International Business Review 23 (2014) 181–194

Contents lists available at SciVerse ScienceDirect

International Business Review

journal homepage: www.elsevier.com/locate/ibusrev

Microfinance, the long tail and mission drift

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ARTICLE INFO

Article history:
Received 11 February 2012
Received in revised form 22 March 2013
Accepted 27 March 2013

Keywords:
Bankruptcy
Financial ratios
Long tail
Microfinance
Mission drift
Outreach
Social performance

ABSTRACT

Poor people were excluded from financial services until microfinance institutions (MFIs) emerged. The mission of MFIs is to alleviate poverty, contributing to women empowerment, especially in rural communities. Microcredits can be analyzed under Pareto's 80/20 Principle. Their clients are situated in the long tail of the wealth distribution function. This niche market is not very attractive, because of its high administrative costs, lack of deposits and the need for compensating low revenues with fluctuating subsidies. Some MFIs have drifted from their mission. This paper presents a model to explain microfinance mission drift, tested with hypotheses. The results from the empirical study show a pattern of mission centered MFI: a small NGO, with labor productivity, receiving donations and obtaining a high yield. It can be concluded that there is a need for reducing interest rates. According to the long tail theory, this could be done by using efficient technology, as it has been achieved in the e-commerce sector.

1. Introduction

Vilfredo Pareto found empirically in 1909 that the distribution of wealth within a population does not follow a normal distribution (bell-curve), but an unequal function (long tail), that took his name. Whereas a few rich people have most of the wealth, there is a long queue of poor people, with barely anything. According to Pareto's 80/20 Principle, most of the profits of a company come from a reduced percentage of good customers. In the financial sector, banks target affluent customers. The costs of managing small loans are proportionally high, so lending to the poor is not worthwhile. The poor were excluded from financial services until microfinance institutions (MFIs) emerged. One of the main threats for the microfinance industry is the loss of social reputation, because of an acute profit orientation in a number of MFIs, CSFI (2012). Some MFIs have drifted from their mission. Mission drift arises when an MFI finds it profitable to reach out to unbanked wealthier individuals while at the same time crowding out poor clients, Armendáriz and Szafarz (2011). Mission drift has been studied by Copestake (2007), Mersland and Strøm (2010), Augsburg and Fouillet (2010), Armendáriz and Szafarz (2011) and Hermes, Lensink, & Meesters (2011). This paper analyzes microcredit, following the long tail theory, in order to explain microfinance mission drift.

MFIs performance involves financial aspects, such as self-sufficiency or solvency, and also social aspects. Different social performance indicators have been proposed, Zeller et al. (2003), but they are not as standardized as financial ratios. Certain rating agencies are already assigning social ratings, Gutiérrez-Nieto and Serrano-Cinca (2007). No consensual measure of mission drift exists. Loan size, the percentage of women borrowers and the percentage of rural borrowers have been proposed, among others, by Mersland and Strøm (2010), Cull, Demirguç-Kunt, and Morduch (2007), and Hermes et al. (2011).

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0969-5931/$ – see front matter © 2013 Elsevier Ltd. All rights reserved.
http://dx.doi.org/10.1016/j.ibusrev.2013.03.006

Schreiner (2010) proposes the use of poverty scorecards, to assess the probability that a borrower is poor in a given country; this way the percentage of MFI poor clients can be obtained. This paper combines both approaches. It proposes an indicator based on average loan size, percentage of women borrowers, and percentage of rural borrowers, comparing a given MFI with its country sector. This is one of the main contributions of the paper. The mission drift ratio suggested ranges from 0 (minimum) and 1 (maximum), which makes it easy to interpret. This indicator allows distinguishing between mission drifted and mission centered MFIs; those really serving the poorest. The patterns of both groups can be identified, and a logistic regression model can be performed to predict group membership.

Most MFIs mission consists in lending to the poor, serving rural communities or contributing to women empowerment. There are many kinds of mission drift. For example, some MFIs use abusive collection practices, or charge interest rates close to usury. Augsburg and Fouillet (2010) discuss the extent to which donors and international organizations influence the microfinance sector by pushing MFIs away from their primary objective of delivering financial services to the poor. This may have negative consequences, ranging from mission drift to questionable practices. They conclude that transparency needs to be a priority to establish a stable microfinance environment.

The idea that borrowers follow a Pareto distribution with a fat and a long tail can explain the tendency towards mission drift of those MFIs without a strong social commitment. The paper models the microcredit business by formulating hypotheses on mission drift drivers and inhibitors related to the kind of MFIs operating in the long tail. There, clients are poor and loans are small. Given the high operating costs and the lack of deposits, mission centered MFIs either need subsidies or have to charge high interest rates. These high interest rates are a clear example of poverty penalty, a term that refers to the relatively higher cost shouldered by the poor, when compared to the non-poor, in their participation in certain markets, Mendoza (2011). Hypotheses are empirically tested using a sample of MFIs. The study identifies patterns of mission centered MFIs and mission drifted MFIs.

After identifying two groups (the most centered MFIs and the most drifted MFIs), a logistic regression model is developed; this model obtains a satisfactory classification percentage. This is the same methodology used in bankruptcy prediction studies. The most drifted MFIs could be candidates to a kind of social failure, in the sense that they do not meet their social mission. This is especially interesting for donors, social investors and rating agencies.

The next section presents the model and its hypotheses. Section 3 calculates the mission drift ratio for MFIs. Section 4 presents the empirical study testing the model with a sample of MFIs. In the final section the conclusions are discussed.

2. Microcredits: the long tail of credits

Wealth among individuals follows an unequal distribution. In fact, it is a power law probability distribution, called Pareto distribution, studied by Stiglitz (1969). Fig. 1 shows the probability density function, visually characterized as a J-shaped curve. A characteristic element is the long tail that approaches the X-axe asymptotically. Pareto distributions are also used in management to identify profitable customers. Juran (1954) realized that Pareto's works on the distribution of wealth were applicable to several managerial functions. In his early works, Juran already found that the lowest 65% in order of sales volume accounted for only 4% of the sales. This has turned out to be a business practice, and several management manuals

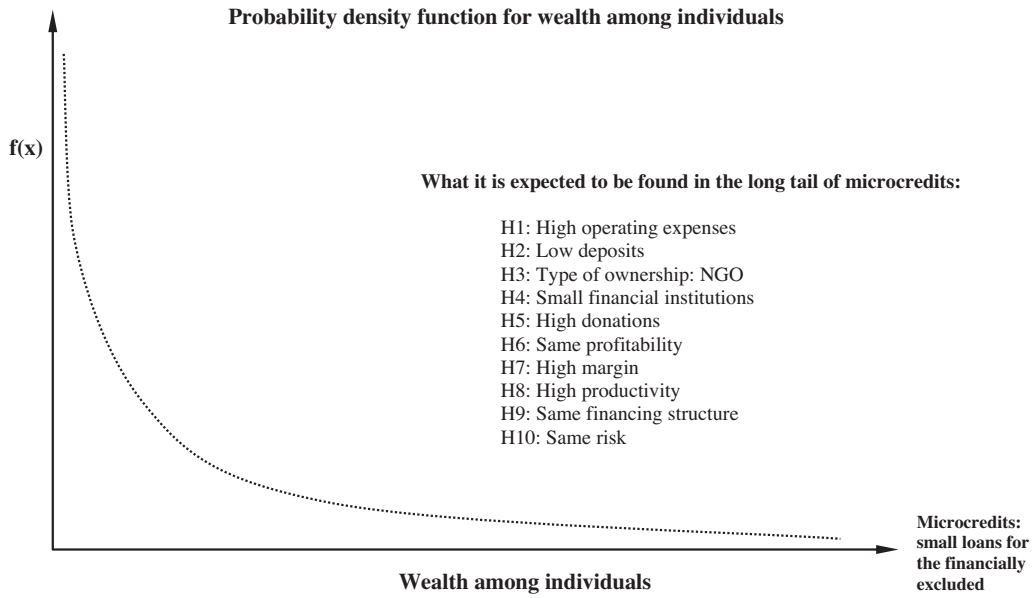

Fig. 1. The long tail of credits.