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Microfinance: outreach versus sustainability

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The challenge is to create feasible mechanisms for the low-income population

The development of microfinance is one of the most promising strategies to fight the current state of global poverty. Although there is not a precise definition, microfinance tends to be understood in literature as the funding of projects for individuals who usually would not have access to traditional credit markets. The basic idea is that poverty is not incompatible with an individual's entrepreneurial potential. In this vein, access to credit would allow impoverished individuals to implement profitable projects, making it feasible for them to permanently increase their income. Public agencies, NGOs and private financial institutions provide funding in a decentralized fashion, generally through non-conventional risk assessment methods and financial incentives (discussed further on).

Although the operational focus is the availability of micro-credit (i.e., small-scale credit), a microfinance operation often involves the availability of other financial and non-financial services, such as: access to checking accounts, training, and health and education services, inter alia.

The main issue lies in the sustainability of microfinance

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institutions (MFIs). The main point is: is it possible to organize a funding method that would contribute to the well-being of low-income individuals, but that is, at the same time, economically feasible, covering at least the lenders' costs?

Today, there is a debate in which, on one hand, some consider that when an MFI goal is to reach financial sustainability, socially desirable projects are impractical. On the other hand, some advocate that profitable institutions should be capable of expanding autonomously, thus attracting commercial capital: profitability would be a condition to broaden the outreach of MFIs.

Traditional analysis proves non effective for agents with limited resources operating on a small scale

The purpose of this report is to investigate this issue based on the Microbanking Bulletin data. Such database is provided by the Microfinance Information Exchange (MIX), a non-profit organization that collects and disseminates information concerning the microfinance industry. In 2007, the MIX surveyed 890 institutions from all over the world, with about 63 million clients and 42 billion dollars in assets.

The main point of this report is that there is an actual trade-off between sustainability and social outreach[1]. More specifically, MFIs whose clients face smaller wealth-related restrictions provide sounder financial sustainability rates than those who have poorer clients. With this, the evidences are that MFIs can reach – in a sustainable fashion – a group of low-income microentrepreneurs whose access to traditional credit markets was in the past restricted. However, financing micro-entrepreneurs with very low incomes – or the "poorest of the poor" – requires some subsidy in the form of government financial support or contribution from donators.

Imperfections in the credit and microfinance market

Granting credit generally means facing two major problems: information asymmetry and transaction costs. Such problems are even bigger in the case of micro-credit.

Information asymmetry occurs when the lender is in doubt about a given characteristic or choice of the debtor. For instance, the entrepreneur may have more information regarding perspectives of success than the bank

1 This is underscored in J. Conning, "Outreach, sustainability and leverage in monitored and peer-monitored lending" (Journal of Development Economics, 1999), using the same database of Microbanking Bulletin, but based on a survey conducted in 1998. The following analysis, based on the 2007 survey, covers a higher number of institutions—about ten times higher—and may be considered more robust and significant.

which is financing the project. Likewise, the bank is not able to verify some actions the entrepreneur has taken and which may impair the success of the project.

Transaction costs, in their turn, are the funds that should be allocated while negotiating and drafting the loan agreement, as well as further follow-up and possible renegotiation or settlement.

There are many "traditional" ways to reduce such problems. Banks try to measure firms' risks by assessing their balance sheets. Once the loan is granted, banks may directly monitor the entrepreneurs' actions. Demanding collateral is aimed at screening substandard projects, or inducing businesspeople to make choices which are more aligned with the banks' interests (in particular, less risky choices).

Such measures, however, are not sufficiently effective for agents with limited resources operating on a small scale. In such cases, information is generally hard to obtain as several micro-businesses — and individual entrepreneurs — do not have balance sheets. Collateral is, by definition, less effective when there is low asset availability. Besides this, the small scale of the projects makes direct monitoring and fixed costs per loan unit impractical. Thus, small impoverished entrepreneurs have little access to traditional credit.

Women represent 83% of the loans whose value does not exceed 20% of GDP per capita

Microfinance is earmarked for microentrepreneurs with low personal resources, where the credit operation is based on non-conventional methods which seek to avoid problems of information asymmetry and transaction costs. Among such methods, we can name group loans (solidary credit). In this type of funding, entrepreneurs, though managing their own projects individually, respond jointly for the payment of loans of other group members (if they fail to do so). All group members lose access to new credits if the group, as a whole, fails to pay its debts.

The potential obligation of joint payment of the loan by other solidary group members encourages micro-entrepreneurs to correctly select the members of their groups; once the groups are formed, all members are encouraged to monitor each other. Additionally, it is possible to minimize settlement costs — since, if a debtor defaults, another member of the group may be inclined to cover such debt.

Besides the solidary credit, microfinance operations generally have other methods to induce more substantial repayments. One example is the so-called dynamic incentives: a credit agreement begins with small loans, which are renewed — several times with expanding amounts – as previous debts are paid.

A global scenario for microfinance

This section describes the profile of 890 MFIs registered in the Microbanking Bulletin database. Geographically, the MFIs are concentrated in Latin America and the Caribbean (40%) and in Asia (35%).

Most institutions engaged in microfinance are NGOs (39%), followed by non-banking financial institutions (32%). The banks' share is small, just 7%, which suggests the low "commercial" orientation of the sector. In fact, most institutions (65%) claim to be non-profit. In spite of this, most institutions (62%) declare themselves self-sustainable, in the sense that financial revenues should at least cover both their financial and operating expenses.

Concerning the type of loan, most MFIs (50%) operate with both individual and solidary credit. Only 10% operate exclusively with solidary credit. Such statistics indicate that other risk mitigation instruments, such as the aforementioned dynamic incentives, play a very important role in micro-credit.

In relation to average loans, MFIs can be divided into those that reach the low-end (average loan to debtors representing lower than 20% of GDP per capita), broad (average loan to debtors between 20% and 150% of GDP per capita), and the high-end (average loans to debtors between 150% and 250% of GDP per capita). About 50% of IMFs operate with the broad segment, and the low-end has been served by about 38% of institutions.

The debate: sustainability and social outreach

The MFIs financial feasibility depends on the target audience of its clients. Despite the existence of financial innovations to facilitate access to credits for micro-entrepreneurs with low access to funds, the issue is the the possibility of incorporating the poorest

Table 1: Outreach Indexes (2007)

Target Market	Average Loan (% GDP per capita)	Average Clients	% Women
Low-end	14.8	120,630	82.9
Broad	61.9	44,444	58.2
High-end	191.1	27,830	43.0

Source: MicroBanking Bulletin, MIX

Table 2: Financial Indexes (2007)

Target Market	Total Expenditure on Assets (%)	Financial Sustainability Index (%)	Return on Portfolio – Actual (%)	Commercial Liability Fraction (%)	Deposit on Assets (%)
Low-end	34.4	99.5	32.4	56.3	7.4
Broad	25.2	104.8	22.4	81.1	24.9
High-end	20.5	109.4	19.6	88.0	35.0

Source: MicroBanking Bulletin, MIX

individuals into the credit market by means of sustainable financial operations.

Drawing a comparison between the performance of MFIs in the low-end, broad, and high-ends, and understanding the loan level as a proxy of the borrower's lack of wealth, the data effectively suggest a trade-off between outreach and sustainability.

MFIs operating in the low-end have a smaller average loan scale than MFIs operating in other sectors. However, the average number of clients is considerably higher. Besides this, the percentage of assisted women is much higher in MFIs operating in the low-end – the difference of women's participation between low and high classes is 40%. Thus, MFIs operating in the low-end support a wide number of individuals, mostly low-income individuals, and tend to have a greater impact on social well-being – especially considering the relationship between the strengthening of women's status and children's well-being.

The financial performance indexes of MFIs that support the low-end, therefore, are worse than those operating in the broad and high-ends. This result did not arise from a soft lending policy. Table 2 shows that the rate of return on the loan portfolio was considerably higher for MFIs operating in the low-end – the actual rate of return on the portfolio was roughly 65% higher for these MFIs vis-à-vis the MFIs operating in the high-end.

On the other hand, MFIs operating in low-end presented higher overall expenses (proportion of assets) than MFIs operating in the broad and high-end markets. Thus, the Financial Sustainability Index is substantially higher for these MFIs: indeed, average institutions operating in the low-end may be considered non-sustainable (index lower than 100).

Notwithstanding, the access of MFIs to trade capital is clearly different according to the market niche. The fraction of liability financed by trade capital was noticeably lower for MFIs operating

Table 3: Production and Risk Indexes (2007)

Target Market	Average cost per loan (US$)	Loans per employee	Write-off ratio (%)	Loan loss ratio (%)
Low-end	86.4	190.5	3.8	3.5
Broad	197.9	124.3	3.2	2.9
High-end	329.3	69.7	2.6	2.1

Source: MicroBanking Bulletin, MIX

in low-end, indicating their difficulty of leverage. The last column reveals that institutions characterized as banks (able to receive deposits) are less representative in the low-end.

The return on micro-credit operations are not enough to support the expenses of most MFIs operating in the low-end. A critical issue is what the impact of a policy earmarked for increasing the financial sustainability of such MFIs would be – whether this involves reducing expenses – increasing efficiency – or increasing earnings – through the increase of interest rate charged by these MFIs.

The reduction of expenses presents limited outreach. Taking into consideration the productivity index, such as the average cost per borrower or the average number of loans per staff member, it is worth noting that both are considerably favorable to MFIs operating in the low-end (refer to Table 3).

Increasing interest rates may not be desirable as potentially profitable projects with considerable social return may be impractical. Furthermore, there is a problem concerning asymmetric information: high interest rates tend to attract risky projects to the market, or may also reduce the efforts of microentrepreneurs to make projects successful.

Considering the write-off measures and the effective rate of loan losses* as proper indexes of credit risk, the low-end presents a combination of higher interest rates and risks – if the risk increases according to the interest rate level in asymmetric information, then increasing interest rates may not be effective in enhancing MFIs' profitability.

Final considerations

The microfinance industry has grown considerably over the last few years, improving the standard of living of several individuals with no access to formal credit. Despite this improvement, a critical issue lies in the possible compatibility between the MFIs´ financial sustainability and access to credit for very low-income individuals.

Updated data shows that recent efforts aimed at assisting the most wealth restricted individuals seem to be limited, even though moderated low-income micro-entrepreneurs are reachable in a sustainable a fashion – which indicates the effectiveness of microfinance instruments. MFIs operating in low-end markets have worse sustainability indexes and lower fund-raising capacity. And they do not have much space to grow concerning financial feasibility, be it through the increase of efficiency or financial income.

Thus, unless new mechanisms for better mitigation of the high operation and information costs, the expansion of access to credits will most likely still require donations or government support.

There is much evidence to justify public support. Program assessments in several regions reported that microfinance availability brought about significant effects on the income growth and social mobility of clients. Besides this, the improvement of well-being tends to be greater when the target audience is comprised of women: the availability of micro-credit for women tends to improve the level of education and the health of their children. Finally, it is worth noting that the availability of microfinance reduces poverty at aggregate levels: there are externalities above the local economy, which should be as positive as the outreach of microfinance operations.

Financing poor microentrepreneurs requires government subsidies or contribution from donators

Such evidence suggests that the support for MFIs, especially those operating in the low-end – which, as shown, face challenges concerning financial sustainability, and which also present a considerable outreach in relation to the number of clients, and which prioritize women in their client portfolio – tends to be socially desirable due to its significant and long-lasting impact on the well-being of low-income individuals.

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