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# The Importance of Funding Channels for Microfinance Performance

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# THE IMPORTANCE OF FUNDING CHANNELS FOR MICROFINANCE PERFORMANCE

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## Abstract

This paper studies the importance of microfinance funding channels by analyzing how for-profit and non-profit microfinance institutions' performances differ in practice. Generally all MFIs seek financial sustainability in order to avoid reliance on external funding and increase efficiency. However, for-profit MFIs tend to rely more heavily on standard economic assumptions established by the neoclassical economics model, shifting the priority away from the social and economic development process among poor communities to the final product of loan repayment enjoyed by such institutions. By contrast, non-profit MFIs attracting donors contributions tend to focus more closely on shifts in social dynamics within communities they sponsor leading to higher development enjoyed by such communities in the long run.

*Key words:* For-Profit MFIs, Funding Channels, Microfinance Performance, Non-Profit MFIs

## Introduction

Microfinance is a source of financial services for people in need (Littlefield, 2003; Mersland, 2010; Morduch, 1998). Such services can vary from bank saving accounts to development financing. Microfinance is mostly associated with the provision of micro loans called microcredit (Littlefield, 2003). Microfinance was developed due to the systemic lack of banking infrastructure in poor, developing communities (Littlefield, 2003; Ngo, 2012). However, microfinance is different from traditional banking services because it does not require its clients to have collateral that guarantees future loan repayment (Vakulabharanam, 2007; Werner, 2010). Microcredit loans and other monetary services are provided through microfinance institutions (MFIs).

This research specifically focuses on funding channels that create two types of microfinance institutions: for-profit MFIs (funded through investments) and non-profit MFIs (funded through donations). Funding channels create structure and incentives under which MFIs operate. The focus on microfinance funding channels is necessary because there has been a significant increase in the number of for-profit microfinance institutions (Quayes, 2012), despite the fact that the microfinance sector was developed to operate through non-profit institutions (Roberts, 2013).

This research aims to analyze microfinance performance by focusing on how MFIs operate. Special attention is given to concrete strategies MFIs use to perform, such as outreach, joint liability and entrepreneurship. Furthermore, MFIs are studied through the lens of the neoclassical economics model. The aim is to analyze how the neoclassical economics model influences microfinance performance through strategies mentioned above. Finally, the importance of funding channels and its relationship to the neoclassical economics model is

established by analyzing a series of case studies for the purpose of distinguishing between for-profit and non-profit MFIs and their performance for empowering poor communities.

This research does not collect or analyze numerical data, nor does it perform its own case studies on microfinance communities. Therefore, it shall be stated that relying on data that has already been published, this research only creates a theoretical framework that can be used to further expand on microfinance performance. It is my best intention to analyze the most recent case studies in order to evaluate the present stage of microfinance performance. Yet, this research uses a variety of sources to build on MFIs operations.

I argue that in order for communities sponsored by microfinance institutions to achieve higher levels of social and economic development it is necessary for MFIs to go beyond the neoclassical economics model and focus on shifts in social dynamics that signify how and in what direction a community as a whole is moving to escape the poverty trap.

This research is divided into three sections. The first section analyzes the neoclassical economics model as the base for financial sustainability among microfinance institutions. The second section focuses on microfinance institutions' operations, specifically analyzing outreach, joint liability and entrepreneurship strategies. The aim of this section is to critically analyze how MFIs perform while seeking financial sustainability. The third section compares funding channels of MFIs and presents case studies in order to analyze how for-profit and non-profit statuses affect overall microfinance performance. The paper concludes with a discussion of the case studies' results and their significance for evaluating microfinance performance.

### **Understanding Microfinance through the Assumptions of Neoclassical Economics**

Microfinance institutions tend to rely on standard economic assumptions, considering their loan recipients as rational agents who seek profit maximization. Moreover, only when clients succeed at maximizing their profits, can MFIs receive loan repayments and, respectively, achieve financial sustainability (Morduch, 2000). Therefore, the neoclassical economics model offers a concept based on profit maximization that guarantees financial sustainability for microfinance institutions. But most importantly, the neoclassical economics model through standard economic assumptions creates social and market structures that undermine the importance and intrinsic value of the process, and rather concentrates on the end results (Anderson, 2012; Lawson, 2013).

The neoclassical economics model creates a keystone for financial sustainability that microfinance institutions operate on. It is also called financial self-sufficiency, which sets the capacity to operate based on revenue and growth (Ayayi, 2010; Quayes, 2012). MFIs need financial sustainability in order to avoid full reliance on their funding channels (investment and donations).

While financial sustainability is not a matter of criticism in the field of microfinance, the connection between neoclassical economics assumptions and financial sustainability deserve attention, as do the way MFIs tend to achieve self-sufficiency (Hermes, 2011; Littlefield, 2003; Kabeer, 2005; Mersland, 2010; Morduch, 1998). Microfinance institutions are criticized for seeking financial sustainability through profit maximization because it shifts the focus away from the progress and places it on the end result. This is also called the “one size fits all” model, meaning the exact same approach to development is implemented in all communities. However, this model undermines the importance of the development process, which is heavily affected by

unique social dynamics and pre-existing stages of social and economic development that differ across communities.

Moreover, while profit maximization might satisfy MFIs' agenda, there is no guarantee that it leads to social and economic development among communities MFIs sponsor. In addition to that, it must be stated that ideally the goal of microfinance in alleviating poverty goes further than simple profit maximization, focusing on wealth accumulation that helps to build up such factors as human and social capital, and social institutions.

The next section will analyze how microfinance institutions rely on standard economic assumptions of the neoclassical economics model in order to achieve financial sustainability. More specifically, to what outcomes among communities their performance leads.

## **Microfinance Institutions' Operations**

### **Outreach**

Microfinance performance is centered on MFIs' capacity for outreach, meaning the capacity of MFIs to locate potential loan recipients. Effective outreach is essential because developing communities lack banking infrastructure (and for that matter very much infrastructure at all), which signifies their inability to obtain services they need (Kabeer, 2005; Littlefield, 2003). As a result, microfinance institutions reach out to the "core poor" - people who most require microfinance assistance (Hermes, 2011). Furthermore, outreach programming is based on the following concept: "The poor have skills that remain unutilized or underutilized but suffer from a lack of capital and cannot access to funding for their business" (Monroy, 2013). Therefore, to provide them with financial services, microfinance institutions create international

and regional networks to identify communities that need microcredit loans for their development (Kabeer, 2005).

The necessity for outreach by MFIs is clear, but the manner in which some MFIs reach out has drawn criticism. Specifically, MFIs are criticized for not actually providing services to the “core poor” (Hermes, 2011). The charge has some validity, and the reason for this failing lies in the imperative to achieve financial sustainability (Hermes, 2011; Morduch, 1998).

However, before delving into this issue, it is necessary to take a step back and expand discussion on social structure within developing communities. A person needs to acquire human capital in order to perform a task. Human capital stands for knowledge and skills (Littlefield, 2003; Maldonado, 2008). In addition, given the fact that humans are social beings, a big portion of all tasks in one way or another is connected to social institutions. Social institutions are a set of norms of behavior that are acknowledged and accepted by everyone in a community (Ostrom, 1990; Taylor, 2011). The combination of both human capital and social institutions leads to successful completion of a given task. In the case of microfinance services, people in poor, developing communities need to obtain human capital and social institutions regarding profit maximization. Without knowledge, skills and social norms necessary for adequate microcredit loan investments, people are not able to make profits. Microfinance institutions rely on the standard assumption that the “core poor” lack human capital and social institutions required for profit maximization. Respectively, the inability to maximize profits leads microfinance institutions to associate the poorest communities with higher loan write-off rates, which limit the ability of MFIs to achieve financial sustainability (Morduch, 1998). As a result, MFIs tend to shy away from lending in truly “core poor” environments.

The criticism does not stop here, as there is literature in the microfinance field that establishes poor microfinance performance in terms of development achieved among targeted communities and financial sustainability. Microfinance institutions tend to perform worse in regions and communities that already have certain level of development. Furthermore, the inefficiency among MFIs is positively correlated with economic development in regions and communities where such institutions operate (Vanroose, 2013). Higher developed communities are more suitable for MFIs' financial sustainability goals, since they are able to increase loan repayment rates. Yet, such communities do not require as much microfinance assistance, because they have greater access to traditional banking infrastructure. MFIs are unable to shift development among communities with existing financial infrastructure through the provision of microcredit loans. Respectively, operating in higher developed communities signifies inefficiency among MFIs (Vanroose, 2013).

In *Why Doesn't Microfinance Work*, Milford Bateman (2010) explains how economic development within communities correlates with MFIs' inefficiency. Bateman (2010) points out that people who require microfinance assistance the most are those with very little to no economic development - the "core poor." Respectively, given their rudimentary stage of development, they can benefit from micro loans the most, since the progress they need to achieve does not cost much in absolute terms. Yet, the "core poor" have little chance to obtain microfinance assistance. By contrast, people who do receive microcredit loans potentially cannot benefit from them as much as the "core poor," because they already have a certain level of development (it is also a reason why MFIs target them). Such development also means that they require higher loans in order to achieve further progress. For this reason, Bateman (2010) argues that microfinance institutions are more inefficient in terms of delivering progress to communities

with developed economic infrastructure. By contrast, they can be efficient in achieving development among the “core poor” communities (Bateman, 2010).

Outreach is an essential component of microfinance performance. Ideally, the goal of MFIs is to target the “core poor” communities for two main reasons. First, people in such communities require microfinance assistance the most. Second, such communities require very little in absolute terms in order to achieve the next stage of social and economic development - which is the goal of microfinance (*i.e.* to alleviate the initial poverty trap). Yet, due to the financial sustainability goal, MFIs choose not to sponsor the “core poor” communities to avoid loan risks, instead targeting safer communities that already have economic development and can guarantee loan repayments.

### **Joint Liability**

Joint liability, also called group lending, is one of the most successful loan provision models implemented by microfinance institutions. The model is based on establishing joint commitment, social capital and social institutions among microfinance communities (Ghatak, 1999; Hossain, 2008; Mayoux, 2001; Ngo, 2012).

Through joint liability, people in the same community form groups in order to receive microcredit loans. Loans are provided to an entire group, while allocation and distribution of a loan is left to its members, and depends on their communal needs and decisions (Kabeer, 2005). In addition, members of a group take responsibility for each other’s shares of a loan. In cases when a member is not in a situation to make a repayment of his share, other members take responsibility for repaying his share. Furthermore, unless the entire loan is payed back to a

supporting microfinance institution, the group cannot receive a new loan (Ghatak, 1999; Hossain, 2008; Ngo, 2012).

Group lending creates joint commitment, due to which members of a group become more responsible and accountable to each other in terms of their loan investments. It is also called the peer pressure mechanism, under which members monitor each other to ensure the success of an entire group (Kumar, 2012; Monroy, 2013). Joint commitment and peer pressure are thought to promise social capital and social institutions, while protecting the donor against nonpayment in an environment of high transactions costs and little collateral from borrower. Social capital stands for the ability of a group to create networks and relations with each other for mutual benefit (Anderson, 2002; Hossain, 2008). As members of group lending acquire necessary knowledge and realize potential positive outcomes from adequate loan investments, they create communal infrastructure that includes development regarding social order and economic progress in terms of new small scale businesses (Littlefield, 2003).

Group lending also helps to eliminate the problem of adverse selection that comes from the outreach program (Kumar, 2012). In the field of microfinance, adverse selection is an information asymmetry according to which MFIs choose to sponsor those clients who can show their ability to make future loan repayments. This means people with no collateral (the “core poor”) are not suitable clients for MFIs. But joint liability takes the focus from individual responsibility away and shifts it to group responsibility. As a result, those people who otherwise would not receive individual loans due to adverse selection are able to obtain financial services through group lending (Kumar, 2012).

Nevertheless, microfinance institutions are criticized for implementing group lending strategy for their own interests, and not for the creation of development through social capital

and social institutions. Joint liability, through joint commitment creates social collateral, which works as an assurance for loan repayment (Chakravarty, 2015). Furthermore, MFIs do prefer joint liability over individual liability for the exact same reason - social collateral. In addition, through joint commitment and peer pressure mechanism group lending enforces members to maximize their profits in order to repay a loan. Microfinance institutions value this, since it guarantees them financial sustainability (Ayayi, 2010; Monroy, 2013).

Moreover, microfinance institutions use a progressive lending (also called step lending) in order to secure loan repayment rates (Kumar, 2012). As part of the progressive lending, MFIs offer higher future loans after the initial loan is fully repaid. This creates incentives for clients to achieve higher profit maximization in order to obtain next bigger loan.

Ideally joint liability creates many positive outcomes; such as the creation of social capital and social institutions, as well as it takes adverse selection off from the loan provision (Ghatak, 1999; Hossain, 2008; Littlefield, 2003; Mayoux, 2001; Ngo, 2012). It is evident that microfinance institutions have their own incentives to implement group lending that do not include any of the mentioned above. As part of financial sustainability, MFIs artificially create conditions and incentives that pressure loan recipients to seek profit maximization. But whether profit maximization leads to the actual development among poor communities is yet unclear.

## **Entrepreneurship**

Entrepreneurship is the core component of profit maximization, and for that reason it is highly valued by microfinance institutions (Bateman, 2010; Pisani, 2015; Quayes, 2012; Shahriar, 2015). Furthermore, the outreach program and the joint liability strategy are both implemented by MFIs in order to create conditions under which entrepreneurship becomes

possible. Among microfinance communities entrepreneurship produces a variety of outcomes that benefit not only entrepreneurs themselves, but also communities. There is a positive correlation between entrepreneurship and economic development among poor communities (Shahriar, 2015). Through self-employment, entrepreneurs are able to obtain human capital necessary for profit maximization. Moreover, the entrance of new businesses in a community creates social capital and social institutions, leading to higher standards of communal development (Pisani, 2015).

Nevertheless, there are setbacks to self-employment that lead to market saturation, higher debt and inability to accumulate wealth among entrepreneurs (Bateman, 2010). First, it is necessary to expand on the economic structure within developing communities in order to understand how factors such as market saturation and lack of wealth accumulation occur.

Market saturation stands for the growth of a particular business or category of goods and services until it reaches its maximum consumption rate. In the case of microfinance communities, market saturation occurs when multiple entrepreneurs open businesses that provide the same category of goods or services. The very first business in its category is able to maintain high consumption due to the scarcity of the good or service provided. However, the entrance of other businesses in the same category diminishes demand for that good or service from the original business, usually resulting in a price reduction due to competition. It leads to market saturation, as the highest consumption rate enjoyed by each business is met (Bateman, 2010). Once such rate is met, it is necessary to improve the product or service in order to attract new buyers.

Product improvements can be achieved through economies of experience and economies of scale. The economies of experience theory suggests with factors such as availability of

resources, trade and market openness, higher productivity can be achieved (Oatley, 2008). To achieve economies of experience, it is necessary to establish networks with other businesses in the area that provide intermediate products, as well as trade within the market in order to gain production expertise. The economies of scale theory suggests that with increase in production, cost per unit of good or service decreases (Oatley, 2008). Once economies of experience and economies of scale are achieved, a business can decrease the price of a unit without sacrificing its profits in order to attract more buyers. In addition, a business is able to improve its products in order to maintain an increasing consumption rate. In the case of self-employment within microfinance communities, entrepreneurs are not able to achieve neither economies of experience, nor economies of scale for the following reasons. First, due to the lack of infrastructure and economic development, there are not enough resources that can be obtained. Second, there are not enough businesses within poor communities that can supply intermediate goods at a relatively low price. Third, developing communities do not have extensive market trade with the outside world in order to gain production expertise. As a result, entrepreneurs in poor communities are very limited in regards to how much they can increase their production, decrease price per unit of good or service and improve their products.

Together, market saturation and the inability to achieve economies of experience and economies of scale lead to market competition between entrepreneurs within developing communities. The result of this competition does not produce winners, but instead forces every business to leave the market in order to avoid future losses. Respectively, many entrepreneurs within developing communities end up with debts due to the inability to expand their businesses (Bateman, 2010).

Self-employment leads to potential individual and communal benefits among poor communities in the beginning of microfinance operations there (Bateman, 2010). In the long run, if a community as a whole does not achieve higher level of social and economic development, increase in the number of entrepreneurs rather leads to negative outcomes (Shahriar, 2015).

Microfinance institutions are criticized for encouraging self-employment and profit maximization among communities they sponsor, as they try to achieve financial sustainability. MFIs rely too heavily on standard economic assumptions and the “one fits all” model, which undermine the process of wealth accumulation necessary for poor people to escape the poverty trap.

### **Microfinance Institutions’ Funding Channels**

When first introduced, the microfinance concept was intended to operate as a non-profit institution. However, recently there has been a significant growth in the number of for-profit microfinance institutions (Chakravarty, 2015; Quayes, 2012; Roberts, 2013; Shahriar, 2015). For this reason, it is important to study the difference between the two types of funding channels in order to further expand on microfinance performance and the potential relationship between two.

According to Roberts, “In 2009, 490 of the 1,169 MFIs (or 42%) covered in the MIX Market database were for-profit MFIs and they collectively controlled roughly two-thirds of the more than \$65 billion worth of assets deployed in that year.” (Roberts, 2013). There is concern regarding the increasing number of for-profit MFIs because it is unclear whether such institutions can successfully operate in the sector that was intended to be non-profit. Specifically, the following criticism of “whether it is possible to effectively blend non-profit ideals and for-profit orientations, and practices” is being raised (Chakravarty, 2015; Roberts, 2013).

To study the relationship between funding channels and microfinance performance this research forms a hypothesis, consisting of two parts that can be tested through further analysis of case studies:

1. For-profit microfinance institutions heavily rely on standard economic assumptions of the neoclassical economics model, seeking financial sustainability, resulting in lower levels of social and economic development in the long run among the communities they sponsor.
2. Non-profit microfinance institutions go beyond standard economic assumptions of the neoclassical economics model focusing on social dynamics achieve higher level of social and economic development in the long run among communities they sponsor.

For-profit, also called profit-oriented microfinance institutions are funded through investments (Chakravarty, 2015; Shahriar, 2015). The majority of investments originates from corporations and can be either of external or internal sources. This type of funding creates a structure for microfinance institutions that is centered on investments and profits. As a result, for-profit MFIs are motivated to expand on potential gains from their investment in order to make profits. Profit-oriented microfinance institutions also experience greater influence from outside of the sector, meaning their investors, which plays an important role for the overall performance among such MFIs. Therefore, for-profit MFIs' efficiency is measured in their ability to make profits and be financially sustainable (Chakravarty, 2015; Shahriar, 2015).

On the opposite end, non-profit microfinance institutions are funded through donations (Chakravarty, 2015; Quayes, 2012; Roberts, 2013; Shahriar, 2015). Such MFIs are not centered on profit maximization. Respectively, their performance is measured not in profits from investments, but rather in monitoring the social dynamics development among the communities

they sponsor. From a donor view, non-profit MFIs' efficiency depends on the ability to empower poor, developing communities and present evidence of such empowerment. Furthermore, inflow of funding (donations) depends on donors' satisfaction in MFIs' success at achieving their stated objectives.

Before going any further it is important to clarify that all microfinance institutions seek financial sustainability, given the nature of the sector. Therefore, funding channels and MFIs' status as for-profit or non-profit does not lead to institutions being more financially sustainable or less. Respectively, the argument and the hypothesis this research raises is that for-profit MFIs do focus primarily on profit maximization factor in order to achieve financial sustainability. While non-profit MFIs while still seeking to be financially sustainable, go beyond profit maximization and focus on social dynamics development among communities they sponsor.

Sugato Chakravarty and Mariya I. Pylypiv (2015) in their study, "The Role of Subsidization and Organizational Status on Microfinance Borrower Repayment Rate," use available data from two major sources on microfinance activities (Microfinance Information Exchange and the World Bank) to analyze how external funding channels affect MFIs performance. More specifically, this research focuses on how for-profit and non-profit microfinance institutions differ in regards to their repayment rates among loan recipients. Chakravarty and Pylypiv (2015) aim to learn how funding channels (investments and donations) affect the relationship between loan recipients and microfinance institutions that support them. This research uses multilevel analysis to discover the following: "The results show that an increase in the number of borrowers leads to an increase in loan write-offs associated with for-profit MFIs and an increase in their total risk" (Chakravarty, 2015). This essentially means that for-profit MFIs that are funded through investments have higher outreach performance.

However, with an increase in the number of loan recipients, for-profit MFIs also experience higher loan risk associated with frequent write-offs. In contrast, “MFIs with higher donation-to-subsidy ratios have lower negative relationships with their respective portfolios-at-risk-at-30-days and lower total risk,” which means non-profit microfinance institutions funded through donations, while not having significant loan provision growth, nevertheless, have better performance in terms of loan repayments. Furthermore, Chakravarty and Pylypiv (2015) state that non-profit MFIs also have better institution-borrower relationships.

### **For-Profit Microfinance Institutions**

Peter W. Roberts (2013) in his work, “The Profit Orientation of Microfinance Institutions and Effective Interest Rates,” addresses the issue of how the increase in for-profit MFIs affects microfinance performance and efficiency. Roberts (2013) uses MIX data to perform analysis on how the growth and development of for-profit MFIs results in the fluctuation of microcredit loans interest rates, the outreach program performed by such MFIs and their overall efficiency. Multiple results were discovered through this analysis. First, as it was expected, the outreach program of for-profit MFIs has increased compared to the overall microfinance performance. However, with that Roberts (2013) points out that for-profit MFIs avoid targeting rural clients. Respectively, such results indicate that the overall number of loan recipients has risen, yet, the overall outreach performance in terms of targeting the “core poor” has not. Another important result signifies the increase in loan interest rates. Even though Roberts (2013) does not provide concrete evidence on how it affects the institution-borrower relationship, it can be argued that it does not lead to positive outcomes. Furthermore, Roberts (2013) points out a very important condition which is necessary for MFIs to outreach and increase their efficiency. It is being

competition between microfinance institutions, due to which interest rates can go down and in practice benefit loan recipients. This in fact should be the main goal for microfinance in general. However, for-profit MFIs do not allow such competition to happen, keeping interest rates high. With that, the paper concludes on rather surprising finding: "...distracting managers from addressing the specific needs of their poor clients, the stronger profit orientation leads MFIs away from the efficiency frontier". As Roberts (2013) points out, such factor is an example of X-inefficiency - a theory developed by Harvey Leibenstein. The X-inefficiency theory suggests that a firm's expected behavior regarding development does not match its actual status. There is no concrete evidence to why this occurs. Nevertheless, Roberts (2013) argues that even in theory for-profit MFIs are not associated with higher profitability when compared to non-profit MFIs. This respectively raises a question: "Why at all to create and support for-profit MFIs if they are keeping high interest rates for loan recipients and do not maximize profits?" (Roberts, 2013).

Abu Zafar M Shahriar, Susan Schwarz and Alexander Newman (2015) in their work "Profit Orientation of Microfinance Institutions and Provision of Financial Capital to Business Start-Ups" also focus on the analysis of the rising number of for-profit MFIs and their particular role in sponsoring small scale start-up businesses. More specifically, this paper analyzes how funding channels (investments and donations) motivate to either sponsor start-up businesses or rather avoid loan risk. Shahriar et al. (2015) uses multivariate analysis to compare how for-profit MFIs view different types of businesses, varying from small scale to bigger and more developed projects. In addition, the analysis also showcases how such MFIs view their profits regarding the provision of loans to different types of businesses. Shahriar et al. (2015) mention that results signify the following: "...the rate of lending to start-ups is much higher among not-for-profit MFIs compared to for-profit MFIs". To further elaborate on this, results do not claim that for-

profit MFIs do not want or do not help small scale business start-ups, but they are more interested in profits they can make from lending loans to more mature business developments, than non-profit MFIs. Finally, Shahriar et al. (2015) claim that in performed analysis there are no other variables that could suggest for-profit MFIs behavior rather than reaching for profits and avoiding loan risks.

### **Non-Profit Microfinance Institutions**

Nompumelelo Thabethe, Vhumani Magezi and Mandla Nyuswa (2011) performed a case study “Micro-credit as a community development strategy: A South African case study”, which is based on The Men’s Project in Africa (also known as TMP). TMP is a community based non-profit microcredit institution which was established in 2003. It operates based on donations and grants. TMP focuses on internal social dynamics and gender norms in communities it targets. The reason it is called “The Men’s Project” is due to social gender norms in South Africa, according to which men have more power than women. While the majority of MFIs choose to empower women, TMP takes a very different approach on addressing social problem of gender inequality. TMP believes that in order to shift the gender hierarchy in KwaZulu-Natal region it is essential to educate men who hold the power in the first place. Another important factor which makes TMP such successful example is the fact that it focuses on monitoring how loan recipients make decisions regarding allocation and distribution of incoming financial services. For many micro loans recipients, including those in Kwa-Zulu-Natal region financial services are new, which means recipients do not have necessary social and economic skills for the proper allocation of loans. Therefore, the outcome of microfinance performance depends on the outreach and provision of loans, but also on whether recipients are able to learn and create social

institutions that are essential for adequate investment. This complex framework resulted in the creation of group lending. A group consisting strictly of men was provided with a loan. The group was consistently monitored by TMP specialists to record how social dynamics are shifting. Results showcase progress achieved by the group as a whole in acquiring knowledge regarding loan investment. Furthermore, it resulted in the creation of local businesses which tend to benefit not only their owners, but the entire community.

Michael J. Pisani (2015) performed a case study “Microfinance in Rural Haiti: A Case Study of Institutional Start-Up & Microenterprise Development”, which is based on a non-profit MFI run by only two people. This case study is based on HAPI-Kredi which is a non-profit MFI created as a result of Haiti earthquake in 2010. The entire budget of this institution was funded through church-centered charitable donations. HAPI-Kredi focuses on a specific region in Haiti - Mizak. This MFI uses the joint liability strategy and primarily targets women empowerment. Usually a group of three women receive loans in the following values: \$75 or \$100 or \$125. After overseeing for two years how this start-up is performing the following results were made. Compared to big for-profit MFIs, HAPI-Kredi is still struggling with the planning and structural foundation, which significantly limits outreach and overall efficiency performance. However, it already shows sign of improvement given the institution-borrower relationship which suggests that due to lower loan interest rates people of Mizak are able to obtain higher loans, repay them on time and continue cooperating with this institution.

### **Conclusion**

This research approached microfinance institutions’ operations through the neoclassical economics model, which is built on profit and utility maximization. It was argued that the

neoclassical economics model creates a keystone for financial sustainability based on which MFIs operate in order to avoid reliance on external funding and maximize efficiency. However, profit maximization (which leads to financial sustainability) is the “one size fits all” model, implementation of which in poor communities cannot be efficient due to unique social dynamics structure and pre-existing stages of economic development among microfinance communities.

The analysis of MFIs operations showed that while profit maximization creates conditions within poor communities for higher loan repayment rates, it does not always lead to social and economic development among sponsored communities in the long run. Therefore, the aim of this research was to expand on whether all MFIs are structured in the same way, under the neoclassical economics model. As the point of entry, MFIs were broken down into two categories based on their funding channels: for-profit MFIs (sponsored through investments) and non-profit MFIs (sponsored through donations). It was established that funding channels dictate the structure and incentives based on which institutions operate. This research formed a hypothesis, consisting of two parts: **1.** For-profit microfinance institutions heavily rely on standard economic assumptions of the neoclassical economics model seeking financial sustainability achieve lower level of social and economic development in the long run among communities they sponsor. **2.** Non-profit microfinance institutions going beyond standard economic assumptions of the neoclassical economics model focusing on social dynamics achieve higher level of social and economic development in the long run among communities they sponsor.

While the majority of literature on microfinance so far has been limited to only distinguishing between types of funding channels (Chakravarty, 2015). This research has gone further to analyze how in practice the status of MFIs (for-profit and non-profit) correlates with social and economic development among poor communities.

Results indicate that for-profit MFIs have higher outreach program in terms of the number of loans provided, when compared to non-profit institutions. However, non-profit MFIs specify more in targeting the “core poor” - people who require microfinance assistance the most. For-profit MFIs experience inefficiency (X-inefficiency) in their loan provision. This factor could be correlated with the following: for-profit MFIs have higher loan interest rates, which takes their loan repayment rates down. On the opposite, non-profit microfinance institutions performance leads to higher efficiency due to lower loan interest rates, which respectively, brings loan repayment rate up. Finally, non-profit MFIs are able to create better networks and establish better institution-borrower relations with their clients, when compared to for-profit MFIs.

Results stated above signify that the hypothesis created by this research is true. While for-profit microfinance institutions seek financial sustainability by focusing primarily on profit maximization undermine the importance of progress among communities they sponsor. On the opposite, non-profit MFIs go beyond standard economic assumptions built on profit maximization, and rather focus on monitoring shifts in social dynamics are able to deliver economic development to poor communities in the long run.

Lastly, this research shows that funding channels are important for microfinance performance for a reason that they dictate the structure and create incentives that motivate MFIs to pursue different agendas.

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