

A R T I C L E S

Microfinance: Creating Opportunities for the Poor?

by Susanna Khavul

Executive Overview

Microfinance is an emerging phenomenon that opens access to capital for individuals previously shut out from financial services. In its direct engagement with the poor, microfinance represents a new way for financial capital to potentially stimulate economic growth in developing countries. However, microfinance is poorly understood, and it remains unclear whether it delivers on its promises. The goal of this paper is to introduce the topic of microfinancing to a wider audience of management researchers and to identify opportunities for future research in this new and growing area.

Images of poverty are ubiquitous. For decades, poverty alleviation has topped the international development agenda. United Nations Millennium Goals state that by 2015 the number of people living in extreme poverty should be half of what it was in 2000 (World Bank, 2000). However, the tools for creating economic growth to move people out of poverty have been hard to come by. Microfinance is now promoted as a means to solve the crushing poverty that faces at least a third of the world's population. Microfinance spans a range of financial instruments including credit, savings, insurance, mortgages, and retirement plans, all of which are denominated in small amounts, making them accessible to individuals previously shut out from formal means of borrowing and saving. The most widespread microfinancing instrument is *microcredit* or *micro-lending*, which is the issuance of small, unsecured loans to individuals or groups for the purpose of starting or expanding businesses. Microfinancing aims to alleviate poverty by stimulating economic growth through entrepreneurial initiative. The

availability of microcredit has opened access to capital, through billions of dollars in small loans, to millions of the world's poorest citizens.

As it has grown, microfinancing has also opened the floodgates of international financial capital. Perhaps the best-known microfinancing organization is Grameen Bank, which, along with its founder Mohammad Yunus, won the 2006 Nobel Peace Prize for establishing a microcredit program in Bangladesh. In more than 30 years, Grameen Bank has disbursed \$9.1 billion in loans and expanded to 37 countries. Notably, 97% of Grameen Bank's clients are women (Grameen Bank, 2010). Today, thousands of microfinancing organizations around the world see lending to the poor as a chance to do well by doing good. Microfinancing has turned into an international industry with multiple stakeholders. However, rapid growth of microfinancing notwithstanding, it is still far from clear whether microfinancing creates the benefits that are often touted by those who advocate it as a solution to poverty.

In this paper, I give an overview of the literature on microfinance and suggest that the emergence of microfinance presents a golden opportunity for management scholars, through our

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Susanna Khavul (skhavul@uta.edu) is an Assistant Professor of Strategic Management and Entrepreneurship in the Department of Management, University of Texas at Arlington.

research, to make a difference in understanding this complex and as yet unsettled phenomenon. The story of microfinance is being written now. The phenomenon is emerging, multifaceted, and engaging for management scholars who are prepared to roll up their sleeves, cross disciplinary boundaries, and move between levels of analysis. My goal is to provide enough background and to identify sufficient opportunities to spark the interest of a broad audience of management scholars to consider doing research in this new and growing field.¹ Its very newness makes microfinance an exciting research domain where the range of questions one could ask is not yet bound by established views.

Microfinance Today

Poverty alleviation is the cornerstone of many microfinance initiatives (Khandker, 1998, 2005). The majority of microfinance is aimed at the estimated 2.8 billion people who live on less than \$2 a day in the developing world. Increasingly, microfinance is also being offered in developed countries to those who want to become micro-entrepreneurs but cannot access credit. Previous solutions to end poverty in the developing world have been the purview of large intergovernmental institutions such as the World Bank, where development economists working with donor and recipient governments formulated strategies to stimulate economic growth (Easterly, 2006; Sachs, 2005). In contrast, microfinancing represents a sea change in the way financial capital is used to stimulate economic growth in developing countries. Microfinancing uses direct engagement with the poor, and looks to the individual and her immediate community to generate economic growth through market-driven business initiatives.

Microfinance organizations are diverse. Many

are nongovernmental, most are private or involve private–public partnerships, and an increasing number are for-profit (Battilana & Dorado, 2010). Indeed, with more than half of the world's population living without access to banking or other financial services (Beck, Demirguc-Kunt, & Peria, 2008; Chaia et al., 2009), the potential market for microfinancing is substantial. As the number of microlending organizations has expanded (Swibel, 2007), so has the supply of microcredit around the world. There are approximately 100 private equity funds that manage close to \$6.5 billion (Reille & Glisovic-Mezieres, 2009) and channel money to microfinancing organizations. Among these are funds set up by international banks, institutional investors, and foundations. However, these are not the only sources of capital flowing into microfinance. Individuals are also participating in microlending using numerous on-line aggregators. For example, MicroPlace, owned by eBay, allows individuals to use PayPal to invest relatively small amounts that are then bundled together with investments from others and routed to microfinancing organizations in the developing world.²

This influx of institutional and individual private capital has allowed well-established microfinancing organizations to scale up activities in terms of their client numbers and their portfolio of services. For example, microsavings and microinsurance are recent additions to the suite of services that microfinancing organizations offer, but they are now increasingly common alongside more traditional loans to individuals and groups. Enthusiasm for microlending is also evident in the several high-profile IPOs of microfinancing organizations, for example in Mexico and India. However, with microfinancing gaining in popularity, observers have recently warned that a potential bubble may be emerging (Gokhale, 2009). This rapid increase in access to capital has allowed borrowers to take on more debt than they can repay, which, in some cases, is leading them to take out additional loans to repay the earlier ones. In India, for example, the average individual microfinance debt has gone up fivefold, from \$27 in 2004 to \$135 in 2009

¹ Two caveats are in order. First, I will not attempt an exhaustive literature review, nor do I believe that the themes identified here are the only ones that could emerge from a review of what has been written or spoken on the subject. Second, the focus here is on microfinance, so the broader questions about business opportunities that exist at the bottom of the pyramid (such as microfranchising and social ventures) are left to future reviews (Anderson & Markides, 2007; London & Hart, 2004; Prahalad, 2005; Webb, Kistruck, Ireland, & Ketchen, 2010; Yunus, Moigeon, & Lehmann-Ortega, 2010).

² For more information, see www.microplace.com.

(Gokhale, 2009). Increases in the availability of credit have brought with them questionable practices (such as high interest rates) that, at least in the eyes of its early founders, conflict with the goals of microfinance (M. Yunus, personal communication, February 25, 2010; Kumar, 2010). This has led to calls for moratoria on loan repayment in some countries, advocacy for regulation and reform in others, and introspection more generally from within the microfinance community and among its outside observers (Chen, Rasmussen, & Reille, 2010; MacFarquhar, 2010). Moreover, uncertainty about the outcomes of microfinance and similar initiatives persists. The practitioner community has been challenged to go beyond emotion-laden marketing of its activities and move towards serious and systematic assessment of their impact across multiple constituencies (London, 2009). At this point, the industry is ripe for researchers to provide sober and analytically rigorous evaluations of whether microfinance delivers on its promises (e.g., Banerjee, Duflo, Glennerster, & Kinnan, 2009; Roodman & Morduch, 2009). In the next section, I revisit the challenges in economic development that bring into sharp relief the need to make financing available to millions living in poverty. I then discuss the barriers that traditional banks have faced in doing business with the poor in developing countries, present the solutions that microfinancing appears to offer, and ask whether microfinancing is delivering on its promises.

Challenges in Economic Development

The last two centuries have brought unprecedented economic growth to millions of individuals across the globe. However, persistent differences in growth rates have left many regions of the world, including sub-Saharan Africa, Southeast Asia, and Latin America, with high levels of entrenched poverty, large income inequalities, and economic instability. Measuring poverty is highly controversial. However, estimates suggest that approximately 1.2 billion people live in extreme poverty, or on less than \$1 per day (in 1993 dollars and adjusting for

purchasing power parity across nations), and an additional 1.6 billion live on between \$1 and \$2 a day (Deaton, 2006). This is the bottom of the pyramid that represents the “latent market for goods and services” (Prahalad, 2005, p. 5), the untapped frontier for multinationals doing business in developing countries (Prahalad, 2005; Prahalad & Hammond, 2002; Prahalad & Hart, 2002).

As a segment of humanity that survives day to day, the poor also experience high seasonal fluctuations in income (Collins, Morduch, Rutherford, & Ruthven, 2009). They have few viable alternatives for smoothing out either income or consumption across time (Collins et al., 2009; Morduch, 1999b; Rutherford, 2000). Moreover, the potential for catastrophic events to unhinge the lives of the poor is evident not only when natural disasters make the evening news, but in millions of unnoticed ways—when a family member is ill, a child dies, fire rips through a shantytown, or a crop fails because the rains never came (Bruton, Khavul, & Chavez, in press; Morduch, 2005). The poor are exposed to risk and have few ways to reduce their vulnerability to its consequences (Morduch, 2005).

Poverty has been seen as a big problem for which historical approaches to development have sought big institutional solutions. However, publicly driven initiatives to reduce poverty have been met with skepticism and mixed success. Critics point out that in the last 50 years several trillion dollars have been spent on foreign aid programs to developing countries. These programs are typically top-down, poorly designed, and mediated through official government channels in countries where good governance is generally absent and where little of the money that arrives trickles down to the poor (Easterly, 2006). Instead of this approach, many people have argued for a bottom up, entrepreneurial solution that promotes investment allocation decisions based on individual initiative. The consequence may be an increase in productivity and innovation that can generate growth endogenously (Aghion & Armendariz de Aghion, 2004).

However, to make the sorts of investment that stimulate endogenous economic growth, one needs access to financial capital that comes either from savings or from borrowing, which is difficult in environments where the formal means of either saving or borrowing are typically absent. Traditional communities do have informal mechanisms for savings. For example, voluntary rotating savings and credit associations of various sorts are proliferating across Southeast Asia and Africa (Anthony, 2005; Mayoux, 2001) and allow individuals to receive periodic payouts from group contributions. These savings mechanisms also serve as self-insurance against unanticipated risks, although in some circumstances, community-based norms of reciprocity also play a part in protecting individuals against risks (Anthony, 2005; Morduch, 1999a; 2005). Even so, these mechanisms are far from foolproof.

The savings that the poor accumulate are vulnerable to depletion by numerous unintended uses. Women in particular find it hard to accumulate savings because their household responsibilities as well as kinship obligations mean that something or someone always comes along to make a claim (Khavul, Bruton, & Wood, 2009; Mayoux, 2001). To control their savings, women often sew their savings into their saris (Morduch, 2005) or bury their cash in the ground (Khavul et al., 2009), and need to watch out for “little mice” who eat banknotes (Bruton et al., in press). For the poor, saving in order to invest becomes not only a psychological struggle of inter-temporal choice but a practical matter of keeping one’s money safe until an investment opportunity arises (Rutherford, 2000; Thaler, 1994). Without access to safe, convenient, and efficient banking services, the link between savings and investment becomes tenuous (Chaia et al., 2009; Rutherford, 2000). Still, the alternative to savings is borrowing, which in developing countries means borrowing from friends and neighbors or as a last resort from moneylenders at triple-digit interest rates (Collier, 2007; Cull, Demirguc-Kunt, & Morduch, 2009). Microfinance has evolved to

tackle these challenges by making a range of financial tools available to the poor.

Accessing Financial Capital

Why Not Traditional Banking?

Traditional financial institutions find serving the poor risky and expensive. The poor are often illiterate, have limited collateral and no official credit histories, and are often dispersed across a rural geography. Moreover, they operate in the informal economy and start businesses that are often unregistered and untaxed (Castells & Portes, 1989; de Soto, 2000; Schneider, 2005; Portes & Haller, 2005; Webb, Tihanyi, Ireland, & Sirmon, 2009). This leads to agency and transaction cost problems that traditional banks have a hard time overcoming.

First, financial institutions in developing countries have limited information on the creditworthiness and reliability of specific individuals. Institutional tools on which financial organizations rely in the developed world (e.g., credit scores) are simply not available in the developing world. When such information exists informally, it is embedded in the local social networks to which traditional formal banking institutions do not have access (Portes, 1998; Smith-Doerr & Powell, 2005). Thus, the first barrier that traditional banks face when lending to the poor is how to overcome the asymmetry of information—how to figure out who is a good risk and who is not.

Next, financial institutions in developed economies typically go through an information-intensive process of due diligence *ex-ante* and monitoring *ex-post* in order to avoid agency risks. After all, the role of banks is not to provide risk capital (generally the domain of equity investors) but to make money on the spread between the interest they pay out on savings deposits and the interest they charge for loans. When lending to the poor, traditional banks find themselves exposed to multiple sources of risk they can neither afford to assess nor differentially price. This presents opportunities for *ex-ante* moral hazard in the choice of projects funded by the microloan and *ex-post* moral hazard in the non-repayment of the loan (Armendariz de Aghion & Morduch, 2005).

Finally, the transaction costs associated with banking to the poor are non-trivial given the small size of the loans involved and the geographic dispersion of rural borrowers. On the one hand, the cost of servicing small loans is high and this may drive up interest rates or lower profitability (Ahlin et al., in press). Borrowers pay the price in terms of the cost of capital, but they also incur additional transaction costs when they forgo new income or pay to travel to loan centers to make payments. On the other hand, financial institutions need distribution networks that reach the poor, which raises costs. In addition, most transactions are cash based, which creates a potential for fraud. As they scale up, financing institutions have to design processes and procedures that facilitate monitoring and compliance. It is not difficult to see why traditional banking has neglected the poor and why informal means of financing and saving have been the norm in impoverished communities.

The Microfinance Solutions

Microfinance offers several innovative solutions to problems of adverse selection, moral hazard, and transaction costs. Individual microloans are commonplace in certain countries, but across the world microfinance is known for popularizing group-based lending. Group lending practices have evolved since they were first pioneered in the 1970s. At least three models of group lending currently coexist: joint liability group lending, individual liability group lending, and village banking. Under *joint liability group lending*, borrowers come together to take out individual loans but ones for which they are jointly responsible. Joint liability group lending was the original model of Grameen Bank, and it is one that some microfinancing organizations still offer (Gine & Karlan, 2008). Under *individual liability group lending*, borrowers are formally released from the joint liability requirement but adhere to other elements of group lending. Specifically, groups of borrowers come together in their local community for regular weekly or biweekly repayment meetings with the local representative of the microfinancing organization. The loans are repaid in public, and often the meeting does not end until all loan payments

are covered. Finally, under the *village banking model*, groups of individuals are jointly given a loan amount that they then allocate to their members. Village banks establish leadership roles among members who are responsible for managing the lending activities. Village banking requires that members cross-guarantee each other's loans.

Albeit in slightly different ways, each of the group lending scenarios relies on local social networks, the behavior of small groups, and dynamic incentives to alleviate the moral hazard and adverse selection problems. On their own, microfinancing organizations cannot identify risky borrowers because they have no information on their past behaviors. As a result, they cannot price this information into the cost of the loan and charge higher interest rates for riskier loans. Instead, they set a uniform rate of interest and rely on borrowers to self-select into groups using local information about each other's trustworthiness. Some economists have suggested that this associative matching process will mean that safe borrowers will select other safe borrowers and risky borrowers will be left with other risky borrowers (Armendariz de Aghion & Morduch, 2005). This process takes place without the microfinancing organizations' direct involvement in trying to control the adverse selection (Armendariz de Aghion & Morduch, 2005).

Group lending also mitigates moral hazard because individuals in highly networked communities can observe each other's choice of project *ex ante* and monitor behavior *ex post* to avoid strategic default (Bolton & Sharfstein, 1990). Such mechanisms substitute for the information-intensive due diligence and monitoring process of banks in developed economies. The costs of selection and monitoring are shifted to group members as is peer monitoring (Stiglitz, 1990). The motivation for socially enforcing loan compliance is being eligible for the next loan. Initial loan amounts start small, but if all members of a group are in good standing, once a loan is repaid the borrower is eligible for subsequent, larger loans. For individuals, the incentive to comply is bound up in the reputation costs of letting down the group in front of the community and the lender.

In small communities, such costs can be socially prohibitive for individuals and their families.

Microfinancing has also shifted the focus towards women as borrowers, a strategy that reinforced the group-based lending practices. Although men may have been the original targets for microloans, microlenders such as Grameen observed early on that women were more likely to repay (Rahman, 1999). Extremely high repayment rates were the most unexpected outcome of initial microloans to women. Today, women are still the majority of microloan recipients. From the viewpoint of adverse selection and moral hazard, women make better borrowers than men because they are susceptible to group peer pressure to repay the loan, are less mobile and easier to monitor, and are more conservative with their choice of business ventures. From the standpoint of poverty alleviation, they are also more likely to want to invest in the education and health of their children and therefore are less likely to risk being excluded from future loans by defaulting (Armenariz de Aghion & Morduch, 2005). Thus, it appears that microfinance has circumvented the adverse selection, moral hazard, and transaction costs barriers that have kept traditional banks out of the developing world.

Is Microfinancing Working?

The jury is still out on whether microfinancing is working. As with most complex phenomena with many stakeholders, the answer depends on whom one asks, what data are invoked, and (most important) how performance is defined and measured. Research typically focuses on repayment rates and the sustainability of microfinancing organizations on the one hand, and the effectiveness of group lending practices and the outcomes of microfinance for the borrowers on the other.

Loan Repayment Rates and Sustainability

Loan repayment rates are the single most watched figure in microfinancing. For example, Grameen Bank posts on its Web site monthly statistics on the repayment rates on loans. From its early days, high repayment rates have been the gold standard of performance in the micro-

financing industry. However, recent work questions whether repayment rates are an appropriate measure of success. Borrowers may be taking out additional loans to repay their original loans, artificially increasing repayment rates and separating them from the desired measures of success such as new business starts, investments, and economic development.

The focus on repayment rates is understandable, as repayment rates are linked to the sustainability of the microfinancing organization. Microfinancing organizations have multiple operational and financial goals to meet in increasingly competitive markets. They have to raise financing, offer an attractive product, recruit and retain clients, keep operating costs low, and motivate and control the distribution and delivery systems (Roodman & Qureshi, 2006). They have few choices but to keep the repayment rates high (Rosenberg, 1999). However, repayment rates need to be considered in conjunction with variables such as underlying business performance (Bruton et al., in press).

With voluntary disclosure more commonplace now than even five years ago, data are emerging that can shed light on the sustainability question. It is clear that the industry is concentrated. One study reported that in 2006 approximately 10% of microfinancing organizations served 75% of the borrowers (Gonzalez & Rosenberg, 2006). Moreover, Cull et al. (2007, 2009) showed that of the 346 microfinancing organizations they analyzed, 45% are nongovernmental organizations (NGOs), 30% are non-bank financial institutions (not-for-profit and for-profit institutions that have regulatory permission to, for example, take client deposits), and 10% are banks, with the remainder spread across other types of organizations. In terms of profitability, Cull et al. (2009) show that 54% of NGOs and 73% of banks are profitable. However, the return on equity for banks is significantly higher (22% at the 75th percentile) than that for NGOs (13.8% at the 75th percentile). Indeed, many not-for-profit microfinancing organizations with clear social missions do not achieve profitability, but instead rely on subsidies from donors to survive. However, the entry of commercial for-profit banks into microfinancing has prompted a

range of questions about operational business models, future sustainability, and mission drift in view of the industry's increasing commercialization. Finally, NGOs charge higher inflation-adjusted interest rates than banks (25% per year versus 13%). Individual loans are more profitable than group loans or village loans; 68% of organizations that make individual loans are profitable, compared with 50% of group-lending organizations and 43% of village-based lending organizations. Of course, market segmentation could be skewing these results. For example, only 6% of bank clients but 73% of NGO clients are women. In addition, individual borrowers serviced by banks are typically better off than borrowers who join groups (Cull et al., 2007).

There are clear differences between NGOs and banks in terms of proportion of women clients, loan sizes, return on equity, profitability, and interest rates charged. These differences speak to the likelihood of the sustainability of the microfinance industry. The "diseconomies of transacting in small loans" (Cull et al., 2009, p. 183) suggest that increasing volume, in a mad dash for growth, may not be the answer for small microfinance organizations. Larger loans and more services to existing customers will most likely be necessary to maintain sustainability. Understanding the differences between the microfinance practices of NGOs and for-profit banks helps us to predict what might occur as microfinance, and economic development more generally, transitions from an endeavor of the not-for-profit sector (provided by NGOs) to an endeavor of the private sector (provided by for-profit banks). Finally, Ahlin et al. (in press) showed recently that the macro economy of the country also matters to the sustainability of microfinancing organizations. Microfinancing organizations benefit from a robust national economy in terms of cost recovery and growth. These findings embed the microfinancing organization in the larger context of the country and have important implications for future research that aims to explain why some microfinancing organizations succeed while others falter (Ahlin et al., in press).

Group Lending Practices

One of the major innovations of microfinance is the reliance on group lending practices. Social capital explanations (Coleman, 1988; Portes, 1998) suggest that the power of locally embedded knowledge and social relationships in group lending circumvent the information asymmetries and agency problems between the lender and the borrower. Numerous studies have tried to evaluate this claim, with mixed success (Hermes & Lensink, 2007).

Studies generally find that repayment rates are high, but differ on the mechanism for this result. Some point to social capital. For example, Wydick (1999) found support for a positive effect of social ties but not social pressure on deterring moral hazard. Others point to the negative side of social capital. For example, Rahman (1999) observed Bangladeshi borrowing groups and found that both the lender and the community put intense social pressure on women borrowers to repay their loans. Others have focused on the hierarchical versus peer relationships in the group-lending arrangement. Hermes, Lensink, and Mehrteab (2005) found that group leaders in Eritrean microfinancing groups mattered more in overcoming the moral hazard problem than other group members. Ito (2003) similarly observed that the hierarchical relationship between the borrowers and the lenders influenced compliance with repayment schedules in Bangladesh. Finally, Bruton et al. (in press) showed that Guatemalan borrowers with high-performing businesses invoke their roles as brokers in the relationships between the group and the lender to motivate compliance. While the data are consistent with the observation that repayment rates are high, the reasons are not entirely clear, and may not accord with the narrative around group lending.

Explaining borrower behavior remains a challenge. One theme that emerges repeatedly is that borrowers often have little understanding of what the lender can and cannot do (Bruton et al., in press). For example, even in situations without joint liability, borrowers often enforce compliance as if joint liability exists. In part, this behavior results from dynamic incentives or the sequential

nature of loan disbursement that encourages group monitoring (Egli, 2004). But it also reflects confusion on the part of the borrowers about the terms and conditions of the loans they receive (Bruton et al., in press).

Researchers have taken different approaches to understanding how group-based loans operate. A series of papers theoretically explores optimum contract design for group-based loans (Bond & Rai, 2008) and empirically tests the implications of different theories of joint liability contracting (Ahlin & Townsend, 2007). An increasing number of studies use controlled experiments to identify the impact of microfinance contracts on borrowers, avoiding endogeneity and other problems that can arise from strictly observational data. For example, Karlan (2007) conducted a study in Peru, where FINCA-Peru³ randomly creates groups of borrowers from a waiting list of interested individuals. This offers a natural experiment in a joint liability setting, which disentangles the effects of group selection from those of loan monitoring. Karlan (2007) showed that individuals with stronger connections to others in the group are more likely to repay their loans. In a related study, Cassar, Crowley, and Wydick (2007) used field experiments in multiple countries to show that social cohesion and group homogeneity promote loan repayment more than the levels of trust in the society as a whole.

Finally, if social enforcement through groups matters for maintaining high repayment rates, particularly in joint liability contracts, then removing the group structure should reduce repayment rates. Gine and Karlan (2008) conducted such an experiment in the Philippines in the context of joint liability group borrowing, and showed that removing the liability provision and moving from group to individual loans does not reduce the repayment rates one year after the intervention. This appears to be corroborated by Cull et al. (2009, p. 179), who observed that “while there are differences in profitability and target market, there are no differences in the loan portfolio quality”; that is, the proportion of the portfolio at risk is approximately

the same across organizations making individual, group, and village type loans. Experimental approaches hold promise in resolving the conundrum about which face of social capital explains the high repayment rates on microloans.

Outcomes of Microfinance for Borrowers

The promise of microfinance is that it spurs entrepreneurship and empowers borrowers to help themselves. Some research has focused on how microfinance delivers on this promise. As mentioned above, repayment rates have been the main dependent variable used in numerous well-crafted studies. However, it is not clear what repayment rates tell us about the effect of microfinancing on the borrowers, particularly the women who are the focus of the group-based lending environment. Ample evidence now suggests that borrowers will go to great lengths to repay their loans even when their businesses fail (Bruton et al., in press). To understand the impact of microfinancing we need to look deeper, ask more probing questions, and use sharper tools.

Many studies have used randomized designs focused on explaining repayment rates on loans (e.g., Gine & Karlan, 2008; Karlan, 2007), on the intervention effects of training on repayment (Karlan & Valdivia, in press), and on savings (Ashraf, Karlan, & Yin, 2006). Recently Banerjee et al. (2009) shifted attention away from repayment rates and toward identifying the effect of microcredit on the profitability of small businesses, investment, and household consumption. Working with a local microlender in Hyderabad, India, researchers randomly assigned 104 neighborhoods with no prior microfinance activity to either have a microfinancing branch opened or not. The microlender in this case practices group-based lending with joint liability that allows borrowers (all of whom are women) to self-select into groups, and does not require that loans go towards starting businesses. Researchers conducted a baseline census of the neighborhoods and compared borrowing patterns of households in both the treatment and control areas after 18 months. They found that in areas where microfinance became available there were 32% more new businesses than in the control area. Moreover, those in the

³ FINCA Peru is a nongovernmental microfinance organization. For more information, see www.fincaperu.net/cms/index.php/en/.

treatment group reported significantly higher monthly business profits, but not revenue, spending, or number of employees than those in the control group (Banerjee et al., 2009). Furthermore, they found no difference in household expenditure but did detect shifts in the composition of consumption.

Next they unpacked this relationship across different groups of borrowers: established business owners, new entrepreneurs, and those who did not go into business. They found that established business owners increased their investment and saw their profits increase, new entrepreneurs saw their household consumption decrease (most likely because they were investing in new business activity), and those who did not go into business increased their nondurable spending (Banerjee et al., 2009). These results provide a welcome new direction: evaluating the success of microfinance initiatives by measuring business investment and household consumption consequences rather than simply by looking at repayment rates.

Empowerment of Women

Promoters of microfinance emphasize women's empowerment as a social goal and another way to evaluate the success of microfinance. In a departure from the neoclassical assumptions about households (Becker, 1981), supporters argue that offering microfinance loans to women will increase the level of control the women have in using the loan. As a result of securing the loan women may gain social and economic self-reliance, influence, and control over resources (Sanyal, 2009). Observers, however, have suggested that this goal is illusive (Morduch, 1999b). Many women often do not control the loans they take. Rahman (1999) reported that most of women who took loans in one rural village in Bangladesh said that they did so at the request of their husbands. In contexts where financial capital is scarce but then becomes suddenly available only to one gender, it may be folly to expect that the other gender would not attempt to exercise unscripted control over the resource (Rahman, 1999). Moreover, some microfinancing organizations keep male family members explicitly involved in the lending process by making them cosign initial loan appli-

cations (Bruton et al., in press). Such practices are not dissimilar to those used by commercial lenders in the U.S. as late as the 1980s. Whether microfinancing practices perpetuate or change cultural norms that restrict the independence of women is an open question.

Even women who use microfinance loans to start businesses that generate returns rarely have full control over the proceeds. The combination of family obligations, norms of reciprocity, and general vulnerability of the impoverished to cries for help mean that women have a limited ability to refuse requests for money. In addition, in the randomized control study discussed earlier, Banerjee et al. (2009) reported that microfinancing clients did not show improvements in health, education, or women's empowerment. Women in a neighborhood with a microfinance branch were no more likely to make spending decisions, non-food spending decisions, or decisions on health expenditures than women in neighborhoods without a microfinance branch.

On the other hand, a study published in the medical journal *The Lancet* showed that microfinance combined with a gender and HIV training program significantly reduced the incidence of intimate-partner violence for women who received both than for the control group. There were more modest or marginal effects at the household and community levels (Pronyk et al., 2006). A different approach to empowerment is offered by Sanyal (2009), who showed that microfinance may empower women outside the home by fostering their ability to take collective action (Sanyal, 2009). On balance, more rigorous and systematic evidence for empowerment of women as a result of microfinance would be welcome.

Research Opportunities

Management research on microfinance is limited. Clearly, there are questions of interest to management scholars, and issues where our expertise could add value to the discussion. Microfinance is a flexible phenomenon and can be analyzed at multiple levels, using multiple theoretical perspectives, and with multiple empirical tools. To understand the opportunities for research, one approach could be to follow the

money from its source, through its distribution, and to its use. At each point there are unanswered but intriguing questions—about the investors who look to microfinance as an opportunity to do good and do well, about microfinancing organizations who create financial markets where few existed before, and about their clients whose investment decisions are looked on with hope for economic growth. Here are just a few examples of research questions that could be asked and that could draw on expertise from across the management research community.

Sources of Capital (the Investors)

Financial Institutions. With nearly 100 private equity funds raising money for microfinancing, there are opportunities to understand who is investing, how, and with what expectations. Do financial investors in microfinance have different expectations from corporate investors? What are the corporate social responsibility expectations from investing in microfinance? How do investors decide which microfinance organizations to select as partners and on which parts of the world to focus? Do they embed in relationships with multiple microfinance organizations or develop deep ties with a few? How do they monitor investments, assess the risks involved, and value the investment portfolios? Do investments in microfinance have value to their customers? To what extent are political risks relevant? How do they evaluate reputation risks? In light of the financial crisis, how has risk valuation changed? What are the exit strategies from investments in microfinance?

Individual Investors. With millions of individuals making small social investments in microfinance, there are opportunities to look at the effect of social media on creating the supply of capital. What is the motivation to invest? What are the expectations of returns and repayment? How do individuals who invest multiple times differ from those who invest once? Do individuals monitor their investment portfolios? Why do individuals stop investing? What is the effect of viral marketing on investments? To what extent do individual investors perceive themselves as part of a larger community, and how does this affect their pro-

pensity to make future investments? What are the network effects of investing? Such research could productively tie in with work on marketing through social media.

Distribution of Capital (the Microfinancing Organizations)

Diffusion and Institutionalization of Practices. Taking an institutional perspective, there are opportunities to look at the historical adoption of microfinancing models and the ongoing institutionalization and diffusion of innovative practices. How do new lending practices become adopted? Who selects them and why? What is the role of industry and professional organizations? When and how are old practices abandoned? Does organizational form matter for the absorption of innovations? When organizations are networked in one or multiple countries, do innovative practices travel through horizontal or vertical channels? What is the speed of transfer and adoption? What is the role of incentives and monitoring in the institutionalization of new practices?

Ownership, Governance, and Management. Microfinancing presents an opportunity to test and extend our existing models of ownership, governance, and management. Do organizations make active decisions about whether to enter the microfinance field as not-for-profits and for-profit organizations? How does the founder influence the choice of strategy that the firm pursues? How do the tenure and composition of the top management team/board of directors affect performance? How does shareholder/funder diversity affect performance? Who controls the organization? What is the role of international board members? How does the professionalization of management affect performance? What is the effect of management or the board on performance? What is the role of formal succession planning?

Performance, Sustainability, and Survival. How should microfinance organizations measure performance? What should be the balance between financial and social performance? How should performance be measured in the presence of multiple stakeholders? What are the time horizons for performance? Does profitability detract from the social

mission? How do microfinance organizations define sustainability? How should they assess threats to sustainability? What predicts survival of microfinance organizations over time? What are the effects of size, age, network position, and resource dependence on survival?

Diversification and Internationalization. Microfinance organizations are beginning to offer more services (savings, insurance, and mortgages). Does this diversification affect customer recruitment and retention? How do microfinance organizations manage the risks of multiple financial products? Microfinance is rapidly becoming a global business with lenders crossing international borders in search of additional markets. How do microfinance organizations cross international boundaries? What is the relationship between diversification and performance, sustainability, or survival? How important are tight linkages among international subsidiaries?

Norms, Voluntary Codes of Conduct, and Regulation. Addressing concerns over excessively high interest rates on loans, some in the microfinance community have offered to submit to regulatory caps; others call for voluntary norms. Microfinance is ripe for asking the “what if?” questions about regulation and voluntary adoption and compliance with codes of conduct.

Use of Capital (the Borrowers)

Interest Rates and Dynamic Incentives. Microfinance relies on borrowers paying back their loans with interest. However, evidence suggests that borrowers have a limited understanding of what interest is or how much of it they are paying (Bruton et al., in press; MacFarquhar, 2010). To what extent do interest rates influence loans that borrowers take, investment decisions they make, and repayment rates? Karlan and Zinman (2010), among others, looked at the role of interest rates in credit expansion, but the specific effect of interest rates on business decisions has been neglected. Likewise, the role of dynamic incentives (opportunity to take the next loan) has been regarded as a motivating factor both for compliance with and enforcement of repayment rates. How do borrowers decide to

take additional loans, and, more important, how do they decide to forgo the option?

High Performance and Failure. The arguments against microfinance suggest that it generates many subsistence businesses and few high-performing businesses that are able to scale up for employment (Karnani, 2008). Why are there so few ventures that generate additional employment? How are borrowers who create high-performing business different from those who do not? Likewise, there is an absolute dearth of research on failure in microfinance. Much of the failure in microfinance is hidden from view by high repayment rates (Bruton et al., in press). What are the causes and consequences of business failure? Why do some borrowers recover and others not? What are the long-term impacts of business failure on the poor? What are the social consequences of loan default? What are the long-term effects of indebtedness as a result of failed businesses?

Microloans to Individuals. Group-based microfinance receives the bulk of attention in the literature and was, indeed, a major thrust of this paper. Relatively little is known, however, about individuals who take microloans but do not rely on the support of a group. In cases where both choices are an option, how do borrowers decide whether to take loans solo or join a group?

Women and Empowerment. Finally, the question of women’s empowerment as a result of microfinance remains wide open, even though it has received much research attention. For microloans to make a difference in the lives of women, what do they need from society, their families, and the lenders?

Microfinance Research Is a Challenge

Microfinance research is not an armchair exercise. Certainly, questions about the accessibility and availability of microfinance data abound. There are thousands of microfinancing organizations active in the field and billions of dollars in microloans issued over the last 30 years, yet archival data are relatively scarce. As in other fast-growing fields that evolved from the bottom up, systematic data collection has been an afterthought. Practitioners facing the day-to-day challenges of building fledgling organizations focus on staying ahead of the workflow. However, as

the field matures and seeks legitimacy, the need for reliable data has increased.

Over the last ten years, archival datasets tracking microfinancing organizations have slowly become available. The best known of these is MIX Market,⁴ an online database to which microfinancing institutions voluntarily contribute data. These data include general profile information of the organizations as well as some audited financial statements. Since MIX Market started to collect data, 1,785 microfinance institutions have reported. The gross loan portfolios tracked is \$39.5 billion, and savings deposits are \$22.7 billion. The 76.9 million borrowers included in the MIX database have an average loan balance of \$576.5.⁵ Cull et al. (2007, 2009) and Ahlin et al. (in press) among others, have used the MIX Market data to analyze the microfinancing industry. The data available is spotty, and those who use it generally report consistent data for 350-400 microfinance organizations (Ahlin et al., in press). While this database is useful for understanding organizational differences and trends, it does not provide the level of detail one might need to answer many of the questions of interest, especially about the uses and consequences of microfinance loans on the lives of borrowers.

Archival datasets at the borrower level exist, but they are proprietary and their quality varies. Some microfinance organizations systematically collect data, track their clients, and conduct periodic performance assessments. A number of these organizations offer their data for sale; others allow use of them free of charge but under confidentiality agreements. However, even the best of these datasets reflect their piecemeal evolution. They may not include electronic versions of key documents that remain on paper in moldy boxes stacked in back offices. When available, large-sample archival data are immensely useful.

An alternative to using archival data is to go to the borrowers directly. Many research designs call for exactly this approach. The prevalence of community centers as coordinating institutions for

microfinance loans means that one can compare microfinancing across local, regional, and national geographies. Furthermore, the internationalization of microfinance allows for cross-country and cross-cultural research opportunities. However, practical challenges of collecting primary microfinance data are substantial. Data collection in emerging and developing markets is notoriously complicated and expensive. Although microfinancing organizations are relatively easy to identify, their clients are spread across rural geographies and are difficult or impossible to reach. To collect primary data, researchers have to visit microfinance clients in villages clinging to mountainsides, perched in the high plains, or squeezed between the endless sea and miles of sugarcane fields. Here, the road that brings the researcher in also accommodates livestock. Interviews are frequently interrupted by chickens or children running in and out of small huts that look as though they barely withstood the last storm, to say nothing of the next one to come. This type of data collection takes time, money, and perseverance, but it also takes cultural sensitivity and empathy for the respondents' contribution to the research enterprise. For some researchers, it is also infused with deep meaning and relevance.

To understand what microfinance is about and what it is achieving researchers need multiple tools to collect data. In-person survey interviews, in-depth case comparisons, as well as observational and experimental studies each add unique contours to our understanding of the phenomenon. Collaboration with individuals trained in methods appropriate to these endeavors is especially useful. Irrespective of the data collection method, proper design and sampling are absolutely essential. Partnerships with microfinancing organizations are often the only way to gain access to their clients. However, studies that focus exclusively on clients miss the broader picture of examining individuals who do not take loans (and understanding why they don't), or individuals who provide the social ties to bind together the communities, but who do not themselves use microloans.

When working in the field, loan officers, who see borrowers week in and week out, can be a

⁴ For more information, see Microfinance Information Exchange at www.mixmarket.org.

⁵ From www.mixmarket.org. Accessed on May 24, 2010.

trove of information and insights. Loan officers manage the relationships that microfinancing organizations have with their clients, so their role as both gatekeepers and guides cannot be overstated. However, like gatekeepers found in other research contexts (e.g., business incubators), loan officers can also be a source of bias. As microfinancing research becomes more popular, loan officers face increasing pressure to shepherd researchers around, showing favored clients or highlighting success stories. Taking the time to develop precise sampling criteria and spending time on the ground can improve the quality of information that a research project collects. That said, for certain research designs, loan officers may be the most important link to the client. Clients who have paid off their loans but may have seen their businesses fail are difficult to identify and locate. Similarly, loan officers are an indispensable source of information about the often small group of high-performing clients in a particular region. Involving loan officers in the research process sends a positive signal that their views are valued and have a place in the research process. It does not eliminate the need for nor does it conflict with tight control over the research process.

Finally, many questions that management researchers want to ask can become entangled in endogeneity traps. Experimental studies, whether randomized control experiments, natural experiments, or even lab-based experiments, allow researchers to avoid endogeneity and to ask very specific questions about behaviors that are difficult to tease out of cross-sectional and even longitudinal approaches to data collection. Such methods are increasingly useful and popular in fieldwork on microfinance and poverty (Parker, 2010). However, their results may not be generalizable across countries or cultures or even within localities without further validation and testing.

Conclusions

Some see microfinance as the long-sought-after tool for eliminating poverty around the world. After all, microfinance has the appeal of bringing financial power to the people who need it most and whose resourcefulness and ingenuity it will fuel. Others question the whole premise.

Ultimately, social and economic historians will judge whether microfinance has made a difference in development. As academics, we have a chance to ask the tough theoretical and empirical questions as well as to apply management tools to design interventions that increase the impact of microfinance. Only rarely do we have an opportunity to try and affect the lives of so many so deeply through research. This is our chance.

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