International Labour Organization

Executive Summary

Microfinance and public policy: Outreach, performance and efficiency

Edited by Bernd Balkenhol

Microfinance and public policy: Outreach, performance and efficiency is a research study seeking to clarify an issue that practitioners of microfinance and donors often face: how to preserve the dual commitment of microfinance institutions (MFIs) to both poverty reduction and profitability, whilst ensuring their progressive integration into the financial market and the phasing out of subsidies.

Survey of MFI performance

In order to better understand the links between social and financial performance in microfinance, 45 diverse MFIs situated in 24 countries were examined using a common standard, efficiency. Five factors were selected to determine the level of efficiency of any MFI in relation to comparable MFIs: location; legal form; delivery technique (i.e. use of individual or group loan contracts); subsidies and staff issues.

Using cluster analysis, four distinct patterns in performance emerged:

- MFIs that are inefficient in terms of both social and financial performance
- MFIs that are good as social performers
- MFIs that are good as financial performers
- MFIs that perform well socially and financially

The first finding is that there is not always a 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 necessarily performing well financially. A major implication of this is that **financial performance does not always coincide with efficiency**. A lack of local competitors may mean a financially self-sustaining MFI may not necessarily be run efficiently. By the same token an MFI may operate efficiently but fail to fully break even – not because of poor management, but contextual factors in the local market that keep staff and capital costs at comparatively high levels.

This divergence of financial performance and efficiency suggests that public policy has a role to play in settings where efficient MFIs may fail to break even but are nonetheless making a tangible contribution to the stabilization of incomes and economic security of the working poor and where no other institution, private or public, would take their place.

Measuring efficiency

Efficiency in microfinance is a question of how well an MFI allocates inputs (such as assets, staff and subsidies) to produce the maximum output (such as number of loans, financial self-sufficiency and poverty outreach). The efficiency of an MFI can be assessed only in relation to its own class of MFIs, namely units that operate in similar markets and under comparable institutional governance.

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

- Efficiency measurement of MFIs is always relative to the institution that is closest to the efficiency frontier: the “best in class”. Linear programming techniques like DEA (data envelopment analysis) capture the distance from the frontier and help determine whether or not an MFI is moving closer to the frontier over time.
- The level of efficiency can be established on the basis of input and output variables: number of clients, number of loan officers, number of staff members, administrative expenses, number of loans, the size and composition of the overall loan portfolio and so on.
- For an MFI’s performance to be qualified as more or less efficient requires information on a batch of comparable MFIs positioned similarly on the poverty–profitability continuum. This would take into consideration whether an MFI operates in rural or urban areas, whether it has a monopoly or has competition, and also differences in output mixes and production functions.
- It makes more sense to compare the efficiency of MFIs within the same country than between countries, given the major differences in regulatory frameworks, policy regimes and levels of competition in domestic markets.
- There are determinants of efficiency that MFI managers can influence and there are other factors for which they cannot be held accountable, and others still that are neither fully endogenous nor exogenous.

Uses and focus of subsidies

Subsidies are common in microfinance, especially in the form of soft loans. All 45 MFIs reviewed in the survey were being subsidized in one way or another, of which 34 were convinced that without subsidies, they would not be able to move up-scale by improving their use of human and financial resources. These results have implications for public policy, and especially subsidies. Subsidies should enhance and stimulate efficiency, rather than obliging an MFI to choose between its social objectives and financial performance.

Subsidies represent less than 10 per cent of total liabilities in ten of the MFIs studied, between 11 per cent and 50 per cent in 11 MFIs and between 51 per cent and 100 per cent in 12 MFIs. The use of subsidies has over the years decreased in 12 MFIs, and increased in 14 cases. In return donors wish to see an MFI aim for more poverty impact **or** for profitability, but never for greater efficiency.

This suggests that public resources could play a critical role in assisting MFIs to combine social and financial goals. Subsidies can enhance efficiency and competition, but experience shows that they can also corrupt management and induce market distortions. To avoid these negative externalities, the form, intensity, timing, conditionality and transparency of subsidies must be carefully defined.

Policy implications

The study calls for donor communities to focus on efficiency as the fundamental performance criterion so as to encompass the different degrees of social and financial missions of MFIs. In order to work, the funding relationship between a donor and an MFI should be put on a more stable, transparent and longer-term contractual basis, with performance targets and exit strategies. Performance-based, contractual and far-reaching support would allow for a broad, competitive and varied supply of financial services to the poor.

- Performance-based contracts should contain standards for areas for which MFI managers can be held accountable, and specify the period over which progress should be made.
- The consequences for failure to progress in efficiency should be clear to MFI managers so that they can anticipate the cost of non-compliance in the form of a reduced or cancelled subsidy.
- Most importantly, the contract should signal the rewards and incentives that the MFI can expect if it progresses in efficiency. This accommodates a variety of MFI types in a single country; the more homogeneous the domestic microfinance market, the easier it is to define the rewards and incentives.
- The system of allocating subsidies to MFIs should become more rational and transparent, in order to gear donor monies towards greater efficiency in each type of MFI instead of favouring one type over another. This would work towards a more economical resource use in all MFI configurations.

Possible negative externalities in supporting and subsidizing individual retail MFIs can be contained by choosing the right type of subsidy.

- Subsidizing the intermediary distorts the market less than subsidizing the client directly.
- Subsidies that come without strings attached are likely to have a greater detrimental effect on the MFI than performance-linked grants.

- Regressive subsidies are preferable to linear subsidies.
- Subsidies with an exit strategy are preferable to subsidies without limit of time.
- Subsidies to networks or apex institutions risk fewer distortions than subsidies to individual MFIs.

Such an efficiency-based approach to the use of subsidies in microfinance can work if all donors and government agencies subscribe to and abide by the same principles of transparency and incentive-based support.

Department of Communication and Public Information
International Labour Organization
4 route des Morillons, 1211 Geneva 22, Switzerland
For more information, visit our website **www.ilo.org**