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RESEARCH ARTICLE

THE EFFECT OF FOR-PROFIT ORIENTATION OF MFIS ON INTEREST RATES, PROFITABILITY AND SUSTAINABILITY

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ABSTRACT

Micro finance institutions are the financial institutions. their main aim is to provide the financial services to poor. their cost is divided into two variables 1. fixed cost 2. variable cost. their revenue is generated from interest on investments and comes from non lending activities and financial assets gain.they charged high interest rates and their cost is also high. they provided the small scale financial services to poor on sustainability basis. The sustainability is the primary issue for the success. I used the penal data in my research and used the data of different MFI's from different countries of South Asia. I take the data from MFI's website. the results show that the more number of female borrowers and small scale loans are not effective. Their profitability decrease if they increased in percentage.i used the fixed effect model and random effect model and my results are in significance relation.

INTRODUCTION

Global population is 7.125 billion, and even in 21st century around 4 billion people are not earning more than US$2 per day and this is the reason why approximately half population of the world is considered as poor (Microfinance Bulletin, 2008a, 7). Presently, United Nation Development Programmed (UNDP) through its 8 Millennium Development Goals is combating against poverty globally. These 8 goals are to be achieved by 2015 as set by UNDP. As noted in (Helms, 2006, ix), around 3 billion poor people had approached commercial banks to obtain financial assistance. However, almost all of them were rejected on the basis that they could not repay the loan. Commercial banks considered them as "un-bankable" on the grounds of having low incomes and this is what poor have faced for decades. As claimed by Robinson (Robinson, 2001, 9), 90% of the people from developing countries are unable to access financial institutions. However, Micro-financing has worked as the live savior for those who could not get benefited from the existing financial system. Undoubtedly, it could not spell a magic where poor can get rich in a couple of days, but at least, micro financing has helped poor to make an attempt to bridge the gap. Grameen bank which was chaired by Prof. Muhammad Yunus who received the Nobel Prize in 2006, explained that how micro financing can help poor practically. The first micro loan of Grameen Bank was issued about 30 years ago for a group of poor Bangladeshi women and since then microfinance market has become considerably huge even it has crossed the portfolio size of microcredit sector. This much pace proved that micro finance market can be very huge as compared to it is today. Besides, it made it explicit that how much needy the working poor are of financial assistance. Since then microfinance became the hot favorite for banks due to higher interest rates and most importantly due to almost 100% loan recovery. This is the reason why recent trend explains that commercialization of microfinance institutions (MFIs) has made this market another place from where investors can pocket interest taken out of the business of poor customers. The critics of "profitable" microfinance argue that loans for poor people should have to be subsidized instead. The reason being microfinance's mission is not to pocket interest but to help the poor workers to help them grow.

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Definition of Microfinance

MFIs, banking organizations, are considered as one of the vital ingredients in the development process of a country. The goal of any MFI is to offer a poor worker with an opportunity to access numerous financial services to help grow in developing countries. Small Size loans and little or no collateral, these two are the basic problems which MFIs made an attempt to overcome (Armendariz and Morduch, 2005). In order to remain competitive due to rapid growth of the market, most of the MFIs started introducing many new services and that explosion in the market encouraged MFIs to be nothing but profit-oriented. Whereas, the main objectives of the Microfinance institutions is to reach additional poor people of the population and make sure financial sustainability (Mersland & Strom, 2008a, P.663). Generally, when it comes to Microfinance, so it is more like a small loan which the borrower plans to invest in micro enterprises or other activities where income can be generated (Churchill and Frankiewicz, 2006, 18). Such infant enterprises are small retail cabin which includes small workshops like tailoring, woodworking shops and family run market stalls, established in home or a few made at any other place than home, not having more than five employees (Whole Planet Foundation, 2009). In Microfinance, micro-credit is still the most prominent financial service which poor workers are interest to acquire out of wide range of microfinance services. The amount of loan offered varies from region to region and it falls due within a year.

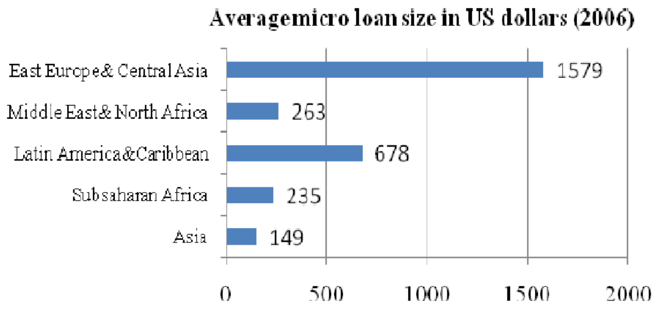


Figure 1. Loan size according to Swiss contact 2008

Generally, the borrowers include hawkers, small traders, farmers and service providers like small salon, drivers, small producers who are making artificial jewelry specifically, and those families having poor background. These families are considered as self-employed and it's not that they are located in any particular area but such families are in rural and urban areas both (Ledger wood, 1999, 2).

Due to being aware of responsibilities, women are considered as more reliable than men. Women compose bigger portion of the poor population as compared to men. Besides, women are still discriminated in many countries in work place and even society as well. Alongside, it is observed that increase in woman's income brings in additional benefits for family members and community as compared to benefits drawn in case of increase in man's income (Ledger wood, 1999, 38).

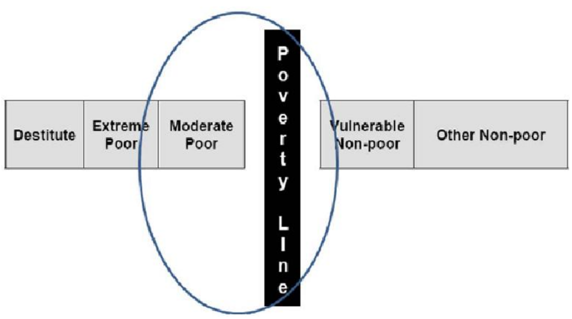


Figure 2. Defining the Poor based on CGAP 2003

Otero (1998) argues that MFIs are compelled to generate profits because this is what their investors demand however, alongside they should make sure that they do not stop serving the objective of micro-financing. Loan returns are estimated and set with great efficiency and this is what attracts investors however, the price should have to be appropriate enough which poor workers can pay off. Keeping balance in both aspects is one of the important ways to remain sustainable (Hermes & Lensink, 2007). The figure 2 above clearly indicates that microfinance service clients are those who are living near poverty line only. Besides, we can see that World Bank has made it clear that extremely poor people are still away of the microfinance services. However, the programs run by international donors on social safety net are helpful enough to reach extreme poor and destitute individuals (CGAP, 2003). Churchill and Frankiewicz (2006, 21-22) states that commonly known microfinance products list is the upcoming exhaustive list, and these include: Loans specifically borrowed by entrepreneurs, loans borrowed to meet unexpected expenses like family death or catastrophes, loans to buy house, to get the land on lease for farming, insurance, savings, financial and non-financial services similar to social intermediation, shop expansion, technical or non-technical assistance. Undoubtedly, microfinance service is good enough to help eradicate the poverty and help poor living better life.

History of Microfinance

Microfinance terminology is not a new terminology in finance. It was thought about in Europe, whereas Germany and Ireland more specifically. However, the chairperson of Grameen Bank redefined the microfinance sector and revived it with his focused and appropriate policies. He started operation in 1970s and since then Grameen Bank is expanding with considerable pace. In 15th century era of the Europe, the renowned Catholic Church was established to help spreading awareness about the loans at high interest rates. This Catholic Church called as pawn shop, later whole continent was its head quarter (Helms, 2006). Seibel described: "Europe, the place where informal finance and self-help was introduced, is considered as the origin of microfinance" (Seibel, 2005, 3). The history of microfinance brings forth the fact that inauguration of Indonesian People's Credit Bank was the largest microfinance institution in 1895 (Helms, 2006, 3). Prof. Muhammad Yunus distributed first micro loan, to rural women in Jobra in 1976, out of his pocket in Bangladesh (Yunus, 1999). It was his endless efforts which developed the microfinance a phenomenon for the market with the help of Grameen Bank, and later on made it global.

Profitability of MFI

MFIs are successfully generating considerable portion of their profits by issuing loans to small entrepreneurs. However, Asia, Africa, and Latin America, these places are considered as quite competitive markets and this is the reason why MFIs' profits have contracted considerably (Lascelles, 2008). Having said that, now we will analyze that what kind of cost MFIs incur, and what kind of revenues are generated by MFIs.

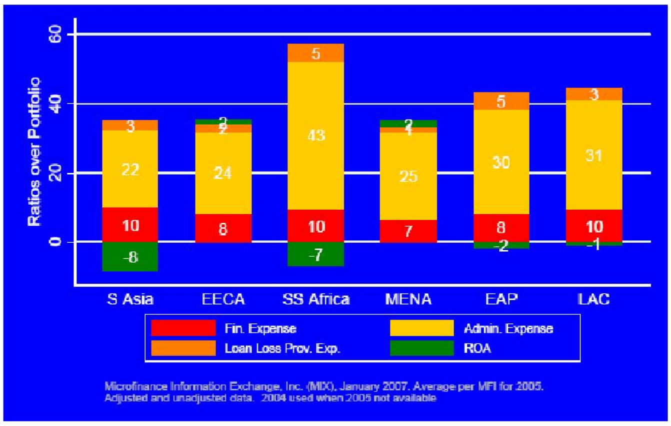
Cost

When any organization does business so it is compelled to incur cost, so does any MFI. Generally, costs are divided in to two costs, direct and indirect cost. However, in case of MFIs sometimes distinguishing costs is considerably difficult because associated activities also include non-financial services like consultancy, technical assistance, and training. The reason being these activities are necessary to incur to make sure a creditworthiness and risk minimization. Often, the cost which is incurred due to getting involved in marketing or helping people understand about the microfinance is offset by the earnings from micro-financing service. Following are the additional costs incurred in rendering the service are: salaries expense, training for employees, refunds to employees, transportation, loss provision, and cost of capital (Helms, 1998). Besides, just like any normal business activity, the MFIs cost are divided into two broad categories like fixed and variable cost (Churchill and Frankiewicz, 2006, 338). Besides, just like normal organizations these cost heads differ from one organization to another. Following figure will further highlight the various other costs categories:

Interest Expense	Utilities
Loan Loss Provision	Staff Training
Personnel	Repairs and Maintenance
Rent	Legal Services/Other Service Fees
Office Materials/Supplies	Bank Charges
Publications/Publicity	Taxes
Transportation/Travel	Depreciation
Telephone and Postage	Other
Insurance	

Figure 5. Cost categories based on Helms, CGAP 1998

Following figure shows that MFI's administration cost is a major costs component witnessed globally. The admin cost represents the borrowers' meetings, application processes and documentation costs incurred to issue loan to the borrower.



The loan provided to the borrowers is itself a money taken from investors and nothing comes for free. Therefore MFIs are under a pressure to make sure the repayment of microloans disbursed. Not only the repayment but opportunity cost should be given to investors therefore, estimating cost incurred is very crucial for any MFI (CGAP, 2001, 10). MFIs have started to take measures to reduce their admin cost by making sure that the distance between markets get reduced and under one administration additional work can be carried out which will result in lesser cost. This will not only help MFIs but borrowers will be able to secure loan at lower cost hence market will witness expansion. Besides, MFIs are making sure that their representatives should not be put in a situation where they are required to travel a lot because in this way cost incurred is directly charged to the borrower and results in additional cost (UNCDF 2009 and Churchill *et al*., 2006).

Revenue

The revenue is generated from the portfolio of loan which is obviously the core activity from which any MFI earns its revenue. This core activity includes interest income, commission and fees. However, revenue is generated from other sources as well. A normal size MFI is observed to allocate almost 3 quarters of its assets as loan used to generate interest income whereas around 1 quarter of the assets are invested in other activities to generate return from them as well (Microfinance Bulletin, 2008b, 22-29). So, cutting the story short, revenue comes from non-lending activities, financial assets gains, and interest from investment. Apart from the above mentioned revenue streams additional streams are service provisions, insurance service, and non-financial provisions like passbooks or Smart-cards sale containing gains from net exchange (Microfinance Bulletin, 2008b, 43). Besides, MFIs have the policy to maintain the savings account as a mandatory requirement for clients, so this amount is used to generate additional revenue stream. These accounts by clients are essential to get a loan. For instance, Grameen Bank has set the requirement for clients to contribute $0.86 every month in the pension savings accounts if they wish to get loan of $138 (Yunus, 1999, 240).

Following formula will help you in understanding the revenue sources:

Financial Revenue = Revenue from Loan Portfolio + Revenue from Other Financial Assets + Revenue from Other Financial Services (Microfinance Bulletin, 2008b, 32)

Loan portfolio formula is:

Revenue from Loan Portfolio = Interest on Loan Portfolio + Fees and Commissions on Loan Portfolio
(Microfinance Bulletin, 2008b, 32)

Actually, the interest earned on loan portfolio is representing the outstanding loan interest revenue. Whereas if we talk about fees and commission, so it includes penalties imposed on bank and commissions paid to officers selling loan service. Besides, donations is the another revenue stream which is recognized separately to explain the real and pure income earned. Big loans with high interest rates will undoubtedly help in generating more and more revenue for MFIs. However, if we look at this big loan situation from another perspective, so we can comment that what if these poor people fail in paying off big loans! Undoubtedly, MFIs will be in great trouble.

Interest rates

The portion which is considering for client is the interest rate, whereas for any MFI the same is of equal concern. Now, we will thoroughly understand it. Microfinance industry is criticized due to the fact that it charges higher interest rate as compared to commercial banks. In 2006, 24.5% interest is recorded as the average globally (CGAP, 2009, 7). However, globally there are organizations charging from 50% to 100%. (Sundaresan, 2008, 87) states that in comparison with the amount borrowed, it typically reveal the extraordinary 'all in' costs instead of MFI's high profits. Interest rates should have to be enough from which MFIs can get the functioning expenses, along with refinancing outflow and expected portfolio loss provision and inflation. Contrary, it is often said that it is high interest rate which has pushed industry upwards and expand widely due to the fact that numerous microfinance institutes were capable enough to get their costs back and use incomes to declare more loans to get the wider poor workers' population.

Generally, lender's income and borrower's cost, both, can be alleviated by imposing additional fees and commission. However, MFIs keep on struggling to make sure that fee and commission is as low as possible in order to remain competitive. Besides, an institution cannot get an advantage due to borrower's lack of knowledge because increasing knowledge has made them aware of financial matters. Therefore, ultimately the aim is to make sure that cost of capital for MFI's goes down hence interest rates will go down. It is definitely recommended that interest rates should be set at the point where at least a lender can generate more than or at least equal to principal lent per unit. Scholars do have the following formula to calculate the financial efficiency:

$r \geq (i+\alpha+p)\ (1-p)$

Let's start with r, here it means the interest rate imposed on principal's per unit, then I represents principal per unit cost of raising resources, α denotes the admin cost incurred to supervise the principal per unit lent and p interprets the principal and interest payment percentage due and unrecoverable (Khandker, and Khalily, 1995, 39).

Sustainability of MFI

The basic question which should be answered is, does in the long-run MFIs need support from donors or not? Along with this question another question regarding its sustainability should be raised because both the questions are interlinked. So, it could be said that sustainability of MFIs is not important as much it is important for micro-enterprise. However, our question is to examine MFI's sustainability so we will focus on that part only. The objective of existence of MFIs is to reach poor workers as far as possible in our societies who are putting enough efforts to make their lives better than before and to make it possible, sustainability and determination adopted by MFIs cannot be denied. However, critics do not agree with the argument because they claim that sustainability cannot be achieved by approaching poorest on the planet because MFIs will have to compromise either on sustainability or reaching poor. Broadly, sustainability is described as capacity of the organization to carry out its activities efficiently in the long run to keep the organization revive and stick to its statutory objective. Ideally, MFIs should take this as the capability to continue working as an institution which believes in developing rural poor (Khandker and Khalily, 1995, 36). Apparently MFIs are merely focusing on profitability earned through financial services, so it is important for them to make sure that costs are reduced over the period by taking strict measures in order to keep sector profitable.

Operational sustainability

Operational Self-Sufficiency (OSS) concept is accompanied by operational sustainability. It estimates percentage of operating revenue against financial and operating expenses encompassing loan loss provisions and other similar heads. As a result, if it generates 100% so it is clear that MFI is efficiently paying off cost from its revenues, which ultimately means not begging donors to help it in surviving (Churchill and Frankiewicz, 2006, 367).

OSS is calculated as:

$$\frac{\text{Financial Revenue (Total)}}{\text{(Financial Expense+ Loan Loss Provision Expense +Operating Expense}}$$

(Microfinance bulletin 2008a, 13)

So, if we sum it up, we can say that operational sustainability is the MFI's OSS future sustainability. Achieving OSS is very important for any MFI, and that's what make it one of the goals such institutes want to achieve, the reason being it leads to expansion in operations and presence.

Financial sustainability

Financial sustainability refers to the position where MFI is capable enough to cover all its costs. Besides, it further explains that MFI is firm enough to work for the foreseeable future without utilizing subsidies. However, United Nation Capital Development Funds or (UNCDF) helps in explaining the difference in amid OSS and FSS based on adjustment. Basically, FSS is a kind of indicator which estimates the size of operating expenses which are being covered by operational income of MFI. This ratio is calculated by using:

$$\frac{\text{Adjusted operating income}}{\text{Adjusted operating expense}}$$

(UNCDF, 2009)

MFIs are surviving in considerably competitive market so it is very important for them to recover both operational and financial costs so they can maintain their position firmly. When MFI is able to cover up its costs sufficiently, it becomes easy for the institute to generate more capital to offer and increase its loan portfolio. The growth is very much needed in MFIs operations because after all these institutes are working for poor and helping them grow (Rosenberg *et al*., 2009). Operating sustainability associated with the MFI depends on various factors laying inside and outside the organization. When we talk about inside factors contributing to success so these include good governance, transparency, cost allocation, and most importantly reaching breakeven point. At the same time, MFIs have to face conditions which are beyond its control and are commonly known as market conditions, these activities encompass low-cost, easy access to the poor who are economically active, an environment which is in support of the organizations so these can grow like interest rate ceiling and size of the loans (Dichter and Harper, 2007).

"Double bottom line" principle

Microfinance institutions focus providing small-scale financial services to poorer clients on sustainable basis. The sustainability of microfinance institutions is the primary issue for the successful Microfinance sectors. Microfinance institutions meet the "Double bottom line" outreaches the poor people and sustainability. MFIs are required to meet other goals like social bottom line. It adequately measures the business model's positive impact on poor. So when both social and financial goal is achieved it creates the effect that is known as MFI's "Double Bottom Line" (Microfinance Bulletin, 2008b, 12).

According to International Labor Organization (2007), how any MFI utilizes its resources like human capital, subsidies, assets and active borrowers is what determines if MFI is efficient or not. Efficiency in microfinance institutions can be divided into two components in order to meet the double bottom line objectives of MFIs. These are financial efficiency and social efficiency. Financial efficiency is based on the assumption of productivity that is depending on the choice of input and output variables. The social efficiency is based on the ability of MFI to manage and utilize its resources effectively such as assets and personnel. The efficient MFIs are more sustainable. Their sustainability is depended on their productivity and profitability. The author concluded that the key success of MFI is its ability to build relationship based on trust with customers because it can result in lower costs to both parties to the contract.

MATERIALS AND METHODS

In the analysis one variable is focused having uninterrupted impact for the MFIs customers, and that is the profit status of each MFI. In this paper I have analyzed the impact of profits on MFI's efficiency, interest rates effectiveness, and other core assertions of MFI. The actual profit orientations consistently associated with higher interest rates and cost. In this paper I use the data of different MFI's from different countries of South Asia. I use the panel data in my research and take it from the MFI's website. I use it because I have enough time and also the availability of data.

It's a fixed effect model and shows the return on assets for the profitability of microfinance institutions. In this model I use the different variables such as interests, female borrowers and cpb (cost per borrower). The results show that when microfinance institutions charge high interest rates their profitability would increase like their profitability is 3.28% when they charge high interest rates. The 2nd variable female borrowers show that the percentage of profitability decreases due to the increase the percentage of female borrowers. The main reason behind this the female borrowers could not utilize loan amount effectively so their capability is low in return of loan. Moreover it's a trend in South Asia that the loan is passed on females names but use the loan amount their male relatives. This is the one reason of low profitability of microfinance institutions.

Table 1. Fixed affect

xtreg roa interest female borrowers cpb,fe

F (4,161) = 36.52
Corr (u_i, Xb) = 0.0354 Prob > F = 0.0000

roa .	Coef.	Std.err.	T.	p>|t|.	[95% Conf.	Interval]
Interest	.396724	.1209937	3.28	0.001	.1577847	.6356633
females	-.2235267	.0983012	-2.27	0.024	-.4176528	-.0294007
borrowers	3.16e-09	6.80e-09	0.46	0.000	-.0082067	1.66e-08
Cpb	-.0070202	.0006008	-11.69	0.007	.0729062	-.0058338
-cons	.2656484	.0976004	2.72			.4583905
Sigma_u	.04112024					
Sigma_e	.07324445	(fraction of variance to u_i)				
Rho	.23964914					

After reading the different articles and my research results show that the female borrowers are not effective for microfinance institutions. Their profitability decrease when increase the percentage of female borrowers. The results of 4th variable cost per borrower show that when the cost per borrower is increase the profitability of microfinance institutions is decrease. When the microfinance institutions deal with small amount of loans, the numbers of customers increase. So for the dealing more customers the time factor and num of staff should be increase. When the staff of institutions increase the cost is also increase and the profitability ratio would decrease.

Table 2. Rendom effect

.xtreg roa interest female borrowers cpb, re

Wald chi2(4) = 178.06
Corr (u_i, X) = 0 (assumed) Prob > chi2 = 0.0000

Roa	Ceof	Std.Err.	Z	p>|z|	[95%cont.	Interval]
Interest	.2787137	.0948493	2.94	0.003	.0928125	.4646149
Female	-.162654	.047166	-3.45	0.001	-.2550977	-.0702102
Borrowers	-1.71e-09	4.50e-09	-0.38	0.703	-1.05e-08	7.11e-09
Cpb	-.0074258	.0005625	-13.20	0.000	-.0085282	-.0063234
_cons	.2411772	.0466654	5.17	0.000	.1497148	.3326397
Sigma_u	.0244728					
Sigma_e	.07324445	(fraction of variance due to u_i)				
Rho	.10042781					

This is a random effect model. Its results are also same with the results of fixed effect model. P>|z| values shows the significant relation with variables profitability. When the values are less than 0.005 its shows there is a significant relation. The result of 1st variable 0.003 shows the significant relation. The 2nd variable results are 0.001 also show the significant relation. The 3rd variable the percentage of borrowers is not in significant relation. And the results of 4th variable cost per borrower are in significant relation.

Table 3. Coefficient

- Estimates store re
- Estimates stor fe
- Housman fe re

Coefficients

	(b) Fe	(B) Re	(b-B) Difference	Sqrt(diag(v_b-v_B)) S.E
Interest	.2787137	.2787137	0	0
Female	-.162654	-.162654	0	0
Borrowers	-1.71e-09	-1.71e-09	0	0
Cbp	-.0074258	-.0074258	0	0

b = consistent under Ho and Ha; obtained from xtreg
B = inconsistent under Ha, efficient under Ho; obtained from xtreg
Test: Ho: difference in coefficients not systematic
chi2(0) = (b-B)'[(V_b-V_B)^(-1)](b-B)
= 0.00
Prob>chi2 = .(V_b-V_B is not positive definite)

The results of Housman show that the results of fixed effect and random effect model are same with the results of Housman. So the profitability of microfinance is directly affected by these variables which are use in my results.

DISCUSSION AND CONCLUSION

After reading the different articles we can say that the profit earning is not a main concept of microfinance institutions. These social based institutions and provide the loan to poor people to give them chance to compete the society. To conclude, the MFI is now more like the profit earning institute even if its targeted customers are poor. That particular category of population had left behind all because they could not get access to such services where they can get financial assistance for their small businesses, and luckily it turned out viable sector and both parties are found in win-win situation, ultimately. So, after going through the dedicated reports we are of the opinion that even if yet there is much to achieve but still MFIs have achieved enough and successfully going upwards and winning the confidence all over the world.

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