TRUE OR FALSE: Trade-offs occur between social performance and financial performance in microfinance. Conventional wisdom says true. Extending formal financial services to poor and hard-to-reach clientele necessarily entails higher costs and lower per unit returns and is, subsequently, harder to scale up. The trade-off inherent in this relationship creates incentives for microfinance institutions (MFIs) to move up-market and away from their traditional poor clientele—a phenomenon known as mission drift.

But as is often the case, conventional wisdom does not necessarily represent reality, since it frequently draws from personal bias and limited anecdotal experience. Contrary to the conventional wisdom, the relationship between social and financial performance is actually more complex than imagined, and evidence exists to suggest that the relationship is not always negative. In some cases, particularly in ones relating to social performance management (SPM), the relationship may actually be significantly positive.

The nature of the relationship also depends critically on how one defines social performance. In practice, social performance entails more than poverty outreach or poverty impact. Once we allow for a more expanded definition, it opens up possibilities in which the two can work in concert with each other.

CONVENTIONAL WISDOM

Microfinance is unique among development approaches in that it offers the potential for both massive scale and operational sustainability. Perhaps more than any other development or humanitarian strategy, microfinance offers a diverse group of stakeholders a real opportunity to “do well by doing good.” Microfinance combines the ethos and practices of development with the ethos and practices of capitalism to provide, potentially, hundreds of millions of persons with vital services necessary to increase their labor productivity, smooth consumption, manage risks and withstand shocks, and build social capital. Or so goes the popular thinking.

Things are, once again, a bit more complicated in practice. One thing that appears almost certain is that microfinance is a victim of excessive hype. Dozens of
impact studies find that microfinance does have significant and positive impacts, but they are substantially less dramatic than those touted by enthusiastic microfinance advocates. A realistic conclusion is that microfinance should not be expected to end poverty any time soon; there is simply no way that microfinance can live up to the lofty expectations of its more zealous advocates.

On the positive side, we now know indisputably that financial services constitute an integral component of the livelihood and coping strategies of the poor. The poor need and use financial services no less than do the wealthy. Few people question the value of financial services in general (Their benefits are well understood and well documented.), and few among the wealthy could imagine their lives without access to financial services.

Given this, it might be argued that we do not need to promise that microfinance will eliminate poverty; it unnecessarily complicates the case by weighing it down with unrealistic expectations and other rhetorical baggage. A preferable approach in this case is to strip microfinance of this baggage and focus instead on reaching as many people possible in the least expensive way possible and in the most sustainable way possible.

Following this argument, social impact may best be achieved by building financially sustainable MFIs with significant outreach. Large and sustainable MFIs, the logic goes, are bound to pick up poor customers in their wider net—more poor customers than some MFIs that exclusively target the poor. In this context, investing resources in managing an MFI’s social performance, moreover, is at best a benign distraction from the core business concerns of scale and sustainability. At worst, it is a costly distrac-
tion that inappropriately diverts organizational resources, with negative implications for scale and sustainability.

Others argue that discarding the antipoverty agenda of microfinance entails risk. In particular, the quest for scale and sustainability (i.e., profitability) will invariably create pressures for MFIs to abandon their traditional clientele to target easier-to-reach (less costly) and more well-off (less risky and more profitable) clientele. The result of this mission drift will be that the very persons that MFIs were originally created to reach—the hard-to-reach and poor—will once again be left without access to formal financial services.

Indeed, as some survey the microfinance landscape, they see unsettling portents. The industry has, by and large, accepted the primary goal of financial sustainability among industry mores and practices. Increasingly, MFIs are adopting commercial business models (including transformation into profit-seeking, regulated institutions) and the subsequent values. Donors, who tend to identify more with the industry’s social roots, are increasingly giving way to private investors who are unconnected to the sector’s social roots and who tend to emphasize financial returns. These developments, while good in certain important aspects, will only increase the trend toward mission drift.

For those concerned about industry trends, the antidote to mission drift is to keep the industry tethered to its historical social moorings. This requires constant attention to the social objectives of microfinance and, critically, practical methods to manage social performance. Developing cost-effective measurement methods is, moreover, a necessary condition for creating social transparency, which is in turn a necessary condition for creating social accountability.

**REASSESSING THE CONVENTIONAL WISDOM**

The truth probably lies between these two stylized arguments. Still, the competing perspectives on this issue each incorporates a set of questionable assumptions. One of the most important assumptions is that social performance is largely defined by poverty outreach or impact.

**Defining Social Performance**

Defining social performance in terms of poverty outreach is both conceptually and practically inappropriate. Social performance may include poverty outreach, but it also need not. The Social Performance Glossary on the SEEP Network’s Web site, for example, defines social performance as “the effective translation of an organization’s social mission into practice. Social performance is not just about measuring the outcomes, but also about the actions and corrective measures that are being taken to bring about those outcomes.” In practice, it is entirely feasible for an MFI to have a distinct social mission that does not include serving the poor. An MFI might, for example, define its social mission as “to improve the economic well-being of persons traditionally excluded from formal financial markets” or “to create jobs and promote enhanced social status for small and medium-sized agro-businesses.” Neither of these two mission statements specifically mentions the poor, and both MFIs could
One thing that appears almost certain is that microfinance is a victim of excessive hype.

conceivably fulfill their social missions without reaching a single poor person.

How does the absence of reference to the poor or to poverty in an MFI’s social mission make its social mission less valid? It doesn’t, nor should the MFI’s social performance be judged relative to this standard. Rather, its social performance should be judged, and the MFI held accountable, for performance relative to its stated social mission.

To carry the point further, an MFI might have no social mission. It may exist solely to earn a profit by targeting nontraditional customers or formerly excluded persons, or it may position itself to compete directly with the mainstream commercial banks in certain nonpoor market segments. It is, again, inappropriate to hold this MFI accountable for social outcomes that are not part of its institutional mission. This general point is important, so it deserves emphasizing: Social performance is a broad concept of which poverty outreach is one component—an admittedly important component, but one component nonetheless.

Social Performance as Core Business Activity
I now turn to the assertion that social performance is a distraction from core business activities. Whether this is true depends to a large extent on the mission of the MFI in question. If the MFI claims a distinct social mission, it is hard to see how dealing purposively with this mission constitutes a distraction. This does not imply that the MFI needs to devote x amount of effort to managing its social performance, but it does imply that it needs to devote some effort, particularly if it solicits funding on the basis of this mission.

Even if one is committed to the concept of social performance, MFIs historically have not been held accountable for it for the simple reason that there was no cost-effective way to measure it. To date, MFIs have been able to opt out of measuring and reporting their social performance with more or less impunity.

This is no longer, or will soon no longer be, the case, however. Recent years have seen a number of technological innovations in measuring social performance that overcome the cost barriers and that promise cost-effective collection and reporting of social performance information. These include development and emerging consensus on critical social performance indicators, the development of tools such as the social rating and social audit, and the integration of methods borrowed from the corporate social responsibility (CSR) movement in the private sector.

The Business Case for Social Performance
Researchers have produced over one hundred studies examining the empirical relationship between social and financial performance. The findings are mixed across the entire range of studies, but there do exist distinct trends in the findings suggesting a significant and positive relationship between social and financial performance. A caveat to these studies is that they were done among private firms engaging in CSR, so the results are unlikely to translate directly to microfinance. At the very least, they serve to rebut any general argument that paying attention to one’s social performance constitutes an inappropriate and potentially dangerous diversion from the pursuit of making money.

There are several ways to explain these positive findings. The actual causal factors linking social and financial performance are likely a combination of them, plus other factors.

• The instrumental stakeholder theory suggests that the satisfaction of various stakeholder groups is instrumental for organizational financial performance.

• The stakeholder–agency theory argues that the relationship between stakeholders serves as a monitoring mechanism that prevents managers from diverting attention from broad organizational financial goals. By addressing and balancing the claims of multiple stakeholders, managers can increase the efficiency of their organization’s adaptation to external demands.

• Slack resources theory proposes that prior financial performance is directly associated with subsequent social performance because prior high levels of financial performance may provide the slack resources necessary to engage in SPM.

• Firm-as-contract theory stipulates that high firm performance results from the simultaneous coordination and prioritization of multiple stakeholder interests, in addition to separate satisfaction of bilateral relationships.
<table>
<thead>
<tr>
<th>Institution Type</th>
<th>Borrowers</th>
<th>Profit Margin</th>
<th>Financial Self-Sufficiency</th>
<th>Return on Equity</th>
<th>Average Loan Size / GNI per Capita</th>
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<td>Banks</td>
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<td>NGOs</td>
<td>16,193</td>
<td>10.8</td>
<td>112</td>
<td>10.5</td>
<td>23.5</td>
</tr>
</tbody>
</table>

The Consultative Group to Assist the Poor (CGAP) and the Ford Foundation are spearheading a stakeholder engagement process called the Social Performance Task Force. Their goal is to coordinate work on social performance assessment (SPA) and social performance management (SPM) in the microfinance sector. Information on the Task Force and other initiatives in social performance is available on the Social Performance Resource Center’s Web site: http://www.microfinancegateway.org/resource_centers/socialperformance/.

SPM helps firms develop new internal competencies, resources, and capabilities that become embedded in the firm’s culture, technology, structure, and human resources.

- Within so-called high density networks, SPM improves a firm’s competitive advantage by improving management’s ability to weigh and address the multiple and often competing claims of stakeholders in a fair and rational manner.

- Where social performance is preemptive and a firm’s environment is dynamic or complex, SPM may help build management competencies because preventative efforts of this nature require significant employee participation, firm-wide coordination, and a forward-thinking management style. In such cases, SPM can help management develop better scanning skills, internal processes, and information systems, which in turn increase the organization’s capacity to manage external changes, turbulence, and crisis.

- According to reputation theory, a firm’s communication with external stakeholders about social performance may help build a positive image with customers, investors, and suppliers. Firms with high social performance can use social performance disclosures as one of the information signals on which stakeholders base their assessments of firm reputation. Firms with high social performance reputations may also improve relationships with bankers and investors, or they may also attract better employees or increase employees’ goodwill—all of which help improve financial performance.

The purpose here is not to establish definitively a positive relationship between social and financial performance but to provide sufficient evidence to establish the empirical plausibility of this relationship. In the worst case, there appears to be no harm to SPM, and in the best case, there appears to be significant financial benefit.

Conventional Wisdom vs. Practice
How does the presumed trade-off between social and financial performance play out in the context of microfinance? Table 1 offers preliminary evidence to suggest, once again, that the conventional wisdom may be simplistic. It presents average figures from the April 2007 issue of The MicroBanking Bulletin comparing end-of-year values in 2005 for selected performance measures at commercial banks, nonbank financial institutions (NBFIs), and NGOs. NBFIs are for-profit, regulated financial institutions operating under different supervisory standards than the commercial banks. NGOs typically operate with a greater development, or social, focus than banks or NBFIs, and they will tend to work with a poorer and more marginal clientele.

As expected, the commercial banks have on average significantly more borrowers than the NGOs, confirming that there is a trade-off between social focus and scale. In contrast, the average loan size relative to gross national income per capita is significantly smaller among NGOs, confirming the conventional wisdom that NGOs tend to work with poorer clients. (Average loan size is a very
rough proxy of poverty outreach based on the intuitive assumption of an inverse relationship between income and loan size.)

In terms of financial performance, however, the conventional wisdom is not a good guide. Commercial banks do not consistently outperform the NGOs across the financial performance categories. Banks earn higher profit margins on average, but NGOs earn a higher return on equity on average; yet there is no difference between the two in terms of financial self-sufficiency. Also, the for-profit NBFI s consistently do worse than the NGOs in all five performance categories.

Far from showing a clear financial advantage for commercial banks, Table 1 seems to suggest that NGOs can serve a poorer clientele while still earning returns comparable with commercial banks and superior to NBFI s.

CONCLUSION

The conventional wisdom asserts an inverse relationship between social performance and financial performance. I’ve outlined three reasons why the conventional wisdom in this case is simplistic or even wrong. First, the conventional wisdom largely defines social performance in terms of poverty outreach. In practice, however, social performance is a much broader concept of which poverty outreach is but one dimension. A broader definition of social performance makes evident any number of alternative scenarios in which social and financial performance need not be in conflict and may even be complementary.

Second, the preponderance of empirical evidence taken from the private sector points to a positive and significant relationship between financial and social performance. All else equal, firms that actively manage their social performance earn higher financial returns than otherwise. Doing social performance management, apparently, yields a variety of benefits that translate into higher financial returns, such as improved stakeholder relations, greater management capacity, improved internal capacities, better inter-firm communication, improved employee relations, and enhanced reputation. While the empirical findings in the private sector may not translate directly to microfinance, neither is the microfinance sector so different that the findings are not relevant to it.

Third, preliminary evidence in microfinance fails to show a systematic inverse relationship between social (or poverty) orientation and financial performance. Overall, microfinance NGOs perform similarly to, or better than, commercial banks and nonbank financial institutions on critical financial performance indicators. This evidence is far from conclusive, but there is, at the very least, sufficient contrary examples to suggest that the relationship between social and financial performance is by no means set. The exact form of the relationship depends on the situation. A strong social orientation need not result in the sacrifice of financial return. Conversely, a strong financial orientation need not result in the sacrifice of social return.

What is the answer to the question of trade-offs between financial and social performance? It depends on the situation. There may be a trade-off; there may not be. Digging a bit deeper in these numbers uncovers examples of large, sustainable MFIs that serve more poor clients and do so more profitably than poverty-focused MFIs operating in the same markets. But there are also large, sustainable MFIs serving very few poor people, fewer than poverty-focused MFIs operating in the same markets. There are also some very large MFIs exclusively focused on poverty. Scale and sustainability do not guarantee poverty outreach, but a poverty focus does not rule out scale or sustainability. Conversely, a poverty focus does not guarantee poverty outreach; but scale and sustainability can promote it. It is hard to generalize. A more thorough analysis of the data might yet reveal some general trends, but within these general trends, there are bound to be numerous exceptions. The reader is well-advised to be wary of simple generalizations and the simplified policy prescriptions that might flow from them.

In any case, there is reason to believe that MFIs can produce reasonably good financial performance even if they target poorer or harder-to-reach clientele. It may or may not be equal to what the MFI could earn in other market segments, but it is neither desirable nor feasible for every MFI to target the same market and the same clientele. There is ample room for different MFIs to target different market segments and, within these market segments, generate “good” financial returns.

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