

# **Financial results of Microfinance Institutions: Social performance matters**

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Acknowledgements: Authors are listed alphabetically. The views expressed in this paper are not necessarily shared by the Principles for Responsible Investment.

## **Abstract**

The purpose of this study is to contribute to the research on the relationships between social and financial performance of microfinance institutions. The Centre for Responsible Banking & Finance at the University of St. Andrews (UK) applies advanced statistical techniques to the in depth social performance data from Microfinanza Rating. The hypothesis that the relationship is parabolic instead of linear is broadly confirmed by the empirical results. Social performance management and social responsibility towards the staff are needed to sustain financial performance but lose their positive financial impact after a certain point (inverted U-shape). In contrast, building client protection systems from scratch can be costly, but the efforts pay off once the “minimum critical mass” of client protection is achieved to ensure the clients’ and investors’ trust (U shape). The findings imply that social performance matters for the financial results; understanding the synergies and the trade-offs between the two is key to balance the sustainability and the progress towards the social mission.

## **1 The state of knowledge: little information**

A key promise of microfinance is poverty alleviation combined with a notion of economic development and social responsibility. The underlying expectation is that good business can do well, as microfinance institutions can be profitable businesses and jointly play a meaningful part in the quest for poverty alleviation. This hypothesis is charming but also challenging. Is it really possible that an organization engages to hundred percent in two aims: profit and poverty alleviation? Or will any organization eventually have to prioritise profit or poverty alleviation?

A lot of debate has been heard on this topic but the empirical basis is still small due to a lack of data or resources. Academics lack data on the social performance of microfinance institutions to conduct practically meaningful analyses of the relationship between the financial performance and poverty alleviation of microfinance institutions. They usually employ the average size of a microfinance institutions loan as measure of poverty. This measure, however, relates about as much to institutional policies and strategies as to the financial requests of clients, whereby even the financial demands of clients might be more related to a type of business opportunity than to poverty. In fact, it is possible that a client requests a smaller loan just because she has small existing funds to support her business.

Professionals, in contrast to academics, have access to social ratings of microfinance institutions, which employ a wealth of rich indicators. However, their main expertise lies naturally in commercial microfinance operations. Conducting advanced statistical analyses to ensure that a research finding describing the relationship between the social responsibility/poverty alleviation and the financial performance of microfinance institutions can be accredited best possible to a specific narrative by eliminating all other thinkable narratives is beyond the resources of most professional microfinance organizations. Nevertheless, organizations working in the microfinance sector within the Social Performance Task Force such as Cerise, Microfinanza Rating, MIX and microfinance investors (e.g. Blue Orchard, Incofin, Oikocredit and Triple Jump) are committed to understanding the relationship between the social and the financial of microfinance institutions. They have conducted initial analyses of the relationship which indicate that social aspects might matter for financial

performance. Sensibly, their analyses focus on general measures of the social performance of microfinance institutions instead of a cryptic single indicator such as the academics' average loan size. This social performance measure of professionals is largely concerned with poverty alleviation but also includes other aspects such as client protection or social responsibility towards staff.

## **2 A new study: professional data meets academic rigour**

In a new study, academics and professionals are, seemingly for the first time, joining forces to study the relationship between social and financial performance of microfinance institutions. This working paper of the Centre for Responsible Banking & Finance at the University of St. Andrews analyses in depth social performance data of Microfinanza Rating, whose social rating methodology received a very positive assessment in the user review supported by the Ford Foundation<sup>1</sup>. The paper is titled 'Do Microfinance Institutions pay for social responsibility? Evidence from social ratings' and is authored by Andreas Hoepner, Frank Liu and John Wilson<sup>2</sup>.

Interestingly, the study departs from the conceptual view that a linear relationship between the social responsibility and the financial performance of microfinance institutions unlikely exists. The reason for their view lies essentially in the argument that the complexities of the real world are seldom well described by a simple linear line even after statistically eliminating the influence of several complexity generating variables. For example, if a genuinely positive relationship between social responsibility and financial performance would exist, then any further investment in social responsibility should allow microfinance institutions to generate positive financial effects. However, no organisation worldwide can probably afford to invest all its cash in social responsibility aspects if it still aims to maintain self sufficient in financial terms. In other words, there is a sensible maximum investment of corporate resources in social responsibility beyond which any further investment is unlikely to translate in additional financial outcomes. Similarly, it is also unlikely that any organization and especially a microfinance institution could afford to disregard social responsibility altogether and treat its clients and employees inhuman. Hence, there is also a sensible minimum

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<sup>1</sup> [Social Rating user review](#) available on the social performance task force website, in the [User reviews](#) section.

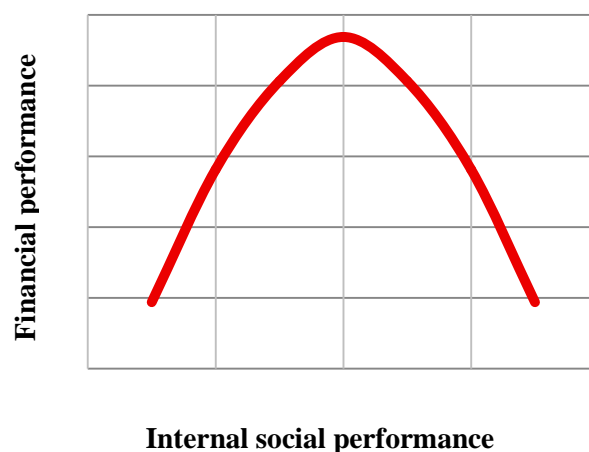
<sup>2</sup> The academic working paper and the statistical analysis are available on the [Social Science Research Network](#).

investment in social responsibility below which an organization would risk substantial financial penalties. The question remains though how the relationship between social responsibility and financial performance is shaped between a sensible minimum and a sensible maximum investment. It might be linear but the authors from the Centre for Responsible Banking & Finance argue that it is not.

Andreas Hoepner and his colleagues suggest that the relationship is parabolic or inverse parabolic which means in layman language looking like a U or a U rotated by 180 degree. The type of U-shape depends on the nature of social performance in their view. They argue that internal and external social performance has to be distinguished.

Internal social performance is directed at employees and other resources within an organization, for which the organization does not compete strongly with its peers. This internal social performance is needed to sustain and enhance financial performance (e.g. through employee motivation) but loses its positive financial impact after a certain point. Hence, the authors argue that the relationship between internal social performance and financial performance has the inverse parabolic shape of a ‘U heads down’ (figure 1).

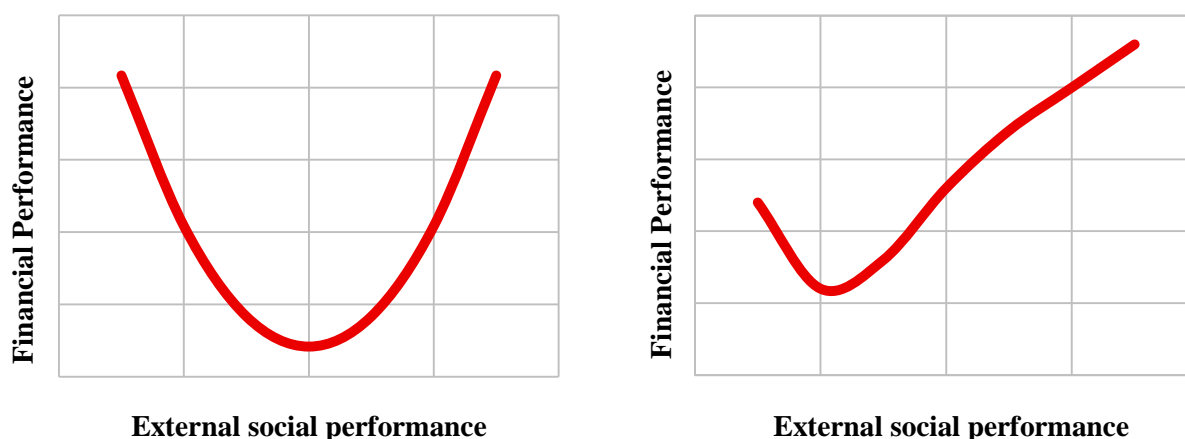
**Figure 1: Suggested relationship between internal social performance and financial performance**



E.g. social responsibility staff; social strategy; social monitoring system; systems alignment to mission

External social performance, however, is directed at clients and resources outside of the organization for which the organization competes with its peers. Some organizations may stay away from a competition for being the most socially responsible and only commit to the necessary minimum but those organizations actively entering the competition need to win it to realise the gains (e.g. client wins) they expect from their social responsibility investments. Hence, the authors expect that the relationship between external social performance and financial performance looks like a mix between a U and a J (figures 2 and 3), whereby those organizations investing in social responsibility but not winning the competition perform worst, those staying a way from the competition perform second best and those risking to enter the competition and winning it perform best.

**Fig. 2-3: Suggested relationship between external social performance and financial performance**



E.g. client protection; social responsibility towards community and environment

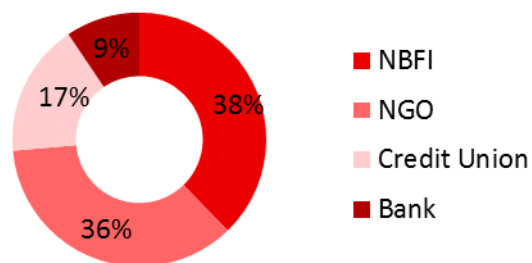
The authors conduct an in-depth statistical analysis to test their expectations, whereby they control for effect of characteristics of microfinance institutions such as age, region of activity, operating expense ratio, real gross portfolio yield or risk coverage ratio to distinguish regional and managerial influences from the effects of social responsibility. They study six aspects of social performance management and social responsibility assessed by Microfinanza Rating. Two aspects (‘client protection’ and ‘social responsibility to the community and the environment’) represent external social responsibility whereby four aspects assess internal forms of social responsibility.

Among these internal aspects, the authors describe two as people oriented (‘social responsibility to staff’ and ‘social strategy’) and two as process oriented (‘social performance monitoring’ and ‘systems alignment to the social mission’).

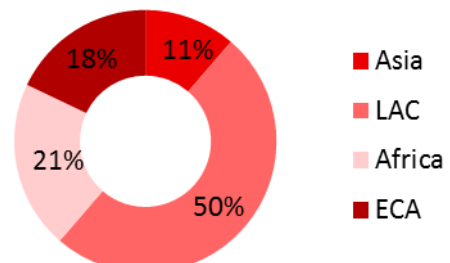
The social performance management and social responsibility aspects studied by the authors, together with the areas of outreach and quality of the services, are part of the social rating framework of Microfinanza Rating. The social rating of a microfinance institution provides an opinion on the effectiveness of the social performance management and client protection systems, indicating the likelihood of achieving its social mission. Social ratings involve an in-depth analysis whereby the information is validated through a one or two weeks visit to the microfinance institution and a client level study (client survey and focus group discussions) in case of comprehensive social rating<sup>3</sup>. The database for this study is constituted of 114 Social Ratings conducted by MicroFinanza Rating (see region and charter type breakdown in figures 4 and 5).

**Figures 4 - 5: Social ratings carried out by MicroFinanza Rating by charter type and by region**

**Social Ratings by charter type**



**Social Ratings by region**



<sup>3</sup> Social Rating methodology available in the [Social Rating](http://www.microfinanzarating.com) section of our website: [www.microfinanzarating.com](http://www.microfinanzarating.com)

The results of Hoepner et al.'s statistical analysis provide quite a bit of support for their arguments. They find no significant linear relationships between external or internal social performance and financial performance aspects. However, they identify a clear and strong U shaped relationship between financial performance and client protection and social responsibility towards the community and the environment on the other side (external social performance) of for-profit microfinance institutions, while they do not observe the same relationship for non-for-profits. This differentiation is not too surprising, as for-profits are likely to engage more in competition than non-for profits. Improving the client protection, from a weak to an adequate level, results in lower financial gains, but upgrading the client protection from an adequate to good and very good goes along with higher financial performance. Building client protection systems from scratch can be costly, but the MFI's efforts to implement client protection will pay off once the MFI has reached the client protection "minimum critical mass" necessary to build the clients' loyalty and the trust of the government and investors.

In contrast, they find a relationship between financial performance and social strategy, social performance monitoring and social responsibility towards the staff (internal social performance) only for non-for-profit microfinance institutions. This relationship is weaker than the external social performance one, as it only applies to internal people oriented social responsibility and has a lower statistical significance level. However, it has the expected inverted U-shape and it is intuitive to observe that internal, employee motivating social responsibility is more important in a non-for-profit, while external competitive social responsibility is more crucial for a for-profit. The inverse U-shaped relationship suggests that for instance, once the staff satisfaction has reached an adequate level, the financial costs of improving the social responsibility towards the staff would be higher than the financial gains. In other words, marginal improvements in labor conditions, which are already standing at a good level, may not have a significant short term effect on staff commitment, productivity and staff retention so as to make the financial gains outweigh the financial costs. However, improving the staff conditions up to "decent" levels is reflected in improved financial performance.

### **3 The implications: social responsibility matters**

So what do the results of this new study imply? Three outcomes are noteworthy:

- 1) Social performance simply matters for the financial performance of microfinance institutions.

While Hoepner et al.'s results are only fully valid for social ratings by Microfinanza Rating, their observations of multiple, statistically and economically significant relationships between social responsibility and financial performance clearly highlight that the social aspects of performance are not neutral to the financial performance of microfinance institutions. Once the synergies and the trade-offs between the social and the financial performance are understood, the strategy can be wisely directed to balance the sustainability and the progress towards the social mission. A balanced positioning can be achieved while upgrading the social performance by developing the potential synergies with the financial performance on one hand, and by managing the possible trade-offs on the other hand.

- 2) The relationship between social performance and financial performance of microfinance institutions is unlikely simple and linear. It is not just a matter of 'doing good by doing well' or 'paying for social responsibility' but microfinance decision makers will need a little more sophistication to develop an in depth, performance enhancing understanding of the relationship between social and financial outcomes.

- 3) The effect of social performance on financial performance depends most likely on the type of social aspect. While external, competition oriented social aspects such as client protection seem to experience a U or J shaped relationship with financial measures; internal, employee oriented social responsibility seems to share an inverted U type relationship.

Of course, Hoepner et al.'s study is by no means the holy grail of the social responsibility and microfinance literature. More studies are needed to improve our understanding of the interrelations between social and financial outcomes in microfinance. The European Microfinance Platform and the Principles for Investors in Inclusive Finance are working on further enhancing research as is Microfinanza Rating and the research team from St Andrews. Nevertheless, this new study adds new light to a very important debate.