvency and sustainability for MFIs. Improving ratings efficacy and applicability would help to attract investment capital flows and to increase the growth potential of MFIs.

The increasing participation of traditional finance in micro-finance is not without controversy, however. In an interview with University of Pennsylvania

¹¹⁰ FELABAN, pg 11.

Economics professor Tayyeb Shabbir,¹¹¹ he suggests that micro-finance is entering a period of formalization that will give market forces a greater role in the allocation of capital. This of course makes some long-time proponents of micro-credit uneasy, and Dr. Shabbir elaborates, "people committed to the MFI movement for the last 20 years feel apprehensive. They worry that all these profit-hungry banks are going to come in and want to dismantle everything. But I think this fear is somewhat misplaced. There will be room for, and a need for, both non-profits and for-profit institutions."¹¹² It is clear that the social mission of micro-finance cannot continue to grow at its current pace by relying primarily on continued handouts or on the limited efforts of NGOs alone. At the same time, micro-credit organizations arose because of a failure by markets and the traditional banking sector to provide opportunity to the poor. There is always going to be a part of the social mission based on NGOs, which in turn rely on market institutions for technology and funding. The challenge is to find the ideal combination and balance of commercialization and formalization of the sector, while not compromising the original goal of providing opportunity to those who previously were overlooked. This challenge is discussed in the following section. The key question, then is how the technology, expertise and resources of the traditional financial sector can be matched with MFI's direct knowledge of serving low-income customers, in order to build more inclusive financial system as a means to lasting and effective poverty reduction.

¹¹¹ Interview with Tayyeb Shabbir, Economics Department University of Pennsylvania. January 17, 2009.

¹¹² Shabbir interview.

Chapter V. Policy and social mission

Definition of double bottom line

In building upon the analysis of the commercialization trend, the social function of microfinance is of utmost importance if it is to truly contribute to poverty reduction. In theory micro-finance, when compared to traditional finance and to consumer lending, has a uniquely *social mission* that aims to go beyond merely providing credit to low-income individuals. From its beginnings the 'success' of micro-finance was overwhelmingly judged on the basis of the financial sustainability of the MFI itself; that micro-finance made a positive development and had a poverty reduction impact within the local community was assumed as given. 'More micro-finance' became fully interchangeable with 'more poverty reduction'.¹¹³ At present, however, the business of making loans to the poor in underdeveloped countries is entering a critical period of development,¹¹⁴ often facing legitimate concern that the micro-lending industry is tending to pay more attention in the future to investors' returns than to fighting poverty. "Our goal was to force out the usurers," says Yunus. "Now they're coming back, disguised as do-gooders."¹¹⁵ Most MFIs have in common the goal of reducing poverty while at the same time achieving financial sustainability, yet where they differ is in the emphasis they put on either financial or social performance. MFIs with a

¹¹³ Chang, Ha-Joon. "The Micro-finance Illusion" London: University of Cambridge, 2007.

¹¹⁴ Chang, pg. 5.

¹¹⁵ Yunus, Muhamad. Hacia un mundo sin pobreza. Madrid: Andres Bello Publishers, 1999.

commercial focus, usually in the form of banks, RFIs and financial intermediaries, aim to *consolidate financial stability*, which they view as a necessity for institutional sustainability. They tend to focus on a few products, usually high return micro-credit, and often rely on above-market interest rates to be sustainable. On the other hand, MFIs with a social focus, in the form of NGOs or non-profits, look to *respond effectively to the diverse demands of poor clients*, often offering in addition to micro-credit, services and products that can help by providing skills to reduce risk and marginalization, often via job training, primary education, basic health care and childcare. In this sense, the core product – micro-credit – is on the whole similar across different institutional models; the way in which micro-credit is administered and the various accompanying services varies greatly.

This paper has tried to show that an MFI's goal need *not* be understood as either a social mission *versus* a commercial mission, or that the two aims are mutually exclusive. Instead, a dual mission of both social and economic goals is indeed possible, and this concept can be described as a "double bottom line." The notion of *double bottom line* encompasses both a MFIs a *social mission* of providing opportunity via financial capital to the working poor, as well as an *economic mission* of generating profit and achieving long-term financial sustainability. Weighing in on the dynamic between making a profit and helping the poor, UNDP Administrator Helen Clark states, "the real reason we (micro-

finance practitioners) are in this business is to help people out of poverty. It's going to be in our best interests as businesses to provide additional services to our clients. The Economist in me wants to say that if the clients are coming to you, it's because you are providing something that is of value to them. The social activist in me wants to be able to say, 'we're on mission.'¹¹⁶ Therein lays the uniqueness of micro-finance: the unique double bottom line of “doing good” – providing financial products to the poor – while “doing well” – generating profit to achieve sustainability. It is clear that micro-finance to help the poorest sections of society improve their lot is an entirely different entity from micro-finance as a new investment class for Western banks. Yet as explored in chapter four, the boom is in the latter, more commercial sector: currently 75 percent of micro-loans in Latin America and 50 percent globally¹¹⁷ are being issued at commercial interest rates, and this percentage is rising rapidly. Under these conditions, without careful attention and policies implemented towards protecting the double bottom line, the poorest of the 2.2 billion potential customers in Latin America and the rest of the developing world may be overlooked yet again in creating opportunity for them to be able to make better lives for themselves.

Micro-finance and consumer lending

¹¹⁶ Clark, Helen. UNDP Administrator Annual Address, April 17, 2009.

¹¹⁷ ACCION, pg. 3.

In understanding micro-finance's unique double bottom line, it is important to understand the difference between micro-finance and consumer lending. They are differentiated based on lending activity, and take into account the following:

- Loan size limits – an upper limit on loan size is often specified. A more nuanced approach might be to specify that a micro-finance loan portfolio must contain no loan above a certain amount and a given percent of the loans must be below a determined value.
- Microentrepreneurs as borrowers – as opposed to borrowers seeking to finance *consumption*, micro-finance is oriented towards *productive investment* in an entrepreneurial project.
- Credit decisions – are based primarily on the borrower's character and (business or household) cash flow, rather than collateral. Note that this does not preclude the use of collateral in all cases.

Consumer lending and micro-finance start with entirely different motivations and philosophies and yet increasingly compete for the same customer. Consumer lending tends to be aggressively commercial, with a strong focus on achieving scale and profit. In contrast, MFIs begin with a social bottom line and are more likely than consumer lending to reach the poor clients and especially the self-employed. Socially-oriented MFIs are often praised for their intangible benefits including enhanced skills, self-confidence, self-initiative and community cohesion. Many in the development arena argue that micro-credit does not

advance individuals *economically*, but it does advance them *personally* in the aforementioned ways.¹¹⁸

This difference in perspective between consumer lending and micro-finance sets up one of the most interesting dynamics at play in the quest for creating inclusive finance. Particularly in Latin America, consumer lenders (via downscaling) are specifically targeting core micro-finance clients – informal microentrepreneurs – while concurrently MFIs are developing consumer lending practices (via upscaling). Still, according to the UNDP’s Helen Clark, MFIs have a ways to go to catch up to the outreach potential of consumer lenders. Clark claims, “MFIs overall tend to lack sophisticated technologies that have enabled consumer lenders to reach scale, and many MFI leaders worry about how to engage with the mainstream financial sector and to compete with consumer lenders for poor clients.”¹¹⁹ Perhaps instead of MFIs and consumer lenders competing with each other over clients, they could recognize that the demand for accessible financial services by the poor is nearly insatiable, with 2.2 billion marginalized by traditional financial system. They should instead focus on how to make their services accessible, efficient and sustainable.

Conclusion: micro-finance in development policy

¹¹⁸ ACCION, pg. 4.

¹¹⁹ Rhyne, Elizabeth. *Micro-finance for Bankers & Investors*. ACCION Center for Financial Inclusion, Boston: July 27, 2009.

While consumer lending does not claim to have social objectives, the fact that micro-finance does, and has been shown in numerous cases to be effective in achieving them, makes it an important component in economic development policy. Admittedly the access to a micro-loan is arguably better than not having one, but it also could have the potential to distract the public from the macro obligations of building financial and government institutions oriented toward providing structural solutions for improving the circumstances of the working poor. Anis Chowdhury from the UN-Department of Economic and Social Affairs (UN ECOSOC) argued in a recent paper that while it may dull the edge of chronic poverty, "micro-finance is not a panacea for poverty reduction; without a supportive macroeconomic, trade and industry policy framework, micro-enterprises will remain micro, with no backward or forward linkages or employment creation possibilities."¹²⁰ What are the factors that comprise such a framework that Chowdhury advocates? According to CGAP,¹²¹ the following are elements of a favorable macroeconomic climate for micro-finance that contribute to business and consumer confidence and foment long-term growth:

- Monetary and fiscal stability
- Market-based pricing structure
- Clear and enforced contract law
- Impartial legal system
- Low and stable interest rates
- Relatively full employment

¹²⁰ Chowdhury, Anis. "Micro-finance as a Poverty Reduction Tool – A critical assessment" UN Economic & Social Affairs Council. DESA Working Paper No. 89: ST/ESA/2009/DWP/89, December 2009.

¹²¹ Chowdhury, pg. 7.

Such elements are structural economic adjustments, which help to address the structural roots of poverty, while microcredit alone without these elements does little to address long term poverty. The original goal of microcredit as contributing to poverty reduction should not be overlooked due to the increasing prevalence of consumer finance, which is devoid of social mission and is rapidly expanding its client base due to high profit margins. What is preoccupying that purely profit-driven, consumer finance has even less potential than micro-credit in contributing to poverty reduction. Instead, the focus should be on increasing economic opportunity for the poor by creating access to employment and to financial services. Without these, mere access to cash via micro-loans is at best a temporary fix to a serious challenge.

Conclusions

While NGOs are making valuable contributions to the social safety net of a country by providing micro-credit to the poor and vulnerable, the State cannot overlook its role in the area of social provision. The State has to be a major player in the design and operation of an inclusive financial sector. Markets operate on incomplete and costly information; it is necessary for the State to take an active role to promote social justice, since markets have shown repeatedly, and especially over the past year, that when left entirely alone they are likely to fail. Furthermore, there is consensus in micro-finance literature that the State's

role in the financial sector is to promote the social, rather than merely economic, impact of micro-finance. Public investment in infrastructure and education, along with strong labor and financial sector regulations to keep big business or unfair practices from monopolizing opportunities for growth are fundamental to the development agenda, and micro-finance cannot be relied on in place of these measures. In particular, it is crucial to ensure that growth is employment-intensive in order to maximize its impact on poverty reduction. Yet in the developing world in general, governments have not produced regulation in pace to keep up with rapidly growing micro-finance sector, nor have they responded sufficiently to the need to create prudent legal framework to incorporate MFIs into the formal financial sector. Similar to traditional finance, the micro-finance sector requires a favorable macroeconomic and political climate in order to develop and grow in a sustainable manner.

Micro-credit can be seen as a type of “micro solution” for a macro problem, that of structural causes of poverty and underdevelopment. As a micro solution, micro-credit programs do nothing to change structural conditions – such as loss of land rights, privatization of public services, or cutbacks in health and education spending – that reproduce poverty in developing nations. When a crisis strikes, be it the recent global financial crisis or the recent string of natural disasters, micro-loans cannot make up for the shortage of solid living-wage jobs and macroeconomic stability. Micro-lending alone will not end poor people's struggles

or promote sustainable livelihoods on a mass scale. Instead, the solutions to poverty must focus not only on micro solutions that adjust the conditions of individuals, but on macro measures of building structures of inclusion. Expanding the State sector to provide the basis of a working social infrastructure is, therefore, a far more effective way to help improve the socioeconomic conditions of the working poor.

Chowdhury goes on to explain how only concrete pro-labor policies can truly bridge the gap between mere subsistence and economic independence; he says that labor should be priced at a “decent” or legislated minimum wage to enhance poverty reduction. Employment (self or otherwise) at a wage below a decent rate only adds to the pool of the so-called “working poor”. Earning a few extra cents may be a significant advantage for a person living on less than \$2 a day.

Chowdhury elaborates, but does not generate enough profit for reinvestment to grow his business. He still remains part of working poor, and perhaps even more vulnerable to shocks due to the debt burden.” The call, then, for the State and private sector is to work together to provide financial services of credit and savings to the world’s poor by building a more inclusive financial system, through an integral solution of both public and private sector initiatives. The responsibility of the State is to implement policy initiatives to expand access to employment, increase the offer of credit and to loosen lending, while the private sector should create incentive for banks to downscale and offer affordable and quality micro-

finance services. As such, micro-finance must be anchored in comprehensive development policy, with both bottom-up micro solutions and top-down macro solutions to development strategy, considering micro-finance as it figures into *greater goal of providing sustainable financial services for poor.*

Returning to the case study of this investigation, my field experience with Fundvis serves to elucidate this point. Providing cash to small-scale business owners in the form of micro-loans does little to increase their economic opportunity over the long run. While Fundvis' Project CIC micro-credit program has provided loans for seven years to over 1000 entrepreneurs, it is evident that these loans themselves are not enough for micro-loan recipients to overcome poverty. Even the loan recipients who have participated in Project CIC since its beginning, have received upwards of ten micro-loans and have seen their micro-enterprise grow; have not been able to make any significant and definitive strides out of poverty. As this paper has argued, such lack of real growth is due to deeper structural causes, which are arguably the norm in the developing world and in the experience of Fundvis in Buenos Aires in particular. Among these causes the most significant impact on Fundvis micro-entrepreneurs are the following: lack of formal education, living in precarious neighborhoods without basic sanitary services and infrastructure, socio-economic discrimination for being from a poor sector of society, limited mobility from living far from the center of economic activity, lack of affordable transportation to move merchandise and

to travel to reach potential clients, low levels of social capital and social networks to expand business. Even more far-reaching than local social and economic challenges, the political context – in which policy continually changes by presidential decree, discriminates against un-favored sectors and has little continuity or coherence over the long term – is seemingly without a sincere interest in ending poverty. To this end, the chart below shows the steady growth over the past 40 years of the percentage of the urban population living below the poverty line in Argentina.

Growth of poverty in Argentina, 1968 to 2009.

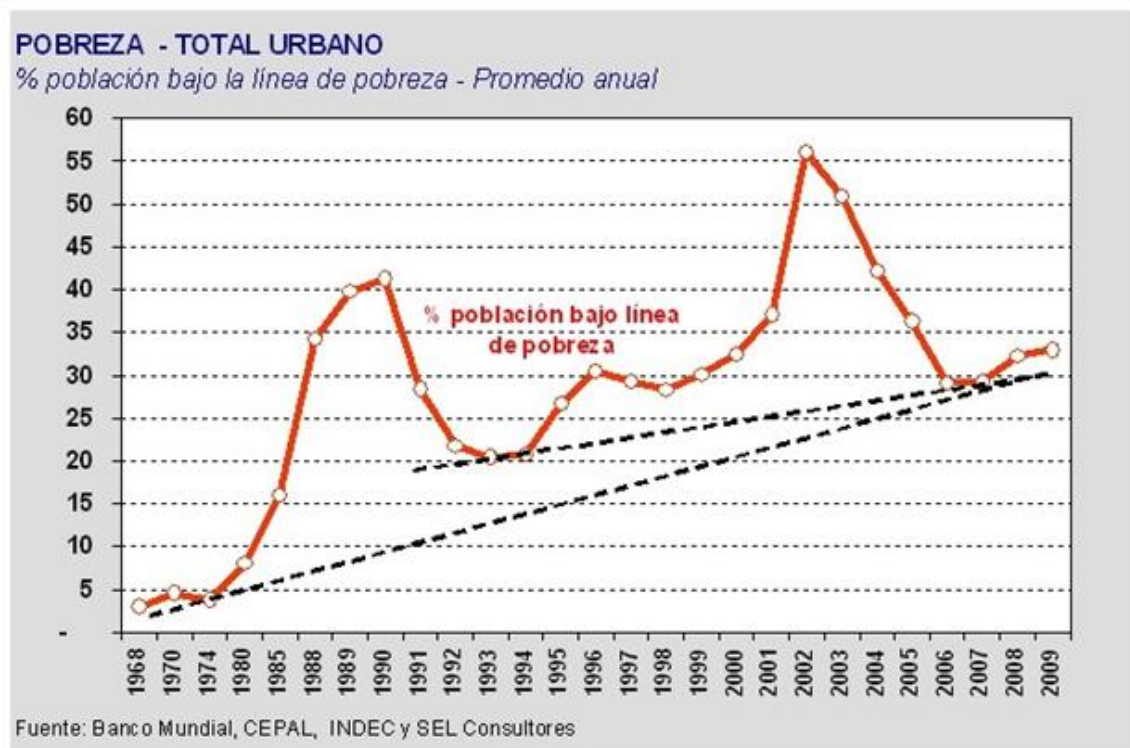


Figure XVIII. Increase in percentage of population in urban areas living below the poverty line since 1968. Source: Diario La Nación.

Most notable in the figure is that the percentage living below the poverty line has grown remarkably, from 3.8 percent in 1974 to 33 percent today. Furthermore, the lowest percentages of the population living in poverty, from 3.8 in 1974, to 20.5 in 1993 and reaching 29 percent in 2006 show a tendency of increasingly higher poverty levels. It is important to note that while poverty has risen the country has experienced economic growth on average of 7 percent per year since 2003; and leads to the question of why has this growth not been reflected in decreased levels of poverty.

One of the major factors that poverty has increased during a period of economic expansion is political climate. A few basic adjustments in political focus and corresponding policy objectives could arguably go a long way. The country could benefit from a mature democracy that works to improve the well-being and opportunity for the majority of the population. Such governance would include measures that harness the notable economic growth of the country in the past five years to lead to social development in order to decrease the gaping and increasing divide between the most affluent and the most poor in society. They include taming inflation, which is suffered by the poorest sectors, controlling corruption levels by enhancing respect for rule of law, combating tax evasion and clientalism and promoting enhanced security by working towards a more just and integrated society. A country like Argentina, full of potential, rich in natural resources and human capital, provides a fertile backdrop for development policy

to be effective and to bring about positive change. One-third of the entire population is fighting daily for a subsistence-level existence and cannot continue to wait.

Epilogue

I hope my work will contribute to the understanding of how to build inclusive financial systems, in particular through micro-finance, to achieve a more just and sustainable economic system, in order to ultimately reduce poverty on a global scale. It is an economic system rooted in “social economy” where those previously excluded *can* participate and benefit from opportunity to improve their well-being. To be sure, this paper only briefly mentioned many topics worthy of intricate discussions – concepts for building inclusive financial systems, factors contributing to the current state of Argentina’s micro-finance sector, the role of major financial institutions in micro-finance – each one warrants a separate and extensive investigation on its own. Yet the reality remains, what may be done to confront the fact that half the population works in the informal sector, while an even greater number (estimated by the World Bank) – 70 percent of the population – is denied access to the formal financial system. This is not a reason to despair, but rather a call to action and micro-finance *can* be an effective measure against poverty, but not the only one. Micro-finance, when rooted in social economy, has the potential to be an effective tool for

empowering low-income individuals around the world to better their lives and take control of their futures. In the words of Yunus, “micro-credit is not a miracle cure that can eliminate poverty in one fell swoop. But it can end poverty for many and reduce its severity for others. *Combined with other innovative programs* that unleash people’s potential, micro-credit is an essential tool in our search for a poverty-free world.” Yunus’s words ring true; creating opportunity and empowerment for the poor is not something that can be achieved from one day to the next, nor by strictly State-run programs, nor wholly private-run initiatives; rather it takes a collaborative effort by all parties involved working together patiently and prudently implementing policy over many years. Do the activities of the Grameen Bank and other micro lenders romanticize individual struggles to escape poverty? Yes. Do these programs help some women "pull themselves up by the bootstraps"? Yes. Is the support for micro-enterprise in the informal sector alone sufficient to contribute to ending world poverty? Not a chance.

Appendix A

Structured Interview Form
For Micro-finance practitioners

*Investigación de tesis – Preguntas para Micro-finance practitioners
Example of form for interview with Brenda Cerbone, Responsable de
Capacitación y Comunicación FIS Empresa Social
octubre de 2008*

1. Me interesa el modelo innovador de FIS como 'Empresa Social.'
¿Qué beneficios ofrece este modelo? In particular, ¿cuáles son las ventajas para sus prestatarios y sus inversores?
2. Leí que el Fondo es el primer de este tipo en el país.
¿Hay replicaciones o copias del modelo FIS? ¿Cuáles son los competidores principales de FIS, o quienes son las IMFs con operaciones más parecidas?
3. Mi tesis está enfocada en la comercialización de microcrédito y las consecuencias de esta transición en la misión social.
¿Cuáles son unas diferencias y similitudes entre FIS y un banco comercial que ofrece microcrédito? ¿Ves algún incentivo para FIS se convierta en un banco comercial?
4. Dicen que un obstáculo importante es que las IMFs legalmente no pueden captar ahorros.
¿Cuán importante es la posibilidad de captar ahorros para sustentabilidad?
¿Existe una demanda de los clientes de FIS para poder tener ahorros con FIS?
5. Leí que FIS cuenta con más de cien inversores (Foncap, BID, Fund. Ford). Me interesa el dinámico de fondeo de una IMF entre inversores y donantes. Con un ámbito competitivo de financiamiento, ¿cómo ha incentivado los inversores para que colaboren con FIS, dado tantas otras opciones?
6. El informe anual dice que en 2007 FIS logró sustentabilidad. ¿Qué implicaciones tiene; contará con inversores pero no con donantes/subsidios?

7. Entiendo que FIS ofrece crédito rural y urbano. ¿Cuáles son las principales diferencias entre el programa de crédito en Lomas comparado con el de Santiago del Estero?

8. En las Jornadas de RADIM discutieron la nueva colaboración con Grupo ACP. ¿Qué cambios traerá en la organización de FIS, su modo operativo y su misión social?

9. En las Jornadas mencionaron el relativo atraso de Argentina en microcréditos en la región. En su opinión, ¿a qué se debe, y que está haciendo FIS para enfrentar esta situación?

10. Me interesa la visión que FIS tiene para sus proyectos en el futuro. ¿Cuáles son los mayores desafíos legales, sociales, económicos de FIS siendo una empresa social en Argentina?

Appendix B

Impact Analysis Survey

Project CIC loan recipients, six months into loan repayment

Credit line from the Ministerio de Desarrollo Social

Economic Impact

1. How has your business revenue varied in the past year?

Increased		%
Decreased		
First year of business		
Total change		

2. Have you purchased more productive assets in the past year than in previous years?

Yes		%
No		
First year of business		
Total change		

3. How have you invested in your business?

Purchase merchandise		%
Improved locale		
Invest in tools/transport		
Other		

4. How has your household income varied in the past year?

Increase		%
Decrease		
Equal		
Total change		

5. If household income increased, what was the cause?

Increase sales		%
Increase household income		
Increase hours worked		
Innovation/improvements		

6. Are you able to save?

Yes		%
No		
If possible, would you save		
Y/N		

7. If you have savings, how have your savings varied in the past year?

Increase		%
Decrease		
Equal		
Total change		

8. Over the past year, how do you consider your business performance?

Better		%
Equal		
Worse		
Expectations		

Social Impact

1. In the past year, have you made improvements in your home?

Yes		%
No		
Plan to do so		
Not necessary		

2. What type of improvements were made?

Improvements		%
Expansions		
Move		
Plans		

3. In the past year, could you buy more or better food for your family?

Better		%
Equal		
Worse		
Health		

4. With respect to the future, how has your perspective changed in the past year?

Better		%
Equal		
Worse		
Expectations		

5. Has your schooling or your children's schooling level changed?

Primary complete		%
Primary incomplete		
Secondary complete		
Secondaryincomplete		

Other data

Survey date	
Survey number	
Years as CIC client	
Type of business	
Number of children	
Highest school level attained	

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