The State of Microcredit – Outreach, Profitability, and Poverty

Findings from a database of 2600 microfinance institutions

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"Microfinance" is often defined as financial services for poor and low-income clients. In practice, the term is often used more narrowly, referring to services delivered by self-described "microfinance institutions" (MFIs) who usually use techniques developed over the last three decades to make and manage tiny uncollateralized loans. These techniques include group lending and liability, pre-loan savings requirements that test clients' willingness and ability to make regular payments, graduated loan sizes, and most importantly an implicit guarantee of quick access to future loans if present loans are repaid promptly.

Data sources and limitations.

Increasing numbers of MFIs in developing and transition economies are reporting their performance to international databases in recent years. The databases with the highest participation are

- **The Microcredit Summit (MCS) Database** contains limited information on a large number of MFIs. In the most recent update, 2,153 MFIs provided their number of borrowers (totaling about 90 million), their number of "poorest" borrowers, and their profitability.[2] Summary information is published annually; and the annual reports can be found at http://www.microcreditsummit.org. The rest of the information not publicly available there is confidential.[3]
- **The MIX Market (MM)** database contains financial and other performance information as of 2004 from 671 MFIs serving about 22 million borrowers, collected and processed by the Microfinance Information eXchange (MIX). Data for participating MFIs, including simplified financial statements and a number of standard financial performance indicators, is publicly available online at www.mixmarket.org. About 81% of the MFIs are externally audited, and 28% have been independently rated, usually by a firm specialized in microfinance. The MM does not adjust MFIs' reports to compensate for subsidies or to standardize loan loss accounting.
- **The MicroBanking Bulletin (MBB)** database has the smallest number of participating MFIs but the best information quality. It contains information on 346

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[2] "Poorest" borrowers are defined as those who are among the lowest half of individuals below the national poverty line and/or living on a dollar or less per day. Profitability is measured as "operating self-sufficiency" (OSS) which is income divided by cash costs for a given period, with no standardization of loan loss provisioning and no adjustments to compensate for the effects of subsidies the MFI may be receiving. OSS is self-reported by the MFIs, unverified, and not reported publicly by MCS. Where possible, MCS does some independent verification of MFIs' reported numbers of borrowers.
[3] We are grateful for the access to this database granted by the MCS.

MFIs who reported a total of about 19 million borrowers as of 2004. The participating MFIs are identified and peer-group averages are reported in periodic updates of the Bulletin (www.mixmbb.org/en/index.html), but individual company information is confidential. The MBB tracks a full range of financial information and indicators, and adjusts the financial statements that it receives. About 80% of the reporting MFIs have external audits or ratings/appraisals from independent agencies that specialize in microfinance. All financial statements are adjusted by MIX staff to compensate for the impact of subsidized funding costs, in-kind subsidies, and non-standard loan loss provisioning.

These three sources have been consolidated into a single database that includes about 2600 MFIs with about 94 million borrowers, after eliminating double-counting.

The database covers the vast majority of organizations of significant size that are commonly referred to as "microfinance institutions"—mainly organizations employing recently-developed techniques to provide tiny uncollateralized loans. This group of institutions is only a subset of poor people's finance. There are thousands of other financial institutions that include some significant proportion of poor and low-income people among their clientele, including government agricultural and development banks, postal and other savings banks, savings and loan cooperatives, and rural banks. The database captures only a small fraction of these other institutions. Furthermore, the database contains relatively little information about the savings services of the participating institutions. Unless otherwise noted, the rest of this paper refers only to borrowers and credit services.

Outreach

Geographic distribution *[slide 5]***.** Measured by number of borrowers, microfinance is dominated by Asia, which accounts for seven out of every eight MFI borrowers. Much of this dominance is a function of higher population, but even when measured on a per capita basis, South Asia has twice as much microcredit as any other region *[cf. slide 8]*. The Middle East and North Africa (MENA) and Eastern Europe and Central Asia (EECA) have relatively little microfinance, probably reflecting the fact that microfinance got a later start in those regions.

Distribution by institutional type *[slide 6]***:** Some people think of microfinance as being dominated by non-governmental organizations (NGOs), but these MFIs account for less than a quarter of total borrowers. In fact, most microfinance is provided by governments: state-owned institutions and Indian self-help groups (most of which are financed by state banks) each account for about 30 percent of borrowers. One sixth of the clientele is served by licensed private banks and finance companies.[4]

[4] Some financial cooperatives report to the database, but not enough to provide a meaningful sample, so the borrowers they report have been omitted from this analysis. Some Indian self-help groups are organized and monitored by NGOs, and in a minority of cases the banks lend to the NGOs, who then retail the loans to the groups.

Growth in total borrowers *[slide 7]***.** Between 1998 and 2004, the number of microcredit clients at year-end grew by an average of 12 percent per year. Growth appears to have slowed during that period. The growth rates reported here are considerably lower than those reported by the MicroCredit Summit, because the analysis here adjusts out the apparent growth produced when institutions with years of history start reporting for the first time.

Penetration rates *[slides 8-9]***.** The apparent slowing of microcredit growth between 200 and 2004 should not be taken to suggest that the market in developing and transition economies is reaching saturation. Penetration rates, as measured by percentage of total population who have microloans, are very low, ranging from about 0.5 percent in EECA up to 2.5 percent in South Asia.[5] There are still hundreds of millions of potential clients not being served. The regional averages mask a wider variation among individual countries, ranging from almost zero percent of the population with microloans in Russia to 18 percent in Bangladesh, where the market may be moving toward a point of saturation.

Concentration *[slides 10-11]***.** Like many other industries, microfinance tends to be concentrated. The median share of the largest MFI in a country is one third of the entire market. The median share is 81 percent for the top five MFIs, and 95 percent for the top ten. A similar concentration is visible when looking at the worldwide market, where 9 percent of the MFIs account for 75 percent of the borrowers. This pattern would seem to have strategic implications for development agencies and policy makers. In moving toward saturation of the microfinance market, it is probably not necessary to "let a thousand flowers bloom." It may make more sense to concentrate support and licensing on the small minority of MFIs whose managers show the potential to produce massive growth.

Profitability

Industry profitability *[slides 12-13]***.** Is the microfinance industry in general financially sustainable—that is to say, profitable after making adjustments to compensate for subsidies received? Most MFIs are unprofitable, especially if one includes the many small MFIs that do not report to the international databases. However, it is more meaningful to assess the profitability of the industry by counting clients or assets, not MFIs. Overall, 44 percent of all microborrowers are being served by profitable institutions.

Further breakdown reveals a wide gap between private and public providers. Of the clients of private providers, both NGOs and licensed institutions, over three fifths are being served profitably. The corresponding fraction for governmental providers is only one eighth. There are probably two main causes of this wide profitability gap. In the first place, profitable credit administration requires screening out borrowers who are not likely to repay, charging interest rates high enough to cover costs, and responding vigorously to late payments—all of which run counter to the practical incentives of even the sincerest working politician. Secondly, government institutions can often keep access to funding even if they are unprofitable.

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[5] Potential micro-borrowers represent some fraction of the total population. Population is used as the denominator in this measure of penetration because data for a more meaningful denominator are unavailable or inconsistently applied in too many countries.

Measured by borrowers served, the profitability of NGO microcredit appears to be trending upward, from 53 percent in 2001 to 64 percent in 2004.

MFIs vs. commercial banks *[slide 14]***.** When one compares the MFIs in a country (using MBB and published ratings) with the commercial banks in the same country (using BankScope), the MFIs tend to be considerably more profitable. Return on Assets (ROA) for the MFIs averaged 2.8 percent, compared to 1.5 percent for the banks.[6] This differential does not indicate that microfinance is inherently more profitable than commercial banking. Rather, the explanation is probably the fact that microfinance is an immature industry where fewer of the providers are having their profits squeezed by competition. However, it seems evident that microfinance is profitable enough so that it can be integrated into the mainstream financial sector in many places.

There are thousands of tiny MFIs—most of them probably unprofitable—that do not report to the MBB, so this analysis compares all commercial banks against a relatively profitable subset of MFIs. Nevertheless, the comparison is a meaningful one, because the MBB is a reasonable representation of the group of larger MFIs that care about financial performance, and this is the group that is most likely to seek entry into the licensed mainstream financial system.

Profitability and growth *[slide 15]***.** Not surprisingly, profitable MFIs tend to grow much faster than unprofitable MFIs do. Regressions mentioned later in this paper suggest that the growth is not linked to the profitability, at least once the MFI gets beyond its early years and a modest level of clientele. In fact, growth temporarily depresses profitability, all other things being equal. Rather, the more likely explanation is that competent managers produce both growth and profit, and that the profits help fund the growth.

Years to break even *[slide 16]***.** How long should it take an MFI to reach profitability? Analysis of the profitable MFIs in the MBB and MM reveals that a half of them broke even in three years or less, one fifth of them took four to six years, and less than a third took more than six years. These results include some MFIs that began operations 20 years ago or more. Younger MFIs tend to get profitable faster.

Profitability and Client Poverty

Loan size and client poverty *[slide 17]***.** One of the most controversial issues in microfinance has been the extent of the trade-off between financial sustainability and reaching poorer clients. It would seem evident that there are some circumstances in which the two objectives would conflict. In the first place, there are some potential borrowers who are extremely poor, have no reliable source of income from which a loan could be repaid, and lack the opportunity (not just the capital) to start a microbusiness. Clearly it cannot be profitable to lend to people who are unlikely to repay. Secondly, some very poor people live in remote and sparsely populated areas where administrative costs of lending are extremely

[6] The MFIs also had higher average Return on Equity than the commercial banks did, but the difference was smaller, because the banks tend to be more heavily leveraged (higher asset/equity ratios) than the MFIs.

high, and where interest rates would have to be correspondingly high to cover those costs. The conventional wisdom has been that microcredit clients are relatively insensitive to interest rates.[7] But obviously there is some limit to the interest rate that poor borrowers can pay without nullifying the benefits of the loan arrangement.

The practical question, then, is not whether there is *some* trade-off between MFI sustainability and client poverty, but whether such a trade-off has significant force in the circumstances in which most MFIs are actually operating.

Addressing this question through available MFI performance information is not simple. The most serious problem is finding indicators for the poverty level of clients. The most commonly used proxy is loan size, on the assumption that people with less income and assets will want smaller loans. But there are several problems with loan size as a proxy, not the least of which is that loan size in some cases can be driven by the MFI's graduated-lending rules, not just client demand.

MFIs in the MIX Market report on what percentage of their borrowers are poor, and what percentage of their loans are for amounts below $300. Since few MFIs measure client poverty, the reported percentage of poor borrowers is usually just a management estimate. The percentage of loans under $300 can often be drawn from the MFIs' information systems, but in some cases it may be only a rough estimate. The numbers that MFIs report for these two indicators are not validated by external auditors or raters. Obviously, caution is in order when interpreting such data.

The MIX Market data shows a moderate correlation between loan size (percentage of loans below $300) and the MFI's estimated percentage of poor clients.[8] The slope of the line is fairly high: for instance, increasing the percentage of loans below $300 from 50 to 60 percent tends to be associated with increasing the percentage of poor clients from 52 to 59 percent. This may mean that loan size is a meaningful though very rough proxy for client poverty. Alternatively, it could mean that MFI managers who overestimate the percentage of their clients who are poor also tend to overestimate the percentage of their loans below $300.

Loan size and profitability *[slide 18]*. Do MFIs that make smaller average loans (perhaps a proxy for poorer clients) tend to be less profitable? In the MIX Market data the correlation between these variables is very weak.[9] Furthermore, the slope of the curve is low. When average loan size moves from 50 percent of per capita national income to 40 percent, Return on Assets tends to drop only slightly, from –1.55 percent to –1.62 percent.

Percentage of very poor clients and profitability *[slide 19]***.** MFIs reporting to the MicroCredit Summit estimate the percentage of their clients who are "poorest"—that is, living on $1 or less per day or falling in the bottom half of the population below the poverty line. The MFIs also report their Operating Self-Sufficiency (OSS), defined as income divided by

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[7] But see Dehejia, Montgomery and Morduch (2005), "Do Interest Rates Matter? Credit Demand in the Dhaka Slums" and Karlan and Zinman (2005), "Elasticities of Demand for Consumer Credit".
[8] Pseudo R2 = 11.8%
[9] R2 = 0.5%

cash costs, with no adjustment to reflect subsidies the MFI may receive. Many of the MFIs report round numbers for their OSS, suggesting an unreliable management estimate rather than a number produced from the MFIs' financial statements. The correlation between these variables is very weak.[10] The slope of the relationship is quite low: for instance, moving the percentage of "poorest" borrowers from 80% to 90% is associated with moving OSS from 69.5 percent to 68 percent.

Taken together, these observations suggest that as a general matter there may be relatively little conflict between improving sustainability and reaching poorer clients, at least for the circumstances in which most MFIs are operating today. This suggestion is buttressed by the fact that it is not hard to identify individual MFIs who are strongly profitable despite serving very poor clients. However, given the limitations of the data, the question cannot be regarded as definitively settled.

Regression results

[The regression findings that are summarized here will be detailed in a later version of the paper. They are drawn from MBB data only.]

Efficiency *[slide 20]***.** Costs were measured as Operating Expense Ratio: administrative costs divided by gross loan portfolio.

- Scale (number of borrowers) lowers costs early on, but not much once the MFI moves past 5,000 – 10,000 clients.
- Higher loan sizes reduce the Operating Expense Ratio, though not as much as might have been expected.
- Not surprisingly, for-profit institutions tend to be more efficient than not-for-profits.

Profitability *[slide 21]***.** Profitability was measured as Adjusted Return on Assets: net income minus adjustments for subsidies and loan loss accounting, divided by period-average assets.

- Surprisingly, not-for-profit MFIs tend to be more profitable than for-profit MFIs. A probable explanation is that not-for-profits are less likely to be operating in competitive environments.
- Interest rates and spreads (= interest rate minus cost of funds) drive profitability more than costs or productivity do.
- Scale (number of borrowers or asset size) doesn't help profitability much.
- After a very few years, older MFIs do not tend to be much more profitable than younger ones, suggesting that there is not a strong learning effect beyond the initial years.

[10] R2 = 1.2%

Main themes emerging so far

Governments continue to be major providers of microcredit, accounting for as much as half of the market. Most government microcredit programs incur losses—often heavy losses—but they are nevertheless able to obtain funds to continue their operations.

Private microfinance is profitable and stable enough to move into the mainstream financial system. Private licensed banks and finance companies served about one in every six microcredit customers in 2004, and the percentage will probably continue to grow.

Microfinance is not NGO-dominated: NGOs account for only about a quarter of the borrowers (and a much smaller percentage of savers, due to legal restrictions). Nevertheless, microcredit operations in NGOs and other not-for-profit institutions can be solidly profitable, suggesting that they may play a more substantial role than some observers have suggested over the long term.

MFIs that have not gotten profitable at a fairly early stage (3-5 years; 5,000-10,000 borrowers?) should not expect that further growth by itself will make them sustainable.

While the data is subject to important limitations, there is no indication so far that serving poorer customers tends to hurt financial performance seriously.