

Managing Microfinance

- What distinguishes failed from successful microfinance?
- How are staff members motivated and equipped to do their jobs?

Huge performance variation

- As measured by?

“Productivity” indicators. Basic Message:

“ While most MFIs employ some or all the mechanisms already described in previous lectures and in A-M (2005), performance variation is largely UNEXPLAINED”

→ Hence, this lecture’s main puzzle

Operational self-sufficiency?

- Most MFIs are covering self-sufficiency or operational costs (salaries, overhead, etc.), but there are huge variations
- Why?
- Woller- Schreiner (2003): “ interest rates, administrative efficiency, loan officer productivity, and staff salaries are important determinants of financial self-sufficiency”

If social missions are held constant, then, how can MFIs provide incentives for enhancing productivity?

- One possible explanation: to achieve both financial and social objectives is very complicated

So, dual goals lead to:

- MFI managers need to meet non-profit objectives, and
- Self-sustainability objectives

Key principles

- Incentive theory (key tensions)
- Just qualitative experiences from Latin America and Asia

(Armendariz – Morduch, Chapter 10, 2005)

Rise and Fall of CORPOSOL, Bogota, Colombia

- ACCION Internacional affiliate which started in 1988, and went bankrupt in 1996
- Why?
- Managers wanted to grow very fast because
a) scale economies, and b) prestige

Rewards for fast growth (outreach)?

- Yes! Offered to loan officers → results: 1990 each loan officer responsible for 258 clients (on average), and in 1992 (!!) each loan officer responsible for 368 clients
- Another measure of pace of growth: dollar value of portfolio. It increased by > 300% from 1994 to 1995

How about “loan quality”?

- It did not seem important to top managers
- Larger bonuses offered to loan officers who expanded rapidly (in terms of volume)
 - how about demand (new clients' quality?)
- If not important, then:
 - increase the number of “products” offered
- However, what happens if emphasis on volume regardless of number of clients?
 - Loan sizes increases prompting an overindebtedness crisis which shows by average loan increases (more than doubled in 1995)
- Moreover, well-documented stories show that lending techniques changed from group lending to individual lending (group lending clientele fell by 30% in 1995)
- What happened if growth-oriented performance not met? Employees were fired.

Ultimately: repayment rates fell drastically from 98% in 1994 to 36% in 1996 and CORPOSOL went bankrupt!!

This in turn shows the importance on disregarding loan quality!!!

With the benefit of hindsight

- Top management failed to appropriately decentralize decision-making
- Failed to set realistic growth targets for staff
- Failed to create “internal control” mechanisms
- Failed to balance social objectives while preserving financial ends
- Failed to create a “culture of openness and professionalism

Big question:

- How to simultaneously motivate staff with dual objectives and cut costs?

→ Principal – agent theory

Principal: Top managers. Agent: Loan officers

Main problem: Agent takes actions that principal cannot observe (i.e., PG & A's paper last Friday on recruitment)

What do principals have to worry about?

- Individual rationality constraints
- Incentive constraints

An important trade-off is often invoked between insurance (risk) on the one hand and bonuses (incentives) on the other

By emphasizing bonuses (incentives) for growth performance targets, CORPOSOL underperformed.

Reality in microfinance is somewhat different, however

- Multitasking: top managers care about profitability on the one hand, and poverty reduction on the other.
- → So, why not offer incentives based on number of borrowers and high repayment rates?
- Not so simple: team work matters!