



## **Unsubsidized Microfinance Institutions**

**B. D'Espallier, M. Hudon and A. Szafarz**

This paper starts from the observation that 23% of the world's microfinance institutions (MFIs) manage without subsidies. We examine how unsubsidized institutions cope with their social mission. Overall, the lack of subsidies worsens social performances. However, our results show that strategies to achieve financial self-sufficiency differ substantially across regions. African and Asian MFIs compensate for non-subsidization by charging higher interest rates. In Eastern Europe and Central Asia, unsubsidized MFIs find it more suitable to target less poor clients. Unsubsidized Latin American MFIs tend to reduce their share of female borrowers.

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# Unsubsidized Microfinance Institutions

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## Abstract

This paper starts from the observation that 23% of the world's microfinance institutions (MFIs) manage without subsidies. We examine how unsubsidized institutions cope with their social mission. Overall, the lack of subsidies worsens social performances. However, our results show that strategies to achieve financial self-sufficiency differ substantially across regions. African and Asian MFIs compensate for non-subsidization by charging higher interest rates. In Eastern Europe and Central Asia, unsubsidized MFIs find it more suitable to target less poor clients. Unsubsidized Latin American MFIs tend to reduce their share of female borrowers.

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## **1. Introduction**

Microfinance institutions (MFIs) are hybrid entities combining social and financial motivations. A vast majority started their business with subsidies (Armendáriz and Morduch, 2010). However, the industry has experienced a notable shift toward commercialization (Mersland, 2009). In particular, we find that 23% of the world's MFIs survive without subsidies, willingly or not. Hence, we compare the social performances of unsubsidized MFIs to those of their subsidized counterparts.

The literature gauges the social performances of MFIs with various indicators including: average loan size, interest rates on loans, and share of female borrowers. Shifting priorities from social to financial performances is commonly labeled “mission drift” (Ghosh and Van Tassel, 2008; Mersland and Strøm, 2010; Armendáriz and Szafarz, 2011). Surprisingly, however, the literature pays little attention to the trade-offs that take place simply among social performances.

The bulk of the microfinance industry in developing and emerging countries is subsidy-dependent. Subsidies emanate from international organizations, aid agencies, charitable foundations, and local public authorities (González and Rosenberg, 2006). According to figures from CGAP (2011), donors committed to more than USD 14 billion in 2010. Nevertheless, the impact of subsidies on poverty alleviation remains controversial (Armendáriz and Morduch, 2010; Banerjee and Duflo, 2011).

Subsidies are meant to help MFIs focus on their social mission (Zeller and Meyer, 2002).<sup>1</sup> Cull *et al.* (2009) however show that subsidies are not necessarily associated with lower efficiency. In fact, they may slightly enhance it, according to Hudon (2010) and Hudon and Traça (2011). In contrast, Caudill *et al.* (2009) find that lower subsidies are associated with tougher cost management. Armendáriz *et al.* (2012) show that subsidy uncertainty is associated with mission drift, and they interpret this as the consequence of MFIs making precautionary savings.

Overall, evidence on subsidies in microfinance is scarce, probably because of the difficulty in properly assessing the amount of subsidies granted to MFIs. To circumvent data limitations, this paper adopts a novel approach by singling out unsubsidized MFIs. Leaving aside the obvious financial impact, subsidization can affect managerial decisions by giving donors the power of control (Mersland, 2009). In contrast, unsubsidized MFIs set their agenda independently. This is fertile ground for scrutinizing how financially constrained MFIs arbitrate between different types of social performances.

## **2. Data and Results**

Our database is extracted from annual accounting statements provided by the Microfinance Information Exchange (MixMarket). We use a worldwide sample of 1,074 MFIs active in 98 countries in 2010. We use a cross-section analysis to avoid time distortions associated with the global economic situation. In this way, we can draw a very recent worldwide

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<sup>1</sup> Many donors also insist on reaching financial self-sustainability (Conning, 1999; Copestake, 2007).

picture of the whole industry. The variables of interest are grouped into three categories. First, social indicators include the share of female borrowers, the poverty of the clientele, proxied by the average loan size scaled by GNI per capita, and interest rates charged on loans, proxied by the nominal yield on gross portfolios. Second, we use two financial indicators: return on equity (ROE) and operational self-sufficiency (OSS). These social and financial measures are standard in the microfinance literature. Third, we provide data on for-profit versus non-profit status.

< Insert Table 1 here >

Table 1 reports summary statistics. MFIs are split into subsidized and unsubsidized institutions. Subsidization is captured through donations reported in the income statements. Table 1 suggests that unsubsidized MFIs have a lower share of female borrowers and reach a less poor clientele than their subsidized counterparts. Although subsidy takers tend more frequently to be for-profit oriented than subsidy-free institutions, financial performance and interest rates do not seem to vary with subsidization.

< Insert Table 2 here >

Table 2 concentrates on social performances broken down by geographic zone. The results reveal that strategies to cope with budget constraints differ substantially across regions. In Latin America, unsubsidized MFIs serve fewer women than do subsidized MFIs but keep similar loan sizes and interest rates. In Africa, and to a lesser extent in Asia, unsubsidized MFIs charge higher interest rates than their subsidized counterparts. The interest rates charged by African unsubsidized MFIs are more than 50% above those

charged by subsidized MFIs (21.1% vs. 34.3%), the highest level worldwide. Interestingly, the interest rates of Asian unsubsidized MFIs are lower than those charged by African and Latin-American subsidized MFIs. In contrast, unsubsidized MFIs in Eastern Europe and Central Asia offer larger loans compared to same-region subsidized MFIs. This suggests that subsidization in this relatively more developed region really makes it easier to target poor borrowers.

### **3. Conclusion**

According to the prevailing narrative, the microfinance industry aims to bring financial access to the poor while reaching self-sustainability. That said, the industry remains dominated by subsidized institutions. The literature is silent on how subsidies interact with MFIs' double bottom-lines. Our paper addresses this issue by comparing the social performances of unsubsidized MFIs to those of their subsidized counterparts. To acknowledge for geographic disparities, we split our sample into four zones. Overall, the picture that emerges is consistent with the idea that subsidies are associated with better social performances. However, our results show that strategies to meet financial self-sufficiency differ substantially across regions. African and Asian MFIs compensate for non-subsidization by charging higher interest rates. In Eastern Europe and Central Asia, unsubsidized MFIs find it more suitable to target less poor clients. Unsubsidized Latin American MFIs tend to reduce their share of female borrowers.

Our findings call for further investigation of regional characteristics that would explain why (non)-subsidization has such dramatically different consequences depending on

the region. It could be that MFIs in Africa and Asia fail to attract less poor borrowers and/or face relatively low interest-rate elasticity. In contrast, in Eastern Europe and Central Asia, profitable borrowers are probably easier to attract because they are more numerous than in very poor regions.

More puzzling is the situation of Latin America, where unsubsidized MFIs manage to keep interest rates and loan sizes similar to those of their subsidized counterparts, but sacrifice female borrowers. Actually, the interplay between commercial orientation and serving women is not clear-cut. On the one hand, women are known to repay loans more reliably than men (Agier and Szafarz, 2013a), suggesting that fewer subsidies are needed to sustain this business. On the other, women are poorer than men on average, and tend to request smaller loans (Mersland and Strøm, 2010; Agier and Szafarz, 2013). A higher percentage of female clients is also related to lower portfolio risk (D'Espallier *et al.*, 2011).

Interestingly, the absence of subsidies is not necessarily associated with profit orientation. Our sample of unsubsidized MFIs includes about 30% of non-profit organizations. Focussing on this particular segment is a fruitful avenue for further research. Possibly, cross-subsidization (i.e. using profits derived from wealthier clients to serve poorer ones) may help NGOs resist the temptation of abandoning non-profitable clients. This, in turn, is imaginable only in a context where competition is not too strong. Otherwise, wealthier clients would get fairer conditions from profit-oriented institutions. In this respect, our work has confirmed that the privilege of subsidized MFIs consists in offering very small loans and prioritizing women.

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## Tables

**Table 1. Subsidized versus unsubsidized MFIs: Worldwide statistics**

The table provides median values. The subsidized MFIs are those reporting yearly subsidies in their 2010 income statement. S \*\*\*/\*\*/\* indicate that the distributions are significantly different for subsidized and unsubsidized MFIs at the 1%/5%/10% level using the Pearson  $\chi^2$ -statistics.

<b>World</b>	Subsidized MFIs (N = 693)	Unsubsidized MFIs (N = 380)
% female borrowers	<b>69</b>	<b>55***</b>
Average loan size over GNI/cap (USD)	<b>0.23</b>	<b>0.32**</b>
Interest rates (%)	21.89	20.97
ROE (%)	7.19	8.60
OSS	1.11	1.13
Non-profit status	<b>61.47%</b>	<b>30.00%***</b>

**Table 2. Subsidized versus unsubsidized MFIs: Regional statistics**

The table provides median values. The subsidized MFIs are those reporting yearly subsidies in their 2010 income statement. **LAC** is Latin America and the Caribbean. **AFR** is Africa. **ASIA** groups South Asia and the East Asian Pacific regions. **ECA** groups Eastern Europe and Central Asia. \*\*\*/\*\*/\* indicate that the distributions are significantly different for subsidized and unsubsidized MFIs (same region) at the 1%/5%/10% level using the Pearson  $\chi^2$ -statistics.

	<b>LAC</b>		<b>AFR</b>		<b>ASIA</b>		<b>ECA</b>	
	Subsidized MFIs (N = 192)	Unsubsidized MFIs (N = 159)	Subsidized MFIs (N = 178)	Unsubsidized MFIs (N = 35)	Subsidized MFIs (N = 205)	Unsubsidized MFIs (N = 102)	Subsidized MFIs (N = 118)	Unsubsidized MFIs (N = 84)
% female borrowers	<b>65</b>	<b>53***</b>	56	53	98	92	43	42
Average loan size over GNI/cap (USD)	0.23	0.29	0.45	0.42	0.12	0.15	<b>0.36</b>	<b>0.78***</b>
Interest rates (%)	29.39	23.45	<b>22.12</b>	<b>34.3**</b>	<b>14.76</b>	<b>16.99*</b>	24.20	16.66