



*How can we define responsible financial performance? This is part three of a four-part series covering our current state of knowledge about the relationship between key financial and social performance indicators, produced as a prelude to the [annual meeting of the Social Performance Task Force](#), June 19-24 in Den Bosch, Netherlands. Prior installments covered [growth](#) and [profits](#), and a final review of the linkages between financial and social performance will be posted in late May.*

The [high costs of microfinance institutions](#) (MFIs) are often misunderstood, especially in comparison with other credit industries. For [all costs that must be covered by interest rates and fees paid by borrowers](#), operating expenses represent 63 per cent on average, financial expenses 21 percent, and profits less than 8 percent. Therefore, from the point of view of efficiency it makes sense to focus our discussion on operating expenses. Financial expenses are less able to be controlled by MFIs, while profits explain only a small share of costs.

From the point of view of social performance, MFIs should try to improve efficiency while balancing social responsibility to staff (appropriate salaries and incentives to staff) and social responsibility to clients (thorough the provision of high quality services at low cost and sound consumer protection principles).

[Multiple factors](#) determine the actual costs of MFIs. This article focuses only on the most relevant and those for which data is available. Important cost determinants that are excluded from the current analysis include:

- Provision of other financial services beyond credit (with particular emphasis on savings mobilization)
- Provision of non financial services (like education or health programs)
- Population density of actual clients
- Physical and financial infrastructure

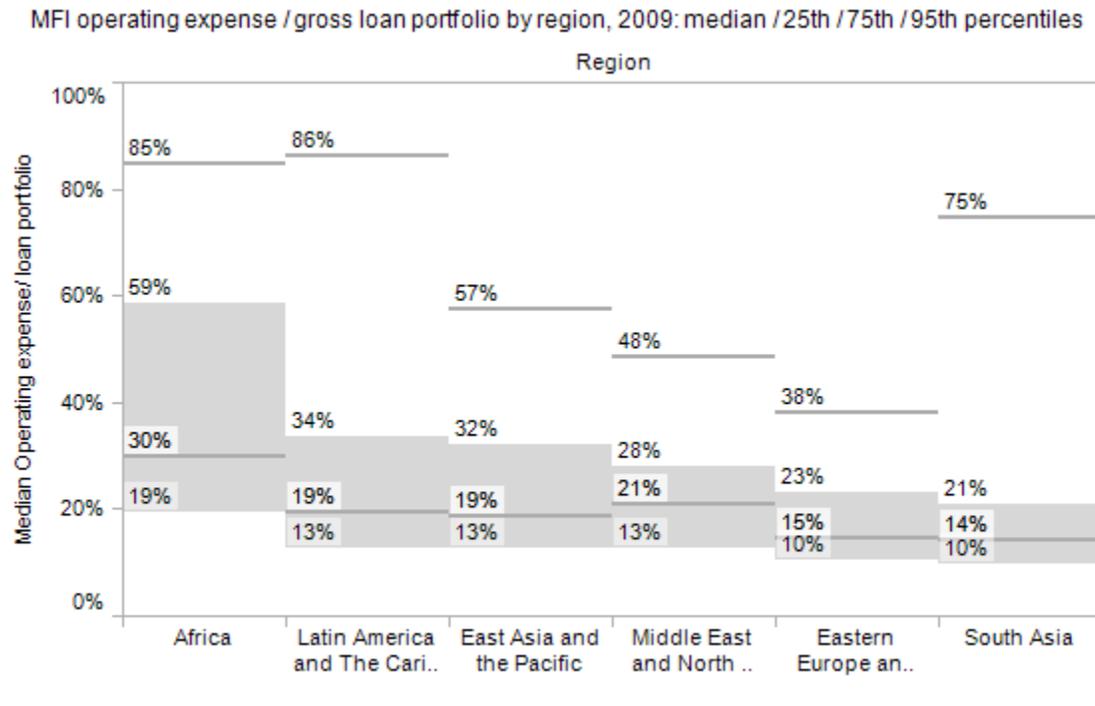
The current analysis focuses on two complementary indicators of efficiency:

- Operating expense as a percentage of average gross loan portfolio (OER), usually known as operating efficiency
- Cost per borrower as a percentage of GNI per capita

Operating efficiency measures the average cost *per dollar* lent by MFIs, and is useful for [the analysis of the average yield regularly used as proxy for average interest rate at the MFI level](#). The second indicator measures average cost *per borrower*, standardized by GNI per capita in order to make figures more comparable across countries.

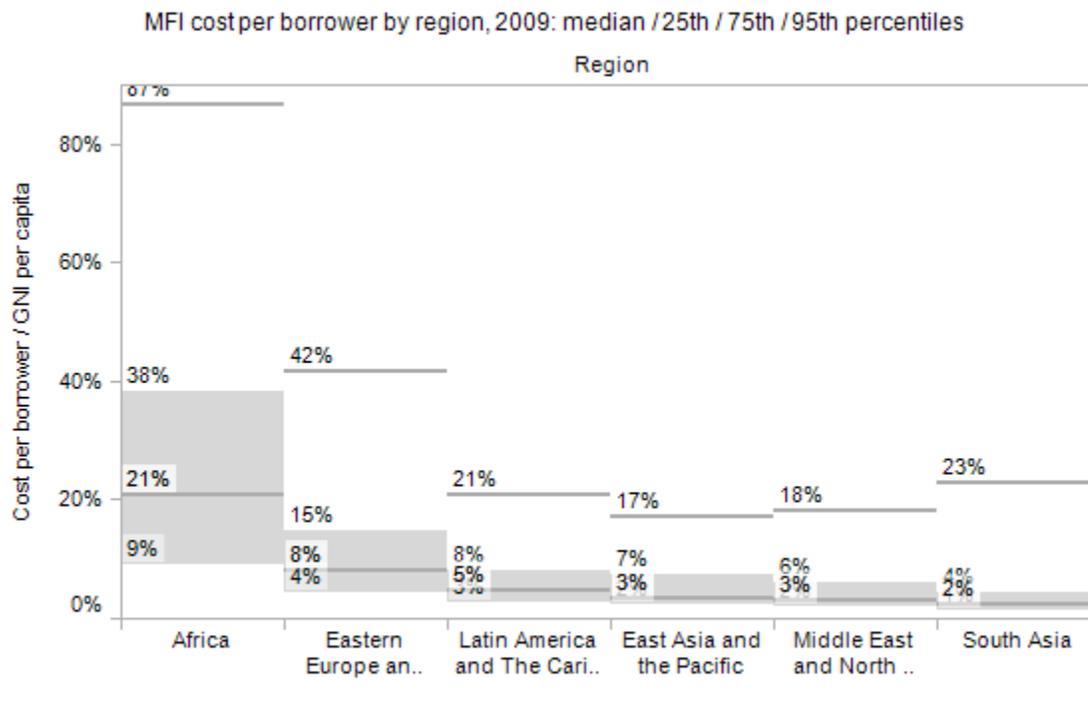
The distribution of operating expenses reveals a lot of dispersion, as well as regional differences. South Asian MFIs are the most efficient, while those in Sub-Saharan Africa and Latin America are the least efficient. It would nonetheless be naive to argue that *all MFIs* should aim for efficiency levels similar to those of South Asian MFIs: salaries in South Asia (the main component of operating expenses) tend to be among the lowest in the world, and MFIs predominately operate through solidarity groups and village banks.

## Operating Expense as Percentage of Average Gross Loan Portfolio



The distribution of cost per borrower reveals a lot of dispersion as well, with the least efficient quartile of MFIs having costs per borrower over 12 - 16 per cent of GNI per capita historically, while the most efficient quartile have costs per borrower under 3 per cent of GNI per capita.

## Cost per Borrower as Percentage of GNI per capita

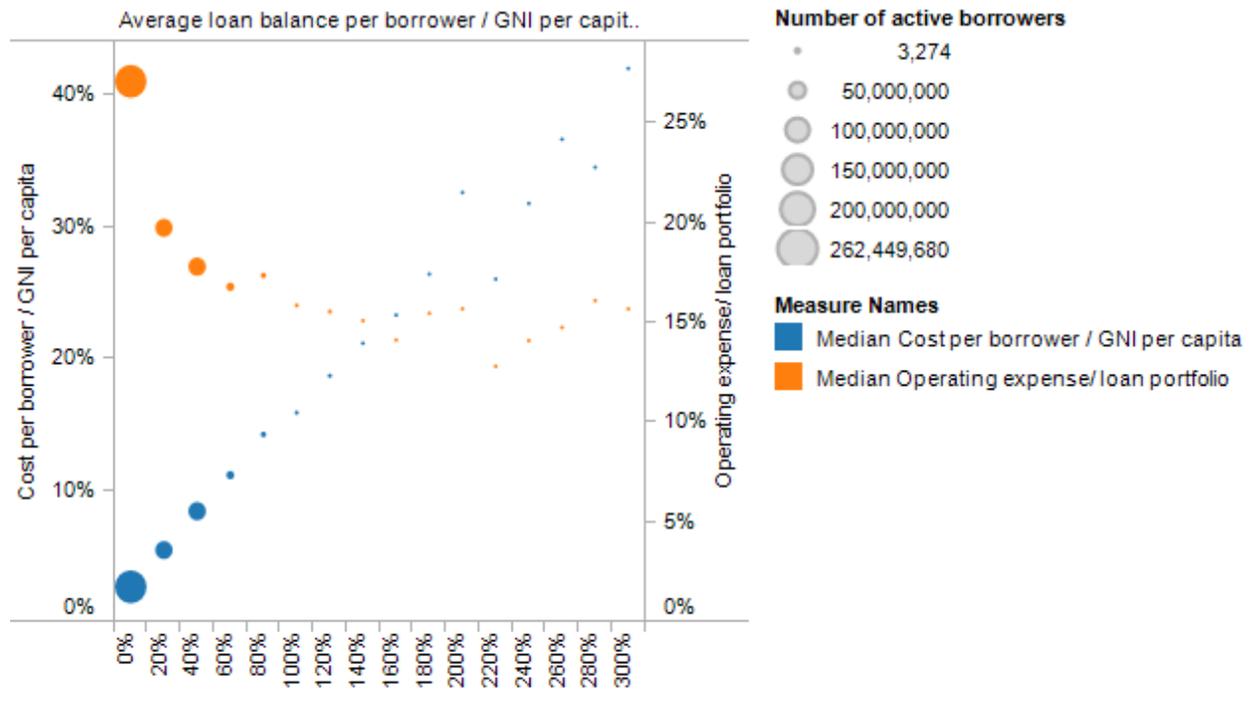


1/ 95% percentile (87%) was omitted from the graph for visual purposes.

## Larger Loans are more expensive, but cheaper per dollar lent

Average loan size is one of the most important determinants of the average cost of microcredit. The average cost per dollar lent (OER) is lower for larger loans, while the average cost per borrower is higher. This relationship is the main reason why smaller loans require higher interest rates than larger loans. As shown in the graph, the effect of loan size is particularly relevant for loan sizes under 20 percent of GNI per capita, and starts diluting for loan sizes over 100 per cent of GNI per capita.

### Efficiency Levels versus Average Loan Size as % of GNI per capita

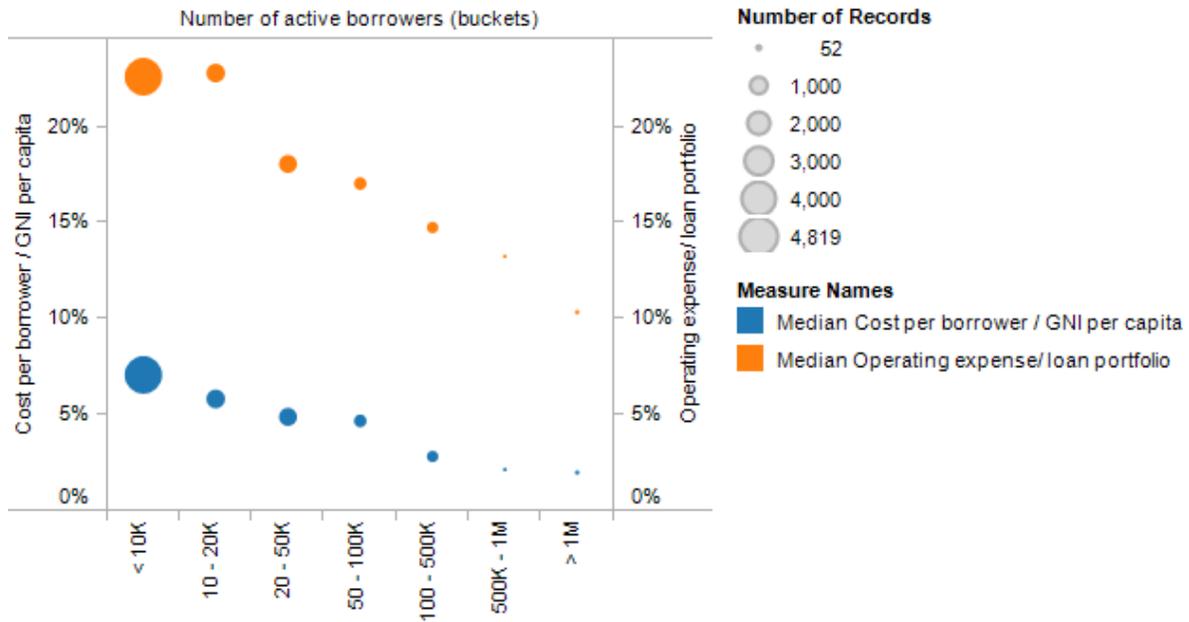


*MFIs were grouped by loan size in bins for each 20 percent increase in loan size and median values calculated per group. The size of the circles represents the number of active borrowers for the group.*

### Efficiency improvements with scale

Larger MFIs have both lower costs per borrower and costs per dollar lent. In particular, efficiency gains are larger for MFIs with fewer than 20,000 borrowers. As previously discussed, since larger MFIs are probably older (learning curve effect) and disburse larger loan sizes, not all improvements in efficiency shown in the graph are directly associated with scale.

## Efficiency Levels versus Number of Borrowers

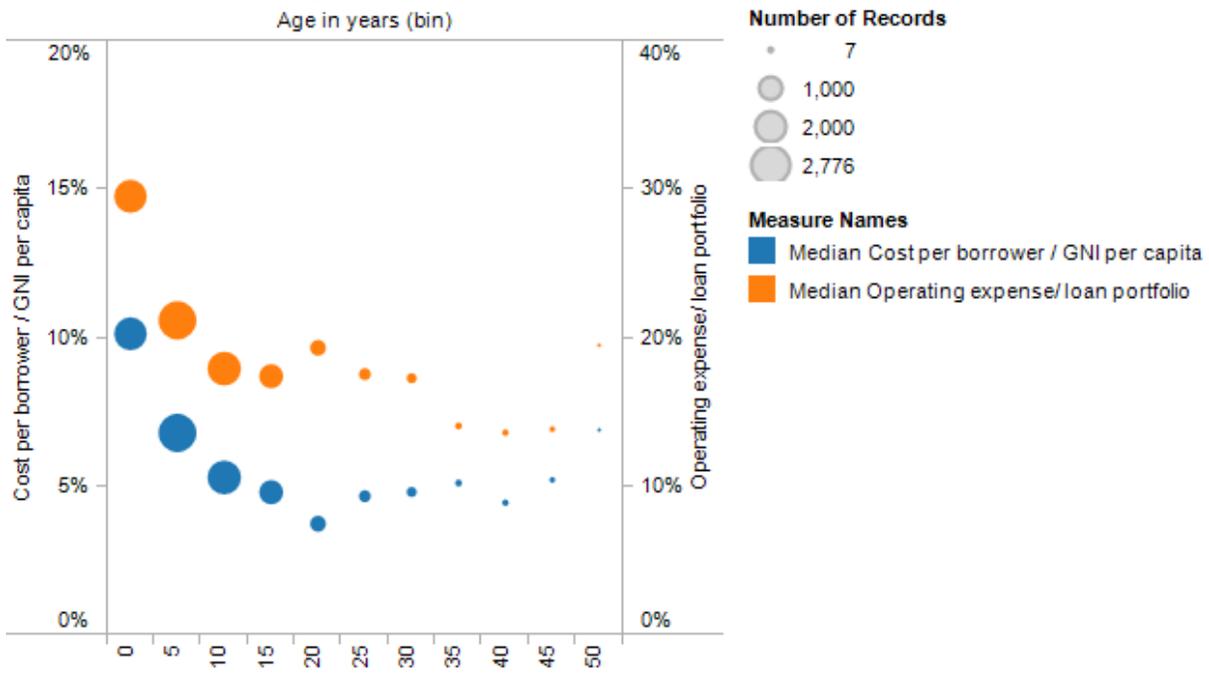


MFIs were grouped by age in five year intervals, and median cost levels were computed for each group.

### Younger MFIs have higher costs

Efficiency levels improve as MFIs age. Improvements are largest for MFIs younger than 5 years old and still meaningful for MFIs between 5-15 years old. Efficiency gains slow down for MFIs older than 15 years old.

## Efficiency Levels versus Age



MFIs were group by age in one year intervals, and average levels of costs were computed for each group.

As MFIs age, usually other changes happen as well, including increasing average loan sizes and increasing scale. As these two factors are associated with efficiency, some of the efficiency gains in the previous graph (efficiency versus age) can be explained by differences in loan size and scale. However, the general trend, especially for very young MFIs has been observed previously as [well](#). The same caveat is valid for the analysis on loan sizes previously discussed, and for the analysis on scale below.

### Takeaways

**Do consider differences in salaries and cost of living as one of the main drivers of costs.** At the high level, at least consider regional differences. Even better if country benchmarks are considered. The industry can work to identify international benchmarks for average salaries in financial services industry (or other related industries), to analyze differences in efficiency levels between across countries.

**Do consider differences in loan size, age and scale as the main factors driving operating costs:** Smaller loans are more expensive per dollar lent. Socially responsible MFIs that care about the sustainability of their operations and the provision of services in the future must charge enough to cover costs. A universal standard that ignores differences in loan size, age and scale will adversely affect young MFIs, small MFIs and those MFIs disbursing the smaller loans, and most likely, reaching the poorest clients. This could also incentivize institutions to move further up-market to improve efficiency.

**Do remember the unknown.** There are still other relevant variables associated with efficiency that have not been properly evaluated because of the lack of sufficient evidence, including the provision of other financial and non-financial services. Many case studies have analyzed these issues, including, [education](#), [training for microentrepreneurs](#), and [remittances](#), but have often found different results for different programs.

### RELATED PUBLICATIONS:

- [Defining responsible financial performance: how to think about social performance](#)
- [Defining responsible financial performance: the role of profits](#)
- [Defining responsible financial performance: how to think about growth](#)