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Microfinance Mission Drift?

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Summary. — Claims have been made that microfinance institutions (MFIs) experience mission drift as they increasingly cater to customers who are better off than their original customers. We investigate mission drift using average loan size as a main proxy and the MFIs lending methodology, main market, and gender bias as further mission drift measures. We employ a large data set of rated, multi-country MFIs spanning 11 years, and perform panel data estimations with instruments. We find that the average loan size has not increased in the industry as a whole, nor is there a tendency toward more individual loans or a higher proportion of lending to urban costumers. Regressions show that an increase in average profit and average cost tends to increase average loan and the other drift measures. More focus should be given to cost efficiency in the MFI.

Key words — microfinance, mission drift, panel data, GMM estimation

1. INTRODUCTION

The microfinance industry is coming of age, and with its maturation have come claims that the industry is abandoning its mission to serve the poor (Dichter & Harper, 2007). According to the Nobel Peace Prize winner Muhammad Yunus, clients who are financially better off crowd out poorer clients in any credit scheme (Christen & Drake, 2002, p. 10). The mission of all microfinance institutions (MFIs) is to provide banking services to the poor, that is, to lend very small sums to very poor borrowers. The objectives of this paper are first to determine the extent of mission drift, and second, to provide explanations for why mission drift does or does not occur.

Financial viability is a major concern for the industry. A recent survey conducted by the MicroBanking Bulletin (autumn 2007) based on the THEMIX 2006 benchmark data set of 704 MFIs reveals that 41% are not financially self-sustainable; they rely on donor support to keep afloat. However, in pursuing financial objectives, there is the risk of losing sight of social objectives. Ever since PRODEM, a Bolivian nongovernmental MFI, was commercialized and transformed into the shareholder-owned Banco Sol in 1992, addressing the risk of mission drift has been high on the industry's agenda (Rhyne, 1998). Recent events, such as the initial public offering of Banco Compartamos in Mexico that led to a handful of people making a USD 450 million fortune, have added steam to the debate (Rosenberg, 2007).

Thus, some critics fear that MFIs become too focused on making profits at the expense of outreach to poorer customers. The argument is that higher profits lead to lower outreach. However, Rhyne (1998) and Christen and Drake (2002) conjecture that a more commercialized microfinance industry is better able to serve the poorest members of the community, since their profit motives lead them to be more efficient and more willing to seek out new markets for their loan products. The implication is that when we seek explanations for mission drift, we should focus upon the MFIs costs as well as its profits. In this paper, we address these issues in the framework of a bank's profit function freixasrochet2008, where we also include the MFIs risk.

Preliminary empirical evidence supports the Rhyne (1998) and Christen and Drake (2002) position. Hishigsuren (2007) thoroughly analyzes one MFI in Bangladesh using archival, survey, and interview data from different stakeholders. This important case study concludes that the MFI shows no statistically significant mission drift when measured by depth, quality, and scope of outreach to poor clients, at the same time that the MFI is able to achieve greater cost efficiency. In country studies, Paxton, Graham, and Thraen (2000) argue that there is a trade-off between serving the poorest segments and being financially viable, since transaction costs associated with smaller loans are high when compared to those associated with larger loans. However, in a study of commercialized and transformed MFIs in Latin America, Christen (2001) concludes that mission drift has not taken place. Littlefield, Morduch, and Hashemi (2003) find that programs that target very poor clients perform better than others in terms of cost per borrower, an efficiency indicator that neutralizes the effect of smaller loan size. Fernando (2004) analyzes 39 transformed MFIs and finds that their financial positions improved significantly and they did not lose sight of their mission. Both case and country studies lack generality. Until now, Cull, Demigüc-Kunt, and Morduch (2007) is the only larger cross-country study to address mission drift. Using a sample of 124 MFIs in 49 countries, they find that MFIs can stay true to their mission even when they aggressively pursue financial goals. Our study differs from theirs in that the data material is larger, we use instruments in estimation, and our study is specifically geared toward the mission drift question.

Woller, Dunford, and Woodworth (1999) and Woller (2002) hold that mission drift occurs when an MFI leaves the poor customer segment. We subscribe to this view, to which there seems to be general agreement in the microfinance industry.

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If mission drift occurs, the MFIs outreach to poor customers, its depth dimension of outreach (Schreiner, 2002), is weakened. Depth outreach concerns the MFIs provision of financial services to the poorest segments, and is first and foremost defined as average loan as in Cull *et al.* (2007), but depth outreach also includes the extent of lending in rural communities, to women, and lending through group loans (Bhatt & Tang, 2001). This paper gives characteristics of outreach measures, and provides explanations for mission drift using panel data regression estimations with the generalized method of moments (GMMs) for average loan and logistic regressions for the other depth measures. The GMM methodology enables estimations without endogeneity bias, and, since we use a set of country variables in the instrument set, country effects are neutralized.

Despite the interest that has been expressed in mission drift, few studies have been carried out to examine the issue, even fewer rigorous empirical studies. "Since relatively few rigorous studies on the impact of microfinance have been completed, ideology tends to dominate" the debate on mission drift, a *New Yorker* article by Bruck (2006) runs. In this paper we intend to replace ideology with analysis. The ongoing debate and the lack of cross-country studies involving a large number of MFIs indicate a need for our study. We address mission drift explicitly using data from rated MFIs in 74 countries.

We test three main hypotheses for mission drift derived from Freixas and Rochet (2008): profitability per customer, costs per customer, and customer risk. The first two hypotheses imply that an MFI will increase the size of its average loan in order to improve financial results, while risk is uncertain. The MFI may limit risk by making smaller loans, or by migrating to customers who are better off. The first strategy implies a smaller average loan size, the second strategy implies a larger.

The data set used to conduct this study includes observations of 379 MFIs in 74 countries collected by rating agencies during the years 2001–08. Since the data were collected by third parties, they are more reliable than self-reported data. We find no evidence of mission drift in the industry as a whole; however, panel data estimations using GMM reveal that the size of the average loan increases with increased average profit and average cost. These results imply that mission drift may occur if an MFI seeks higher financial returns, but that this effect is neutralized if the MFI is more cost efficient. These results confirm the Rhyne (1998) and Christen and Drake (2002) conjecture. Furthermore, we find that average cost is more important than average profit in determining average loan size. Though profit seeking leads to mission drift, attention should be given to reducing an MFIs costs.

The remainder of this paper proceeds as follows: In Section 2, we describe our data on rated MFIs. In Section 3, we discuss what we mean by mission drift and provide descriptive statistics. The aggregate data show no signs of mission drift. In Section 4, we develop our theory and hypotheses. Section 5 provides an overview of the panel data methods used. The hypotheses are tested in Section 6, and our conclusions are presented in Section 7.

2. DATA

Our study is based on the observations of 379 rated MFIs in 74 countries. Third-party organizations established the standardized ratings, and outside organizations subsidized part of the costs involved (www.ratingfund.org). The main motive for an MFI to submit to a rating has improved access to external funding. The third-party and standardized MFI data collected from the rating agencies are judged to be better than self-reported data as found, for instance, in the Mixmarket database. The data set includes both financial and outreach data, and is thus well suited for studying the mission drift issue.

At each rating, four years of data were commonly obtained, although some MFIs report five and six years of data. The rating agency obtains data for the current year as well as for immediately preceding years when visiting. The method of data collection means that the panel of data is highly balanced. This means that we have 1,159 observations for average loan and a similar number for other variables in the analysis. The ratings were performed from 2001 to 2008, which means that we have data from 1998 to 2008, with more than 100 observations for each year from 2001 to 2006. The variables used in the analysis are defined in Table 1.

The index number problems associated with country-specific effects make comparisons between countries difficult (Deaton, 1995). We alleviate these problems by several procedures. First, we convert the monetary variables into USD at the going exchange rate, and then adjust them for purchasing power parity (PPP) bias based on IMF data. According to the purchasing power parity principle in the international finance (Solnik & McLeavey, 2004) the first step means that country inflation rates are reflected in the exchange rate. However, conversion by market rates only is criticized for not taking account of the true purchasing power in the local market. The IMFs GDP–PPP is an attempt to correct for this. By adjusting with this index, we make each loan (and each local cost) more comparable acrosscountries. Second, we use country variables as instruments in the regressions. Third, panel data statistical methods, specifically the fixed effects method, remove time invariant and idiosyncratic differences from the data (Woolridge, 2002).

3. MISSION DRIFT

The average loan is the most commonly used indicator among microfinance investors and donors to measure the degree of MFI outreach to poor customer segments (Bhatt & Tang, 2001; Cull *et al.,* 2007; Schreiner, 2002). Mission drift occurs when the size of the average loan increases. This indicates that an MFI has moved into new customer segments, either because it begins to include customers who are better off or because existing clients experience success and are thus able to take on larger loans. In Schreiner (2002) average loan is one proxy for the *depth* dimension of outreach. Let us look at some others.

First, increasing the depth of outreach means reaching more women. Outreach to women has been a priority almost since the inception of Grameen bank (Dowla & Barua, 2006). Second, group lending has been the cornerstone of microfinancing. Instead of requiring formal collateral, loans are backed by peer groups (Armendariz de Aghion & Morduch, 2005; Ghatak & Guinnane, 1999). Therefore, a shift from group lending to individual lending leads the MFI away from uncollateralized lending necessary to reach the poorest customers and may bring about mission drift and a reduction in the overall developmental impact stemming from group participation (Thorp, Stewart, & Heyer, 2005). Third, reaching rural areas is a significant goal in microfinance, since this is where poverty is most concentrated (United Nations, 2006). When the relative weight of loan allocation shifts to the urban market, mission drift occurs.

Table 2 provides an overview of the depth characteristics.