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The Profit Orientation of Microfinance Institutions and Effective Interest Rates

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Summary. — With the rise in the number of for-profit microfinance institutions (MFIs), commentators are asking whether the sector benefits by MFIs having stronger profit orientations. We address this question by analyzing the relationship between interest rates and adopting the for-profit legal form, appointing private sector representation and traditional banking experience to advisory boards, and participating in more extensive for-profit networks. The results consistently indicate that a stronger for-profit orientation corresponds with higher interest rates for MFI clients. However, this does not contribute to greater profitability and therefore sustainability because the stronger profit orientation is also associated with higher MFI costs.
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1. INTRODUCTION

"*Some Fear Profit Motive to Trump Poverty Efforts in Microfinance*"—
New York Times headline, August 28, 2009

Microfinance institutions (MFIs) are banking organizations whose primary purpose is to provide financial services to poor and otherwise marginalized clients (Mersland & Strøm, 2010). Collectively, the microfinance sector has been lauded for modifying standard banking practices in order to effectively extend credit to the poor and in doing so helping to elevate their standards of living. More specifically, the innovations that led to the modern microfinance movement overcame two problems previously thought to prohibit lending to the poor: small loan sizes and lack of collateral (Armendariz & Morduch, 2005).

The recent evolution of the microfinance sector can be viewed in terms of the rapid growth in the number of active MFIs, increases in the volume of business they conduct, a broader range of financial services on offer, *and changes in the orientations of MFIs*. In this latter respect, an important marker in the sector's evolution is the explosion of for-profit and profit-oriented MFIs. This collective push toward a more profit-oriented sector is reflected in the relatively high incidence of for-profit MFIs around the world. In 2009, 490 of the 1,169 MFIs (or 42%) covered in the MIX Market database (www.mixmarket.org) were for-profit MFIs and they collectively controlled roughly two-thirds of the more than $65 billion worth of assets deployed in that year.

Although lauded by many as critically important for the maturation of the sector, this trend also ushered in debates about whether it is possible to effectively blend nonprofit ideals and for-profit orientations and practices (Morduch, 2000). Practically, these debates are rooted in questions about whether MFIs with stronger profit orientations are better able to sustainably address the needs of poor borrowers. Here, commentators clearly place emphasis on the anti-poverty orientation of MFIs: "the first goal of MFIs is to reach more clients in the poorer strata of the population, and the second goal is financial sustainability (Mersland & Strøm, 2008a, p. 663)." However, it is also believed that many (especially nonprofit) MFIs are not earning sufficient income to cover their full costs of operating and expanding and must therefore rely on subsidies—in the form of grants and donations—to sustain themselves. Concerns about the reliability of these latter funding sources makes the financial viability of MFIs a major concern for sector participants (Mersland & Strøm, 2010).

In this respect, profit-oriented MFIs are seen as part of the movement toward a more businesslike microfinance sector. They are supposed to set more appropriate loan prices and operate with greater efficiency, and thus have an easier time attracting needed investment into the sector. This should, in turn, allow the social impacts that MFIs deliver to be more sustainable (Hermes & Lensink, 2007). Profit-oriented MFIs also raise concerns about MFIs trading off social impact for financial performance. Their greater emphasis on profits might push concerns about the well-being of poor clients toward the back burner. While these concerns clearly apply to for-profit MFIs, they also apply to nonprofits, where increased attention to financial sustainability is leading managers to emphasize the generation of financial surplus, even if that surplus is not distributed to shareholders. In both cases, many worry that we will see MFIs abandoning serving the poorest clients in search of more reliable profit streams—something commentators are calling mission drift (Copestake, 2007).

Even MFIs that remain focused on the poorest clients might alter the balance of costs and benefits that they offer as they strive for enhanced profitability (Yunus, 2011). We address this question by studying whether MFIs with stronger profit orientations tend to charge higher or lower effective interest rates to their clients. While this is not the only variable that matters to microfinance clients (Cull, Demirguc-Kunt, & Morduch, 2009), it does capture the effective price of credit access. We examine differences between the interest rates charged by nonprofit and for-profit before proposing that an MFI's profit orientation extends beyond its decision to operate as a for-profit. It is also manifested in several of the other commitments that an MFI makes; those that influence the flow of information, insights, and advice that guide their numerous strategic and operational decisions. In particular, we examine

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the composition of governing boards to ascertain whether they contain private sector representation or individuals with traditional banking experience. We also examine the extent to which MFIs' network support organizations (Cook & Isern, 2004, p. 3) are populated by other for-profit MFIs.

In the end, this analysis paints a sobering picture of the relationship between stronger profit orientations and interest rates charged to MFI clients. Each of the profit orientation variables included in this analysis is associated with higher effective interest rates and most of the revealed relationships are statistically significant. However, these increases are not accompanied by superior MFI profitability and therefore sustainability because MFIs that are more profit oriented also have significantly higher costs. We close the paper by discussing the implications of these findings for discussions and debates about the evolution of the microfinance sector.

2. PROFIT ORIENTATION OF MFIS

Recently, the *Financial Times* succinctly captured the excitement surrounding a stronger profit orientation among MFIs when they reported how "supporters of commercial microfinance argue that business models generating profits and returns to shareholders can overcome the reliance on scarce donor money."[1] The logic underpinning this excitement is rooted in basic economics: "The lure of profit, economists assume, motivates all entrepreneurs and managers and fosters efficient decision making by private firms. In contrast, nonprofit organizations … have been assumed to be insulated from competitive pressures and hence prone to inefficiencies (Weisbrod, 1998, p. 71)." Claims to financial surplus, it is argued, provides the incentive to operate more efficiently which translates into some combination of lower interest rates to MFI clients and higher returns to investors. The former outcome benefits clients directly while the latter serves to attract more capital into the sector.

This incentive-based argument relies on the "lure of profit" and requires the relaxation of the nondistribution constraint imposed on nonprofits. It therefore applies to MFIs that have adopted the for-profit legal form. However, the decision to operate as a for-profit is not the only choice that indicates the profit orientation of an MFI. In fact, Mersland and Strøm (2008b) recently concluded that MFI ownership (e.g., shareholder *versus* NGO) is not particularly relevant in determining its social or commercial orientation. Rather, as Cull *et al.* (2009) suggest, "earning profits does not imply being a 'for-profit' bank." Nonprofit MFIs can and do earn positive profits that are simply not distributed to shareholders but are reinvested in activities that further service their clients.

Several other organizational choices are plausibly related to an MFI's profit orientation. Appointing individuals to the board of directors represents an important strategic decision for business organizations (Pfeffer, 1972). Advice from and oversight by board members have consequences for decisions taken within an MFI. Those interested in adopting best practices from the for-profit world and from the traditional banking sector might appoint individuals to their boards who bring experience from these domains. Appointing individuals from the private sector—as opposed to the government or NGO sectors—indicates a desire to be influenced in this direction. The same may be said about appointing individuals with traditional banking experience.

Another indication of an MFI's profit orientation is its participation in networks comprised of many other for-profits MFIs. Sociological and managerial research on networks indicates that the behavior and performance of organizations is influenced by the networks in which they participate (Brass, Galaskiewicz, Greve, & Tsai, 2004). From an organizational learning perspective, the ties that make up organizational networks are conduits through which knowledge and ideas flow. This effect is evident in a statement taken from the website of one prominent microfinance network: "MicroFinance Network (MFN) is an international association of leading MFIs. Through the MFN, 31 members from 27 countries *share ideas, experiences, and innovative solutions* to the challenges they face in search of continuous growth and progress. MFN members *seek to be models of what is possible in the industry* (www.mfnetwork.org)." The latter aspiration points to the control aspect of networks. The predominant participants in an organizational network tend to define the norms and practices in that network (Owen-Smith & Powell, 2004). If the other MFIs that populate microfinance networks are for-profits, then the orientations and ideas that tend to flow through those networks will support and reinforce a stronger profit orientation among network participants.

Assuming that these three variables also indicate the profit orientation of MFIs, the question becomes how they influence MFI behavior and performance independent of whether or not the nondistribution constraint is relaxed. The optimistic view is that even if claims to profit streams are not made available to owners, efficiency will still be improved by incorporating more commercial thinking and market discipline. A countering view suggests that this profit orientation will be either distracting or detracting from the pursuit of poverty reduction as an organizational goal. Even when there is not an explicit substitution of owner and manager remuneration for client impacts, there are concerns about the implications of shifting emphasis away from serving the needs of poor clients and toward the profit streams that help with sustainability and growth. In such cases, MFI decision-makers may appoint bankers or individuals with private sector experience to their boards with the goal of strengthening long-term social performance through improved financial performance, but then lose control of the marginal decision to those that tend to operate under a different logic.

In their recent study of two MFIs (BancoSol and Los Andes), Battilana and Dorado (2010) discuss the need for MFIs to blend the competing logics of "development" and "banking." Because these logics can be misaligned in their underlying goals, target populations and management principles, they tend to support different choices when it comes to, for example, hiring and employee socialization. Armendariz and Morduch (2005, *emphasis added*) also indicate the prospect of differing logics when they stress that "pioneering models grew out of experimentation in low-income countries … *rather than from adaptations of standard banking models in richer countries*." In other words "banking as usual" did not lend itself to the practices that might allow organizations to effectively offer banking services to the poor. Given these two sets of observations, it is possible that advisory inputs from individuals with private sector backgrounds, traditional banking experience, or experience running other for-profit MFIs may not help navigate the challenges associated with the efficient delivery of financial services to the poor.

If there are indeed trade-offs across these two logics, then it seems plausible that traditional MFIs will tend to lean and therefore learn in the direction of the development logic. After all, their nonprofit form "reduces the incentive to engage in activities that, while privately profitable, are socially inefficient … a nonprofit organization has little incentive to skimp on quality of output or otherwise take advantage of poorly in-

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