

MICROFINANCE, OR PAYDAY ADVANCE, OR BOTH?

by

Rick Settle

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Project Approved:

Steven Mann, Ph.D.
Department of Finance
(Supervising Professor)

Pete Locke, Ph.D.
Department of Finance

Michael Sherrod
Department of Entrepreneurial Management

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INTRODUCTION

The concept of microfinance as we know it today was formulated in the 1970s by a Bangladeshi banker and professor, Muhammad Yunus. It is said that “42 poor women craftsmen came to him for a small loan, he lent them \$27 and charged them \$0.02 each in interest,” (Firoz, 8) Yunus immediately saw the untapped market for providing financial services to those who had been forgotten by the financial system. Although community-oriented financing practices such as pawnshops and cooperative lending banks have been in existence since the early 15th century, when Franciscan monks created the original community securitized lending concept, it was not until Yunus and the Grameen Bank received the Nobel Peace Prize for their “efforts through microcredit to create economic and social development from below” (Osio) that microfinance was seen by the public as a sustainable and socially responsible practice. In contrast, public sentiment for payday loans (also known as a “payday advance”) is overwhelmingly negative. Payday loans are short-term, small unsecured loans, “regardless of whether repayment of the loans is linked to a borrower’s actual payday” (Hodson, Owens, and Fritts). The public backlash to payday advance companies in the United States is mainly due to the exorbitant interest rates they often charge, leading some to argue they are engaging in usury.

In order to better understand the types of debt that will be discussed throughout the thesis, Figure 1 shows a hierarchy of debt. The hierarchy of debt lists the type of debt, along with the issuer credit quality and the quality of collateral that is associated. The highest type of debt on the table is home mortgages, where the issuer has good credit and the quality of their collateral, or rather home, is good. This type of debt usually carries the lowest interest rates. As we move down the hierarchy, the credit quality of the issuer

declines, as well as the quality of their collateral for the debt (that is if they have any). The level within the hierarchy that will be discussed in depth is payday lending. This level of debt falls below pawn shops in the hierarchy as pawn shop requires collateral for their loans (poor collateral, but collateral nonetheless). It is at this level that lenders offer uncollateralized debt at much higher levels of interest.

Figure 1:

Hierarchy of Debt

| | Issuer Credit Quality | Quality of Collateral |
|------------------------|-----------------------|-----------------------|
| Home Mortgage | Good | Good |
| Subordinated Home Debt | Good | Average |
| General Personal Debt | Average | Average |
| Pawn Shops | Poor | Poor |
| Payday Lenders | Poor | None |
| Loan Sharks | Poor | None |

Despite the public's distinct views of microfinance loans and payday advances, there are important similarities between the two forms of lending. The financial theory behind microfinance (in its for-profit form) and payday advances is fundamentally the same. This thesis will examine these similarities by first examining the varied forms of microfinance and then by comparing the theoretical basis of microfinance loans to that of payday advances. If we ignore the public misperceptions about these practices, we can analyze their underlying financial concepts and investigate their sustainability. By examining the evolution of these two types of loans- including their positive and negative social effects- we can see if there are important differences between the two.

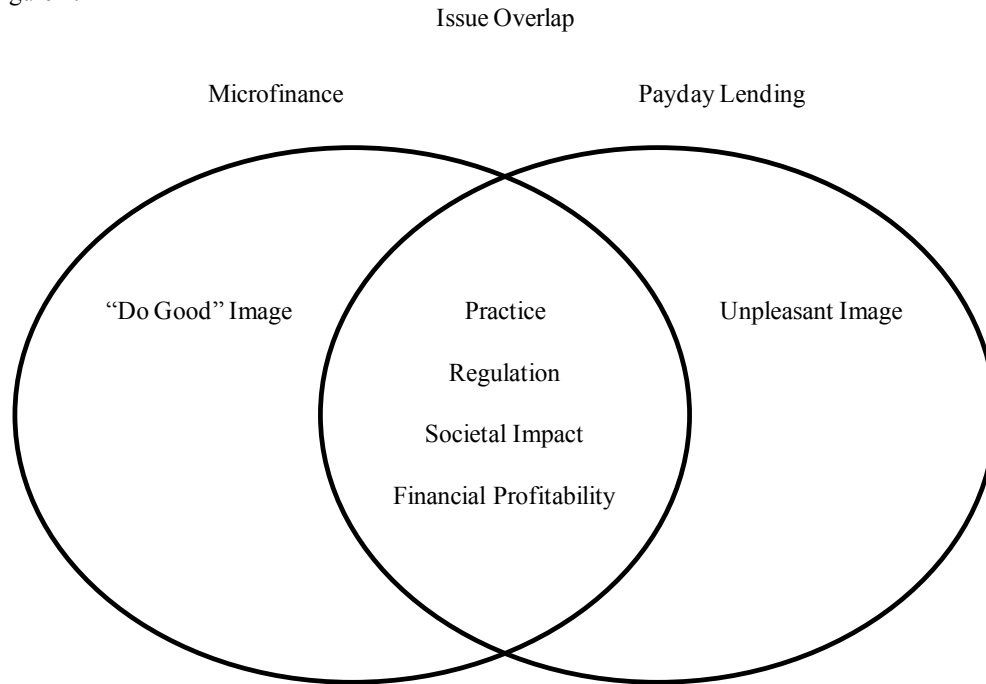
RESEARCH QUESTION

The question at hand is relevant since over \$6 billion worth of funding was spent in 2012 alone on microfinance loans across the globe. Revealing the success or failure of

for-profit microfinance loans is important not only for those making the loans, but also for the general public, since public government funds are often allocated annually to microfinance firms, raising the question of whether free markets could do a better job. For the many corporations and individuals that have chosen to invest in microfinance initiatives since its creation in the 1970s, the successes that were presented by microfinance's founder and his bank have since been proven exaggerated truths or manipulated statistics. Recipients of these loans would naturally be interested in knowing if there was a better solution. If this thesis is able to debunk microfinance as synonymous with payday lending, then society as a whole is not only allowing corporations to act as global loan sharks to the underprivileged, but is openly supporting and advocating for it. And if it is proven that microfinance is providing a measurable benefit to those that it claims that it helps and "empowers," (Adams & Raymond 438), are there other sources and outlets of funding in the free markets that would create a greater benefit for the poor and underprivileged?

This thesis will attempt to answer this question by performing a meta analysis in hopes of identifying patterns among study results that will expose the similarities and differences between microfinance and payday lending. In addition to the meta analysis, the thesis will provide a study of the financial theory that underlies both practices, additional theories of flaws within the microfinance model, and conclude by suggesting better solutions that exist within the free markets that have the potential to provide a greater societal benefit than the practices of for-profit microfinance. Figure 2 shows the differences that will be evaluated throughout the thesis.

Figure 2:



In answering this question, not only will a greater knowledge of the practices of microfinance be developed, but perhaps more importantly, a better understanding of sustainable socially responsible financial practices will be gained. With this knowledge will come the power to discern whether the claims of self-proclaimed socially responsible financial institutions are supported or are purposefully misleading to gain an unwarranted advantage and support from the market?

LITERATURE REVIEW

Microfinance

In October 2006, Muhammad Yunus and the Grameen Bank were awarded the Nobel Peace Prize for the microcredit facility that Yunus founded in 1976. The microcredit facility that he created has been described as a socially responsible and sustainable money lending practice whose chief aim was to alleviate poverty among the

poorest families and empower women in developing nations (Adams and Raymond 435). Yunus's innovation was to create loan circles —groups of five or so women—that the money would be loaned to, creating “social suasion to ensure higher repayment rates” (Adams and Raymond 435) and increase the creditworthiness of the women in the group. According to Yunus, the microcredit concept was developed in order to “cater to individuals who are often shut out of traditional banking,” (Lepro 24). Microfinance developed out of microcredit with the former being the for-profit form of the latter. Although Yunus's idea of microcredit took off globally and garnered widespread international donor support, eventually that support began to dry up and there was a solution found in “commercializing the [microcredit] concept and turning it into a for-profit business” (Bateman 7). Since the inception of the Grameen Bank, nearly all poor nations, and even some advanced nations, have Grameen-like clones, including the United States.

Microfinance is, in effect, rethinking standard banking. That is, microfinance institutions “are providing small loans without collateral, collecting deposits, and selling insurance, all to customers who had been written off by commercial banks as being unprofitable” (Beatriz and Morduch 4). Traditionally, banks have not provided financial services to individuals that have little to no income due to the substantial costs of client account management. Microfinance entered the market to fill this void and provide credit to micro-entrepreneurs, low-income employees, and the impoverished. While most microfinance firms are for-profit institutions, the industry states that “capacity building, employment generation, trust building and fostering entrepreneurial spirit” are their top priorities rather than “profit maximization” (Firoz 8). Among microfinance firms, there is

a widespread range of loan granting processes. The range of standards reveals a flaw within microfinance and various loan granting practices will be discussed in the critique of microfinance.

A Critique

The simplicity of the idea and the early positive impact of microfinance have garnered widespread global support. But perhaps the “goals and potentials of the Grameen model [have] far outdistanced its institutional and incentive features” (Dichter and Harper 36). Not only has the microfinance model come under fire for its kinship to exploitative lending practices but also for its false claims of successes and lack of “valid benefit-cost or statistical studies of impact” (Palmer 1). From a legal standpoint, there is “nothing intrinsically wrong with it,” (Block 58) but the win-win ideals of microfinance are highly problematic. A crisis point arose following “reports of suicide by desperate borrowers unable to meet their [loan] commitments” in Andhra Pradesh, India in October 2010. Repayment of loans slowed and as of April 2011, less than 20% of the loans were being repaid in Andhra Pradesh (Palmer 2). Tired of the exploitation of the women in the region, legislators in Andhra Pradesh introduced “An Ordinance to protect the women Self Help Groups from exploitation by the Microfinance Institutions” (Palmer 2). The state’s new legislation on loans attempts to stymie the recent trends on increased suicide rates, but also has the potential to “bankrupt one quarter of the microfinance institutions in the province” (Palmer 3).

For-profit microfinance has been accused of replicating lending practices found to be partly responsible for the recent financial crisis of 2008, where scholars and other observers have proven that certain lending practices were exploitive and severely hurt the

economy (Palmer 3). The misalignment of interest and incentive in home mortgage lending prior to the financial decline in 2008 placed a large incentive on loan officers to increase the volume of loans, without considering the interests of those who would eventually hold the loans. The U.S. lending market dramatically expanded as loan officers “accepted at face value” (Palmer 4) recipients’ claims of their ability to pay back the loans at regular installments. With the inflow of capital into the housing market, home prices were artificially inflated, while the number of defaults on loans increased. As the process played out, the housing bubble burst, with no concern of the loan officers, who held little to no financial interest in the loans. Parallels exist between the housing market collapse and for-profit microlending. Except in the for-profit microfinance bubble, the boom is the “valuation of lending to poor women” (Palmer 4) and the bust has begun with the failure of microfinance in Andhra Pradesh.

False Claims & Hidden Truths

Beneath the acclaim of Yunus’s Grameen bank, the most highly regarded microfinance institution, are multiple highly controversial claims and hidden truths.

According to one scholar (Tucker 3), the Grameen Bank

- Is government subsidized
- Exaggerates its repayment rate
- Is not subject to outside monitoring, unlike all other banks
- Is owned by the government to the extent of 6% of its assets
- Is owned 94% by borrowers who cannot sell or trade their stock
- Charges rates of interest that would be illegal for pawnshops and pay day check discounters

- Has been subsidized by the United Nations, the Bangladesh government, and US Foundations

While not all these same assertions can be made for all microfinance institutions, scholars have proven that many of these hold true for the fair majority of firms, especially in concern to subsidization (Nawaz 98). Despite injections of donor funding estimated at close to US\$400 million over the past five years, only 2 of the 27 institutions reporting to the Pakistan Microfinance Network are sustainable (Adams and Raymond 437). Here the term “sustainability” is referring to financial sustainability, or as the Guidelines for the Economic Analysis of Projects defines it: “the assessment that a project will have sufficient funds to meet all its resource and financing obligations, whether these funds come from user charges or budget sources; will provide sufficient incentive to maintain participation of all project participants; and will be able to respond to adverse changes in financial condition” (Desai 198).

As a result, in order to continue operating with depleting capital, microfinance institutions must continue to rely on donors and subsidized credit, or must change their lending practices to those that are more profitable. According to another study, for the year of 2005, 153 MFIs out of 204 were subsidy dependent, and based upon a with and without subsidy analysis of conventional financial ratios confirm the fact that MFIs financial performance declines without subsidies (Nawaz 120). The Grameen Bank claims to have between 95-98% (“Microfinance Basics”) repayment rates, but these repayment rates have been questioned by numerous scholars. According to a study by Agricultural Economics, the median rate of repayment is 72% within the sample of microfinance institutions (“MFIs”) that they studied (Raghunathan, Escalante, Dorfman,

Ames, and Houston 468). An important fact to note about the 95% - 98% repayment rate that Grameen suggests is that it is only relevant to first time loans (first time loans are traditionally considerably smaller in size than subsequent loans), but also must take into consideration that Grameen Bank lends to large groups of mainly women, and in order to receive future funding, the entire amount of the loan must be repaid.

What can occur when “relying on support groups to substitute collateral” (Engler 2009) is that although perhaps half of those receiving loans cannot repay their portion, the remainder of the group will pay their portion of the loan, in order to get future capital. Therefore, while the figure may be valid in the fact that 95-98% of the first time loans are repaid, it is misleading to claim that 95-95% of those who are loaned money actually repay it or that this holds true for subsequent loans. What also must be taken into consideration is the fact that “selection bias is another difficulty” (Beatriz and Morduch 188) in creating a valid cost-benefit analysis. Grameen Bank could be lending to only those that have the highest likelihood of repayment, or rather, individuals that would already have access to capital through other means. If the quantitative assertions made by microfinance firms are exaggerated, the fundamental qualitative benefits of the microfinance institution could not hold true as well.

Women’s Role

A critique of the microfinance model is in its tendency to make loans primarily to women. Yunus claims that “when men make money they tend to spend it on themselves, but when women make money, they bring benefits to the whole family, particularly the children” (Engler 2009). Yunus is not alone in this strategy, according to the New York Times, the Full Circle Fund, a scheme based on the Grameen concept that operates in

Chicago's Englewood neighborhood, has all women borrowers (New York Times Books 24). Supporters of microfinance claim that by lending strictly to women, there will be greater positive effects on their children, their children's education, increased economic empowerment, and increased social empowerment of women. The issue with these claims is that "the theoretical and empirical literature on all of these tentative hypotheses is sparse and inconclusive" (Adams & Raymond 439). While there certainly are benefits of independence for women, there are also some risks that can be associated with their increased independence and deviation from their traditional role in the family. The traditional role of women across the globe is raising the children, managing the household, assisting in farming operations, and providing meals for the family. If a woman were to obtain microfinancing obligations, it could force her to relinquish some of her traditional activities within the family. In addition, there is nothing to stop the male in the household from demanding that the woman hand over the funding to him, by force if necessary. Or perhaps the male would reduce his work efforts with the empowerment of his wife. Making women independent of their husbands could increasingly lead to the breakdown of the family structure, which is "one of the most important explanatory variables for poverty" (Block 60). All of these are equally potential options that may be occurring from lending to the women of the household rather than their male counterparts. Nonetheless, there is little data to confirm the overall positive or negative effects on the overall welfare of the household.

Further Indebtedness

Perhaps one of the strongest critiques of microfinance is that it only leads the poor into a state of indebtedness. According to a 2010 report, "for 2008, poor families

contracted about 8.2 loans per year” and the number rose to 9.6 as of November 2010 (Srinivasan). What these figures suggest is that poor families in developing nations are not using the microfinance funds for investment that will eventually lead them out of poverty, but rather for consumption. A senior microfinance executive conducted a study that found that “90 percent of loans are used for consumption, not investment” (Adams & Frank 441). There is also a lack of consistency in regards to the characteristics of the loans. For a family that has an income level of 50,000 rupees/year (\$1100), the average outstanding debt for the household is somewhere around 62,000 rupees (Mukerjee). The question becomes whether or not the microfinance funds are creating a benefit to those receiving the funds, or only sending them even further into poverty.

Removal of Muhammad Yunus

Beginning in late 2010, Muhammad Yunus received a letter from Bangladesh’s central bank governor, Atiur Rahman, ordering the Grameen founder to step down from his current position as Managing Director of the Grameen Bank (Elliot). The grounds for removal from the bank were based upon Bangladeshi law that states: anyone working at a Bangladeshi financial institution must retire at the age of 60. During an interview with Euromoney, Rahman reassured that it was a “legal matter” rather than one of political motivation, yet others feel differently, including Yunus himself (Elliot). Yunus, who is currently 70, had previously addressed this issue with the central bank when he was 62 and was able to convince then Central Bank Chief, Mohammed Farashuddin, that there were legal grounds for Yunus to continue as managing director without an age limit. Despite an appeal from Nobel Peace Prize laureate Muhammad Yunus, the Bangladesh

High Court has upheld the Central Bank's removal of Yunus (Bajaj, Manik, and Polgreen).

The removal of the father of microfinance has not come without controversy. The battle between Yunus and the Bangladeshi government has drawn attention to some key shortcomings of the microcredit movement that have been discussed thus far. While it is uncertain whether the removal of Muhammad Yunus was due to these shortcomings, many journalists suggest that it played a key role (Engler 2011). At this point in time, there is not enough information to assert whether his removal was warranted or not and the effects that it will have on the Grameen Bank, but it certainly has brought even more attention to the controversial subject of microfinance.

Payday Lending

Lending to the poor is not unique to microfinance institutions around the globe. The payday loan, also known as payday advance, industry has been growing within the United States since the early 1990s. In the early decades of the 20th century, when Americans began to move from the farmlands into the city and there was an influx of immigrants entering the country, "wage-earners had difficulty getting small loans to meet their cash needs between paychecks" (Consumer Alert 34). During this time, banks did not provide small cash loans and the only means of receiving a loan was to have a set of assets as collateral. Recognizing that there was a fundamental need for small-dollar, short-term credit (Herrmann & Tescher 7), payday lenders entered the market to satisfy the unmet need.

In payday loans, the borrower provides the lender with a forward dated check (currently a debit authorization) for the amount of the loan plus a finance charge

(Hodson, Owens, and Fritts). The lender agrees to defer processing the check until the agreed upon future date, usually a period of 2 weeks or less. Payday loans are typically less than \$500 in size. A Colorado state government issued report suggests that 52.4 percent of payday loan customers are women, and over 65 percent of borrowers are single (Colorado 5). The borrowers of these types of loans are generally high-risk borrowers, and have a relatively high likelihood of defaulting on their loans. For this reason, in order for firms operating in the payday advance field to make a profit, they charge exorbitant interest rates (sometimes more than 300% APR) to make up for the number of loans that are defaulted upon. For example, “in South Carolina, a \$500 loan from Advance America costs \$75.40, a 393 percent APR” (Wright 15). Payday loan shops have increased from a few hundred storefronts in 1990 to over 24,000 (Palmer 7) by 2007. Despite the industry’s attempt to champion themselves as beneficial to the working class and those who need bridge funding from paycheck to paycheck, payday loans have come under harsh scrutiny and attempted governmental regulation.

Regulation?

The government has attempted to step in and regulate payday loans, but their efforts have mainly been unsuccessful. In the early 20th century, most states imposed “interest rate caps of 24-42 percent” (Wright 12) on loans to consumers. These regulations lasted until the early 1980’s and the presidency of Ronald Reagan. With the deregulation that came during the Reagan-era, entrepreneurs took advantage of the erosion of state lending laws, and developed national payday lending companies to take advantage of this rapidly growing niche market. The Payday advance industry has since ballooned and is well over a \$30 billion-a-year industry (Wright 11). In 2005 alone,

“predatory practices of the payday lending industry cost American families approximately \$4.2 billion dollars” (Wann & Wann 167) in interest charges (what operators within the space prefer to call “fees”). Multiple states have attempted to ban Payday lending operations within their state, including Arkansas , Maryland, and North Carolina (Wann & Wann 172; Doster 12), but have found that even after “passing a 36 percent interest rate cap in 2003, Advance America went right on lending at triple-digit rates” (Wright 17). The one area where the federal government has stepped in and regulated the industry is when lending to military personal. During the growth of the Payday Lending industry, companies would prey on enlisted men around military bases who were strapped for cash. On October 17, 2006, “consumer loans to service members [was] limited to 36% annual interest under a law President Bush signed” that was aimed at store-front lenders that had popped up around military bases (Firoz 5). A writer from the USA Today claimed that the law “means that we’re going to protect our servicemen and women from this kind of abuse,” (Welch) an acknowledgement that the government knew of the crimes of Payday lending. The issue of regulation on payday lending continues to garner newspaper headlines. On April 23, 2013, the New York Times ran a piece that suggested that federal regulators are again prepared to crack down on payday loans by restricting big banks such as Wells Fargo and U.S. Bank from participating in such practices (Silver-Greenberg). It is yet to be clear whether this regulation attempt will be successful.

At first glance, the conditions of a group of five women taking out a loan of six dollars and an American family living on several hundred dollars a day may not seem comparable, but it is their indebtedness that places them both in need of short term

uncollateralized credit. In both situations, they have been forgotten and overlooked by the traditional banking system that requires either a credit history or assets that could be used as collateral. Despite the differing public sentiment between the two, the fundamental concepts behind for-profit microfinance and payday lending are strikingly similar. That is, both lending practices seek to solve the fundamental need for small dollar, short term credit, both are involved in subprime lending, and both practices are unregulated for the most part. The head of a Reserve Bank of India, Y.H. Malegam, and a committee made a recommendation to the providence of Andhra Pradesh to limit a maximum of 24% plus fees be set for loans that must not exceed 25,000 rupees for families below an income line of 50,000 per annum (Somasroy). These terms would allow families obtaining microfinance loans to become up to 50% indebted annually. The recommendation was denied. Where have we heard this sort of attempted regulation fail previously?

Financial Theory

When microfinance loans and payday advance loans are broken down into their fundamental financial theory, it becomes quite evident which practice is sustainable, and why for-profit microfinance firms cannot continue to operate in an environment of uncertain loan repayment. In order to evaluate the similarities and differences of these two apparently distinct lending practices, the core concept of loans and interest payments needs to be evaluated. All else being equal, revenues from loan fees come from the number of loans (A) multiplied by the average loan size (B) multiplied by the annualize interest rate (C) multiplied by the repayment rate (D). An assumption made was that although the usual time period of both payday loans and microfinance loans were very short (often only a few weeks), that the firm (either microfinance or payday advance)

could immediately re-lend the funds, therefore only varying the number of loans, this justifies that the annualized interest rate can in fact be used in the calculation. To calculate the loan loss from loans that defaulted, we take the number of loans (A) multiplied by the average loan size (B) multiplied by 1 minus the repayment rate (D). By taking the revenue from loans and subtracting the loan loss and setting it equal to zero, we can solve the formula for the interest rate and we find that the annualized interest rate is equal to 1 minus the repayment rate (D), all divided by the repayment rate (D). Through these steps, we can see that the annualized interest rate is purely a function of the repayment rate. These calculations can be seen in Exhibit A.

Exhibit A:

$$(A * B * C * D) - [A * B * (1 - D)] = 0$$

$$A * B * C * D = A * B * (1 - D)$$

$$A * B * C * D = A * B * (1 - D)$$

$$C = (1 - D) / D$$

Where: A = Number of Loans

B = Average Loan Size

C = Annualized Interest Rate

D = Repayment Rate

Perhaps more importantly, from this equation, we can conduct a breakeven analysis for various repayment rates, which has been done in exhibit B. There is an inverse relationship between the repayment rate and the annualized interest rate that must be charged to breakeven. There are some additional assumptions to this model that must be addressed. These calculations do not take into consideration the cost of managing the

client accounts or the time value of money. Both of these would have a negative effect on the lender, and therefore would require a higher interest rate on loans to break even than stated in exhibit B. Costs such as client management fees would vary across lenders depending upon the size, scope, scalability, and cost structure of the lending operation, therefore making it difficult to present a standard model that would include these costs. There have been some scholars that have attempted to address these costs within their analysis but for the sake of simplicity in our analysis, we can accept that these overhead costs will negatively affect the lenders rate of return (Arsyad 258, “Financial Performance” 117)

Exhibit B:

| Repayment % | B/E Interest % (APR) |
|--------------------|---------------------------------|
| 100.0% | 0% |
| 97.5% | 3% |
| 95.0% | 5% |
| 92.5% | 8% |
| 90.0% | 11% |
| 87.5% | 14% |
| 85.0% | 18% |
| 82.5% | 21% |
| 80.0% | 25% |
| 77.5% | 29% |
| 75.0% | 33% |
| 72.5% | 38% |
| 70.0% | 43% |
| 60.0% | 67% |
| 50.0% | 100% |
| 40.0% | 150% |
| 30.0% | 233% |
| 20.0% | 400% |
| 10.0% | 900% |
| 1.0% | 9900% |

This analysis reveals useful information about lenders. For those lending to clients with high credit scores and a high asset base (those with assured repayment), they can charge very little interest and breakeven with few lost funds from default. As lenders

move down the repayment rate scale, the inversely related breakeven interest rate increases. It is important to evaluate where payday lenders and microfinance firms fall on this table. As discussed previously, a \$500 loan in South Carolina from Advance America costs \$75.40 (393 percent APR). According to our model, the repayment percentage necessary for Advance America to make a profit on these loan practices would be about 20%.

Revelations from Breakeven Analysis

Yunus claimed that his Grameen Bank has somewhere between 95-98% repayment rates for its loans. If his bank were to achieve 98% repayment, then the bank would just barely make a profit on its 3.037% that it claims it charges on loans (based upon Yunus' claim that he loaned \$27 to 42 poor women, charging them each \$.02 interest), but if 98% of the loans are not repaid, the bank could lose up to 2% on each additional loan that is offered (at 95% repayment). Yunus claims repayment of 95-98% on first time loans, but he makes no claims as to the repayment rates on loans thereafter. It is widely understood that secondary loans do not carry the same repayment rates. The number of loans that a bank offers acts as a leverage factor to the difference between the interest charged and the necessary break even annualized interest rate. For those for-profit microfinance firms that are looking to contribute positively to society while generating a profit, assuming that we set the maximum annualized interest rate at 24% (as proposed by the leader of an Indian reserve bank), the microfinance firm must obtain a repayment rate of slightly less than 81% in order to potentially generate a profit. It is a potential profit because we must also consider other costs such as client management fees. If, for a period, a firm falls below the target repayment rate, the downside risk is

significant. For example, if a firm were only to collect 20% of all loans, which is what happened when the microfinance bubble burst in Andhra Pradesh in October of 2010, then they have the option of closing their doors, or increasing their annualized interest rates, entering into the world of predatory lending. To qualify- microfinance firms often suffer from what has been described as the “mission drift,” which is the pursuit of outsized profits at the expense of social goals (Vanreusel 67). While a MFI may have good intentions, if an event occurs similar to that of what happened in Andhra Pradesh in 2010, where many MFI’s lost a considerable portion of their loan portfolio to default, firms are likely to abandon their social goals and increase the interest rate on their loans to return to a level of profitability. If a firm remains focused on their mission, and refuses to increase their interest rates in the following months/years, they will need increased subsidization during those times, or face considerable losses.

Assumptions to the Model

This model also assumes lenders can re-lend the loans immediately after repayment, that we are evaluating a firm’s aggregate loans, and that all else remains equal. By assuming the lender has the ability to re-lend out loans, it allows us to use the annualized interest rate rather than attempting to calculate interest rates for specific loans. The model is meant to look at a firm’s aggregate loans, rather than specific loans or a given set of loans. Finally, the model does not consider such things as early repayment, discounts for early repayment, economic conditions of the operating firm’s nation, and assumes that these do not affect a lender’s breakeven interest rate percentage. All these assumptions favor the lender, and if we were to factor in additional costs such as overhead and client management fees, the break even interest rates would increase slightly.

If not Monetary, Is there a Societal Value?

Beneficial in its Non-Profit Form

If not monetary, what kind of value is created by for-profit microfinance institutions? By this point and time it has been proven that for-profit microfinance is (1) not sustainable, (2) highly subsidized, and (3) can very easily transform itself into predatory lending similar to payday loans. But is there still a place for microfinance? In its non-profit form, I believe that there is a benefit to society. I believe it creates a societal benefit in its subsidized and non-profit form, but not when it is intended as a for-profit business. The reason being is that when microfinance firms enter into foreign markets with the purpose of doing well by doing good, the model makes it impossible to “do well” financially while still “doing good” within the society. When a firm attempts to make a profit in the microfinance business, they must sacrifice either their purpose or their society friendly loan practices, and for profit-minded firms, most commonly it is the latter. While microfinance and payday lending are different on multiple levels, they do share the same fundamental financial theory of interest rates being driven by repayment rates. Therefore profit-seeking microfinance firms have a high likelihood of moving up the interest rate scale as their repayment rates decline, making them no better than their ill-incentivized cousin.

Strictly as a non-profit entity, microfinance can contribute greatly to society at large. I believe that there is a lot of good that can come from providing small-dollar, short-term credit to those living in impoverished nations and those living below poverty levels. Subsidized microfinance firms have the ability to enter into areas such as Andhra Pradesh, India and enable the people of the area to develop a line of credit that will

support them and lift them out of poverty. If instead of subsidizing for-profit microfinance firms, these funds would be given to those microfinance firms that can provide evidence of their lasting improvements to the people and the villages that they have entered into, actual change could occur. I am not recommending that non-profit microfinance firms enter into these markets and give out interest free loans. Even structured as non-profits, these practices would be short lived and highly unsustainable given the level of loan loss described previously. Instead, by pegging an interest rate that is somewhat sustainable (somewhere below 10% APR), and keeping lending size amounts constrained, non-profit microfinance could maintain some levels of sustainability with only minimal amounts of subsidized investment.

Kiva.org

An example of a non-profit microfinance institution that somewhat fits the mold that I have suggested is Kiva.org. Kiva is an online non-profit organization that was founded in 2005 and since has made over \$428 million in loans in 67 different countries. How Kiva works is that Kiva teams up with field partners (MFIs, social businesses, schools and non-profit organizations) who disperse loans as soon as they are needed. The Company claims to be 70% financially self-sustainable, with the remaining 30% being subsidized by multiple donation sources (Kiva.org). The field partner collects borrower stories, pictures, and loan details and uploads them to Kiva's site. Then anyone can go online and make a loan to an individual of whom you choose (you are provided a short bio and image of the borrower). Throughout the life of the loan, you receive updates about the progress that the borrower is making towards repaying the loan. As the borrower repays the loan, the money is returned to the lender without an interest fee. The loans are provided with a small interest fee to the borrower that is used to cover the field

partner's operating costs of granting the loan. Donating to Kiva.org involves risk of principal loss, and Kiva does not guarantee repayment. While Kiva is a step in the right direction for MFIs, it is not truly practicing peer to peer donations, but rather is simply backstopping microfinance institutions (Strom).

A New Solution

As I have suggested, I think there is a place for non-profit microfinance in today's society, but I don't believe that anyone has perfected the practice. An important aspect of microfinance is that in order to create value for society, microfinance must be more than just a loan. A second piece to the puzzle that is often left out is the support that is needed for these borrowers. It is equally important that this support be culturally relevant and support that corresponds with the level of business that is necessary. Often, in the current microfinance model, once the borrower receives their requested funds, their next interaction with the loaning agency is during the repayment process. In order for societal change to occur, this needs to change. A more sustainable microfinance model would be one that distributed loans in association with support and business education to its lenders. Organizations like Kiva are moving closer to this type of an operating model.

A possible way to provide funding and support is through a crowdsourcing solution that is similar to kickstarter.com, in which personally interested lenders agree to donate a certain amount of money in exchange for a good or product produced by the borrower of the microfinance loans. While this would only work for those loans distributed to entrepreneurs producing products, it could lead to a more sustainable source of funds rather than government subsidization. Rather than focusing on the individual that the MFI loan empowers, it is important for these non-profit microfinance

organizations to realize the benefits of community building. If microfinance organizations enable individuals to create businesses that in turn create more jobs for their village, there could be a lasting impact on the community that the loans were provided.

DISCUSSION

When beginning the development of the thesis, the level of opposition to microfinance was not expected. Among the general public, it seems that there is overwhelming support behind microfinance and that most people are in favor of it. The same could not be said about the academic world. That being said, the number of academic articles that were in favor and support of microfinance severely outnumbered the number of critiques and papers opposing it. While the amount of qualitative data gathered on microfinance is substantial, there is very little quantitative data available. There are a couple reasons that might account for this. For-profit microfinance firms operate mainly on foreign soil, and the majority of them are private companies (with the exception of three publically traded companies that operate within the micro-loan space). This makes it difficult to obtain hard facts, and the majority of statistics that are provided by firms are those that they choose to share, which are not audited by a governing body. Firms are secretive about their loan practices; no microfinance firm openly provides their loan information in any of the academic articles. While this may be because there is a wide range of loan practices that their firm conducts, it is most likely because they form their practices on a loan to loan basis.

I expected there to be a greater level of governmental regulation on payday lending companies. With the exception of loans to active military, there is basically no

federal regulation that monitors the activities of payday advance companies. In large part, this could be due to the lack of enforceability of the regulation that they have passed previously. Because of the lack of empirical data on microfinance firm practices and the lack of regulation on payday loan companies, I found it hard to nail down an exact profile for both types of companies, which in turn made it difficult to discern the similarities and differences between the two. Even after an in-depth study of current academic sources, it appears that both industries could be most succinctly described as the “Wild West.” Regulators in both markets have attempted to enforce regulation, but have done so unsuccessfully. This can most likely be accounted for due to the problem of a lack of small-dollar, short-term credit. Even with regulation in place, those seeking credit will search for whoever will provide them with the credit, even if that means paying exorbitant interest rates.

A limitation of this project was the scope of the current data that has been collected by other academics. It was unfeasible to travel to foreign lands to collect primary data for the study, and therefore the analysis relied on others’ data. By collecting the data that many other academics have gathered, I was able to draw conclusions that they individually had not been able to do, but it certainly was a limitation to be restricted to others’ data rather than being able to collect my own. Another limitation was that much of the information that was necessary to build upon my theory was information about private companies that were very tight lipped. While these firms were willing to speak about the supposed societal benefits of their actions, not one was willing to reveal their neither loan structure terms nor financial profitability, which made evaluating their potential financial sustainability difficult.

The next steps to be taken would be to obtain primary data from individuals who have taken loans from microfinance companies. By doing so, we would be able to construct typical loan terms for firms that are operating as for-profit microfinance firms. It could perhaps be beneficial to reach out to a number of those who have conducted some of the qualitative studies within the space and speak with them about the sources of their information and their means of obtaining it. To build on the theory that I have developed, overhead costs and client management fees could be modeled into the basic breakeven analysis. With overhead costs and client management fees integrated into the model, it would paint a better picture of actual breakeven costs. The difficulty in doing so, and the reason why this has not already been done, is that these costs will differ from firm to firm, and enough data was not gathered to make assumptions to standardize these costs across the entire sample size that the model was built to evaluate.

Future studies on microfinance could consider societal impact of these firms operating within poverty stricken communities. Studies that are able to show economic improvement, stagnation, or decline due to microfinance in terms of empirical evidence will greatly advance the study of microfinance. A future study could be the source of the differing public sentiment of the public about varying lending practices. It appears that there is a disconnect between the public and the practices of the firms, and that the general public is more prone to listen to the hype, than base their opinions on quantitative facts, or in this case, the lack of them.

IMPLICATIONS

These findings are relevant to non-academics since they reveal the for-profit microfinance industry puts out exaggerated truths and exaggerates their benefit. We must

be scrutinizing the statements of “environmentally friendly” firms claiming to have a positive societal impact. Because in doing so, we expose ourselves to be taken advantage on by those companies seeking profit under the pretense of providing a societal benefit to the world. For-profit microfinance is experiencing a boom, much like the housing market experienced a boom in the late 2000’s. Because of this, the industry is seeing an influx of government and private funds. This thesis serves as a warning to those seeking investment opportunities in microfinance firms as well as to educate the general public as to the false claims of those within the industry and the harsh truths of the unsustainable nature of for-profit microfinance.

The most applicable group for the thesis is those seeking investment opportunities in microfinance firms (either through private equity opportunities or through the stock of those foreign publically traded firms), those donating to microfinance firms, and those managers considering entering into microfinancing agreements. The answers to the question of whether or not for-profit microfinance is a financially viable and beneficial to society can aid these three different groups in different ways. For those seeking investment opportunities in microfinance firms, I would recommend that there are other businesses that are more sustainable and financially feasible in the “green” and socially responsible space to invest in than microfinance. Other investing options include such things as investing in publically traded corporations that focus on green initiatives and have a large non-profit arm or investing in venture capital firms that focus on socially responsible investing. For-profit microfinance must use financial engineering to appear profitable. History tells us that when firms must resort to financial engineering and falsifying such claims as repayment rate and loan loss rate, it is best to steer clear of

investment. For those either currently donating to microfinance firms or those considering donating to microfinance firms, seek out quantitative data that supports the assertions that the firm is making. If no such data exists, then perhaps they are false claims and there would be a better firm to donate to.

Secondly, speak with the people who the microfinance firm has lent to previously, and to those who the firm is supposedly assisting. These people will reveal the actual impact of the firm. And finally, for managers who are considering becoming associated with microfinance institutions, there may be other means of being perceived as environmentally friendly rather than participating in a microfinance initiative. A recent trend that we have seen is for start-ups to donate their first year's revenues to microfinance institutions, which, in theory, will be returned to the start-up in a year in exchange for the start-up to be labeled as "green" and "socially responsible" by society as a whole. While the concept sounds solid in concept, the microfinance firm exposes the start-up to many unforeseen risks.

The best recommendation that I can give to companies operating within the for-profit microfinance industry, is to maintain loan practices that are favorable to those seeking capital, and in times of declining repayment rates, seek additional subsidies that will allow them to continue to try to provide a societal benefit to the people. Also, it may be worth considering evaluating the options of transforming the business into a non-profit model that is more sustainable. For those companies that are seeking to do business with microfinance firms, do not evaluate the business through rose colored glasses. For too long have microfinance firms been credited with a greater societal impact than they

deserve, and while there is potential for them to make a lasting impact, business opportunities must be carefully analyzed.

CONCLUSION

In conclusion it can be determined that despite the differing public sentiment surrounding microfinance institutions and payday lending, that both practices share many of the same characteristics as well as the same underlying financial concepts. As we saw with the hierarchy of debt, the level of issuer credit quality was directly related to the quality of the collateral that the lender had to offer for the loans that they were granted. In the case of payday advance loans and loans from microfinance institutions, the issuer has no collateral and poor levels of credit, therefore must pay increasingly high amounts of interest due to their increased risk to the lender.

Throughout the study, it was proven that despite the good intentions of Muhammad Yunus' creation, microfinance cannot exist in both a for-profit and socially beneficial manner. When the practice, regulation, societal impact, and financial profitability were examined, it was revealed that for-profit microfinance and payday lending shared many of the same characteristics. More so, during periods of high default rates, for example those experienced during the fall of 2010 in Andhra Pradesh, India, that microfinance can inevitably shift into predatory lending practices in order to regain financial profitability. This concept is known as mission drift or the pursuit of outsized profits at the expense of social goals. Given the nature of providing uncollateralized loans to high risk individuals, eventually all for-profit microfinance institutions come to a point where they must sacrifice their social goals, in order to recapture their losses to achieve financial profitability.

The only question left to answer, is how do those individuals that are left out of the traditional banking system get credit without resorting to the likes of the illegal loan shark business? I have presented an improved microfinance model that couples current non-profit microfinance loan practices with the added component of support as an answer to the need for small dollar, short term credit. While there are non-profits that are attempting to attract more personally devoted investors, they still face the problem of lacking a financially sustainable loan model. A solution for these organizations would be to integrate a level of crowdsourcing into their current loan model, which would provide the borrowers with additional funds along with non-financial support that could assist the entrepreneurs in their business development process. While for-profit microfinance as we know it today has failed to raise the impoverished out of poverty, there is hope that a new model, one that provides borrowers funds and support, will be able to bring a better quality of life to those suffering from poverty around the world.

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ABSTRACT

This study focused on the similarities and differences between for-profit microfinance institutions and payday advance lending companies. Specifically, I examined the methods, regulatory attempts, societal impact, and financial profitability of the two lending practices. The thesis presents a critique on the microcredit practice created by Muhammad Yunus that is known as microfinance. The hypothesis that for-profit microfinance institutions and companies participating in payday lending are fundamentally the same was supported through the use of Meta analysis. The hypothesis was advanced by revealing that the profitability of the both types of lenders is dependent upon annualized interest rates and repayment rates and by providing alternative solutions that could substitute the role of microfinance institutions within society. Implications for the general public, investors, and borrowers of loans are discussed.