Chapter 18
Depth of Outreach and Financial Sustainability of Microfinance Institutions:
An Empirical Revisit

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ABSTRACT

Microfinance institutions tend to rely on donations and subsidies to achieve their social objective of outreach to the poor. Over the years, the industry has experienced tremendous growth, with donor funding pouring in. The question, however, arises whether microfinance firms can operate and continue to serve the poor clients on cost-covering basis without ongoing subsidies. There has been a growing tendency in the industry, which was traditionally a domain of not-for-profits, to embrace commercialization and pursue profitability to ensure self-sustainability. This chapter makes an empirical revisit to an inconclusive research question: Is there a trade-off between microfinance outreach and sustainability? Based on data for 1,232 microfinance firms from 43 countries, the study confirms the existence of trade-off between the two bottom lines of microfinance.

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INTRODUCTION

"Money, says the proverb, makes money. When you have got a little, it is often easy to get more. The great difficulty is to get that little." — Adam Smith

This *great difficulty* was apparently noticed by microfinance pioneers who started giving small amount of loans to the people in the bottom of the pyramid. Having got the *little*, poor people now can unleash their creative and entrepreneurial power to *get more*. It was sort of a revolution, because poor people were widely considered unbankable, due to their lack of collateral, and ignored completely by the conventional banking system. Microfinance institutions (MFIs) proved that wrong by giving and recovering loans successfully through innovative mechanisms. Over four decades, microfinance has evolved and emerged as a promising tool for financial inclusion and poverty alleviation.

MFIs' credit is disbursed in very small sums to very poor people for income generating activities. The idea is that the poor will invest microloans in microenterprises, repay in installments out of profits, and gradually be able to lift themselves out of poverty. This credit is different from formal credit as the loans are small and without physical collateral, clients are poor, and techniques are unconventional such as group lending, immediate and frequent repayment in small installments, progressive loan structure, peer pressure and collateral substitutes. MFIs tend to rely on donations and subsidies to achieve their social objective of outreach to the poor. Over the years, the industry has experienced tremendous growth, with donor funding pouring in.

The question, however, arises whether microfinance firms can operate and continue to serve the poor clients on cost-covering basis without ongoing donations and subsidies. In recent years, microfinance providers have increased their attention for financial self-sufficiency. There has been a growing tendency in microfinance, which was traditionally a domain of not-for-profits, to pursue profit in order to ensure self-sustainability. A wave of commercialization is currently gaining momentum in the industry where private capital, rather than donor aid or government funding, becomes the source of MFI finance. The unprecedented growth of the microfinance sector, in fact, contributes to this recent trend of increased commercialization. Microfinance firms now increasingly focus on earning profit, and some microlenders even turn themselves into purely commercial institutions. Their excessive focus on financial performance is due to increased competition, commercialization, and involvement of private investors in microfinance.

Doubts however arise whether MFI financial performance comes at the expense of social performance. Do MFIs lose their focus on outreach to the poor because of increased focus on profit-making? Do they drift from their social mission due to a stronger focus on commercial mission of profit and sustainability? In other words, can sustainability be attained without undermining depth of outreach? Is there a trade-off between the two goals? Based on cross-country microfinance data, this chapter makes an empirical revisit to the trade-off debate.

LITERATURE REVIEW

As a social venture, microfinance firm concentrates on providing financial services to the poor and help overcome poverty, primarily by using credit. The goal is to reach the poor, especially the poorest of the poor, with subsidized credit as it is argued that the poor cannot afford higher interest rates (Hermes & Lensink, 2011). MFIs rely on donations, government subsidies and other concessional funds to achieve

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