A Modified Microfinance Model Proposed for the United States

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ABSTRACT

Microfinancing is the concept of providing very small amounts of funds to a person or project who would otherwise be unable to obtain a loan. The concept has been successful in many developing countries. However, attempts to apply it to the United States have had little if any success.
This paper cites earlier research that identified several critical conditions that exist in the United States that help to explain its failings. Significant differences exist in the size of the microenterprise sector, the existence of the functional social safety net, competition from both large firms and commercial lenders, and limits to forming a group based upon joint liability all differ.
While the goal in the traditional model in developing markets is the elimination of poverty, we show how those critical conditions help to explain the lack of success in the United States. We propose a modified model whose goal is the establishment of an entrepreneurial venture that would lead to the creation of new jobs.

Introduction

Microfinance has been successful in developing countries (Wrenn, 2005; Canale, 2010; Bateman, 2011). But when this model is replicated in the U.S. the outcomes have been discouraging (Schreiner & Morduch, 2001; Bhatt & Tang, 2001; Canale, 2010; Lieberman, Mudd, & Goodeve, 2012). Several key factors have contributed to the disappointing results of microfinance in the U.S. such as the size of the microenterprise sector, the existence of the functional social safety net, competition from both large firms and commercial lenders, and limits to forming a group based on joint liability (Schreiner et al).

Some researchers pointed out that the microfinance business model needs to be modified when it is attempted to be applied in the United States and other developed nations (Schreiner & Morduch, 2001; Canale, 2010; Lieberman, et al; Bredberg & Ek, 2011).

This study attempts to address the key issues faced by microfinance institutes in the United States and proposes a modified model that may improve the existing practices of microfinance in the United States.

Literature Review

Many studies of microfinance in the United States revealed unsatisfactory results and some researchers found that early attempts to implement the microfinance model that had been successful in the developing countries failed to reach the degree of success achieved by microfinance institutions in developing nations (Schreiner & Morduch, 2001; Bhatt & Tang, 2001; Lieberman, et al, 2012).

Bhatt & Tang (2001) pointed out that the replicated microfinance model encountered challenges in the United States in three dimensions. Those factors explained why the model failed to accomplish the same results obtained by their counter parts in the developing countries.

The three dimensions are 1) social intermediation; 2) financial intermediation; and 3) administrative intermediation (Bhatt & Tang, 2001). Social intermediation is the process of reaching the targeted

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borrowers and providing them with needed financial services. Financial intermediation is the ability of microfinance institutes to maintain financial viability. Administrative intermediation refers to the proper management of the microfinance institutes.

Studies indicated that many microfinance institutes in the United States were unable to reach their targeted clients and to help them build human capital. The researchers provided evidence of two microfinance programs in the United States, the Women's Development Association (WDA) and Neighborhood Entrepreneurship Program (NEP), as examples. The data collected from the microfinance institutes showed that 62% of the microfinance borrowers were not low-income individuals (Edgcomb et al., 1996). Inability to reach the targeted clients led to failures in helping low-income social groups improve their economic situation.

Failure in financial intermediation often results in a portfolio with higher than average risk; that leads to low financial performance, increased loan losses, and ultimately in a high default rate compared to results obtained in developing countries. As a consequence, in the United States there is a higher cost structure (Bhatt & Tang, 2001).

Inadequate administrative practices include a lack of well-established policies and procedures, a lack of data collection and record keeping, and managing microfinance programs like social programs that tend to treat funds as free money and to distribute it without due diligence.

Later studies found similar results. Lieberman, et al, (2012) found that microfinance institutes in the United States tend to be much smaller in terms of their scale, more expensive to operate due to their high cost structure, experience high delinquencies and loan losses, and are highly unlikely to be financially viable.

Schreiner & Morduch (2010) suggested that "the social and economic context for microfinance in the United States differs greatly from that of Bangladesh, Bolivia, and Indonesia". They provided seven reasons why microfinance models developed in the developing countries were not similarly successful in the United States.

They proposed that 1) there is not a big enough microenterprise sector in the United States; 2) a functional public safety net in the United States provides an alternative for the low income group; 3) strong competition from large firms challenges microenterprises; 4) microfinance faces competition from commercial lenders, mainly credit cards; 5) it is difficult to apply group lending practices; 6) it is not practical for microfinance institutes to make loans for home improvements; 7) U.S. banking regulations are much tighter than that in the developing nations.

The small size of the microenterprise sector makes it difficult for microfinance institutes to reach low-income entrepreneurs. Small operations also lead to much higher operating costs in microfinance. Microfinance is a type of financial intermediation, and financial intermediation is a scale business. In general, financial institutes need to operate on a large scale to be cost effective and financially viable. Small scale operation makes it impossible for microfinance institutes to lower their operating costs. Bhatt & Tang (2001) presented financial data showing that during 1992-1994, WDA's average cost per loan was $10,863 while the average loan size was $3,338. The small size of the microenterprise sector resulted in microfinance in the United States being unable to fulfill both social and financial goals. In other words, because of the small size of the potential borrowers, microfinance failed to reach a significant number of the low-income population and to remain financially stable.

The existence of a functional public safety net sets an income floor for potential micro-entrepreneurs and may result in a disincentive to starting their own businesses, because starting a business could incur longer hours, more risk, and less pay (Novogratz, 1992; Schreiner & Morduch, 2001; Canale, 2010).

In an urban environment, small, entrepreneurial U.S. service firms face competition from large retailers and chain stores such as Wal-Mart, COSTCO, and Pizza Hut. Small U.S. manufacturing firms compete against large manufacturers and imported products. In the United States, farming is unlikely to be profitable on a small scale. In general, U.S. households do not spend significant shares of their incomes on the products and services of microbusinesses. Those small firms represent the potential clients for microfinance institutes and the limited market size creates a barrier for the microfinance institute to achieve effective scale and to attain financial sustainability (Schreiner & Morduch, 2001).

Another challenge for microfinance institutes is competition from commercial lenders in the United States. The major rival to microfinance is a personal credit card (Bouman, 1995; Christen, 1989). Different from developing countries, many of the low-income individuals in the United States are able to get a credit card (Bird, Hagstrom and Wild, 1997). Credit cards can provide microenterprise owners small and hassle-free loans in a timely manner. Low income groups in the United States have access to formal financial products that usually are not available in developing countries (Schreiner & Morduch, 2001; Hung 2001).

The ability to implement joint-liability group practice is an additional hurdle. One of the basic risk control mechanisms of microfinance practice in developing nations is group lending. In this practice, microfinance does not require collateral from the borrowers. Characteristically, a microfinance institute will ask the borrowers to form a group of about five people. All of them would be seeking loans from the microfinancer. The understanding is that if one group member is unable to repay his/her loan, he/she is discharged from the group and the others assume the responsibility for the debt. This mechanism puts pressure on each group member to pay back the loan if they want to continue borrowing from the microfinancer and to have a good credit record if they want to continue to remain in the group (Armendariz de Aghion & Morduch, 2005).

However, forming such group is difficult in the United States due to social and cultural factors such as a lack of social connections to bind group members, individualism as a dominant social value and the mobility of individuals (Schreiner & Morduch, 2001; Taub, 1998).

This is borne out dramatically using the Hofstede Model. Beside the United States, the only other countries where individualism ranks high are the recognized developed counties such as Australia, the United Kingdom, Scandinavia and Western Europe. Without exception, the countries that have been the most successful in using microfinance funding are the developing countries whose society scores the lowest on individualism, therefore illustrating the value of collectivism in them (Hofstede, 1980).

Differences in regulations result in another critical area that constrains the scale factor in microfinancing. In developing nations, regulatory systems ordinarily do not cover many informal economic sectors (Schreiner & Morduch, 2001). In the United States, there are many regulatory constraints on microfinance affecting both microfinance institutes and microenterprises.

Regulations that cap interest rates in the United States are a key factor that limits the potential profitability of microfinance and financial sustainability. Traditional banking institutes can supply funding on a large scale with much lower interest rates than microfinance institutes, while keeping the operations financially sustainable. The processing and managing costs for a $100 million dollar loan portfolio are not much higher than the costs of processing and managing a $1,000 dollar loan account. If a bank has a portfolio of 10 $10 million loans, the relative costs would be much lower and the profit would be much higher than a microfinance institute with a portfolio of 10,000 $1,000 loans. Capping the interest rates makes it difficult for the microfinancer to reduce its operating costs.

In addition, most clients of microfinance have fewer assets therefore represent much higher risk than do borrowers served by traditional banks. Limited interest rates make it difficult to manage the risks by adjusting interest rates, and the result is a much higher delinquency rate. Figure 1 illustrates the nature of the model commonly followed in the United States.

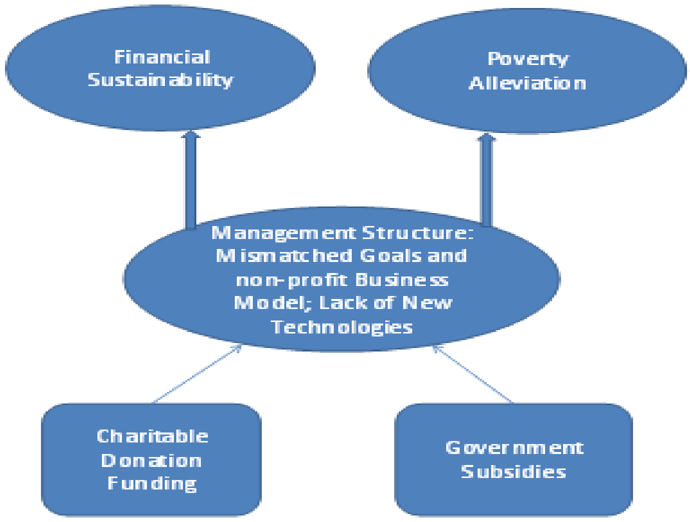

Figure 1 – Traditional model of microfinance

Questions regarding the unsuccessful replication of the traditional microfinance model in the United States suggested that the model developed in the developing countries needs to be modified to fit the social, economic environment in the United States or other developed countries (Schreiner & Morduch, 2001; Armendariz de Aghion & Morduch, 2005; Bredberg & Ek, 2011; Lieberman, et al 2012).

The modifications suggested by many studies point in two directions. First, the purpose of microfinance should be altered to job creation instead of alleviation of poverty (Bredberg & Ek, 2011; Lieberman et al, 2012; Edgcomb, 2012). Second, microfinance should not be used as a "panacea for human reconstruction" (Bhatt & Tang, 2001, pg. 230) and it should be financially sustainable (Cull et al. 2009).

Refocus on Job Creation

Studies of microfinance in the United States and in developed nations seem to reach a consensus that in the United States and developed nations, self-employment and job creation are a more appropriate focus of microfinance than poverty alleviation (Armendariz de Aghion et al, 2005; Canale, 2010; Bredberg & Ek, 2011; Lieberman, et al 2012; ACCION Report, 2012.

Poverty is a relative concept. For example, in 2010, the World Bank defined poverty for the world as $1.25-$2 a day per person. This number equates to an annual income range of $456.25 to $730. However, the poverty line in the United States was $15.15 per day per person in 2010 or $22,000 per year for a family of four ("Poverty Definitions" US Census Bureau 2011), In India it was the equivalent of one U.S. dollar per day per person ("World Bank's $1.25/day (The World Bank 2010) In China the poverty line was US$ 0.55 per day per person (1,274 yuan per year = equal to US$ 0.55 (New Progress in Development-oriented Poverty Reduction Program for Rural China (per day)" The Government of China 2011). Each statistic was calculated according to purchasing power parity basis in 2010.

By the World Bank's standard therefore, as measured by the data for the remainder of the world in the United States there is no poverty. In addition, there is a functional safety net in the United States that is designed to prevent the poor or those vulnerable to economic shocks and poverty from falling below a certain poverty level.

The social safety net mighty include cash transfers, food-based programs such as supplementary feeding programs and food stamps, vouchers, and coupons, income transfers such as school supplies and uniforms, conditional cash transfers, price subsidies for food, electricity, or public transportation, public works, and fee waivers and exemptions for health care, schooling and utilities.

In 2013, about 12 percent of the U.S. federal government budget, or $398 billion, was spent on social safety programs that provided aid other than health insurance or Social Security benefits to individuals and families facing hardships (Center on Budget and Policy Priorities, March 2014).

In the United States, the social safety net prevents millions of people from falling into poverty. An analysis conducted by Center on Budget and Policy Priorities shows that 41 million people were not considered below the of poverty level in 2012 because of federal government social safety programs, which spent about $9,700 on each recipient (Policy Basics: Where Do Our Federal Tax Dollars Go? Center on Budget and Policy Priorities, March, 2014). The $9,700 per person comes only from the federal government and it does not include support from state or local governments, NGOs, charities or other sources.

With such a functional social safety net and other social safety programs in place, microfinance programs would have a minimal direct impact on poverty alleviation in the United States. Therefore, removing poverty alleviation from the list of direct goals of U.S. microfinance programs is simply a logical step based on findings of many microfinance studies.

Removing poverty alleviation from the list of direct goals of microfinance, however, does not mean that it cannot contribute to poverty alleviation. On the contrary, by concentrating on supporting entrepreneurship and job creation it can indirectly increase income levels of people who own or are employed by microenterprises.

Refocus Enlarges Microfinance's Client Population

If the focus of microfinance programs switches from poverty alleviation to self-employment and job creation, the targeted groups should also change from the most impoverished to microenterprises and entrepreneurs (Bredberg et al, 2011). This switch will greatly enlarge the population of microfinance's clientele.

According to the Association for Enterprise Opportunity's reports (MEES), in 2011 there were 26.4 million microenterprises (those employing fewer than 4 employees not including the owner) in the United States. These small businesses accounted for 88.9% of U.S. business establishments and employed more than 33 million people.

If microfinance programs can channel financial resources to the development of those microenterprises, and if one out of three such microenterprises hired one extra employee, the United States would have virtually no unemployment problem (Lieberman et al, 2012). Those extra employees would earn wages or salaries above the poverty line and that would lead to poverty alleviation.

Both in theory and reality, this switching of goals seems to be actually happening (Armendariz de Aghion & Morduch; Lieberman et al 2012). For example, the Micro-Tracker Outcome Study for the ACCION U.S. pointed out that "the microenterprise industry in the United States seeks, at its core, to extend those who have the capacity to create and run businesses but lack of access to resources and information".

By removing the poverty alleviation from the organizational goals, the new microfinance model proposed by this study will have a much larger client group because it would target microenterprises and entrepreneurs without regard to income level. Empirical data collected by some studies proves that the demand for microfinance funding exceeds the supply in the United States, where job creation and business performance are more important than poverty alleviation (Bredberg & Ek, 2011).

Refocus Allows Microfinance to Access to Funding

Under the old model, almost all microfinance institutions began as Non-Governmental Organizations (NGOs) and relied on subsidized funding (Armendariz de Aghion et al, 2005; Lieberman et al 2012).

Although donations and/or government funding have lower costs than commercial funding it is limited in supply. de Sousa-Shields, Frankiewicz, Miamidian, Van der Steeren, & King (2004) cited numbers from CGAP (the Consultative Group to Assist the Poorest) in their research that worldwide, about $15 billion has been invested in microfinance institutions, and the demand for funding is growing at 15 to 30 percent annually. This can be converted to a demand for funding of $2.5 to $5 billion each year.

They estimated that the potential market size of microfinance is about $300 billion. The researchers argued that non-commercial investors simply cannot provide enough funding to support that degree of microfinance. CGAP conducted a survey in 2004 and the result showed that more than 144 microfinance institutions reported that funding was the number one constraint to growth (de Sousa-Shields et al., 2004). In the United States, as many are constrained by limited donation funding and lack access to funding from capital markets (Armendariz de Aghion et al, 2005; Bredberg et al, 2011 p35; Lieberman, et al, 2012).

Many studies claim that transforming microfinance institutions to commercial institutions is an on-going trend (de Sousa-Shields et al., 2004; Armendariz de Aghion et al, 2005; Lieberman, et al, 2012).

In the proposed new model, microfinance is defined as a type of financial intermediary that targets a special group of clients, "microenterprises and entrepreneurs" to support job creation and to encourage entrepreneurial self-employment.

Obviously, the success of a financial intermediary depends on the success of its clients. In a strict economic sense, a financial intermediary does not create value by itself. The value it generates comes from its clients, businesses or consumers, who borrow funds from a financial intermediary and invest in their businesses or spend in consumption. For a business that borrows funds to invest in a potential to be successful the project must generate profit sufficient to cover the principal and interest. For a individual, to pay back the loan with interest she/he must earn sufficient income as a result of either employment or owning a business. In another words, the sustainability of a financial intermediary basically depends on the ability of its clients to generate adequate revenue. Therefore, a financial intermediary's business status would be determined by the quality of its constituents.

The microfinance model successful in developing countries but not in the United States is a type of hybrid organization with two mismatched organizational goals (Servon, 2006): poverty alleviation and financial sustainability. The mismatched goals lower efficiency in serving targeted clients; donation driven behavior-disincentives for effective operation and financial sustainability; and ineffective and inefficient management (Bhatt & Tang, 2001; de Sousa-Shields et al., 2004; Bredberg et al, 2011; Lieberman, et al, 2012).

The mission-driven, not-for-profit microfinance model is simply not working because its target market and the risk and return of its investments are not well defined. Its financing is highly reliant upon limited donated funds; its operating costs are high; and its interest charged is not sufficient to cover all costs. (de Sousa-Shields et al., 2004; Lieberman et al, 2012)

The risk and return potential of an investment portfolio determines the asset class of a financial intermediary, and what type of capital it can access. The microfinance model replicated from the developing countries to the United States with two mismatched goals leads to an unclear risk and return potential and an undefined asset class.

de Sousa-Shields et al. (2004) pointed out that "the asset class or classes to which microfinance investments belong is not established". As a result, the unclear asset class of microfinance becomes an obstacle to commercial investment funding.

The proposed new model removes poverty alleviation from the direct organizational goals. The removal of poverty alleviation from microfinance's direct organizational goals leads to a much clearer organizational focus: supporting job creation and entrepreneurial self-employment activities. With distinctly defined organizational goals the targeted clients can be well identified and the risk and return associated with those clients can be clearly established.

With a group of clearly identified clients or a clear market section in which microfinance operates, the proposed new model enables a microfinance institution to operate as a commercial business and enables it to access a much larger capital pool not limited by charity funding, and to achieve greater scale in its operation. As a result of the access to a larger supply of funding and greater number of viable clients, a microfinance institution will not only be able to achieve meaningful scale, but will also be able to reduce its costs.

Refocus Improves Administrative Efficiency and Effectiveness

Administrative inefficiency and ineffectiveness are atypical symptoms of the old model of microfinance in the United States (Bhatt & Tang, 2001; de Sousa-Shields et al., 2004; Lieberman et al, 2012). de Sousa-Shields et al. asserted that "in fact, the non-profit model seldom translates into superior MFI performance despite its preferential tax treatment and lack of regulation and supervision" (2004 p31).

Bhatt & Tang listed several reasons for the lack of administrative efficiency and effectiveness of microfinance programs under the old model: "First, most programs do not make enhancing self-sufficiency a priority and therefore remain almost entirely dependent on outside subsidies. Second, operating and administrative costs of microcredit programs, especially in terms of staff salaries and basic infrastructure, are much higher in the United States …". Third, most microcredit programs in the United States do not charge interest rates and fees that can cover their risks and administrative cost structure. Finally, problems in administrative intermediation arise because of challenges associated with program governance." (Bhatt & Tang, 2001, pg. 234)

Mismatched organizational goals and reliance on subsidized funding create a governance mentality that leads to a social mission driven, not for profit, and grant equity influencing mentality (Kooi, 2001; de Sousa-Shields et al., 2002). This type of organizational culture often results in irresponsible decisions and inadequate performance standards. Such culture also creates an incentive to management not to report problems on time and a reluctance to make efforts to fix problems (Bhatt & Tang, 2001).

Removing the poverty alleviation from the organizational goals, the new model is no longer constrained by its social mission of fighting poverty. Therefore, it enables microfinance institutions to focus on following a rigorous business model consistent with for-profit organizational. The introduction a for-profit management system should greatly improve the administrative efficiency and effectiveness (de Sousa-Shields et al., 2004). de Sousa-Shields et al., (2004, p 32) claimed that "even the most poorly structured commercial loan or private investment could impart greater market discipline than the most well-conceived grant or donation".

Managing Operating Costs

One of the key challenges faced by microfinance institutions in the United States is the high cost of managing a large amount of small accounts with unique risk characteristics (Bhatt & Tang, 2001; Schreiner & Morduch, 2001; de Sousa-Shields et al., 2004; Armendariz de Aghion et al, 2005; Lieberman et al, 2012).

The model originated in the developing countries manages the costs and risks through a key approach: peer group lending (Hulme & Mosely, 1996; Bhatt & Tang, 2001). The underlying mechanism for peer group lending is joint liability for the borrowed funds. Because most borrowers of microfinance have meager if any tangible collateral, microfinance employs the peer group lending approach to create a substitute for tangible collateral. Joint liability and peer pressure are intended to create positive and negative incentives for member borrowers to do due diligence and/or to take responsibility for a delinquent member under certain circumstances.

Under the peer group lending practice, a group usually consists of 5 or more members and the group is responsible for recruiting and screening new members. This mechanism greatly lowers the costs of a microfinance institution to screen and monitor its borrowers (Schreiner et al, 2001).

Group lending practice succeeds in developing countries because members of a group usually know each other and live in the same village. Members understand each other's financial situation and are able to screen out risky applicants. This mechanism reduces the transaction costs of repayment enforcement and raises the efficiency and effectiveness of microfinance institutions' operation. However, despite successes in developing countries many studies of microfinance in the United States showed that this mechanism did not work well (Hung, 1998; Sternberg, 1998; Schreiner & Morduch, 2001).

Several reasons were quoted for the failure of group lending in the United States. First, microfinance institutions in the United States rarely are able to recruit group members from the same neighborhood nor do members ordinarily know each other. Forming groups consisting of strangers does not create the bond that is crucial to enforcing due diligence and repayment.

Second, Americans are much more mobile than residents in developing countries. Without true social and economic ties and with abundant chances to move to other places for better opportunities, a group member is highly likely to take opportunist actions is less obligated and is less obligated to fellow group members.

Third, a typical American cultural symbol is individualism and it influences people's behavior. In such a culture, a person is supposed to be responsible for his/her own actions and he/she is also reluctant to take responsibility for other people. Membership in a group that consists of those who strongly believe in individualism will not build any incentive for a member to take responsibilities for other members' troubles and delinquencies (Bhatt & Tang, 2001; Schreiner & Morduch, 2001).

However, others argued that the group lending practice could be an effective instrument if it is implemented appropriately (Bredberg & Ek, 2011). They found in their study of three large microfinance institutions in New York where the clients employed group meetings where they could share business experiences and comments on their business challenges (2011). Compared to Grameen America, an organization that practices group lending, ACCION USA, one that practices individual lending, has 10% lower repayment rates (Bredberg et al, 2011. The evidence supports the theory that the group lending concept works in the United States.

Group lending practice is not a new concept and it has been available for centuries. Evidence presented in many studies of immigrant entrepreneurs in the United States shows that Rotating Credit Associations (RCAs), a type of informal grass-root microfinance practices group lending, have been in operation successfully for a long time (Besley et al., 1993; Bressler & Wiseman, 2011). Many studies on immigrant businesses and ethnic businesses showed that engagement in some type of RCA is a common practice by many ethnic entrepreneurs (Bressler et al, 2011). The names may be different; for example, Korean Americans call them "Kyes" and Chinese name is "Hui" (Brown, Garguilo, & Mehta, 2011).

This type of grass root informal microfinance combines the mobilization of social and financial resources and pooling and exchanging resources. Although the operating procedures may vary in different "Kyes" or "Huis", the principle is the same.

A person, as the organizer, initiates the RCA and recruits other members. The group members function as guarantors for each other, taking responsibility for any loss that may occur if a member fails to repay a loan. Once the members have been recruited, the organizer ranks them to determine who would be a borrower or who would be a lender. The organizer receives preferential treatment as a pure borrower. He or she gets the first loan and pays several installments with interest to the RCA. The last person in ranking is a pure lender. When the loan cycle is completed the pure lender receives the total amount he or she contributed with interest.

The rank received by each member governs the timing and amount he/she must contribute to the fund or monthly installment payment if he/she is a borrower. In "Kyes" or "Huis", the procedure is simple and no collateral is requested. The organizer undertakes a careful screening process to determine the qualifications of a potential member. Reputation is very important because it functions as the social collateral.

In such arrangement, members know each other, and usually live in the same community or belong to the same church. Typically the members meet each month at a church or a restaurant to conduct their business and to exchange ideas.

A prerequisite for a new recruit is that he/she must know at least one existing member who functions as the key reference. The practice of group lending creates strong personal and financial incentives for group members to fulfill their obligations. If a member defaults on his/her loan, the other members in the group have an incentive to take actions to ensure the fund is not negatively impacted (Besley, Coate & Loury, 1993).

In general, RCAs provide entrepreneurs access to financial resources without having to apply for a loan from a formal financial lender such as a bank (Bressler & Wiseman, 2011). Operating in this manner incurs much lower costs than the existing microfinance institutions that are unsuccessful in terms of implementing group-lending practice (Bhatt & Tang, 2001).

Light (1984) documented the successful process of Korean immigrants to New York who used microfinancing. Established merchants would hire and train newly arrived immigrants; they in turn saved money and opened their own stores, usually in the same type of business. This networking allowed the new arrivals to overcome the difficulty of finding employment in the general economy.

Microfinance as a Financial Intermediary

The function of microfinance programs should be more like what the Chairman of the Federal Reserve Ben Bernanke pointed out in his speech: “to offer small loans and other financial services to low-income people to help them increase their incomes through entrepreneurship and self-employment” (Bernanke, 2007). Those studies also argued that microfinance is a type of financial intermediary with special purposes. The financial intermediary has a basic function of transferring financial resources from the savers to spenders (spending on investments or consumptions). The basic business model of the financial intermediary is to attract low-cost funding and to lend the funding out at a higher interest rate. The spread between the cost of funds and the loan’s interest rate is the financial intermediary’s revenue. That margin should cover its operating costs, financial costs, and funds for future growth and development.

To make this business model work three conditions must be met. First, it must serve an identified market or market segment well. Second, the financial intermediary must be able to raise funds at a rate lower than what it can charge its client to cover its operation costs and risks incurred. Third, the financial intermediary must be able to manage its operating costs at a level that can be competitive and efficient. These three basic conditions are similar to the three dimensions discussed as social intermediation, financial intermediation, and administrative intermediation by Bhatt & Tang (2001). The existing microfinance model replicated in the United States so far has not obtained satisfactory results in those aspects.

The microfinance model proposed in this study addresses the three conditions necessary to make if it intends to make microfinance programs work in the United States. It is evident that microfinance institutions are not effective instruments for poverty alleviation in the United States.

It raises the question of whether the group lending practice is not suitable for the United States or it has not been adopted appropriately by the U.S. microfinance institutions.

Technology as a Device for Managing Operating Costs

New technologies in telecommunication and internet provide powerful tools for reducing and managing microfinance operating costs. High technology, such as mobile banking, enables customers to use their smart phones to access banking services as an alternative to a credit or debit card (Lieberman, et al., 2011). Hishigsuren (2006) provided a list of IT technologies commonly used in microfinance including: “ATMs, POS, IVR (Interactive voice response technology), Internet Banking, PDA (personal digital assistant), MIS, Credit Scoring, Smart Cards, and Biometric Technology” (2006). Those technologies have been well developed and available in most markets. However, the majority of microfinance institutions have not been fully utilizing such technology to manage their operating costs.

A report titled “The Use of Technology in Microfinance” produced by the IT & Innovation Working Group sponsored by European Microfinance and Global Development Alliance reported that in their survey of 68 microfinance institutions out of 12 countries, “2/3 of the organizations are completely lack an application to ensure that the data flows automatically from the portfolio management application to the financial accounting software without duplicate data entry”. (2011, p5)

About half of the microfinance institutions surveyed do not employ an application that can electronically report data of repayment record of loan accounts to a credit bureau.

The new microfinance model proposed by this study will request microfinance institutions to employ newest technology in order to outreach clients, to conduct credit screening and transactions, to collect information, to provide financial services, and to manage operating costs.

The New Model

The proposed new model a focuses on a more specific goal: supporting microenterprises and entrepreneurial start-ups for job creation. It proposes to employ a for-profit organizational management structure to improve operating efficiency and effectiveness. It advocates the group-lending mechanism to lower the risk and to reduce the operating costs by shifting part of the recruiting, screening, and managing of the borrowers from the microfinance organizations to the client group members.

In this model, a microfinance institution can be a for-profit or a non-profit organization. However, the business model that operates the organization is a for-profit model.

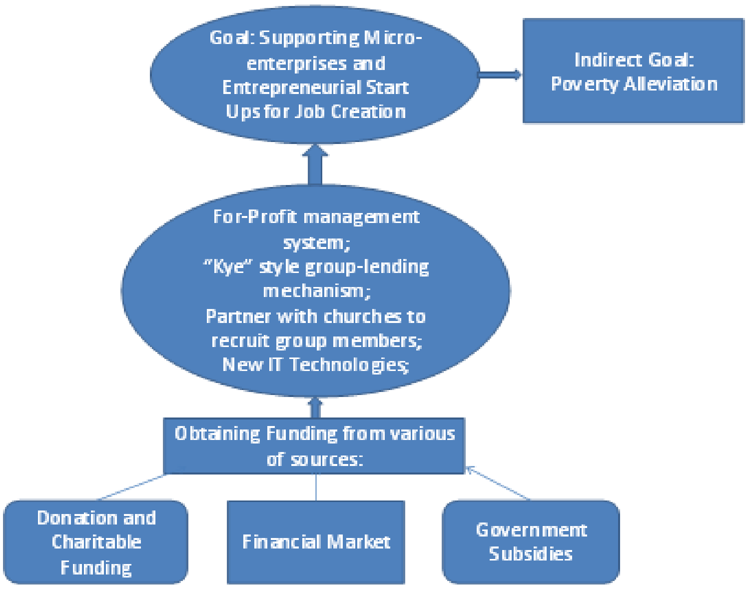

Figure 2 – A modified Model of Microfinance

Figure 2. A proposed modified model for microfinance in the United States
de Sousa-Shields et al., (2011) claimed that regardless region or age of microfinance institutions, in general, for-profit microfinance institutions achieved much higher results than non-profit institutions.

The proposed new model has a clear organizational goal, an efficient and effective management system, and access to multiple funding sources. On the contrary, the old model has dual mismatched goals, an inefficient and ineffective bureaucratic management system, and only access to limited funding sources.

Fernando documented in a study: "for-profit model tend to have stronger governance, greater stability, better access to capital, increased equity and greater scope and scale" (2004).

This proposed new model will provide microfinance institutions in the United States a much broader perspective, a much larger financial funding pool, a much efficient and effective management system, and a clear measurable and achievable goal.

Conclusion

Microfinance is a potentially significant component of the U.S. economy and financial system. However, the microfinance model that has been successful in many developing countries has not worked well in the

United States, and remains inefficient and ineffective. It also depends heavily on limited funding sources from governments and donors (Bhatt & Tang, 2001; Lieberman, et al., 2012). Many microfinance organizations, including organizations in developing countries where the microfinance model was originated, have modified the model to fit specific environments.

The proposed modified model addresses the issues faced by microfinance in the United States and points out that poverty alleviation is not the key issue in the U.S. economy and it should be removed as a key organizational goal of microfinance institutions.

Removing poverty alleviation from the key organizational goals enables the microfinance institution in the United States to introduce private, for-profit capital in the operation. By bringing private capital into microfinance operations the new model will improve efficiency and effectiveness. It also makes it possible for microfinance organizations to increase the scale of their operations and lower their costs. By adopting "Kye" or "Hui" types of group-lending structures, the new model would make costs and risk control more manageable.

There are many reasons for the failure of the replicated model but the key internal factors underlining the failure are 1) the dual mismatched organizational goals; 2) the not-for-profit management system; and 3) heavy reliance on limited government and donor funding. Several external factors also contribute to the failure such as 1) the small size of targeted clientele; 2) competition from large commercial lenders, especially credit cards; 3) difficulty of practicing group-lending; and 4) government regulations (Schreiner & Morduc, 2001).

The proposed modified model removes the three internal obstacles by eliminating poverty alleviation as an organizational goal while concentrating on job creation instead. It proposes a for-profit management system, and offers suggestions for microfinance institutions to access multiple funding sources.

The modified model also addresses the external challenges. By eliminating the poverty alleviation as an organizational goal, it enlarges the targeted clientele from the low income community to microenterprises, small business, and entrepreneurial start-ups. The adoption of a "Kye" style group-lending mechanism enables microfinance institutions to work closely with clients and the group members to support each other at regular bases; such strong working and supporting systems cannot be provided by credit cards.

Studies of microfinance in the United States pointed out that the regulations on microfinance are not onerous, and to certain degree, unclear (Bredberg & Ek, 2011; Walker, 2011). This modified model introduces a for-profit management system that enables the microfinance institutions to operate at lower costs, and makes it possible to be financial sustainable without charging interest rates higher than the legal rates permitted by current regulations.

This proposed model is not completely new. Many studies have focused on multiple aspects of the microfinance model in the United States and provided many viable suggestions and strategies. However, the mismatched goals and the double bottom lines hamper the model's ability to achieve success. If microfinance organizations adopted this model, they could not only improve their service quality but also expand the scale and scope of their service.

Currently, there is a gap between serving the targeted clients and achieving financial sustainability by microfinance institutions in the United States. There seems to be a consensus that introducing a for-profit operation system and access funding from financial market is the trend (de Sousa-Shields et al., 2004; Lieberman, et al., 2012). In reality, there have already emerged other forms of microfinance that are complete for-profit commercial operators (de Sousa-Shields et al., 2004; Lieberman, et al., 2012).

Further research is recommended, especially research on ethnic business financing models, existing commercial microfinance models, and other types of microfinance. A field study is scheduled by the authors to conduct interviews among Korean and Chinese Americans. A ground theory approach will be taken to conduct such research and empirical evidence will be collected and presented in the future study.

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