

Breaking it Down...

MICROBANKING BULLETIN, ISSUE 14, SPRING 2007

Efficiency

Isabelle Barrès, Director for Strategic Development, MIX

There are many common measures for efficiency, either looking at cost per unit such as cost per borrower or cost per loan, or looking at cost per dollar lent: operating expenses over loan portfolio, personnel expenses over loan portfolio or over total administrative expenses. Often times, one of these measures is taken in isolation to identify whether or not an MFI is 'efficient'. But is this sufficient?

Although these measures alone shed light on whether a microfinance institution (MFI) is able to provide its services to clients with lower costs, they do not take into account certain important factors, such as whether the MFI offers multiple products (which may increase delivery costs), is benefiting from higher loan sizes (which improve the efficiency ratio) or faces lower cost structures.

Indeed, with these efficiency ratios, the two main drivers for better performance are: 1/costs control and 2/increase in volume (number of accounts, number of clients, and size of portfolio). An MFI can improve its efficiency by lowering its costs for the same volume of output or by increasing its output for the same costs.

Therefore—when comparing efficiency across institutions—a number of complementary measures are important to take into account as well. Some examples include the average loan size, the average salary per GNI per capita or the loan officer productivity.

First pitfall: average loan balance

As mentioned earlier, an MFI can improve its efficiency measure by increasing its output without increasing its costs. While usually increasing output will increase costs (additional clients served, additional accounts to service), there are a few instances where this is not the case. Consider two MFIs that are similar in all but one aspect: their average loan balance. MFI A and MFI B face the same costs, but MFI A has an average loan balance of US\$200 while MFI B has an average

outstanding loan balance of US\$1,000. Both MFI A and MFI B have 1 million clients, and operating expenses of US\$20 million.

Efficiency for these two MFIs, as measured by operating expenses over loan portfolio, would be:

- **MFI A:** US\$20 million/US\$200 million = 10%
- **MFI B:** US\$20 million/US\$1 billion = 2%

MFI B would *appear* to be more efficient than MFI A, but only because it is benefiting from average loan balances that are 5 times bigger.

Second pitfall: credit-only bias

While some MFIs, as MFI B above, benefit from volume measures, some are at a disadvantage because the common volume measures currently focus on the credit services offered by MFIs. Indeed, the denominator in efficiency is commonly 'borrowers', 'loan accounts', or 'loan portfolio'. With these measures, a true financial intermediary that offers other services than microcredit is judged on one hand on its total costs to provide services, but not on the total volume of services that it provides.

Consider the first common measures of efficiency mentioned above: cost per borrower or cost per loan. MFI C and MFI D are similar in all aspects but one: MFI C offers only microcredit services to its clients while MFI D mobilizes microsavings and offers microinsurance.

Both MFIs have the same total loan portfolio outstanding: US\$200 million and 1 million clients (for an average outstanding loan balance of US\$200). MFI A, which offers only credit services, has total operating costs of US\$20 million, while MFI B faces total operating costs of US\$30 million.

MFI A faces a cost of US\$20 per borrower while the cost for MFI B is US\$30 per borrower.

MFI A *appears* to be more efficient, but this measure does not take into account the fact that, in addition to attending to its 1 million borrowers, MFI B also serves 2 million savers and manages half a million microinsurance accounts with the same total costs.

Third pitfall: higher cost structures

As we saw earlier, another way to improve the results for common efficiency ratios — in addition to increasing volume at a faster pace than costs — is to reduce the costs.

While MFIs have great room to maneuver to control their costs (maintaining a good quality of portfolio in order to maintain the loan loss provision costs down, reducing administrative expenses, leveraging funds to reduce cost of financing), some costs are very difficult for the MFI to push downwards.

Consider the salary expenditures, which represent the highest portion of operating cost in most MFIs. Salary levels are often market driven, and not efficiency driven. An MFI usually has much less room to maneuver to reduce expenses when it comes to salaries and MFIs in countries where cost structures are high need to reduce other operating expenses to an even greater degree in order to maintain the same level of efficiency as similar MFIs in other markets.

Short of offering considerable non-cash incentives to its staff, an MFI that offers salaries considerably below market will simply not be able to attract and retain staff.

Therefore, considering the weight of salary expenses in overall operating expenses, taking a look at the average salary is also crucial. Looking at average salary relative to GNI per capita enables to compare across regions.

In our next example, MFIs E and F are similar in all but their location. Both have total loan portfolios

of US\$60 million, total operating expenses of US\$10 million, and an *efficiency* ratio of 16.67%. Yet the average salary for MFI E is 5 times GNI per capita while it is on average 10 times GNI per capita for MFI F. By nature of factors that the MFI has no control over (its location), MFI E is at a considerable advantage over MFI F.

Fourth pitfall: productivity

Analyzing efficiency without productivity leaves out a crucial part of the equation. Indeed, increased productivity is another way for MFIs to increase volumes of output with the same costs (i.e., same number of loan officers).

Productivity is therefore another important measure that needs to be taken into consideration when identifying why an MFI is – or not – efficient.

In Conclusion

Three of the pitfalls identified here are covered in the concept of ‘salary burden’¹, which looks at 3 key efficiency variables that are necessary to understand the common efficiency measures: 1/average staff salary/GNI per capita, 2/average outstanding balance per GNI per capita and 3/average number of clients per staff members.

By allowing to group organizations according to similar characteristics (i.e., average loan balance, country of operations), and comparing apples to apples, benchmarking is one of the analytical tools that are useful to go beyond an overly simplistic ratio analysis that would want one number to tell the entire story.

The examples above reinforce the need to analyze ratios in a broader context and ‘dig through the numbers’. It is only by looking at the underlying drivers of efficiency and nuances in the analysis that one can truly say whether an *MFI* is more efficient than another, or whether it merely *appears* to be.

¹ For more details on the ‘salary burden’, refer to MicroBanking Bulletin No.4, February 2000, Focus on Efficiency, page 42.