

How can we define responsible financial performance? This is part two of a four-part series covering our current state of knowledge about the relationship between key financial and social performance indicators, produced as a prelude to the [annual meeting of the Social Performance Task Force](#), June 19-24 in Den Bosch, Netherlands. The first installment covered [growth](#); remaining installments will be released once a week and will cover efficiency and a review of the linkages between financial and social performance.

[Profits have been among the most controversial topics in the microfinance community](#) and are intricately linked to our views on the social impact of microfinance institutions. Can institutions make profits *and* improve the lives of their clients at the same time? Can we identify institutions with profit levels that threaten the welfare of their clients?

To answer these questions, we need to measure profit levels using a simple set of standardized indicators; before considering standards for profits, we will need to explore what those measures can tell us. In the end, returns stand as a good measure of *financial* performance, but do not provide clear guidance for building standards on *social* performance.

Profits and social performance

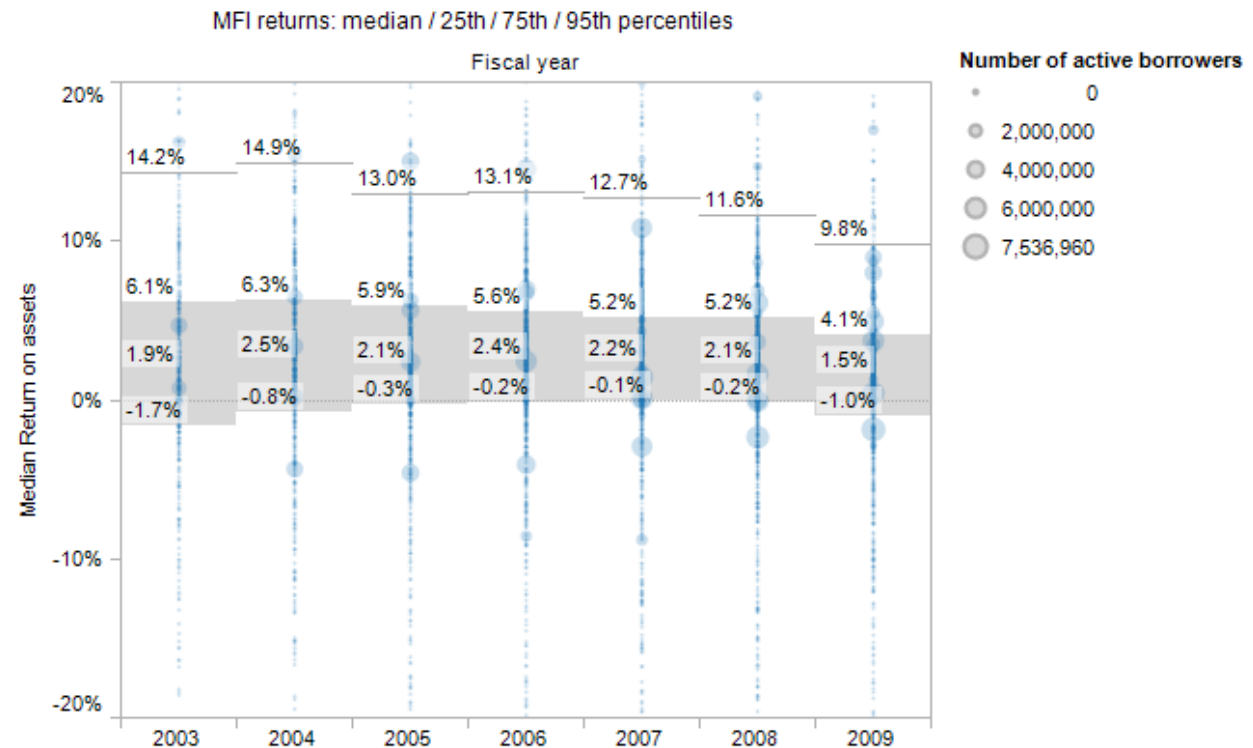
As a starting point, we map out some ways in which profit levels could inform us about social performance:

- ***Persistent negative profits*** are a risk factor for social performance. If an institution consistently has a large gap between revenues and expenses, it may threaten the sustainability of the institution. In this case, the institution would either need subsidies to survive - meaning that funds would need to be re-allocated from other, potentially preferable, uses - or it would need to eventually stop operations - meaning clients would be denied services and would potentially need to fall back on [inferior options](#).
- ***Low profits*** may signal poor social performance. Low returns can be caused by low portfolio quality, which is potentially a sign of ['poor quality microfinance'](#). Low returns can also reflect organizational inefficiency (which may be passed on to clients) or high levels of executive compensation.
- ***High profits*** may signal poor social performance. If an institution makes very high profits, it may be charging clients more than is necessary, paying staff too little or ignoring risks in its portfolio.

However, we cannot yet conclude that moderate profits are the way forward (or that high or low profits are always problematic): profits reflect aspects of financial performance that do not have a direct social impact and different aspects of social performance [have different effects on returns](#). To consider any indicator as a measure of social performance, we look at the information conveyed by that indicator. What do returns tell us about social performance practices?

Signal-to-noise

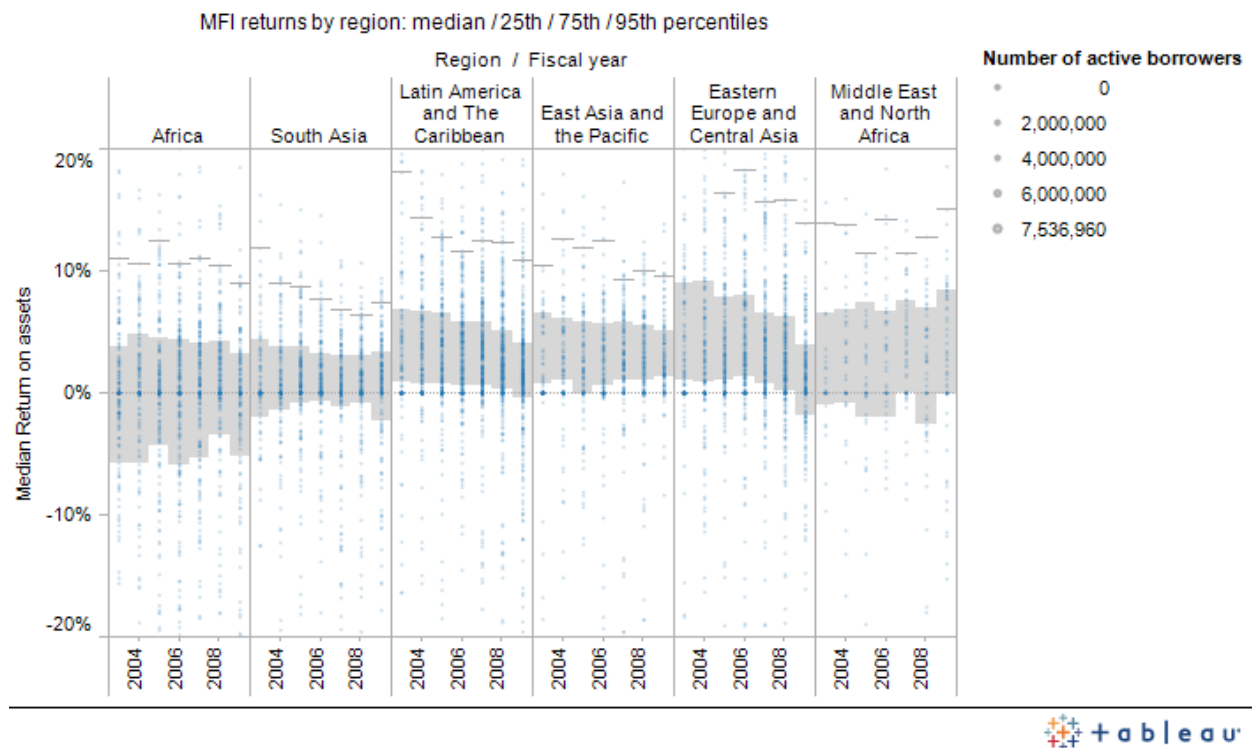
Return on assets is the most basic and most comparable measure of profit for MFIs. Returns capture the net of all revenues and expenses of an institution - income from lending, staff expenses, rent, utilities, provisioning for loan losses. We first look at typical levels of return for MFIs, and then investigate what can drive high and low values.



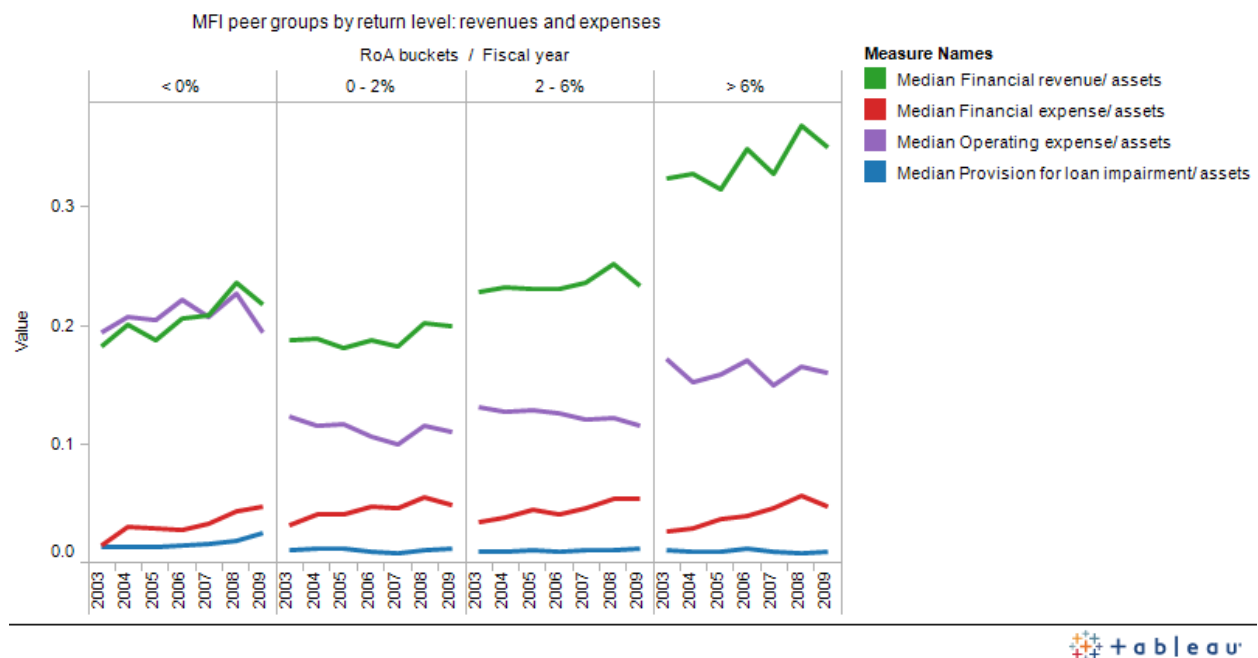
tableau

Despite concerns over excessive profit-making in the sector, [returns have steadily declined](#) for the past several years. The median MFI now has a fairly low return on assets level of 1.5 percent, and median returns have not exceeded 2.5 percent within the past several years. Returns for the top quartile are typically above 6 percent, while the bottom quartile has had negative returns. Only 5 percent of MFIs typically have returns above 10 - 15 percent.

The more we segment the data, the more variation we see. Returns in Africa have been consistently low, while those in the Middle East and North Africa have been among the highest, while historically profitable sectors in Latin America and Eastern Europe have taken a hit in recent years.

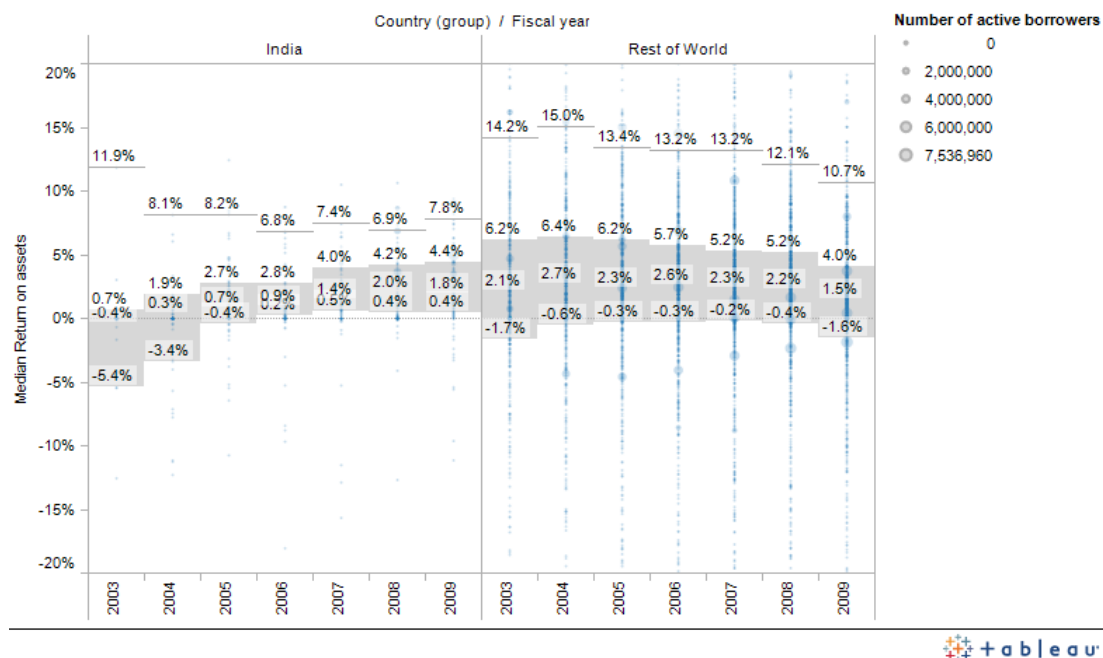


Does this variation tell us something meaningful or is it just noise? If we segment MFIs into groups using the quartile ranges mentioned previously as rough guidelines, we can start to see some more differences in the fundamentals.



MFIs with high returns tend to have higher revenues *and* higher expenses - they earn more on loans, but pay more for financial and operating expenses, although high-cost / high-return MFIs are a [small share of the overall market](#). MFIs with low returns tend to have higher operating expenses. Segmenting by age, loan size, outreach or other factors would tell us more about the root causes of this variation and provide better information on social performance. Three examples can help to illustrate the limits to inference from profit levels alone:

- Earlier, we flagged high returns as a potential risk factor for social performance. One exception is a group of institutions providing financial services to the poor with return levels above the 99th percentile for the ranges above - the median return is well over 30 percent. Should we be concerned about this? Probably not. These high returns are for [savings groups](#), data via [the Savings Groups Information Exchange](#). High profit levels for these groups should not raise social performance concerns. They are mostly explained by extremely low operating costs and the practice of re-distributing all profits directly to the members of the groups (and the groups even manage to encourage savings behavior in the process, for which there is [evidence of positive impact](#)).
- High profits were often cited as central to the crisis in Andhra Pradesh. Would monitoring profit levels have allowed us to spot (and possibly) prevent this crisis earlier on? It is hard to see how this could be the case - the figure below shows that profits for MFIs in India, even for the top quartile, have been below average globally for the better part of the past several years. If, as expected, profits are lower this year, should we read that as 'better' social performance?



Data from MIX Market 2003 - 2009, comparing MFIs in India to MFIs in all other countries. Bars are for 25th, 50th (median), 75th and 95th percentiles.

- We also flagged low returns as a risk factor for social performance. From 2008 - 2009, the Kyrgyz som lost 25 percent of its value relative to the dollar. Since most MFIs in Kyrgyzstan [cannot mobilize savings and must borrow in foreign currency](#), the currency depreciation lowered the average return by 2.4 percent (more than the global median return for that period), as seen in the table below. Do these lower returns reflect poor social performance? In this case, we can attribute the drop in returns to factors largely outside of the institution's control - a lack of local currency financing and a worsening of macroeconomic conditions. Yet there is also relevance for social performance - institutions only suffer these losses when they are exposed to foreign exchange risk. One way of mitigating that risk (and avoiding losses) is to pass the risk to the end borrowers through indexed loans, a practice [rightly flagged as poor social performance](#). A better way to manage such risk is [through hedging](#), although options are limited in many markets. However, both good and bad practices could result in the same financial returns.

Name	Return on assets	Gain / loss on FX / ass..	Returns adjusted for FX g..
Kompanion	7.9%	-7.9%	15.8%
FMCC	6.5%	-5.6%	12.1%
Bai Tushum	6.0%	0.2%	5.7%
1st MCC	4.3%	-2.8%	7.0%
BTA Bank	2.9%	1.5%	1.3%
Mol Bulak Finance	2.6%	-4.2%	6.8%
Aiyl Bank	1.0%	-0.3%	1.3%
Agrocredit Plus	-1.1%	-0.1%	-1.0%
OXUS - KGS	-29.7%	-11.8%	-17.9%



Data for 2009; adjustment is made by taking gains / losses on foreign exchange over average assets and adding back to return on assets.

As [seen with growth](#), we need context to understand the data. Returns provide a wealth of information, but without context it can be difficult to interpret.

Alternative profit measures

Return on assets is not the only measure of profit used in the microfinance sector. Could another measure tell us more about social performance? Four alternatives include:

- Operational or financial self-sufficiency (OSS / FSS): Defined as [financial revenue / \(financial expense + impairment loss + operating expense\)](#), where operating expense includes personnel, administrative and depreciation costs. (FSS is the same formula, but with each value adjusted.)
- Profit margin: Defined as [net operating income / financial revenue](#)
- Subsidy-dependence index (SDI): As defined in [several papers](#) by Yaron and others, SDI is [similar to OSS / FSS in many ways](#), but it explicitly incorporates donations.
- Spreads / margins: While there is not a universal definition, generally these cover the gap between lending rates and the cost of funds, as in the recent [Reserve Bank of India regulations](#) or in the [methodology proposed by Yunus](#).

To test these alternatives, let us consider two hypothetical MFIs, both with \$100 in assets. MFI 1 charges high rates and earns \$80 for the year on its loans, while MFI 2 charges low rates and earns \$20. However, the high-interest rate MFI also has high executive compensation, and it turns out that both MFIs have the same net income of \$5. Most practitioners would say that the first MFI is the 'worse' MFI - it charges higher rates *and* pays executives well above market rates. Let's see what the other measures tell us:

	MFI 1	MFI 2
Assets	100	100
Revenue	80	20
Expenses	75	15
- Financial	3	3
- Loan losses	2	2
- Personnel	65	5
- Administrative	5	5
Donations	5	5
Net profit	5	5
Return on assets	5%	5%
OSS	107%	133%
SDI (fn1)	0%	0%
Profit margin	6%	25%
Spread	77%	17%

Most practitioners would identify the first MFI as the one with the more problematic practices for social performance. However, two of the metrics - return on assets and SDI - cannot distinguish these MFIs for us. Even worse, if we were to set a ceiling on returns, profit margin and OSS could make the 'better' MFI (#2) look worse. Since revenues are higher for the first MFI, it deflates both profit margins and OSS. The spread measures do highlight the 'questionable' MFI, but largely because they are a [proxy for the higher operating costs](#).

While this is an artificial example, it is exactly the kind of scenario where basic indicators should be able to help. Yet we can see that most profit measures do not help us to distinguish between these two MFIs and they may even lead us to the wrong conclusions.

Building better performance measures

Returns are a very good measure of financial performance. However, they do not tell us much about social performance - returns incorporate many factors not related to social performance. MFIs with similar profits can have very different practices. Conversely, high and low profit levels can guide us to good and bad practices alike. Other measures do not do much better, and can be worse. How can we strip out the noise from the signal? What components of returns do we want to focus on?

We can see some promising directions above. First, working to understand more about social performance and client needs and then identifying the key factors that an MFI can influence that relate to social performance. In our next piece, we look at efficiency, which takes us one step closer to this goal. For practitioners, we [again](#) propose three takeaway lessons:

- **Do set a floor for profits:** Institutional sustainability is important and fundamental to any view of social performance. Institutions that consistently are unable to cover costs may drain finite donor resources or force customers to eventually rely on worse options. At the same time, returns are somewhat volatile and any floor should cover a reasonable window of time.

- **Do not set a ceiling for profits:** We cannot look at profits in isolation. We need additional context to understand how profits are earned and how they are distributed. Setting a cap on profits rewards institutions for poor social performance if lower profits are driven by inefficiency, high risk or other factors. Research indicates that high costs [do not always translate into worse outcomes for clients](#).
- **Do start looking at the fundamental factors that an MFI can directly control:** As we dig into profit figures, we can see that high and low profits alike are driven by specific factors - interest rates, staff policies, risk management practices - many (although not all) with a relation to social performance. Standards for responsible financial performance will provide better guidance if they target their [focus on those factors](#), rather than on profit measures that combine disparate types of information.

Fn1: The full calculation for SDI is more complex, so we have relied on the approximation derived in [this article](#). Adjustments are not computed for any indicator in the table.

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