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Does Regulatory Supervision Curtail Microfinance Profitability & Outreach?

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For microfinance institutions, particularly those aiming to take deposits, an advantage of regulation is that it allows semi-formal institutions to evolve more fully into banks. But complying with regulation and supervision can be costly, creating potential trade-offs. World Bank researchers Robert Cull and Asli Demirgüç-Kunt and FAI managing director Jonathan Morduch examined the balance between the benefits and costs of regulatory supervision, with a focus on institutions' profitability and outreach to small-scale borrowers and women. The authors analyzed data on 245 of the world's largest microfinance institutions, with newly-constructed data on their prudential supervision. Regression analysis showed that supervision does not have a significant impact on profitability: microfinance institutions subjected to more rigorous and regular supervision are not less profitable compared to others. However, this type of supervision is associated with larger average loan sizes and less lending to women, suggesting that it does have a significant impact on outreach.

Analyzing the Lenders

Cull, Demirgüç-Kunt, and Morduch looked at data on 346 microfinance institutions in 56 developing countries collected by the Microfinance Information eXchange for the *MicroBanking Bulletin* bench-marking report. The authors also analyzed a subset of the data, comprised of the 154 institutions that both reported detailed financial information and were subject to regulatory supervision. Their key regressors were three dummy variables that summarize whether an institution faces prudential supervision and the intensity of that supervision. They controlled for institutional characteristics like age and size, as well as country characteristics, including the growth rate of real GDP, the rate of inflation, and an index of institutional development developed by Kaufman, Kraay, and Mastruzzi (2007).

Results

The authors found that onsite supervision of microfinance institutions varies, even within the same country and among profit-oriented institutions. In terms of trade-offs, they found that microfinance institutions subjected to more rigorous and regular supervision are not less profitable than others, despite facing higher costs of supervision. Supervision does, however, have a significant impact on outreach. Regulatory supervision is associated with larger average loan sizes (a common proxy for the relative poverty of borrowers) and less lending to women. They also found that supervision is associated with having a higher share of staff concentrated in the head office, a natural response to the administrative burden of increased reporting requirements, for example.

Policy Implications

This study sheds light on an important trade-off that regulated microfinance institutions face. One way that microfinance institutions cope with the financial and administrative burdens of regulatory supervision is by serving relatively better-off customers, who are less costly to serve. While this strategy allows institutions to maintain profitability, it diverts them from pursuing a mission of providing financial services to the poor. Though the trade-off is economically intuitive, this empirical evidence allows microfinance practitioners and policymakers to make better-informed decisions about strategies.