Microfinance: Economic Profitability or Social Performance?

April 22, 2009

The once pioneering field of microfinance now faces a new era, with new risks and challenges. What direction should be taken?

Microfinance is more than minor personal loans without guarantees. It comprises the full range of financial services that a modern banking institution can offer people who would otherwise be excluded from access to credit. Originally conceived as an instrument for solving the problems of poverty and underdevelopment, it is now complemented by a host of additional services that include everything from training to microentrepreneurship to health programs.

Increased microfinance activity over the past few years has largely been the result of the international situation, namely factors such as the worldwide cash surplus, low interest rates, macroeconomic stability in many emerging countries, donors willing to take part in actions of this type, and a growing social awareness on the part of financial institutions.

A debate has arisen over which should come first: the social performance or the economic viability of the institutions?

In "La Responsabilidad Social de las instituciones microfinancieras: contribuyendo a la reducción de la pobreza" ("The Social Responsibility of Microfinance Institutions: Contributing to Poverty Reduction"), IESE Prof. Antonio Argandoña and research assistants Alice Lariú and Ricardo Morel address this dilemma.

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Sustainability or social performance?

A large number of microfinance institutions have shown that they can achieve solid economic performance. Their ability to cover operating costs and provide funding is unquestioned; even the most demanding investors have been enticed by the profits that these institutions generate.

But has the economic dimension of microfinance eclipsed its social dimension? According to the authors, while its purpose is eminently social, "economic self-sufficiency is a necessary condition so that the institution does not have to resort to a constant stream of donations in order to continue operating and expand it according to the needs defined by its social mission."

Challenges and opportunities

Like any other financial product, microfinance is not without its risks and challenges. Although the idiosyncrasies of each environment prevent discussion about global problems, there are some common threads in terms of the challenges being faced.

Private financial institutions, given their unfamiliarity with the specifics of these services, end up investing in other, more time-tested areas. Having said that, the prospects are optimistic and a growing number of institutions are showing an interest in this sector. New technology is helping to bring down the costs deriving from these actions, which are largely carried out in rural areas. Some institutions, such as Kiva, use the Internet as their primary means of communication between donors and recipients.

The extremely limited banking access of people in these environments of poverty makes it difficult to evaluate the credit risks involved. It is virtually impossible for someone to have any financial history when they have never opened a current account. There needs to be a developed source of information about the informal economy to provide institutions with the necessary information for evaluating risks.

Another of the challenges facing the microfinance institutions involves the high costs of the services, which make them unattainable for much of the population and thus contradicts their initial purpose. According to the authors, one way to ease this problem involves the use of low-cost brokerage networks, which would make them accessible to a larger proportion of the population.

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As we see with microcredits, the money transfers sent by immigrants represent very important financial flows for developing countries; however, they also create specific needs. The costs of these remittances are still rather high, despite their current downward trend; lowering these is key, since they create synergies between the money-transfer industry and the banking business.

Yes, but with some rules

Overcoming these challenges and ensuring the proper functioning of these institutions will require a specific regulatory framework to be defined. The goal is to reduce the fragmentation of the sector and create a set of conditions that does not hinder the entry of other financial institutions in these markets.

"The microfinance institutions must be capable of conveying the added value that they provide to the society," say the authors. That requires accountability and transparency. It is not merely about making their accounts public but rather offering an overall perspective of the organization and its operations.

Emphasis must be placed on human capital and the ability to manage these companies. Given the direct link between operational quality and performance efficiency, improving the former will translate into better service and lower costs for customers.

In the authors' opinion, "one of the sector's most pressing needs is to extend the reach and scope of its operations, in order to reach more potential customers." For that to happen, the scale of microfinance needs to be reconsidered, and networking is the best option.

The benefits of microcredit

Despite the criticisms, microfinance has many economic and social benefits. Its recipients see improvements in their quality of life, such as:

1. **Increased household income**. Credit provides the foundation for carrying out business, which leads to higher income and thus a greater investment in health and nutrition.
2. **Accumulation of assets**. The people who participate in the microfinance sector tend to acquire more producer goods than those who do not.
3. **Overcoming conditions of poverty**. The higher income creates a virtuous circle that leads to overcoming situations of poverty.

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4. **Risk protection**. Reducing vulnerability to adverse periods, thanks to the accumulation of assets that can be sold in such times.
5. **Women's empowerment**. Women's access to these programs is claimed as a way to improve their situation within their communities and families.
6. **Microclusters**. The concentration of microenterprises helps to reduce the most common drawbacks, such as size and isolation. Being in close collaboration provides greater competitive advantages.

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