



MEGA TROUBLES FOR MICRO FINANCE

AN ACORN INTERNATIONAL CAMPAIGN REPORT

For many years microfinance has been the 'sacred cow' of the development world. Mohammad Yunus, considered the 'father of the micro-credit movement', and his institution the Grameen Bank of Bangladesh won the Nobel Peace Prize in 2006, the United States Congress repeatedly appropriates more money for microfinance than requested by the executive and in 2009 alone \$14.6 billion of public funds were committed to funding microfinancial institutions.

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Background

Microfinance has traditionally been the 'sacred cow' of the development sector.

The Microfinance Information Exchange (MIX) (an authority on microfinance and microfinancial data worldwide), defines microfinance as 'retail financial services that are relatively small in relation to the income of a typical individual'.¹ For the purpose of this report, we will further broaden this definition to include some hallmarks traditionally associated with microcredit programmes worldwide (overwhelmingly the most popular form of microfinance and certainly the most controversial).

Most microcredit borrowers are poor women. They unite collectively in groups in order to take out small loans which are then meant to finance investment in micro-enterprises. The income from these micro-enterprises goes towards loan repayment, further investment in the micro-enterprise and consumption which allows the borrowers to pull themselves, and their families, out of poverty. Loan repayment usually occurs at weekly meetings. These frequent meetings, joint liability loans and the small size of weekly instalments are key features that make microfinance different from the formal banking sector.

The birth of the microfinance movement is attributed to Mohammad Yunus, an economics professor in Bangladesh. In 1976 he started the Grameen Bank Project as an experiment to extend credit to the traditionally un-banked rural poor.

ABOUT ACORN INTERNATIONAL

ACORN International is multi-national federation of more than 60,000 low-and-moderate income families working in eleven countries. ACORN International works in directly affiliated countries include Peru, Canada, Mexico, Dominican Republic, Argentina, India, Kenya, Honduras, Korea, Czech Republic, and the United States with additional partnerships in Indonesia, Philippines, and Italy.

ACORNInternational.org

Due to the development goals of microfinance, many microfinancial institutions (MFIs) also encouraged social progress. Grameen Bank, for example, requires that their borrowers take an oath to follow the '16 Decisions'. Examples of the 16 Decisions are the pledges to repair dilapidated homes, keep families small, grow vegetables year round, and educate children.ⁱⁱ

The popularity of microfinance as a solution to global poverty was bolstered further in 2006 when Mohammad Yunus and the Grameen Bank jointly received the Nobel Peace Prize. This blending of social and financial development was cited by the Nobel Peace Prize Committee in their statement that microfinance was a way 'for large population groups to find ways in which to break out of poverty'.ⁱⁱⁱ Such praise is also reflected in the large amounts of cross-border funding microfinance has enjoyed over the years.

Introduction

By 2006 microfinance had come a long way in thirty years. During the boom years of 2004-2007, the customer base grew 23% annually. By 2009, there were over **1,955 MFIs with over 91.3 million borrowers in 110 different countries with a gross loan portfolio of \$65.9 billion.**^{iv}

In the same year that Professor Yunus received the Nobel Peace Prize, C.K. Prahalad's much discussed book, The Fortune at the Bottom of the Pyramid, was published claiming that the poor were the world's largest untapped market. Prahalad argued that fitting business models to the needs of the poor were the key both to profits and to improving the economic lives of the world's poor. Grameen Bank was cited as a successful example of this "business model."

Even when the 2008 global economic crisis caused global belt tightening, growth of the microfinance sector remained high at 19% only dropping slightly to 15% in 2009.^v Despite having slowed since the mid-2000s, the growth rate of microfinance during the Great Recession has been *more than seven times* the growth rate of developed countries *in good economic times*. As public sector budgets were being slashed around the globe in 2008 and 2009, microfinance enjoyed a **17% increase in funding commitments with 70% of them coming from public sources.**^{vi} In 2009 commitments to microfinance reached **\$21.3 billion** with at least \$3.2 billion being disbursed that year.^{vii} While \$14.6 billion of this was public commitment, the **private sector's commitment to microfinance had increased 33% to \$6.7 billion.**^{viii}

These figures reflect the increasing commercialization of the microfinance sector as well as the new emerging phenomena of MFIs becoming public companies with listings on national stock markets, most notably Compartamos (Mexico, 2007) and SKS (India, 2009). Such initial public offerings (IPOs) have been widely criticized; particularly Compartamos which openly charges interest rates that, with the value added tax imposed by the Mexican government, soar near 100%. This outraged Mohammad Yunus so much that he famously sniped that he refused to use 'Compartamos' and the word 'microfinance' in the same sentence.^{ix} Also, despite claims that money raised from the IPO (and subsequent gains from the market) went to expanding loans to more poor women at more affordable prices, **one third of the proceeds from the Compartamos IPO went directly into the pockets of private investors.**^x In India, the IPO of SKS was quickly followed by the unexplained firing of the CEO which prompted a drop in shares as well as

an ongoing investigation by the Indian Securities and Exchange Board. Further problems arose for SKS in 2010 when nearly 80 suicides reported in the Andhra Pradesh region were blamed on pressures to repay microcredit loans.^{xi} Since Andhra Pradesh constitutes 30-40% of India's entire microloan portfolio such a development has been labelled India's 'microcredit crisis'.^{xii} At the beginning of 2011, SKS reported losses of over \$15.7 million, a complete about-face from the \$14 million in profits reported the year previous.^{xiii} It would be a massive understatement to describe such volatility in a sector that works primarily with the world's most vulnerable, and whose raison d'être has been its alleged success in poverty alleviation itself, as only "worrying." This development is a full-blown crisis for the sector!

The initial shock when examining microfinance closely is first found in the high nominal^{xiv} interest rates which fall between **25-55%** annually. Many industry participants cite the high costs associated with serving a risky market and dealing with such small amounts of money as justification for the higher rates. The industry tries to rationalize a level of exorbitant interest rates to the poor that most in the developed world would never consider paying. By digging deeper into the calculation of interest rates and the nature of an MFI's costs and funding needs, this report finds that **without substantial help or high interest rates, the business model for microfinance breaks down and is simply not sustainable.**

Microcredit has never been conclusively proven to reduce poverty and scepticism of the microcredit model has existed long before the Andhra Pradesh Crisis of 2010 which catapulted such scepticism into the public spotlight.

The United Kingdom All Party Parliamentary Committee on Microfinance points out that the debate over whether or not microfinance can reduce poverty has been 'rancorous' and even the academic debate over the methodology used to study the impact of microfinance has been 'heated and complex'.^{xv} **It is time that the public became aware of hesitations and doubts that have been floating about within the academic public policy community and in the microfinance sector itself for quite some time.**



The best defence of financial services for the poor can be found Portfolios of the Poor. Financial services, the book claims, can help make it easier to handle the unpredictable and irregular nature of the poor's miniscule incomes. *However, while using microfinance may make it that little bit easier to be poor, you are likely to remain poor.* A paper written in 2009 by the Massachusetts Institute of Technology's Poverty Action Lab conclusively found that while access to microfinance smoothed the consumption patterns of the households who used it, there were *no* positive impacts found on health, education or women's decision-making (areas in which microfinance is traditionally praised for having positive impacts) and there was no conclusive evidence that access to microfinance was an overarching way to escape poverty.^{xvi}

ACORN International is concerned that the \$14.6 billion in public funds committed to microfinance, and more specifically microcredit, in 2009 is a \$14.6 billion commitment to something that has been praised for its alleged, but unproven, positive role in poverty reduction. Not exactly a wolf in sheep's

clothing, but not a sheep either. More starkly stated, those \$14.6 billion are *not* going towards funding development and aid efforts that are actually *proven* to successfully combat poverty. This is \$14.6 billion that places the burden *on the poor* to pull *themselves* out of poverty by *saddling themselves with debt*. The time has come that we see microcredit for what it really is, and even more importantly, for what it *isn't*.

This report first explores the personal importance of microfinance to ACORN International before turning to a more broad investigation of interest rates and their relationship to the sustainability of microfinance's business model. The report will then shed light on the international funding flows of microfinance and the perverse incentives they create for MFIs.

It will be concluded that microcredit is *not* the solution to poverty so many assume it to be and in its present nature it is doing more harm than help.

Why is ACORN International Interested in Microfinance?

ACORN International has **members in 7 countries** that have active MFIs. **3 of these 7** are some of the biggest microfinance hotspots *in the world*. In 2008, **India was 2nd** only to Bangladesh in the number of MFIs within its borders by only 15. **Mexico** came in **4th** on the table and **Peru** was **6th**. Out of a total of 117 countries **Honduras and Kenya** were also near the top of the table at **16th and 24th respectively**.^{xvii} With just over **35.8 million borrowers** in ACORN International partner countries accounting for almost one-third of total borrowers worldwide, microcredit is a topic that hits very close to home for ACORN members. Decisions on policy around microfinance either benefit our members when, and if, they work, or hurt them when, and if, they do not work.

ACORN MEMBER COUNTRIES- A BRIEF LOOK AT SIZE AND SCOPE OF OPERATIONS

(2009 Data; all amounts in U.S. dollars)

Country	Number of Active Borrowers	Total Loans Outstanding	Number of Depositors	Deposits
India	26.3 million	\$4.4 billion	2 million	\$204.9 million
Mexico	4.5 million	\$2.7 billion	4.2 million	\$1.5 billion
Peru	3.1 million	\$5.5 billion	2.4 million	\$3.8 billion
Kenya	1.5 million	\$1.2 billion	6.5 million	\$1.1 billion
Dominican Republic	219, 213	\$224.2 million	240,562	\$118.2

				million
Honduras	164, 789	\$217.2 million	199,997	\$66.3 million
Argentina	30,000	\$21.6 million	<i>N/A</i>	<i>N/A</i>

ACORN MEMBER COUNTRIES- A BRIEF LOOK AT SIZE AND SCOPE OF OPERATIONS

(2008 Data)

Country	Poverty Penetration Percent*	National Poverty Percent	Number of MFIs
India	5 %	29 %	223
Mexico	21	18	98
Peru	18	53	89
Kenya	5	52	28
Dominican Republic	6	42	15
Honduras	7	51	34
Argentina	1	17	18

*Calculated as the number of borrowers divided by the population of the poor.

Source: MIX Market Country Profiles + 2008 MFI count

In each country, the total deposits pale in comparison to loans outstanding. This further drives home the point that microfinance, as we understand it, is **primarily microcredit**. The poor are encouraged to take out small loans to use as investment in an enterprise of their creation from which profits can then be used to pay off their debts. Another way to think about it is as the **purchase of self-employment**, that is, the poor are buying their own livelihoods. These enterprises supposedly create cash flows that allow the borrower to *pull themselves* out of poverty and into a better life. However, the sad reality is that while such success stories exist, many who take out microcredit loans remain poor and, as was seen in Andhra Pradesh, some even end up worse off.



The above tables also show that many of the partner countries of ACORN International have high national poverty rates, but the percentages of microcredit borrowers (the penetration rates) are not very large. This tells us that there are still many poor people in these countries that do not have access, are not using, or have no interest in microcredit. It also may be the case that the elaborate and expensive infrastructure to support microcredit does not exist where they are, particularly in the cities. Unfortunately these groups are increasingly seen as untapped markets for unrealised profits by the increasingly commercial microcredit sector.

It is to protect these groups from exploitation that this report will call for interest rate caps and regulation of privately funded MFIs that deal with the very poor.

Interest Rates

If you were to take out a mortgage on your house today (August 2011), you probably would balk at any interest rate in the United States for example that was much higher than 5%. A credit card paying above 20% interest would be seen as absolutely usurious. So how can it be that microcredit institutions are allowed to charge **25-55% median nominal interest rates** to the world's poorest borrowers? Taking into account that inflation cancels out some of the effects of a high interest rate,^{xviii} real rates remain in the 20-30% range *and never decrease even as borrowers prove by repayment that they have increased their creditworthiness*. Due to long payback periods and lack of an opportunity to pay off a loan earlier than scheduled, the *effective interest rates* (EIR) are even higher than those quoted above.^{xix}

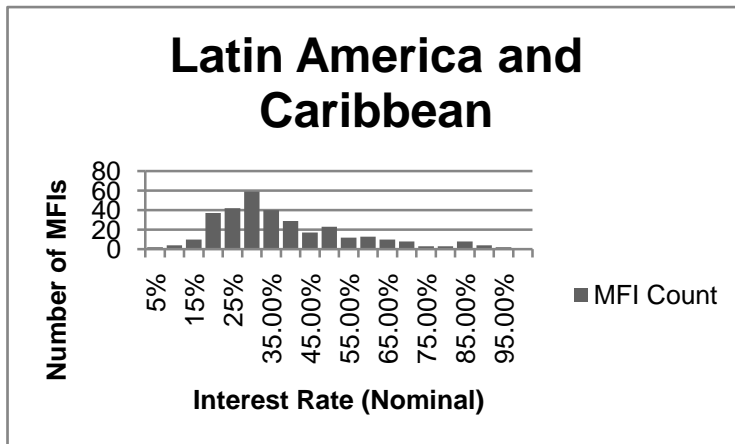
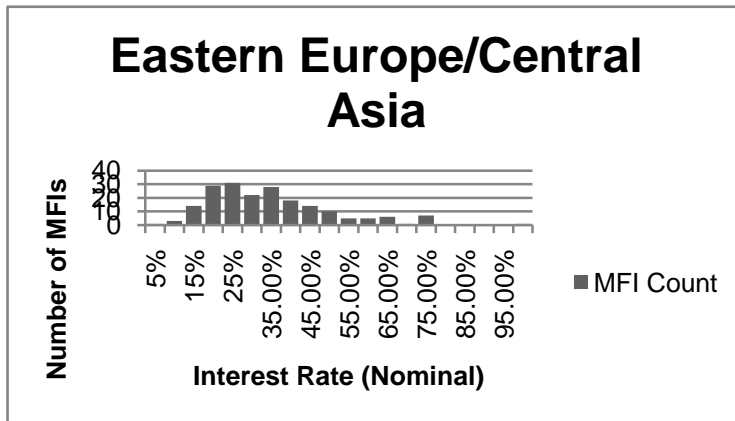
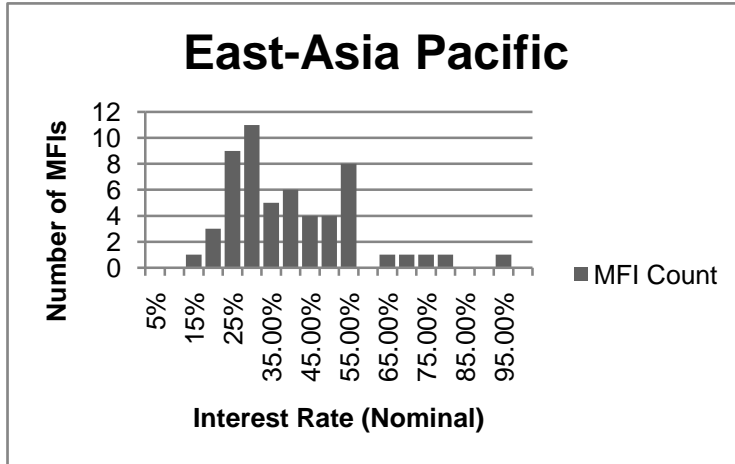
Additionally, microcredit loans often include extra costs of borrowing in the form of upfront administrative costs and forced deposits which drive up the real *cost of borrowing to the client*. By their nature, microcredit institutions tend not to require collateral for a loan. To offset risk they often require the borrower to leave a portion of the loan in a savings account until the loan is paid off. Some attempt to justify this practice by claiming that the borrower will be earning interest on their deposits and enjoying the security of institutionalised savings. However, *it is important to remember* that the money deposited *is part of the principal loan amount* and thus *interest is being paid on it*. Since the interest on the loan is greater than the interest received on the savings, *the actual cost of borrowing to the client is increased even further without any change to the quoted APR*. Can you imagine your bank demanding a portion of your loan *back* and then charging you interest on it? Without regulation in the microcredit sector such practices are common, and there is no other way to regard them, than predatory.

Most MFI clients have very little understanding of interest rates. They often lack knowledge of what an interest rate *is* in the first place, let alone how the quoted rate on their loan has been set. Anecdotally, when interviewing borrowers of the Grameen Bank in Bangladesh, one of the authors of this report was almost unanimously told by bank staff that clients were attracted to Grameen because of their low interest rates. However, when clients were asked what the interest rate they paid on their loan, very few (if any!) could give a correct answer and many were confused by the question.

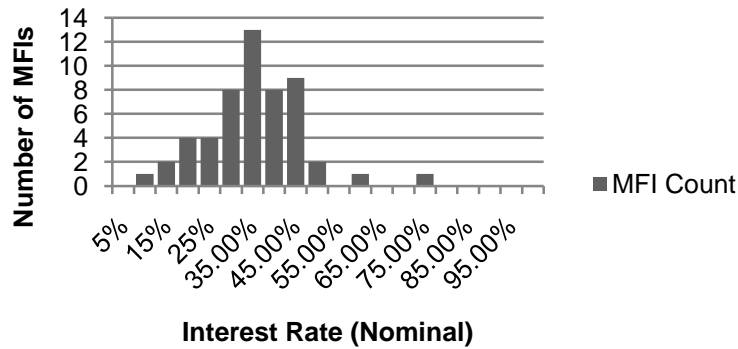
This evidence makes it clear that **APR is not the best way to think about the cost of a microcredit loan since the real cost to the borrower is actually much greater.**

However, since we lack an apples-to-apples comparison for microcredit interest rates, APR is the best tool we have at this time. While keeping the points in mind about the costs not reflected in APR quotes and calculations, we can interpret regional nominal interest rates. (Nominal, rather than real, interest rates have been utilised to create these graphs because while real interest rates reflect the cost to the lender, *nominal rates better reflect the **upfront cost the borrower perceives when taking the loan***).

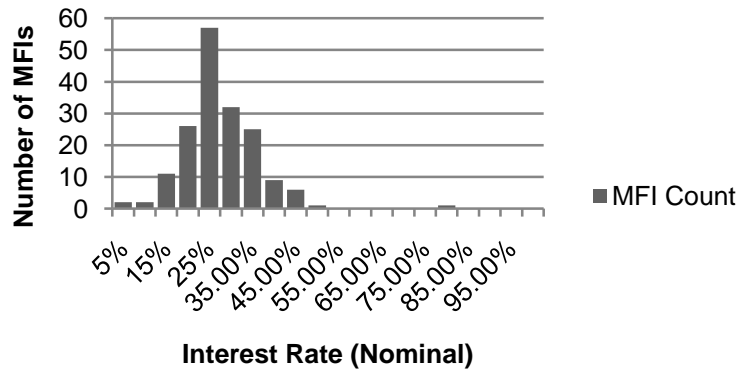
Regional Interest Rate Spread (Inflation not being taken into account)



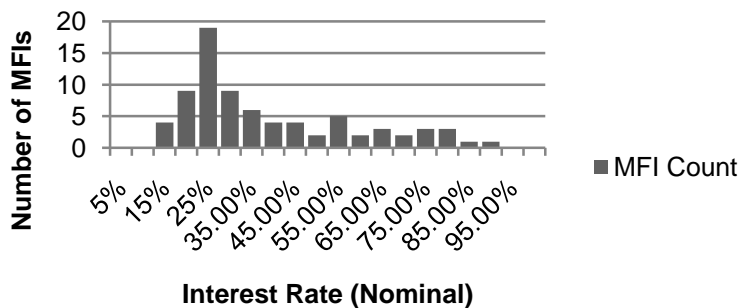
Middle East/North Africa



South Asia



Sub Saharan Africa



Source: Data courtesy of David Roodman^{xx}

It is important to remember that there *is no single interest rate for a given MFI* since there are different loan products offered by each institution and payback periods are structured differently. Furthermore the microcredit sector is *notoriously opaque in disclosing the rates of interest charged to borrowers due to all the various extra*

fees/charges/practices and problems listed above, therefore, the construction of the above graphs was time consuming and cumbersome.

It is because of the extreme opacity of the sector that MFTransparency (MF standing for Microfinance) was founded in 2007, an initiative that is attempting to get to the bottom of microcredit interest rates around the world. After almost five years they still do not have completed data for every country so the search for transparency is very much an ongoing one.

Despite all of this, the above graphs offer a good representation of the interest rate spread and the main message is clear:

MFIs around the world tend to charge nominal interest rates in the 25-55% range and while there are those who charge lower rates, the data all skews towards higher rates.

Why Do We Accept Such High Rates?

Why does the international community accept charging the world's poorest such high rates especially when most people would never consider paying such rates themselves?

This is a very important question.

One argument made by many MFIs is essentially that they could be worse. They claim that simply because they charge lower rates than informal moneylenders (whose APRs can easily reach 100-200%), they are the better option for the poor.

However, we must be very sceptical of these claims. When undertaking the research for Portfolios, the authors found that many who took the very high APR loans from the informal moneylenders only held the money for a short period of time (sometimes as little as a few days). Thus while the *annual* interest rate is high, if one looks at the transaction as requiring a fee for borrowing money on the spot, it can become a much better deal. Obviously there are loan sharks taking advantage of the desperation of the poor, but it must be recognised that these very short term informal arrangements are often much more convenient and fair to the poor than the drawn-out microcredit loans.

Having debunked the myth that an MFI can get away with charging high rates simply *because they offer the lowest alternative*, we can look more closely at *why* MFIs charge such high rates to begin with.

The Mexican MFI, Compartamos, openly makes profits that are **three times the profits of the average Mexican bank.**^{xxi} Putting aside the ethics of using the poor as a market for such excessive profits in the first place, to make *three times as much* off of the poor than the well-off is completely indefensible. With rates above 80% it is clear that there is profiteering and there is *just cause for immediate cutting of interest rates*. Compartamos is not the only MFI in the field that is charging rates *far above* operating cost and thus extracting massive profits off of the poor. We refuse to quibble. Such MFIs **should be singled out as unethical and forced to cut their rates**. Also, **they should definitely**

not receive any public money since it is clear that they are more than capable of sustaining themselves. They plainly choose to take the money as predatory profits and this should be roundly renounced as sector and market pariahs.

In 2011 Mohammad Yunus wrote an opinion piece in the *New York Times* lamenting the commercialisation of microfinance and its 'mission drift' away from its original mantra of poverty reduction. In this article Yunus also suggests that interest rates not exceed 15 percentage points above the cost to procure the funds lent by the bank. The extra 15% is meant to go towards operating costs and, yes, profits, in order to expand the MFI and better serve more customers^{xxii}.

Such an argument sounds reasonable and would definitely rein in interest rates worldwide. However, as the Microfinance Information Exchange (MIX) points out, if such a cap were instituted, many MFIs would go under.^{xxiii} Yunus defines MFIs that operate with interest rates over 15% higher than the cost of their funds as being within a 'red zone' which includes 'moneylenders' and 'loan sharks'. **MIX has found that 75% of MFIs worldwide fall into this 'red zone', especially those who work with the most poor and are not-for-profit.**^{xxiv}



Understanding the divergence between Yunus's metrics and most MFIs is not easy. Yunus is arguing that *profits* are driving high interest rates (as is clear in the case of Compartamos). *However*, a study by MIX has found that **operating costs are 63%** of all costs that need to be covered by borrower deposits and interest rates. Financial costs are 21% and *profits are less than 8% on average*. In fact, only 5% of MFIs have been found to be making returns of over 10-15%.^{xxv} One study found that among financially self-sufficient MFIs in 2006, eliminating all profits and passing savings onto customers would lower interest rates *by just one seventh*.^{xxvi}

Finally, since the cost of obtaining funds for loans is normally out of an MFI's control, it seems as though **cutting operational costs is a key to cutting interest rates**. Easier said than done! Because of the nature of microcredit methodology where the bank *goes* to the clients rather than the other way around, there are going to be attendant higher operating costs. Add to that the small amounts of money in loans and deposits as well as the significant risk that comes with giving collateral-free loans and **operating costs are going to be high almost by definition**.

In fact, rather than curbing exorbitant profits by capping interest rates *we are preventing MFIs from covering their operating costs*. The microfinance sector itself is acutely aware of what regulation could do to their business model. This is reflected in the Centre for the Study of Financial Inclusion's annual 'Microfinance Banana Skins' report^{xxvii} that highlights potential problems within the microfinance sector as identified by practitioners, analysts and regulators themselves. A major concern in 2009 of many MFI practitioners was 'irresponsible regulation' which, in short, refers to interest rate caps being instituted, such as the one proposed by Yunus, by those who believed they were capping profits when instead they were merely preventing MFIs from covering their costs.^{xxviii} An example of what these MFI's would call 'irresponsible regulation' can be seen in the response of the Andhra Pradesh authorities to their 2010 microcredit crisis. The Melegam Committee

Report^{xxxix} capped interest rates at 24-26% and many in the microfinance industry worldwide warned that such caps would drive many MFIs under.^{xxx} As proof of the perceived negative effects of interest rate caps one can look at the sharp drop in collection rates for SKS in Andhra Pradesh since the Melegam Report.^{xxxi}

It is clear that for most MFIs, in order to survive (whether deliberately profiteering or not) interest rates for the poor might need to be much higher than those in the formal financial sector, though this questions the viability and usefulness of microfinance period. There is never a rational argument to save the bathwater and drown the child!

However, just because profiteering is not taking place does not mean that the desperately poor are not being preyed upon. If these high interest rates are the 'best the MFI can do' given their high operating costs then should we blindly settle and accept the situation as 'best' for the poor?

The answer to this question is no, most definitely not. When there is no conclusive proof that access to credit is the answer to poverty reduction, there is no justification for MFIs. In fact it is not difficult to begin to understand why some are seen in the areas in which they work as nothing more than formalised criminals.

Interest rate caps are an absolute necessity and must be implemented immediately! An MFI needs to either lower its rates to an ethical level or get out of the industry altogether.

Sustainability

One of the major reasons microcredit has received so much political global support is its alleged sustainability. Rather than simply being a 'charity-case', microcredit is seen as not only covering costs, but also making a profit and fuelling its own scalable expansion. Because of this perception of self-sustainability, there is overwhelming bipartisan support for microfinance in the US. For example, year in and year out the U.S Congress appropriates more money to fund microfinance than is requested by the president. For his Fiscal Year (FY) 2012 budget, President Obama has requested \$155 million be set aside specifically for microfinance (a figure that is very much in the same vein as previous requests of both his and President George W. Bush's administrations). In FY2010 Congress voted to appropriate \$265 million to microfinance, substantially more than had been requested by the president.^{xxxii} The politically popular nature of microfinance means that next year's appropriation will probably be greater than requested again.



Let's tell the ugly, sad truth to power: **microfinance is not the self-sustaining model that the public thinks it is. Such funds are better spent elsewhere.**

In looking at a typical MFI we can see why the current microfinance model is not sustainable. Since the majority of microfinancial activity is *microcredit*, an MFI needs to

obtain the funds to use as loans for their clients. Because an MFI has to cover operational costs (such as salaries and other administrative expenses), it needs to make some return on the loan asset, and this is most easily done by charging interest. As we have discussed, the problem here is that the higher operational costs of an MFI require interest rates to be charged that reach predatory levels.

Not all MFIs are charging astronomical rates, so how do those who have lower interest rates do it? There are several answers to this question, but none of them are satisfactory enough to bolster microcredit as universally beneficial.

First, when microcredit began as a tool for development, many MFIs accepted donations. Those who did not receive donor support often obtained easy credit through soft loans with low interest rates or were backed by investors (public or private). The big picture is that **most MFIs enjoy or have enjoyed a subsidy of some form**. Despite being over 10 years old, the 1999 estimate that *95% of MFIs would have to drop out of the market if subsidies were outlawed, and those that stayed would not be the ones serving the most poor* is still a valid cause for concern today.^{xxxiii}

In the quest to cut operational costs it is good to look at the microfinancial model developed originally in Bolivia and now worldwide of the Foundation for International Community Assistance (FINCA) whose 'village bank' has very low staffing and administrative cost. The 'village bank' is run by the villagers in groups of around 25-50. They are given a sum of money and then parcel it out as loans among themselves acting as both the staff and the clients.^{xxxiv} However, even by 'outsourcing' the staffing of the bank to the clients themselves, FINCA's village banks *still take losses and many **only recoup 70% of their initial costs***.^{xxxv}

In 2010 the Centre for the Study of Financial Innovation (CSFI) published its 'Microfinance Banana Skins' alerting many to the risk of 'naked swimmers' in the wake of the international economic crisis decreasing the funding for microfinance.^{xxxvi} A 'naked swimmer' was an MFI that had been floated by the enormous amount of liquidity in the microfinance sector prior to 2008, but was highly unsustainable and would sink below water and drown when the safety net was taken away (interestingly enough, the fears and hesitations expressed in the 2009 Banana Skins survey reflected a greater fear of having *too much funding and too high expectations*).^{xxxvii} It was thought then that the micro-financial sector would be protected from the 2008 global financial crisis because it was supposedly not part of the formal financial system. Unfortunately this has been proven not to be true. Because of the enormous amount of cross-border funding microfinance enjoys (\$3.2 billion being disbursed in 2009 alone) when donor/investor countries struggle, MFIs also struggle.

The most resilient MFIs were those who took deposits as well as offered loans. While deposits make an MFI more sustainable, they are also liabilities because the *institution* has to *pay interest to the depositors*, hence deposits are a liability rather than an asset. Some countries, particularly India, do not allow MFIs to hold deposits because it would mean treating them like banks and regulating and guaranteeing their balances like the formal sector. India's retention of public sector banks' power over deposits demonstrates yet another reason micro-deposits are not universally popular.^{xxxviii} Demand for loans has also increased as remittance flows have gone down and food and fuel prices have gone up

in the recent economic climate. All of these pressures on MFIs, and the basic problem of their unsustainable business model, have caused the authors of the CSFI Banana Skins 2010 Survey to describe the tone of the sector at present as 'ominous'.^{xxxix}

Bringing the Message Home

Before we look more deeply into the funding of such an 'ominous' sector it is important to bring the issue home to ACORN International affiliate countries.

The following 2009 data show the top three largest microfinancial institutions in each partner country, their income or loss, total donations and nominal interest rates. (Information from MIXMarket; nominal interest rate data courtesy of David Roodman; donations are in 2009 U.S. dollars.)

INDIA

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income (Loss)	Nominal Interest Rate
SKS	\$36,862,434	-0-	\$36,862,434	25.8%
Spandana	\$43,126,416	-0-	\$43,126,416	25.8%
Bandhan	\$15,598,169	-0-	\$15,598,169	22.2%

MEXICO

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income	Nominal Interest Rate
Compartamos	\$148,614,410	-0-	\$148,614,410	74.6%
Financiera Independencia	\$35,761,294	-0-	\$35,761,294	105.7%
Caja Popular Mexicana	(\$43,142,663)	-0-	(\$43,142,663)	19.3%

PERU

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income (Loss)	Nominal Interest Rate
Crediscotia	\$30,110,954	-0-	\$30,110,954	43.7%

MiBanco	\$32,148,676	-0-	\$32,148,676	31.5%
Financiera Edyficar	\$16,722,968	-0-	\$16,722,968	33.8%

KENYA

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income (Loss)	Nominal Interest Rate
KWFT	\$3,431,750	\$629,957	\$4,061,708	36.7%
Faulu-KEN	(\$921,452)	\$284,329	(\$637,122)	31.7%
SMEP	\$863,866	\$69,404	\$933,271	33.8%

HONDURAS

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income (Loss)	Nominal Interest Rate
FUNDEVI	\$5,390,791	0-0-	\$5,390,791	19.9%
World Relief HND	\$51,422	\$2,973	\$54,395	43%
FUNDAHMICRO	\$17,866	0-0-	\$17,866	41.1%

DOMINICAN REPUBLIC

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income	Nominal Interest Rate
Fondo Esperanza	(\$80,024)	\$1,189,774	\$1,109,750	35.9%
ASPIRE	\$492,193	\$245,693	\$737,886	49.1%

ARGENTINA

MFI	Pre-Donation Post-Tax Income (Loss)	Donations	Final Net Income	Nominal Interest Rate
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Pro Mujer- ARG	(\$295, 531)	\$382,058	\$86,527	75.2%
FIE Gran Poder	\$124,480	-0-	\$124,480	53.9%
Cordial Microfinanzas	(\$1,111,894)	\$247,220	(\$864,675)	63.8%

While on the whole subsidies have determined elsewhere that they facilitate lower interest rates, the above data show no such clear relationship. Even with donations, interest rates are high and revenue may still end up negative even with such help. If there is one message to take from the above tables, it is that microcredit users in ACORN International's countries do not face a very sustainable or ideal situation in any way, shape or, nor are they served by a model that warrants replicability.

Funding

We have so far painted a very bleak, confusing and, to use CSFI's word, ominous picture of microfinance as it is today. Taking a close look at how the industry actually works and what problems they face it becomes very clear that there is *no conclusive way to argue that microfinance is a universal good*. While we lack conclusive evidence that microfinance is a universal bad (though there are more than enough horror stories to go around) we also lack conclusive evidence that it is positive. The international community should treat microfinance with an abundance of caution and scepticism because even after all these years, the industry has yet to prove itself, and if anything, over the past few years has shown signs of imploding.

*Knowing these facts, it becomes all the more outrageous to review how much money is committed to the microfinance sector each year. In 2009 alone, **\$21.3 billion were committed with 70% (\$14.6 billion) being from public sources.**^{xl} Only in Latin America and the Caribbean is public funding rivalled by private funding (54% to 46% respectively). Worldwide, private funders have increased by 33% compared with a public growth rate of 17%. In Africa, private funders increased their commitments by a whopping 63%!^{xli}*

Cross-Border Funding Overview

REGION	OVERALL FUNDING COMMITMENTS*	Public		Private	
		Dollars	Percent	Dollars	Percent
East-Asia/Pacific	\$1.5 billion	\$950 million	63.0 %	\$550 million	37.0 %
Sub-Saharan Africa	\$2.5 billion	1.9 billion	76.0	\$600 million	24.0

Middle-East/North Africa	\$800 million	700 million	87.5	\$100 million	12.5
Latin American/Caribbean	\$4.7 billion	2.5 billion	53.0	\$2.2 billion	47.0
South Asia	\$4 billion	3.4 billion	85.0	\$600 million	15.0
Eastern Europe/Central Asia	\$6.2 billion	4.2 billion	68.0	\$2 billion	32.0

* 'commitment' defined as funds *set aside* for microfinance, whether disbursed yet or not

These figures make it clear that **microfinance is a massive industry propped up and fuelled by huge volumes of foreign capital flows.**

To bring the picture home to ACORN countries we've made a table that gives an idea of the volume and dynamic of funding in our member countries.

ACORN Partner Countries' Funding

COUNTRY	AMOUNT PLEDGED (2009 USD)	CHANGE FROM 2008
INDIA*	Over \$1 billion	Up more than \$20 million
MEXICO**	\$300-500 million	Down more than \$20 million
PERU**	\$300-500 million	Up more than \$20 million
KENYA	\$100-300 million	Up more than \$20 million
DOMINICAN REPUBLIC	\$100-300 million	Down \$5-20 million
HONDURAS	\$50-100 million	No Change
ARGENTINA	\$2-5 million	No Change

Source: CGAP 2010 Microfinance Funding Survey

*India receives 65% of total funding for South Asia

^a Mexico and Peru receive more than 1/3 of all funding for Latin America/Caribbean

It should be clear that ACORN countries have a vested interest in the microfinance sector because MFIs (and the international funding community) seem to have a vested interest in them. In fact, while there is funding for micro-financial activity in over 123 countries, **just ten countries represent 50% of cross-border commitments (including India, Peru and Mexico!)**^{xlii}

Besides the sheer scale and scope of cross-border funding, it is equally (if not more) important to look at *the nature of* these funding commitments. Of the commitments **88% of the funding is meant to directly finance loan portfolios.**^{xliii} The rest is meant for capacity building, but it is clear that most money goes directly to providing liquidity for lending. Very importantly to add to this fact is that **66% of commitments are made in the form of debt.**^{xliv}

Put these two facts together and you have a horrifying situation: **MFI**s are being given immense amounts of money which they then have to *pay back* and the only way they can do this is through collecting interest on loans they give out. This creates incentives to over-lend in an irresponsible manner and to charge higher interest rates in order to recoup costs. This crisis of “affordability” is precisely the problem at the heart of the subprime lending debacle on mortgage lending to low-and-moderate income and other families that led to the financial crises in the United States. Grants are the other popular form of funding commitment, but they are far less significant.

Types of Funders and Commitment Levels

Type of Funder	Commitment (USD)	Percentage of Total	Commitments in Debt (Percent)	Commitments in Grants (Percent)
Multilateral/UN*	\$4.116 billion	19.4%	88%	11%
Bilateral Funders ^o	\$1.585 billion	7.5%	11%	86%
Foundations/NGOs	\$1.116 billion	5.2%	20%	60%
Investors	\$5.594 billion	26.3%	22%	n/a
DFI ^a	\$8.852 billion	41.6%	60%	2%
Total	\$21.26 billion			

*Includes the World Bank

^a Development Finance Institutions. Includes AECI (Spain's Agency for International Development Cooperation), EBRD (European Bank for Reconstruction and Development) and KfW (German-government owned development bank)

^o Includes CIDA, USAID, DFID, AusAID etc

Source: CGAP Funding Survey 2010

NOTE: Investors commit 78% in the form of equity, DFIs commit 21% in the form of equity



This table gives a good indication of the popularity of debt for the majority of cross-border funders. Another important point not to overlook is that investors fund 78% in the form of equity which creates additional incentives for the MFI to over-lend and charge higher interest rates. As was seen with SKS in India and Compartamos in Mexico, when MFIs put themselves on the market they are then answerable to their shareholders and thus incentives become perverse and money that should be used to increase outreach and encourage better service ends up going into the pockets of shareholders. If all this was not scary enough, there is a final bubble that exists in the microfinance industry that has arisen alongside the private sector's increasing commitments. It was reported that 85% of private commitments went through a Microfinance Investment Intermediary (MII).^{xlv} A major form of MII is the Microfinance Investment Vehicle (MIV) which in 2005 had assets of \$1.5 billion, but by the end of 2009 *this had become \$6 billion!*^{xlvi} That is a 400% increase over four years. If this did not seem unsustainable and bubble-like enough, in 2009 MIVs reported that they were only able to place **one-half of their assets with MFIs** leaving them with over \$1 billion in *liquid assets* at the end of the year.^{xlvii}

That there is so much money tied up in MIVs due to a lack of opportunity to place it with MFIs puts the nail in the coffin of cross-border microfinance funding: there can be no question that microfinance is an unsustainable bubble in an extremely over-heated sector.

Unresolved Contradictions and Alternate Realities

Despite microfinance's over forty years of experience a thorough review of the philosophy and reality of the industry still leaves some inevitable head scratching when all is said and done.

It is mystifying given the wide consensus of the international chattering class of politicians and policy makers in international development that there is no clarity about whether or not the microfinance "model" is best suited or applicable to urban or rural families. Having federated country organizations deeply embedded in both Latin America and India, ACORN International was confounded at the dogmatic arguments repeatedly advanced at one extreme in Argentina, for example, that microfinance was totally untenable in rural areas, while as fervently argued in the south Asian context of India and Bangladesh that microfinance was not sustainable in urban areas. The Argentinean position was constructed from an experience that the distances in rural areas were too great to be sustainably served and the community "social capital" too strained while the South Asian position was as adamant that community was stronger in rural areas and too disparate in

the urban context. Ironically to ACORN International neither seemed to advance the role of community based organization in the success and failure. This is largely because the commitment to organization in either model was not really about empowerment or community cohesion as much as it was about pure and simple collection mechanisms. Though we are now highly sceptical of all microfinance claims, we are profoundly concerned that at the developmental and donor policy and decision making level there is little recognition that there is even a dispute around adaptability of microfinance models or any urgency to resolve the urban/rural divide. Certainly the public has no appreciation that there is any difference or distinction whatsoever, and offers both its political support, and sometimes, its financial support as well through Kiva and other vehicles without any recognition of due diligence in this area.

Equally surprising to us after so many decades of activity is that there is no international "list" or comprehensive sorting by countries and locations of the entities involved in microfinance. With so many billions at play, ostensibly in a major frontal assault against poverty, the inability of any agency or organization, whether governmental or membership-based like ACORN International, to be able to determine whether or not microfinance institutions are serving the communities and mega-slums where we operate and therefore accessible to poor families in these areas is astounding. The poor cannot be expected to crawl through the eye of a needle to access the "heaven" of credit assistance. Furthermore when public dollars are involved, the requirement for both transparency and accessibility should be the least assumption underpinning financial justice for the poor.

All of this creates an aura of sketchiness for the sector. The deeper we delved into the world of microfinance, the millions and billions involved, the marginal to non-existent benefits for the poor, and more, the more ACORN International found itself confronting narratives of a totally alternate reality. The most prominent scenario that emerged was that nothing about microfinance is fundamentally about poverty reduction. Instead the entire industry, including the public and private subsidies and "investments" involved, is simply a series of high priced pilot projects designed to create private financial institutions and products for the poor at no risk and investment to existing private financial institutions. When the developmental expenditures from donors and others determine that the "model" is sustainable, then investors cash in greedily as we have seen with SKS and Compartamos. Where that has not happened, we have the mess and "ominous" mayhem that ACORN International found permeating the sector.

If microfinance is not about reducing poverty, then the development cost of creating new financial institutions should plainly be borne solely by private investors and existing financial institutions and their capital, whether publicly or privately owned and operated. There is no rational reason that ACORN International can discern that distinguishes why existing banks and other financial institutions should be able to *de facto* discriminate against the poor by not lending to qualified borrowers at fair and reasonable rates of return.

The substitution of microfinancial institutions in this role seems to encourage and abet such blatant discrimination, creating precisely the same "red-lining" situation that was the focus of so much activity in the United States that it led to the passage in 1977 of the Community Reinvestment Act (CRA) and the companion requirements to provide annual reports through the Home Mortgage Disclosure Act (HMDA). The argument spurring passage of these acts by the U. S. Congress was that banks were amassing deposits from

low income and minority communities and then refusing to provide lending to these same families and communities. In fact, they were using the surplus capital of their deposits to finance expansion of home construction in suburbs and other communities. The decision of private financial institutions, though usually publicly chartered and supervised, in all of our countries to effectively refuse to make the poor “banked” and then when accepting the deposits of low-and-moderate income families to refuse to loan to them according to their needs and requirements, even at smaller levels of microcredit enterprises, is unconscionable. This has only created a public and donor subsidy for outright lending discrimination pursued under the colour of poverty reduction.

Microfinance is a morass that is now devouring the most exalted aims of its mission in the quicksand of its contradictions and realities.

Action

Based on the argument above there are several immediate courses of action that should be demanded of the international community:

- **No public money should be used to fuel the overheating microcredit sector.** Until recently, the success of an MFI was judged on *how many* borrowers it had rather than *the outcomes* of the loans. We can see now that bigger is most definitely not always better, and in many cases can lead to things that are much worse. Public money is meant to be spent on initiatives that have been conclusively proven to make positive steps towards reducing poverty. Microcredit is no such initiative and in many cases has even caused the quest for worldwide poverty alleviation to step backwards. Such sentiments have *already been expressed* by the United Kingdom’s All Party Parliamentary Group on Microfinance who, in their 2011 inquiry report, have recognised most of the issues brought up in this report and have called for DFID (the UK’s version of USAID or CIDA) *not to fund microcredit loan portfolios*.^{xlviii} ACORN believes this call not to fund loan portfolios should be echoed to agencies that deal with public money worldwide.
- **Interest rates should be capped at non-predatory levels.** Yes, this means that some MFIs will then not be able to cover their operational costs and some microcredit organizations will go under. If that is the case, so be it. If an MFI cannot offer credit to the world’s most vulnerable without charging predatory prices then it should not be allowed to float itself on the payments of the world’s poor.
- **A regulatory framework for remaining MFIs needs to be put in place.** Since the private sector is increasingly involved in microfinance there are greater numbers of commercial MFIs around the world who do not have the goal of poverty alleviation as a second bottom line. Such businesses should be recognised as such and not given any special privileges of being able to ‘fly under the radar’ as if they were providing a social service. MFIs are financial institutions and should be regulated as such.

Conclusion

We have dug deeply into the reasoning behind interest rates and despite pleas of the ‘necessity’ of such high rates in order to cover operating costs at the end of the day, rates that high cannot be seen as anything but predatory. This is Strike One.

We have looked closely at how an MFI covers its costs and have found that in reality, many simply cannot. Even when charging usurious interest rates many MFIs still turn to subsidies and donations in order to fund their loan portfolios and continue to expand their customer base (*their* definition of success). This is Strike Two.

We have blown the lid off the international funding commitments finding that enormous amounts of public money are being committed every year to an industry that has never been conclusively proven to be a tool for poverty reduction and has contributed to a number of horror stories alongside those of success. That most of this funding is in the form of debt further drives the point home that the incentive to over-lend and charge higher interest rates in order to payback funding is strong and extremely perverse in the grand scope of what microfinance is *supposedly* meant to accomplish.

This last point makes it Strike Three and **Microfinance has swiftly struck out.**

It is time that we accept the cold, hard evidence in front of us and realise that the international funding community has been barking up the wrong tree. There may be some truth in the argument that financial services can make it that little bit easier to *be* poor, but **it is time that the world stop pretending that by using microcredit you won't remain poor.** Those \$14.6 billion of public funds that were *committed* to microfinance in 2009 are just that: committed. Nothing is set in stone yet and there is always time for us to admit our mistakes and put that money towards something less predatory and more productive. It is still not too late, but the time to act is now.

About ACORN International

ACORN International (www.acorninternational.org) is multi-national federation of more than 60,000 low-and-moderate income families working in eleven countries. ACORN International works in directly affiliated countries include Peru, Canada, Mexico, Dominican Republic, Argentina, India, Kenya, Honduras, Korea, Czech Republic, and the United States with additional partnerships in Indonesia, Philippines, and Italy. With work largely concentrated in mega-slums in the majority of its countries, ACORN International largely works on "survival" issues to win potable water, community services from road paving to school and park construction, decent and affordable housing, social security, and access to equitable health and education resources. Globally, ACORN International has concentrated on financial justice for the poor through its Remittance Justice Campaign (www.remittancejusticecampaign.org) and its current research concerning microfinance and fair trade. ACORN International has also been involved in campaign support particularly in India through the India FDI Watch Campaign (www.indiafdiwatch.org) and the effort to win justice for those displaced by the Commonwealth Games (www.commonwealthgamescampaign.org). For more information on affiliating your organization, directly organizing, or assisting ACORN International as an organizer, researcher, intern, or volunteer, contact Wade Rathke at chieforganizer@acorninternational.org.

About the Authors

The primary researcher and author of this ACORN International campaign and research report is Melanie Craxton, currently an economics student at Edinburgh University in Scotland, along with Wade Rathke, Chief Organizer, ACORN International. Special thanks to Melanie who brought her experience working with Grameen Bank in Bangladesh in 2010 and her time, energy, and skill to ACORN International as an intern in New Orleans in the summer of 2011.

NOTES

- ⁱ MIX Market (<http://www.themix.org/about/microfinance>)
- ⁱⁱ Grameen Bank (http://www.grameen-info.org/index.php?option=com_content&task=view&id=22&Itemid=109)
- ⁱⁱⁱ Nobel Prize Foundation Press Release 2006 (<http://www.muhammadyunus.org/Announcement/press-release-from-the-nobel-prize-foundation/>)
- ^{iv} MIX Market (www.mixmarket.org)
- ^v MIX Market MicroBanking Bulletin (<http://www.themix.org/publications/microbanking-bulletin/2011/05/excessive-microfinance-growth>)
- ^{vi} CGAP 2010 Funding Survey (http://www.cgap.org/gm/document-1.9.49412/Cross-border_funding_to_microfinance_2010.pdf)
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- ^x CGAP (<http://www.cgap.org/p/site/c/template.rc/1.26.4905/>)
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- ^{xii} Financial Times (<http://www.ft.com/cms/s/0/304915e8-d7b1-11df-b478-00144feabdc0.html#axzz1OuKCbCY9>)
- ^{xiii} Wall Street Journal Blog (<http://blogs.wsj.com/indiarealtime/2011/05/09/south-asias-microcredit-crisis-drags-on/>)
- ^{xiv} Nominal interest rates do *not* take inflation into account. They are the interest rates ‘as stated’.
- ^{xv} UK All Party Parliamentary Committee on Microfinance’s 2011 Inquiry (<http://www.appg-microfinance.org/files/Summary%20report.pdf>)
- ^{xvi} Banerjee, Duflo, Glennerster and Kinnan, ‘The Miracle of Microfinance?’ (<http://econ-www.mit.edu/files/4162>)
- ^{xvii} MIX Market (<http://www.themix.org/publications/microbanking-bulletin/2008/12/how-many-mfis-and-borrowers-exist-updated-dec-2008>)
- ^{xviii} If there is inflation, \$100 today will not be worth \$100 tomorrow, it will be worth less. Therefore if someone lends me \$100 today, when I pay them back \$100 tomorrow they are losing value. Inflation benefits borrowers and hurts lenders. As an extreme example, if you have borrowed money at 4% interest and inflation is also 4%, then it is as if you are paying 0% on your loan. This is good for you, but not for the person who lent you the money because they make no gain. It is because of this that high inflation can lead to high interest rates.
- ^{xix} While a blanket calculation of EIRs for various MFIs is a near impossible task (as they all differ so much in structure and practice), it is intuitive that EIRs are greater than quoted rates because they take in account the time value of money.

Money that is tied up in a pay-back schedule is not available to be used for day-to-day expenses. This opportunity cost can be of crucial importance to those with such miniscule incomes.

^{xx} David Roodman is a senior fellow at the Centre for Global Development, an independent and non-profit think tank. He has spent the past few years researching and writing an 'open book' on microfinance which is set to be published later this year. He provided the interest rate data that was used in the construction of these graphs.

^{xxi} CGAP (<http://www.cgap.org/p/site/c/template.rc/1.26.4905/>)

^{xxii} Mohammad Yunus in New York Times Opinion (http://www.nytimes.com/2011/01/15/opinion/15yunus.html?_r=1)

^{xxiii} MIX MicroBanking Bulletin (<http://www.themix.org/publications/microbanking-bulletin/2011/01/sacrificing-microcredit-unrealistic-goals>)

^{xxiv} MIX MicroBanking Bulletin (<http://www.themix.org/publications/microbanking-bulletin/2011/01/sacrificing-microcredit-unrealistic-goals>)

^{xxv} MIX MicroBanking Bulletin (<http://www.themix.org/publications/microbanking-bulletin/2011/05/microfinance-profits>)

^{xxvi} Rosenberg, Gonzalez and Narain, 2009 (http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1401476)

^{xxvii} CSFI 'Microfinance Banana Skins 2010' (<http://www.csfi.org.uk/Microfinance%20Banana%20Skins%202009.pdf>)

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^{xxix} The Melegam Committee Report is the response of a sub-committee of the Reserve Bank of India that was created in October of 2010 specifically to look at microfinance in direct response to the Andhra Pradesh crisis.

^{xxx} Microfinancefocus.com (<http://www.microfinancefocus.com/content/rbi-releases-malegam-committee-report-microfinance>)

^{xxxi} Wall Street Journal Blog (<http://blogs.wsj.com/indiarealtime/2011/05/09/south-asias-microcredit-crisis-drags-on/>)

^{xxxii} Centre for Financial Inclusion Blog (<http://centerforfinancialinclusionblog.wordpress.com/2011/03/29/us-foreign-aid-faces-the-axe-whats-at-stake-for-microfinance/>)

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(<http://www.jstor.org/pss/2565486?searchUrl=%2Faction%2FdoBasicSearch%3FQuery%3Dmicrofinance%2Bpromise%26acc%3Doff%26wc%3Don&Search=yes>)

^{xxxiv} FINCA
(http://www.finca.org/site/c.6fIGIXMFJnJ0H/b.6088437/k.FEF1/What_is_Microfinance_What_is_Village_Banking.htm)

^{xxxv} Murdoch, 'The Microfinance Promise'
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^{xxxvi} CSFI 'Microfinance Banana Skins 2010' (<http://www.csfi.org.uk/Microfinance%20Banana%20Skins%202009.pdf>)

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^{xxxviii} Huffington Post (http://www.huffingtonpost.com/elisabeth-rhyne/on-microfinance-whos-to-b_b_777911.html)

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^{xi} CGAP 2010 (http://www.cgap.org/gm/document-1.9.49412/Cross-border_funding_to_microfinance_2010.pdf)

^{xli} CGAP 2010 (http://www.cgap.org/gm/document-1.9.49412/Cross-border_funding_to_microfinance_2010.pdf)

^{xlii} CGAP 2010 (http://www.cgap.org/gm/document-1.9.49412/Cross-border_funding_to_microfinance_2010.pdf)

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^{xlvi} MicroRate Survey quoted in Microfinancefocus (<http://www.microfinancefocus.com/news/2010/07/23/microfinance-investment-vehicles-have-unsustainable-levels-of-liquidity-microrate/>)

^{xlvii} MicroRate Survey quoted in Microfinancefocus (<http://www.microfinancefocus.com/news/2010/07/23/microfinance-investment-vehicles-have-unsustainable-levels-of-liquidity-microrate/>)

^{xlviii} UK All Party Parliamentary Committee on Microfinance's 2011 Inquiry (<http://www.appg-microfinance.org/files/Summary%20report.pdf>)

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