

FEATURE ARTICLES

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The GIAN/RUIG¹ project “Microfinance and Public Policy” was implemented from 2004 to 2006 by the ILO in partnership with the University of Geneva, the Geneva Institute of Development Studies (GIDS) and the University of Cambridge. The project sought to clarify an issue that microfinance practitioners and donor agencies have been struggling with for some time: how to preserve the dual commitment of microfinance institutions to both social and commercial goals – poverty reduction and profitability – whilst ensuring their progressive integration into the financial market and phasing out of subsidies. The project generated original empirical data about the clients of 45 microfinance institutions in 24 countries, their loan portfolio, financial statements and relations to donor agencies and government. The selected microfinance institutions had a minimum of 3000 clients, had been in operation for at least five years and disposed of continuous financial records from 1999-2003. The study was prompted by the idea that one cannot compare very poverty oriented MFIs with very commercially minded MFIs unless one introduces a third, underlying performance standard: efficiency. We felt encouraged to do so because of the use of efficiency in comparative performance measurement of both profit-maximising and profit-constrained agents (like NGOs or public administrations).

In order to explain the level of efficiency of a given MFI in relation to similar MFIs we selected five factors that we assumed would determine its efficiency rank, and its position on the spectrum between poverty focus and financial performance. On the basis of the literature, notably the *Micro Banking Bulletin* and the *MIX Market*, we singled out the following variables:

- location
- legal form
- delivery technique (i.e. use of individual or group loan contracts)

- subsidies
- staff issues.

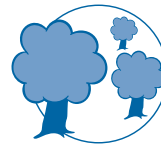
As the attached scatter gram shows (Figure 1) the application of cluster and factor analysis produced four predominant groups of MFIs: those that are inefficient in terms of both social and financial performance, others that experience a trade-off in one direction or another (i.e. they are either good as social or as financial performers) and finally some that perform well in both respects.

The surveys showed also that there is not a clear cut trade off between poverty outreach and financial performance: some MFIs manage to reach very poor households and still break even; others cater to a better-off clientele without performing well financially.

This would seem to signal that financial performance does not necessarily coincide with efficiency, or to put it differently: there can be situations where an MFI operates efficiently but fails to break even – not because of poor management, but due to contextual factors in the local market that keep resource costs at comparatively high levels. The second implication is that not all financially self sustaining MFI are necessarily also efficient. Public policy has thus a role to play in scenarios where efficient MFIs may fail to break even, but make a tangible contribution to poverty reduction and alleviation and where no other institution, private or public would take their place.

The data generated throws light on the critical importance of subsidies – positive and negative. Rather than categorically excluding the use of subsidies we feel that one needs to differentiate between “smart” and “unsmart” uses of subsidies, following the notion coined by Jonathan Morduch. The form, intensity, timing, conditionality and shape of subsidies make a difference to market distortion or institutional moral hazard. This finding has far reaching implications for donor and government policies.

¹ Geneva International Academic Network



Commercial and sustainable refinancing of microfinance institutions worldwide

Who We Are

A bridge between microfinance and the capital markets

BlueOrchard Finance is a Swiss company specialising in the management of microfinance investment products. We assist banks and financial intermediaries who wish to invest in the microfinance industry by offering a comprehensive package of services designed to invest efficiently in this promising sector. This includes initial identification of, and due diligence on, microfinance institutions, as well as continuous monitoring and reporting on their activities and portfolios. BlueOrchard Finance manages the relationship with all the parties involved and strictly adheres to the investment policies and guidelines of its clients.

A leading and preferred investment provider to microfinance institutions

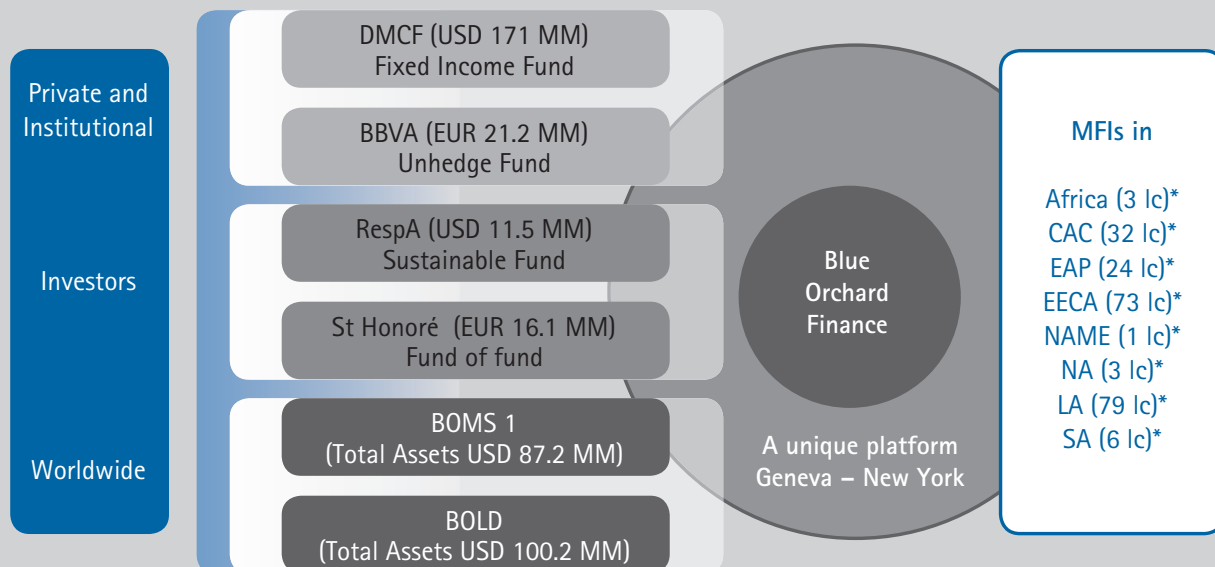
BlueOrchard Finance seeks to develop long-term relationships with microfinance clients and partners by sharing information, knowledge and risks, and by investing jointly in the development of microfinance. BlueOrchard's most important asset is its ability to create value through solid relationships with leading microfinance institutions all over the world. By building trust, listening actively and constantly interacting with institutions in the field, BlueOrchard is able to tailor products and services to fit its clients' needs.

A promoter of microfinance to the commercial investment community

BlueOrchard Finance follows a strict selection mechanism in line with the criteria set out

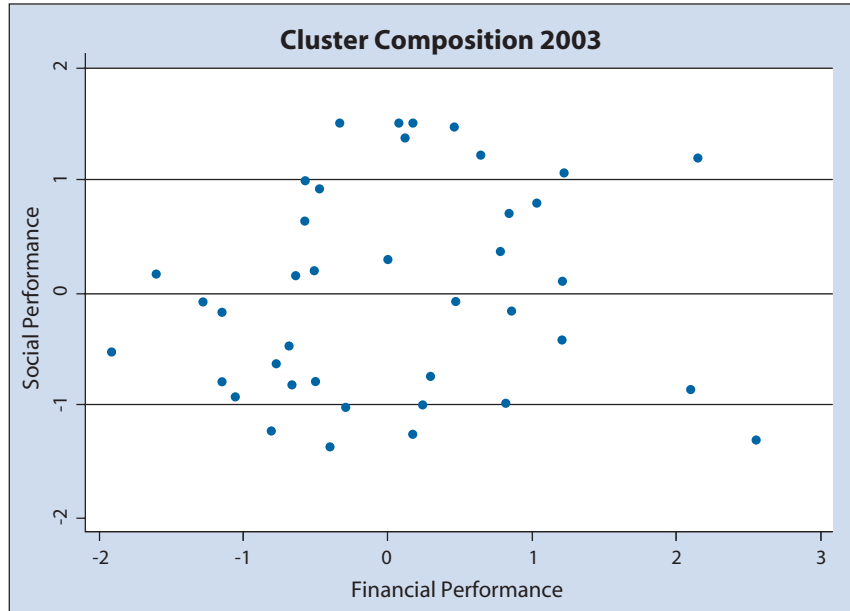
in the investment policies of the microfinance investment products that it manages. This rigorous approach ensures that the portfolios are made up of reliable and sustainable institutions: investment advice is always based on in-depth due diligence, supplemented by the opinions of selected field experts, specialised evaluations companies, rating agencies, networks and international organisations. BlueOrchard's proven track record has convinced an ever-growing number of investors to choose the quality and profitability of a win-win investment: they earn a stable and competitive financial return on their investments while delivering effective social impact in emerging markets by encouraging entrepreneurship at the micro level.

What We Do : Our Products



* lc : loan current
CAC : Central American & The Caribb
EAP : East Asia and the Pacific
EECA : East Europe & Central Asia
NAME : North Africa & Middle East
LA : Latin America
SA : South Asia

Figure 1: Trade off between Social and Financial Performance



Legend: The cluster and factor analysis of 2003 data shows that MFIs either were inefficient in terms of both social and financial performance (bottom left), experience a trade-off with either good social or good financial performance (top left and bottom right, respectively) or were good performers in both respects (top right).

Poverty focus and financial self sufficiency of MFIs are necessary but not always sufficient guide posts for the donor community and national governments to orient their support to MFIs. By themselves they do not allow sound decisions on the allocation of subsidies to some MFIs or the reduction and withdrawal of subsidies from others. Poverty focus and financial self sufficiency are, it is true, fundamental dimensions of the space in which any given MFI has to position itself; but whether it performs well or not, is not a question of whether it just makes profits or – the other extreme – just deals with the rock bottom poor, but rather whether it performs well in its category or class of MFIs.

In microfinance efficiency determines how well a MFI does in allocating inputs (assets, staff, subsidies etc) to produce the maximum output (number of loans, financial self sufficiency, poverty outreach etc.) compared to the combinations performed by similar MFIs in matching situations. The choice of inputs and outputs depends on the MFI/donor agenda and priorities.

Our findings regarding efficiency in microfinance can be summed in the following points:

- Most determinants of efficiency across all MFIs fall in two categories: factors that MFI

management can influence (like the choice of delivery technique, collateral requirements, graduation lending etc) and others that it cannot fully control and for which it cannot be held accountable (like client density, scope of clients' viable income generating activities etc.). A third category of efficiency drivers cannot neatly be attributed to being either management-dependant or exogenous, for example the wages paid to loan officers. Only the first kind of efficiency drivers should and can be used by governments and donors to fix, modify or phase out a subsidy for performance.

- A meaningful qualification of an MFI as more or less efficient requires information on a batch of comparable MFIs positioned similarly on the poverty–profitability continuum. Comparability is based on several criteria, whether an MFI operates in rural or urban areas, whether it is a monopolist or not and whether it faces competition in one or several factor markets; it is also based on similarity of output mixes and production functions (technology, delivery technique like group versus individual lending, or collateral-based versus collateral free lending).

- The level of efficiency may not be immediately visible, but it can be traced and established on the basis of input and output variables, namely number of clients, number of loan officers, number of staff members; administrative expenses, or the subset: "staff expenses", number of loans, overall loan portfolio.
- Comparisons of the efficiency of MFIs across countries with usually very different operating environments make only limited sense. By contrast our country chapters on Mali, Morocco and Chile using a common reference in the regulatory, policy and domestic market environment reveal significant differences in performance and efficiency between MFIs.
- Efficiency is always relative to one institution that is closest to the frontier: the "best in class". Linear programming techniques like Data Envelopment Analysis (DEA) capture the distance from the frontier and help determine whether or not over time an MFI is shortening the distance. DEA accommodates different production functions in microfinance. In frontier analysis the performance of an average firm is expressed as economies in input use that it could achieve if it produced on the frontier instead of on its current location. A 0.79 figure, for example, signals that an MFI could save on 21 percent of inputs, for example loan officer staff time, if it operated on the frontier.

The efficiency drivers identified that make up classes or groups of MFIs like location, legal form etc. are largely country specific. One of the methodological drawbacks of the large geographical coverage in the GIAN/RUIG survey is the great variety of contexts (24 countries), which makes it difficult to appreciate and weigh precisely the impact of, say, interest rate ceilings in one country with a fully liberalized regime of interest rates in another country. To correct for this shortcoming a follow-up survey of MFIs in three countries was carried out in the fall of 2006.

This also helped to go more deeply into an assessment of the variety of real life subsidies. Of the 45 MFIs reviewed in our survey every one without exception had a donor partner that provided some form of subsidy: seven MFIs had one donor partner, 15 MFIs two or three and 20 MFIs more than three; CAME and FDL top the list with 12 and 26 donors respectively. Expressed as a percentage of total liabilities, subsidies represent less than 10 per cent in 10 MFIs, between

11 per cent and 50 per cent in 11 MFIs and between 51 per cent and 100 per cent in 12 MFIs. Contrary to expectations the use of subsidies has over the years decreased in 12 MFIs, but in 14 cases the share of subsidies on total liabilities has increased.

Thirteen MFIs in our sample complained that donors were pushing them towards more emphasis on poverty reduction; 18 MFIs said that their donor partners were prodding them to go into the opposite direction, to accelerate towards financial self sufficiency. MFIs with several donor partners may even send conflicting signals. What emerges generally is that donors either go for more poverty impact or for better financial performance, but never towards more efficiency within given social and financial performance goals.

Subsidies in the form of soft loans are common in microfinance and they are important: in fact, ten of the surveyed 45 MFIs felt that without subsidies they would have to close down, while 34 were convinced that they would not be able to go up-scale without subsidies via a better use of human and financial resources. This responds to the needs of many MFIs which feel they do not dispose of both factors of production in the right quantity and quality: 22 MFIs signal human resource constraints as their dominating need and 26 MFIs identify financial resource constraints.

This suggests that donor money plays a critical role in allowing MFIs to combine social and financial goals, allowing an MFI not to have to choose to go either towards one or towards the other. If the MFI operates in isolation, then this will not have negative externalities; however, if the MFI competes with other MFIs, then there is a risk for market distortions and undercutting operations of competitors, unless donor money is available to all MFIs across the board, for example via an apex. All but four of the 45 MFIs in our survey compete with other MFIs, and of these 33 institutions are subsidized, but only two MFIs felt that their market was undercut by a government subsidy scheme. The longer the maturity of such soft loans, the easier it will be for the MFI to expand its output mix and go into longer term, and more revenue-generating lending, which is of potential interest to clients with investment needs, like the owners of growing micro-enterprises.

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