Prisoner of the past? Overcoming biases to run a microfinance institution

Aman Bhuwania, Indian Institute of Management Bangalore, India

Microfinance institutions are organizations which extends a variety of financial products such as loans, savings, and insurances to people living in poverty and unserved by the traditional financial and banking system. They are a type of social venture and have to balance two simultaneous goals – creating social value (by uplifting populations out of poverty) and doing so in a financially sustainable manner. These two goals are often at loggerheads as over-commitment to either can lead to failure in the other goal.

In such a context the orientation of the founder which they develop over their previous work experiences can play a major role - a founder who has previously worked in a non-profit is likely to be inclined towards the social mission even at the expense of the financial profits; and one who had worked in a for-profit is likely to be inclined towards profits.

Consider MFI A's social-oriented founder Suresh Gupta (name changed) who believes that beneficiaries must be protected against their own misjudgement. "We always tell (borrowers) take (micro-loans) for income and don't take it for consumer goods, don't take it for things where there is no return," said Suresh. This could mitigate credit risk for Suresh but would also be less profitable. Contrastingly consider MFI B's business-oriented founder Ramesh Kumar (name changed) who believes in fulfilling market gaps profitably. "The poor exactly know what they need, and as long as they have income to service the loan, it is acceptable," said Ramesh. This could lead to higher risk for Ramesh but increases the scope for higher profits.

The impact of founders' orientation on the financial performance of their microfinance institutions has been hotly debated in academia and been inconclusive. Does social orientation lead to lower financial performance or does it lead to more financial sustainability? In the current study, by surveying an extensive sample of 104 microfinance institutions operating in India, we found prevalence of the following:

- Business-oriented founders, vis-à-vis social-oriented founders, have better financial performance subject to their choice of business model for their ventures.

- One of these models, the “needs-based model”, focuses on addressing the needs of the rural poor by providing them means for sustenance in the form of income generating loans and leveraging the social structure of this target group to minimize the risk assumed.
- The other model, the “demands-based model”, is focused on addressing the demands of the urban poor by providing them consumption loans at reasonable prices, working on the assumption that the poor are capable of maintaining their budget and prudent allocation of credit. This model is relatively riskier.

What microfinance institutions require is an optimal mix of the two models which could balance out the two competing goals of social benefits with financial sustainability. Traditionally, the microfinance model has been construed as the “needs-based model” (described above) where social value is created through the economic activity of lending to poor and promoting micro-entrepreneurship among them. The second model, however, is an innovation which while producing a completely different social value, can help microfinance institutions by cross subsidizing the first model. At the same time, the first model can help microfinance institutions by lowering their overall credit risk and maintain a safer portfolio.

Finally, our study suggests that experiences, especially early career experiences during the formative years of their work life, form their orientations. These orientations persist through time. They reflect through the decisions that they make in course of their future work. Hence, it is important for individuals to be cognizant of such biases and take steps to compensate for them. We have found that having co-founders with complementary orientations can definitely help with that.

In conclusion, the task of maintaining a balance between social and financial goals is fraught with challenges and paradoxical choices. Such choices are not just influenced by contemporary situational factors, but also by the social entrepreneur’s past. It then becomes imperative for them to be aware of the biases which they have carried because of their experiences lest they are unable to break free from the prison of the past and make unsustainable choices for their ventures.

CONTACT: Aman Bhuwania; amanb18@iimb.ac.in; (T): +91 9971743620; Indian Institute of Management Bangalore; Bannerghatta Road, Bangalore, Karnataka, India 560076.