Managing trade-offs

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Achieving both profitability and strong social performance is the ultimate promise of microfinance. It is not impossible, but neither is it easy and few microlenders are there yet. Ten years ago it had been hoped that achieving both goals would simply be a matter of raising interest rates on loans. If borrowers were willing to pay, say, 50% interest per year for a loan, rather than 30%, the microlender's profits would see an immediate boost, and, it was hoped, the well-being of clients would not be seriously hurt. Both parts of the claim are true up to a point, but increasing interest rates too high can bring financial and political difficulty and risk undermining social impacts.

Today microlenders instead see that the key has as much to do with managing expenses as with raising revenues. Most critically, this means thoughtfully managing human resources. One reason is that salaries make up a large fraction of overall costs for microlenders. The July 2003 *Microbanking Bulletin*, for example, reports that of the 49 institutions in their survey that focus on the "low-end" of the market, operational expenses were, on average, 59% of each dollar of loans outstanding. Personnel expenses made up just under half of that. The high personnel costs arise because it is difficult to reap substantial economies of scale when working with such small loans. The 61 institutions in the survey focused instead on a "broad" client base made loans that averaged nearly four times the size of loans made on the "low-end". One result is that the "broad" institutions were able to cut operational and personnel expenses by about half (as a percent of the loan portfolio). Without the scale advantage, "low-end" lenders must keep a particularly sharp eye on cost-containment.

The other reason to focus on human resource management is that credit officers are the point of interaction with clients. They gather information, shape the experience, provide support and encouragement, and, as needed, enforce rules. Cleverly-designed contracts and products can substitute for these human roles only to a limited degree. Who one hires and how one treats them make a crucial difference to both financial and social performance.

ASA in Bangladesh slashed personnel costs by simplifying all operations so that they could be performed by less-educated staff members. College degrees then became unnecessary for much of the work, and ASA's wage bill dropped sharply. Motivation for workers was provided mainly by the promise of steady promotion over time, together with the cultivation of an ethic built around contribution to Bangladesh's social development.

Some experts argue that lenders can do even better by adding strong financial incentives to motivate the staff. For example, large bonuses can be tied to loan repayment rates and the development of new clients. But Prodem in rural Bolivia, among others, has found that strong incentive schemes can create headaches as staff members focus on getting bigger bonuses to the exclusion of other, broader goals. After experimenting with a variety of bonus schemes, Prodem ultimately reverted to reward systems based on longer-term rewards based on broad criteria. As a result, Prodem was able to re-build a strong institutional culture and improve their financial and social performance.

Pro Mujer, also in Bolivia, has achieved enviable levels of efficiency through careful cost accounting. But profits are still difficult to squeeze out despite charging high fees. With even higher fees or deeper cuts in costs, Pro Mujer should be able to make steady profits. For Pro Mujer, though, microfinance is a vehicle for attaining development for women, and for that reason they are committed to working in very poor communities and providing health education alongside credit. The real question is not: can they squeeze harder and make profits? (They probably can.) The important question is whether their clients, their mission, and the broader social good would be best served by doing so. As long as they can prove their cost-effectiveness, and as long as charitably-minded donors seek cost-effective development efforts, there is no reason that efficient institutions like Pro Mujer should be pressured to both turn a profit and make a social difference.

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Further reading:

Bazoberry

Economics of Microfinance

Microbanking Bulletin