Performance and Transparency: A Survey of Microfinance in South Asia[1]

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A wealth of information on South Asian microfinance lurks in the shadows as the region's impressive achievements in outreach grab the spotlight. Around the globe, microfinance in South Asia is synonymous with giants like Grameen Bank, ASA and BRAC. Together with the self help groups in India, these institutions have revolutionized access to financial services, providing microloans on a grand scale to some of the poorest clients in the world. Massive credit outreach is but a piece of the picture, yet details on the financial performance of the sector are not as well known. These aspects remain hidden behind the veil of weak dissemination of industry reporting standards, poor financial disclosures and few public information centers on microfinance institutional performance.

By applying international reporting standards to a broad set of microfinance institutions from across the region, this paper seeks to highlight the performance of the sector, both within the region and on the global stage. The following pages also draw on the experiences of local and global transparency initiatives to paint a picture of the state of transparency in South Asia, the challenges that it faces, and the initiatives underway to overcome these obstacles.[2]

Performance of South Asian Microfinance Institutions

Performance analysis of microfinance institutions paints a composite picture of the myriad factors affecting service delivery. Such analysis is only possible when performance is reported according to common standards and with sufficient disclosure. Built on a common base of standardized, unadjusted data, each area of the report explores one factor in the performance of South Asian MFIs. Taken together, these factors paint that composite picture of MFI performance and set it in the context of trends within the global microfinance industry.

Outreach

An array of microfinance institutions reports to the MIX, serving an impressive 42 million clients worldwide. Outreach for individual MFIs ranges from a few hundred clients in a handful of villages to 30 million depositors spread across an entire country. From village cooperatives to national financial institutions, these MFIs form a rainbow of institutional forms, product types and service delivery methodologies to meet the needs of a rapidly growing number of clients.

Breadth of Outreach

Within this sample, South Asian microfinance stands alone in scale of credit delivery, serving one in two borrowers globally. As Figure 1 demonstrates, these MFIs cover three times more borrowers than the next closest region. Where microfinance has only taken hold in the last ten years, as in Eastern Europe and Central Asia, or Middle East and North Africa, MFIs barely register on the global map of client outreach.

Bangladeshi MFIs lead both regional and global outreach in credit. Three leading MFIs, Grameen Bank, ASA, and BRAC, count for nearly 75 percent of total borrowers served in South Asia. Their scale and national coverage rival those of any other microfinance service provider within the subcontinent or around the globe. No other microfinance sector in South Asia achieves this coverage. Even after the boom in Indian microfinance, large institutions such as Share Microfin Ltd., Spandana or the BASIX Group together serve as many borrowers as just one of these Bangladeshi MFIs. Rather than national coverage, their combined service delivery extends only to a few Indian states.

While South Asia excels in credit delivery, it serves fewer clients with savings services than other regions. Both sub-Saharan Africa and East Asia focus on voluntary savings services; the largest MFI in the data set, Bank Rakyat Indonesia and its Unit Desa system manage more small deposit accounts within Indonesia than the total of microloans serviced by South Asian MFIs. While many South Asian MFIs do

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2 Local microfinance experts collected data on microfinance institutions (MFIs) and surveyed the local transparency environment for Afghanistan, Bangladesh, India, Nepal, Pakistan and Sri Lanka. Collectively, this sample includes 125 institutions from across South Asia and covers data from financial years 2002 and 2003, with the exceptions of Nepal and India, where larger samples were available for the subsequent years.The analysis in the first section of this paper uses industry standards to survey institutional performance in South Asia and compare it with the rest of the MIX Market's public database on nearly 600 MFIs worldwide.Data are self-reported and cross-referenced with audited financial statements where available. Data collection challenges are cataloged in a second section that reviews the transparency environment throughout the region.

Figure 1: MIX Market microfinance coverage

Region	MFIs	Active Borrowers	Voluntary Savers	Gross Loan Portfolio	Voluntary Savings
	Nb	Nb (million)	Nb (million)	USD (million)	USD (million)
Africa	150	2.2	5.9	570	575
E. Asia / Pacific	39	3.8	30.1	1,832	3,276
E. Europe / C. Asia	84	0.5	0.8	832	698
Latin America	102	2.4	0.8	1,943	1,026
MENA	23	0.4	-	113	-
S. Asia	121	11.8	3.9	959	328
Total	**518**	**21.3**	**41.5**	**6,249**	**5,903**

Source: MIX Market 2003 data as of October 21, 2005. Data presented are totals

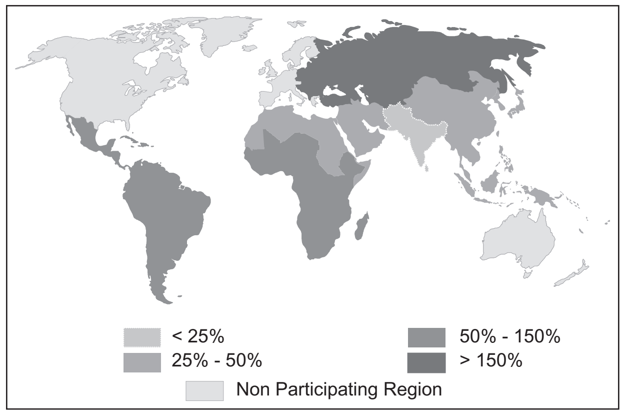
collect customer deposits, such collections are often either a mandatory part of membership or directly linked to access to loans and are hence not included in this analysis of voluntary savings. Low levels of voluntary savings services stem from the fact that few institutions in South Asia have the clear legal authority to collect public deposits. In India in particular, not-for-profit and other institutions that do not have such license have actually scaled back or eliminated their voluntary savings products over the period.

Depth of Outreach

South Asian microfinance, renowned for its poverty focus and deep outreach, lives up to its reputation in this data set. Depth of outreach indicates the extent to which MFIs are serving clients with very low incomes and is often proxied by the percentage of women clients and the average loan balance per borrower. MFIs from the region serve the lowest average loan balances, both in absolute terms and relative to local income levels, as Figure 2 illustrates. Moreover, South Asian MFIs remain resolutely focused on serving women, with an average outreach of nearly 85 percent to women borrowers. Of the other regions, only Middle East and North Africa comes close to similarly small loan sizes, due to the predominance of small solidarity group loans in that region’s portfolio.

Regional averages actually mask even greater depth and smaller loan sizes in most countries in the subcontinent. Across the board, with the exception of Nepal, borrowers hold balances of less than one third of local annual income. As Figure 3 demonstrates, Indian and Sri Lankan MFIs serve the lowest loan balances in South Asia. While three countries in the region focus almost exclusively on women – with 90 percent or more of their borrowers women – Afghanistan and Pakistan buck the trend. In Pakistan, men constitute a clear majority of the clients served. In a country with low microfinance penetration rates, extending more financial services to women would help quickly improve outreach in regions already served by existing microfinance institutions.

Figure 2: Average loan balance per borrower / GNI per capita



Growth of Outreach

Around the globe, microfinance continues to expand its outreach, with South Asian MFIs growing at exceptional rates given their initial size. Over the period studied, South Asia had the second highest growth in borrower outreach, in front of every other

Figure 3: Ten MFIs with the smallest average loan balances

Name	Country	Average Balance per Borrower / GNI per capita
LEAD	India	1.77%
SEVA Microfoundation	India	1.77%
BISWA	India	2.90%
Janodaya	India	3.06%
Bodhana	India	3.23%
Wilgamuwa	Sri Lanka	3.33%
Arthacharya	Sri Lanka	3.52%
RGVN	India	4.03%
WDFH	Sri Lanka	4.46%
Sanghamitra	India	5.00%

region except Eastern Europe and Central Asia, where a very young sector grew by almost 50 percent. Driving strong growth across South Asia were some of the fastest growing MFIs in the data set. Twenty of the top 50 fast growing MFIs work in South Asia. In comparison, established sectors in East Asia and Africa grew at more modest, single digit rates.

Given the large existing client base, South Asian MFIs added the greatest number of borrowers – nearly three million. As Figure 4 shows, Bangladesh and India drove this growth. As the single largest sector in South Asia, Bangladesh dominated total growth, contributing nearly two thirds of additional borrowers in the region over the period. The volume of actual new clients may be tempered, though, in light of widespread acknowledged client overlap among institutions.[3] While microfinance in India does not reach the volume that it does in Bangladesh, its medium and large scale MFIs demonstrated some of the highest sustained growth rates over the period, many averaging 100 percent.

In 2003, a total of 3.7 million additional borrowers were served worldwide, compared with the previous year. Profitable institutions added 91 percent of these, yet represented only 65 percent of the MFIs sampled. This pattern holds true in every region except Africa. In South Asia, 92 percent of additional borrowers were added through the 62 percent of MFIs that earned positive returns.

Despite this positive picture, sustainability has not yet made its mark on growth throughout South Asia. Bangladesh stands alone as the sector where growth is inextricably linked to profitability. Unprofitable microfinance programs in Bangladesh netted almost no new clients over the year. In other sectors across the region, a comparatively greater portion of growth still comes from unprofitable operations. Broad reach of the samples in India and Pakistan would indicate that someone – either a donor or an investor – continues to fund operating losses, directly or indirectly, in order to expand outreach. Investors and donors should watch these trends to ensure that the financial health of their partner institutions does not imperil their social goals.

Figure 4: Ten biggest gains in borrowers served in South Asia

Name	Country	Growth in Borrowers
Grameen Bank	Bangladesh	790,000
BRAC	Bangladesh	574,788
Spandana	India	275,985
SHARE	India	171,274
ASA	Bangladesh	154,509
Sanghamitra	India	74,085
SKS	India	48,836
Cashpor MC	India	40,139
BRAC – AFG	Afghanistan	39,862
BURO Tangail	Bangladesh	36,246

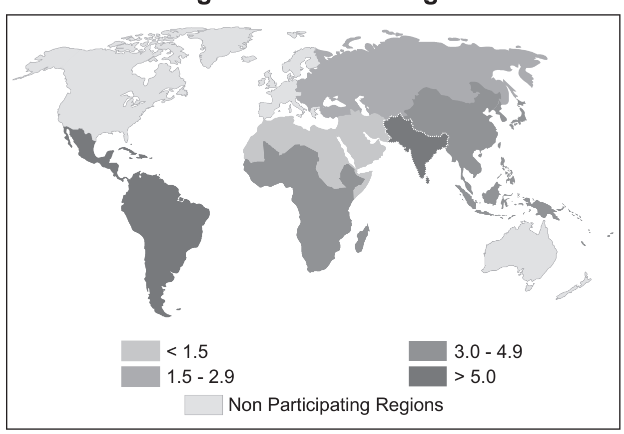
Financial Structure

As MFIs increase outreach, they access a range of funding sources to finance this growth. While the leading Latin American NGOs of the last decade used earnings and donations to build a strong capital base, Asian and African cooperatives and banks leveraged their capital with deposits from clients. The funding picture today continues to show this diversity across regions, as Figure 5 illustrates.

South Asian MFIs have the highest leverage of any region, funding 80 percent of their assets from loans, deposits and compulsory savings, as Figure 6 demonstrates. Even in Africa and East Asia, where deposits dominate the microfinance service offering, MFIs leverage only two USD in external funding for each USD in institutional capital, less than half the rate of South Asian institutions. NGOs still dominate in Middle East and North Africa, as well as Eastern Europe and Central Asia. These institutions depend mostly on equity financing through donations and retained earnings to fund their assets. The picture in Eastern Europe and Central Asia is gradually changing as new banks involved in microfinance, like the ProCredit banks or the recently transformed Khan Bank in Mongolia, grow and attract significant deposits.

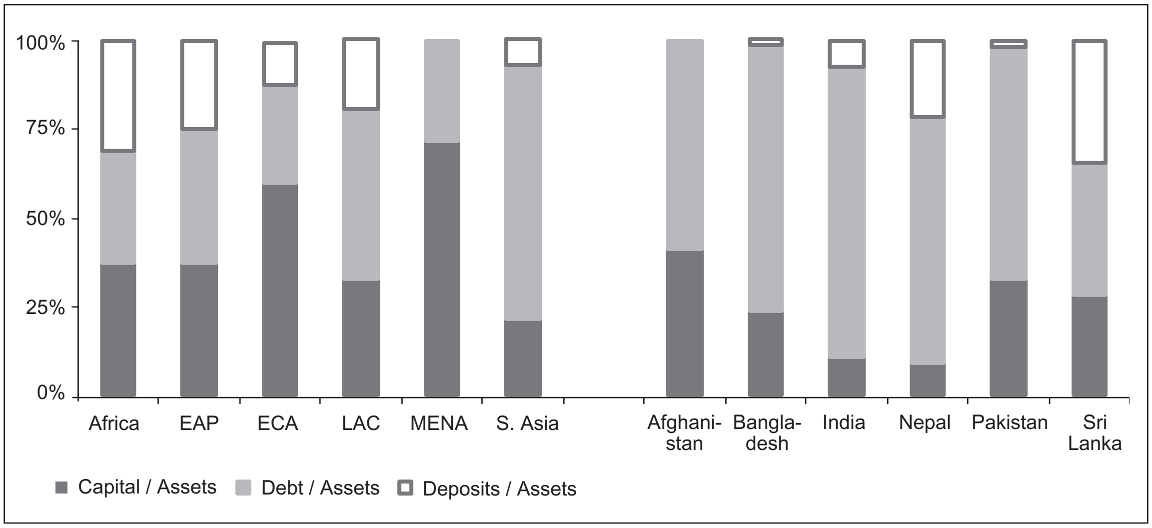
Unlike other leveraged regions, South Asian MFIs hardly rely on voluntary savings to fund their assets. Instead, they rely mostly on debt in the form of compulsory savings and loans. Across the

Figure 5: MFI leverage



[3] S. M. Rahman, "Microfinance Activities Gaining Ground," The Financial Express, 14 Oct. 2005.

Figure 6: Asset funding structure by region



Source: MIX Market 2003 data as of October 21, 2005. Data presented are averages. EAP: East Asia and the Pacific; ECA: Eastern Europe and Central Asia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; S. Asia: South Asia

region, legal form and organizational methodology determine how funding differs within South Asia. Access to deposits in Nepal and Sri Lanka makes the funding structure of MFIs there look more like that of African or East Asian MFIs, averaging nearly a quarter of their funds from public deposits. In both countries specialized banks and cooperative structures offer microfinance services, including voluntary savings. In Bangladesh and much of India, NGO MFIs offer group-based approaches to microfinance, where clients contribute determined amounts on a regular basis as part of group membership or in order to access loans. In the case of Bangladesh, these compulsory savings form an important source of institutional financing. Together with limited voluntary savings, they constitute over 30 percent of available funding, compared with 45 percent from loans.

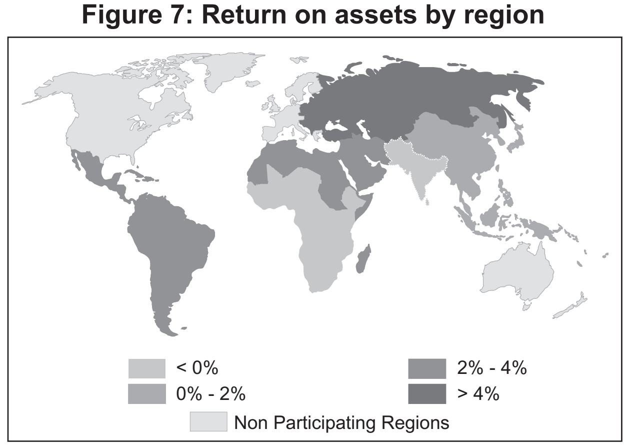
Indian MFIs also enjoy unprecedented access to financing by banks and other financial institutions, making them among the most highly leveraged institutions in the world. Eight out of the 25 most highly leveraged MFIs in the global data set are Indian. In several cases, loans (debt) actually replace donations (equity) to fund operational losses during the start-up phase, filling the void that cumulative losses leave on the balance sheet. Without a sound capital base, though, greater leverage simply increases risk as MFIs lack sufficient capital to cover default in the loan portfolio. Lack of clear performance information impedes a clear assessment of such risk. While some lenders in India rely on ratings to assess institutional risk before extending loans to MFIs, ratings and performance data are still limited compared to the large number of MFIs funded.

Financial Performance

Sustainability plays a determining role in the number of microfinance clients reached and the pace at which this pool of clients expands. In order to sustain operations, MFIs must generate enough revenues from financial services to cover their financial and operating costs and, in many cases, build institutional capital through profits. Strategies for achieving sustainability vary according to the local environment, funding sources and operational models.

On the whole, South Asian MFIs do not fare as well as their global peers in generating profits, as Figure 7 illustrates. Despite boasting one of the lowest expense structures in the world, MFIs' low average earnings do not allow them to cover their costs. In comparison, MFIs in East Asia, Eastern Europe and Central Asia, and Latin America earn positive returns, covering much higher cost levels by earning more from their loan portfolios.

Figure 7: Return on assets by region



Regionally, Bangladeshi MFIs earn the highest returns, as Figure 8 clearly shows. The sector posts an average return on assets of over 3.5 percent, deriving its profitability from exceptionally low cost structures. ASA, the Bangladeshi MFI that leads the list of profitable institutions, maintains a tight grip on expenses, especially costs related to microfinance delivery. In contrast, the Pakistani sector posts the region's lowest returns because of a mismatch between revenues and expenses. While cost structures are on par with regional norms, many MFIs in this country charge exceptionally low interest rates that are not in line with the cost of doing business.

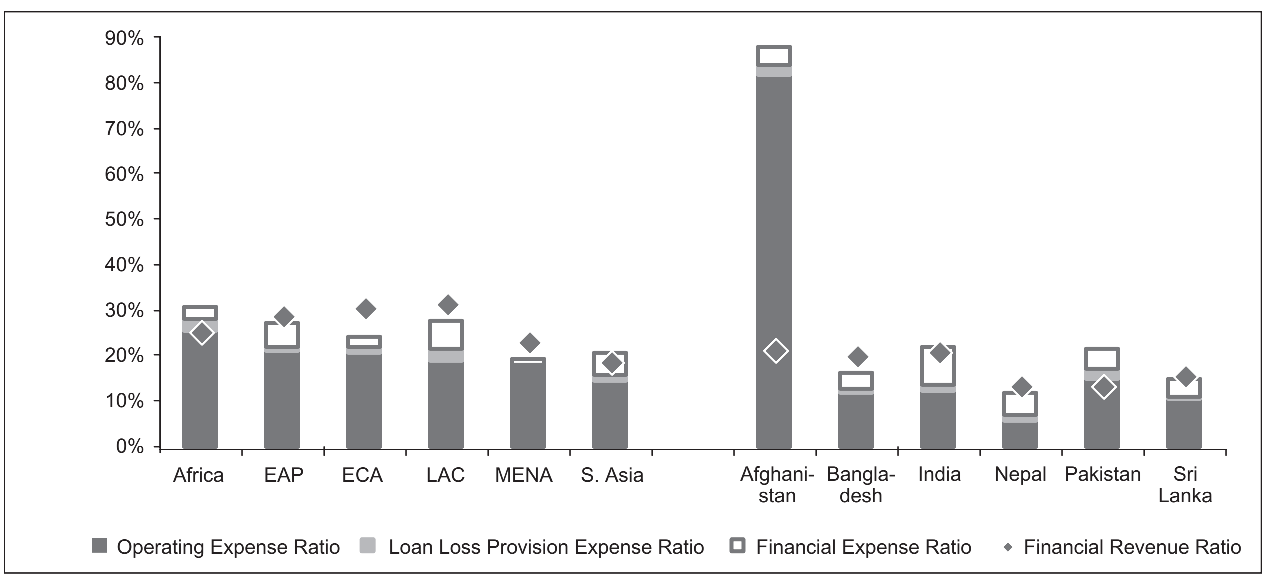
South Asia's low cost structure stems from extremely low operating costs, as the break-out in Figure 9 shows. These represent the costs of an MFI's delivery systems, including its personnel and administrative expenses. Personnel cost represents the single largest expense for an MFI, and South Asian MFIs manage these costs better than institutions in any other region. The predominance of group-based approaches to lending in South Asia allows MFI staff to handle more transactions and incur lower costs than individual approaches more common in Latin America or elsewhere. Within South Asia, country level operating costs fall even lower than the regional average, which is temporarily driven up by the start-up microfinance sector in Afghanistan.

Despite their high average leverage, South Asian MFIs do not bear the greatest financial expense relative to total assets. The region's lower financial expenses highlight a reliance on cheaper sources of funds from customer deposits, including compulsory savings, and government-backed funds. Bangladeshi MFIs, enjoying one of the lowest levels of financial expense in the region, depend on customer deposits,

Figure 8: Ten most profitable MFIs in South Asia

Name	Country	Return on Assets	Financial Revenue Ratio	Total Expense Ratio
ASA	Bangladesh	16.1%	25.8%	9.7%
Lakjaya	Sri Lanka	14.2%	41.4%	27.2%
PMK	Bangladesh	13.8%	22.4%	8.6%
UDDIPAN	Bangladesh	10.6%	24.0%	13.4%
PDIM	Bangladesh	9.5%	26.1%	16.6%
DIP	Bangladesh	9.4%	24.4%	15.0%
BURO Tangail	Bangladesh	8.7%	30.0%	21.3%
Spandana	India	8.3%	17.9%	9.3%
ASPADA	Bangladesh	7.9%	24.4%	16.6%
TMSS	Bangladesh	7.9%	20.7%	12.9%

Figure 9: Breaking down return on assets

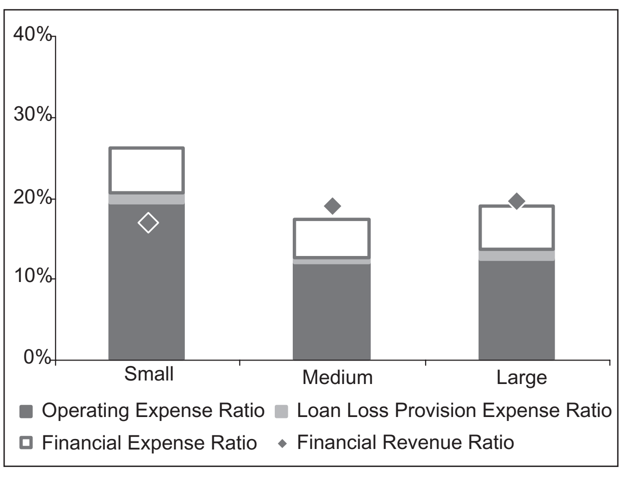


Source: MIX Market 2003 data as of October 21, 2005. Data presented are averages. EAP: East Asia and the Pacific; ECA: Eastern Europe and Central Asia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; S. Asia: South Asia most in the form of compulsory savings, and concessional credit lines from development finance institutions like Palli Karma Sahayak Foundation (PKSF)[4]. As Bangladeshi MFIs access commercial funding sources or if regulations ever restrict the use of compulsory deposits, financial costs would soar, undoubtedly eliminating current sector profitability. Indian MFIs, on the other hand, already draw a significant amount of funding from commercial banks, which, coupled with their high leverage, increases their total financial costs. As a result, they spend nearly nine percent of their asset base on financing their credit activity, topping all other sectors.

Profitable institutions dominate credit delivery in South Asia, but on a varied scale within each country. As with total outreach, Bangladeshi MFIs lead the sector in profitable outreach, with profitability extending beyond the market leaders. In a sample of 43 institutions, 35 earned positive returns and accounted for 96 percent of total outreach. In Pakistan and Afghanistan, the majority of clients in this sample lack access to sustainable institutions. Sector youth and program design explain much of this dearth. In the two years since microfinance first took hold in Afghanistan, no institution has yet broken even. Year on year trends, however, suggest that MFIs in the sector are increasing cost recovery. In Pakistan, many clients rely on the integrated service delivery approach of rural support programs, only one of which provides financial services on a sustainable basis. Without sustainable institutions, the market will continue to rely on donations to serve an important number of clients.

While profitability helps MFIs increase outreach, scale and sustainability are often mutually reinforcing. In the case of South Asia, scale plays a decisive role in cost recovery, as Figure 10 succinctly illustrates. Returns increase with scale, with a notable jump for institutions that serve more than 10,000 clients. Across the region, smaller institutions incur higher operating expense levels and cannot generate sufficient revenues to cover costs, resulting in nearly 10 point negative returns. Cost and revenue levels remain almost constant after the 10,000 borrowers. Strikingly, one cost does increase with institutional outreach: the cost of funds. Larger institutions in South Asia would seem to tap more into commercial markets to fund their growing portfolios, squeezing their existing margins without any noticeable gains in operational efficiency.

Figure 10: South Asian return on assets by scale



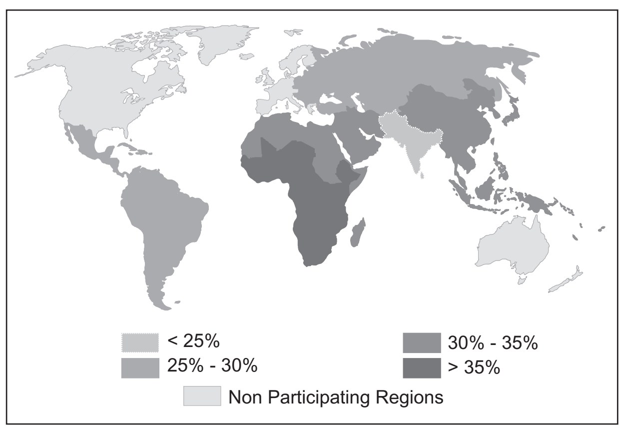
Source: MIX Market 2003 data as of October 21, 2005. Data presented are averages.

Efficiency and Productivity

With their strong outreach and low operating cost levels, South Asian MFIs offer the global microfinance industry some of its highest efficiency models, as Figure 11 demonstrates. Whether in terms of cost per borrower or cost per unit of loans outstanding, these institutions register the lowest costs for the greatest service delivery. Each USD in loans costs just 14 cents to maintain, compared with nearly 26 cents in sub-Saharan Africa. Compared with their peers to the east, South Asian MFIs spend an average 25 USD per borrower, less than half the average for the Philippines, Vietnam, Cambodia or Indonesia.

Low personnel expenses and group-based operating models play an important role in South Asia's efficiency, as does the high average productivity that such group-based models allow. MFIs in the subcontinent serve nearly 50 percent more borrowers per staff member than institutions in all other regions. High South Asian productivity is most pronounced in comparison to Eastern Europe and Central Asia, where MFIs offer individual loan products and serve fewer than 75 clients per person.

Figure 11: Operating expense per USD in loans outstanding



[4] PKSF is an apex fund supporting the Bangladeshi microfinance sector. Information on PKSF may be found at www.pksf-bd.org.

Operational models and industry learning have made significant impacts on Indian microfinance. Indian MFIs boast the highest productivity rates in the MIX database, and, as Figure 12 shows, eight of the ten most productive institutions in the region are based in the country. Several Indian MFIs make use of self help groups to provide credit to microfinance clients, significantly leveraging staff time in service delivery. For others, adaptations to existing lending models like Grameen or joint liability group lending practiced elsewhere have greatly increased productivity.

Portfolio Quality

Portfolio risk weighs more in South Asia than in almost any other regional portfolio. MFIs in this data set generally bear true to the idea that microfinance can be profitable by mastering client risk. However, as Figure 13 depicts, South Asia, along with Africa, carries risk levels almost twice as high as those in other regions – above seven percent. This risk refers to loans with late payments above 30 days. Notably, as Figure 14 demonstrates, little capital is actually written off from the regional portfolio, pointing to one of two potential explanations. South Asian MFIs extend longer term loans than institutions in other regions. Many group-based models make standard 52 week loans, which, in some cases, finance economic activities with long business cycles, like agriculture. Hence, short term repayment delays may not necessarily bear on the final redemption of the loan; although, one may argue that loan structures (weekly or monthly repayments) are not adequately matched to the intended purpose in such cases. Alternatively, low write-off levels may simply reflect the fact that many South Asian MFIs do not have write-off policies and carry delinquent loans on their books well beyond maturity.

Portfolio risk varies enormously across the region but shows most concentration in Pakistan and Sri

Figure 12: Ten most productive MFIs in South Asia

Name	Country	Borrowers per Staff Member
Sanghamitra	India	2,873
Bodhana	India	2,213
Pushtikar	India	826
Guide	India	820
Janodaya	India	800
Sabaragamuwa	Sri Lanka	498
Spandana	India	486
SEVA Microfoundation	India	484
RGVN	India	469
TRDP	Pakistan	421

Figure 13: Portfolio at risk > 30 days

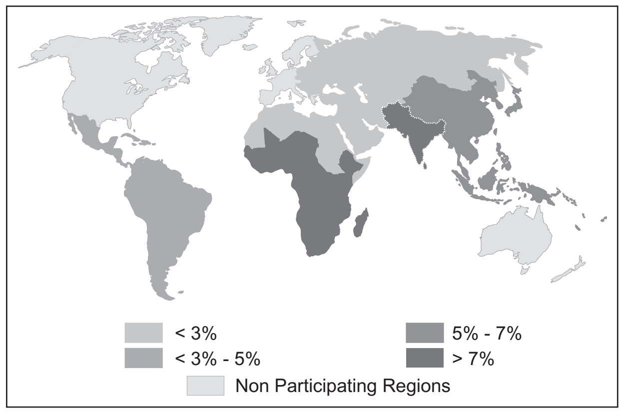
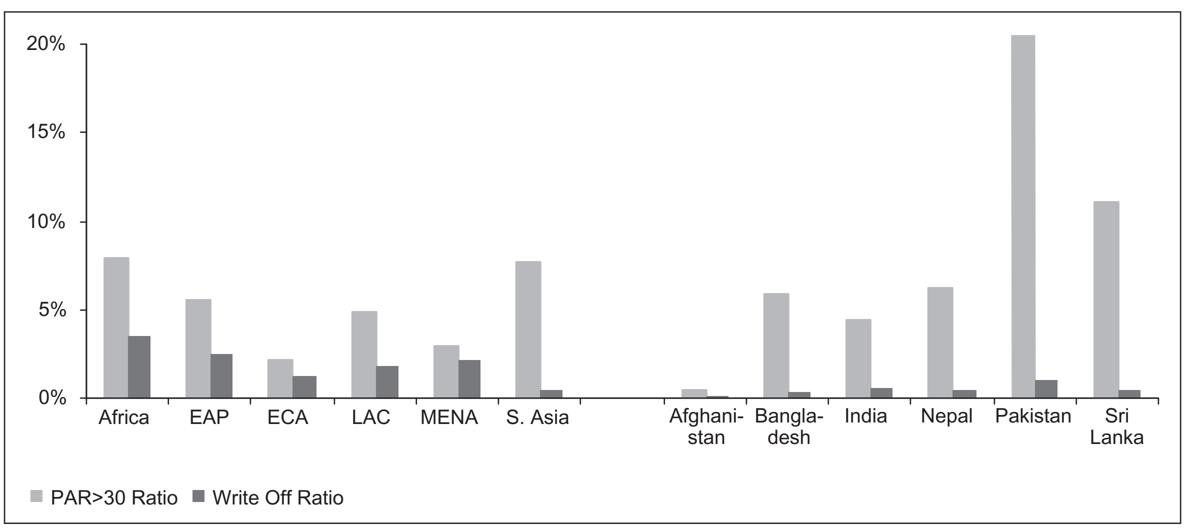


Figure 14: Portfolio risk and write-offs



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Lanka. In the case of Pakistan, risk lies in a handful of institutions with nearly half of their portfolio at risk over 30 days. Worryingly, only one of these institutions has constituted meaningful provision against risk. In the case of Sri Lanka, portfolio-at-risk data were not available on half of the participating institutions. Hence, one outlying institution unduly affects the average.

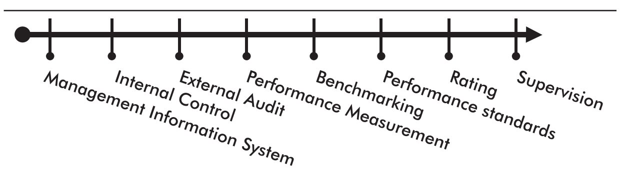
Performance Summary

The microfinance sector in South Asia surpasses all other sectors in outreach, providing microloans to more borrowers than any other region and serving some of the poorest clients in the world. The predominance of group loan methodologies has allowed these MFIs to attain exceptional levels of productivity and efficiency, making current outreach levels possible. But challenges persist. Despite low cost structures and access to subsidized funds, many MFIs continue to generate negative returns. These institutions, however, tend to serve fewer clients as credit outreach is dominated by sustainable institutions serving a disproportionately large share of borrowers.

While this sample provides a good picture of microfinance in South Asia, it is not entirely representative of the region. A wealth of information on microfinance in the region continues to escape analysis. Portfolio quality remains uncertain, and the level of dependence on soft loans and donations is largely unknown. Recognizing the critical role of financial transparency, many local and international actors have worked to improve data flows in microfinance. The second part of this paper examines the state of transparency in South Asia, highlighting achievements and opportunities to overcome remaining challenges.

State of Transparency across South Asia

A continuum of information systems and processes provides for the production, testing, dissemination and use of information related to an MFI's performance. Collectively, the elements of this transparency spectrum are essential contributors to standard reporting and disclosure of MFI performance. Individually, each element must adhere to best practice reporting in order for the chain to work. The subsequent sections review the state of each of these elements and the challenges faced with respect to standard MFI reporting. In each area, new initiatives are underway, or opportunities exist, to overcome these challenges and improve the state of transparency across South Asia.



Industry Reporting Standards

The microfinance industry in South Asia has closely monitored its expansion to reach an ever increasing number of clients. MFIs readily report on rising disbursements, greater loan volumes and the increased tide of funding sources available to finance microloans. Yet this development takes place in a general absence of data on the performance of the institutions at the heart of sector growth. While most institutions use globally recognized lending methodologies to reduce client risk and ensure the viability of their lending operations, only leading MFIs consistently track and report on industry standard measures of their own institutional health and performance.

Project-based indicators still enjoy the widest level of reporting across the region, with MFIs continuing to focus on data such as the amount of loans disbursed and cumulative clients reached. By focusing on cumulative measures, project-based indicators fail to capture the extent to which microfinance is successfully breaking barriers to financial services.

Outside of large, regulated or other leading institutions, such project-based indicators are the mainstay of data on microfinance. One of India's most successful models for scaling up microfinance service delivery, the self help group (SHG) model, suffers from the lack of widely available standard performance information. Even basic outreach information available at the National Bank for Agricultural and Rural Development (NABARD), the development finance institution supporting the financing of SHGs, is limited to data on disbursements and reimbursements, leaving the real reach of SHGs unknown.[5]

Given these difficulties in generating raw data, MFIs are often unable to follow reporting standards that make it possible to accurately analyze financial performance. Despite the importance of sound portfolios, standard metrics for portfolio risk have yet to penetrate the South Asian microfinance market. The most commonly cited measure, repayment rate, varies greatly in calculation and better serves for cash flow management than for risk measurement. Credit and Development Forum (CDF), the national network, reports on outstanding balances past due without clarifying how late the installments are.

[5] NABARD's Microcredit Innovations Department tracks and reports on yearly and cumulative disbursements to SHGs through other financial institutions, but does not track data on outstanding SHGs or end borrowers. Recent MIX discussions with NABARD (June 28, 2005) indicate that the bank may start tracking outstanding loans and loan balances. Information on NABARD is available at www.nabard.org.

It is widely believed, however, that outside of the leading institutions, most MFIs report on portfolio at risk *only after maturity* and not after a late installment. Given the common 52-week loan cycle, portfolio at risk reported in this sector may seriously underestimate actual delinquency. In microfinance portfolios, characterized by frequent installments and short tenure loans, portfolio quality can change dramatically in just four weeks. This information thus arrives too late to have much operational utility and falls short of its risk-mitigating objective.

Tracking and reporting on industry standard performance metrics does not require the sophisticated information systems that give institutions like First MicroFinance Bank Pakistan almost real-time data. What distinguishes this MFI and other leading institutions across South Asia from the rest of the sector is a strategic vision of industry reporting standards and their importance to building successful MFIs. With this vision in place, leading MFIs build best practices into even the most manual information systems. Until recently, Spandana, one of the fastest growing Indian MFIs and a top performer in the region, relied on a largely manual reporting system designed to be simple to use and with built-in checks to verify data accuracy and minimize errors. This manual system enabled its branch offices to successfully collect the raw data necessary to produce financial and operational reports on a weekly basis, providing central managers with an accurate and timely picture of Spandana's financial health.[6]

Initiatives / Opportunities

- Expand training on industry standard reporting and its practical use by MFI management
- Require reporting based on standard metrics

- Sa-Dhan[7], the MFI network association in India, is providing MFIs with guidance on what indicators to track. As part of its transparency efforts, the network
    - Developed a set of minimum reporting standards in collaboration with partner MFIs
    - Published a technical manual explaining and encouraging compliance with standards
    - Organized workshops on the production of performance data.
- Through its reporting requirements, the Microfinance Investment Support Facility for Afghanistan (MISFA)[8] has contributed significantly to the dissemination of industry standards. The agency
    - Requires standard performance data as a condition for funding
    - Uses these data to monitor MFI progress toward sustainability
    - Reinforces current MFI use of data for internal management.

External Audits

Most South Asian MFIs are required to have their financial statements audited on a regular basis. MFIs undergo external audits to comply with regulatory or donor requirements and to attract commercial funding. Despite being incorporated under a variety of legal acts, all MFIs in India are required to undergo audits on an annual basis. In Bangladesh, MFIs get audited to access donor funds and soft loans from PKSF, the apex financing institution in the country. While they are not legally bound to do so, MFIs also submit their audited reports to the Microfinance Research and Reference Unit (MRRU) at the central bank. Compliance with audit requirements tends to be less widespread in Nepal and varies significantly across institutional types, with all microfinance development banks – strictly regulated by the central bank – submitting audited reports but only a handful of licensed NGOs doing so.

While most institutions do indeed produce financial audits, many of these are not useful to understanding an MFI's financial position. Auditors evaluate whether financial accounts are maintained and presented according to certain guidelines and are only useful to the extent that these policies are appropriate to microfinance. No specific guidance is given on disclosure standards for microfinance institutions, irrespective of their legal form. As a result, the audited financial statements of NGO MFIs in South Asia yield few insights on the performance of the institution as a microfinance institution. Few local auditors are aware of international reporting norms for microfinance and generally fail to provide disclosures in keeping with these guidelines. For this reason, this study could not include several MFIs that submitted data for analysis.

Audits in South Asia consistently lack sufficient disclosures related to the portfolio and its provisions. Even when South Asian MFIs do track and report on the delinquency in their portfolio or produce a portfolio aging report to analyze risk, external audit reports rarely carry this information. Portfolio disclosures generally include only disbursements and loan

6 MIX interviews, July 1 and 14, 2005.

7 More information on Sa-Dhan may be found at www.sa-dhan.org.

8 More information on MISFA may be accessed at www.misfa.org.

collects over the year. Without appropriate portfolio disclosures, audited financial statements overstate the loan portfolio and the MFI's asset position.

Disclosure in financial statements is critical to performance analysis, yet account heads are often too detailed or too broad to be particularly meaningful. In the case of Indian NGO MFIs, for example, expenses are often presented as a long list of immaterial accounts that hinder management diagnostics of the cost structure. Too little detail may also hamper analysis. Revenue disclosures often fail to reflect the nature of the service and group together financial revenue with other operating revenue from financial activities, such as fees and penalties, as well as non-operating revenue. In Bangladesh, when donations are not directly capitalized, they are often treated as operating revenue, making it difficult to ascertain MFI self-sufficiency.

MFIs also find it difficult to produce separate financial reports for their microfinance activities. The majority of MFIs in South Asia are NGOs or cooperatives that provide services beyond microfinance and are often very active in areas such as health and education. In Pakistan, most MFIs are rural support programs that act through community development groups to provide a myriad of services to their clients. Expenses associated with the formation of these groups are allocated across various activities, thus understating the full cost of running the microfinance program and exaggerating MFI efficiency and profitability.

Regulated institutions and leading MFIs seeking commercial sources of funds tend to follow better disclosure practices. Audit reports for non-bank finance companies in India and microfinance banks in Pakistan follow appropriate disclosure guidelines that cover the portfolio and its provisioning, asset and liability maturity, as well as interest rate and foreign exchange matching. Moreover, these reports provide appropriate disclosure of costs and revenues, reporting donations separately from other income. While their regulatory reporting requirements are more rigorous than other MFIs, these institutions often exceed requirements to attract commercial funding. Unlike donors and government funding agencies, providers of commercial funds are more likely to factor profitability into their investment decisions and are thus concerned with the full and accurate disclosure of an MFI's financial position. As the microfinance industry continues to expand, competition over scarce donor grants and soft loans will intensify even further, making commercial borrowings and other market-based funding more important. MFIs seeking such funding will have to improve the level and quality of their financial disclosures in order to enhance their credibility and attract funding.

Initiatives / Opportunities

- Ensure a supply of properly skilled local auditors, familiar with microfinance operations and disclosures
- Bring audit disclosure requirements in line with microfinance norms

- In Bangladesh, PKSF efforts to improve financial statements include
  - Training auditors in the specifics of microfinance reporting
  - Establishing a panel of audit firms for partner MFIs.
- In Pakistan, the Swiss Agency for Development and Cooperation (SDC) and the European Commission, in conjunction with the Securities and Exchange Commission of Pakistan (SECP) and the Institute of Chartered Accountants of Pakistan are developing a common framework for MFI financial statements. This common format will
  - Allow better performance comparison across MFIs
  - Make financial disclosures more relevant to microfinance.

Performance Monitoring

A variety of performance monitoring initiatives exists across the region, including those maintained by national networks and national development finance institutions. Despite their strong involvement in financing the growth of many microfinance sectors in the region, the latter publish only aggregate data on the outreach and performance of the institutions that they fund and keep institutional level data outside the public domain. In India, some of the most extensive performance data on MFIs are held by the Small Industries Development Bank of India (SIDBI) and its Foundation for Micro Credit (SFMC)[9], a development finance institution that requires more than 40 partner MFIs to undergo ratings as a condition for funding. SIDBI, however, does not provide public access to its data set, and its reports detail only basic MFI characteristics such as location and scale of activity.

To remedy this dearth of information, MFI network associations have taken the lead in collecting and compiling MFI data. Network associations are active in almost all countries in the region. These associations, however, vary greatly in terms of sector coverage and data quality.

[9] More information may be found online at www.sidbi.com/Micro/index.htm.

In some countries, MFI directories are available, providing limited data but covering a broad number of institutions. In Nepal, the Centre for Micro Finance (CMF) compiled the most extensive MFI directory in the country. This online directory[10] covers 1,848 retail MFIs and includes general survey data on outreach, volume, and funding sources. Despite this important first step, CMF has been unable to thoroughly update the directory since its initial publication in 2003. CDF in Bangladesh has been more successful in collecting and publishing up-to-date information on the sector. The *CDF Microfinance Statistics* has grown from 533 MFIs in 1999 to 720 in 2003. Data in this annual[11] bulletin, however, do not include financial performance measures and are limited to basic market coverage, product details and portfolio funding sources. While they help map the sector, neither of these two publications significantly contributes to knowledge on MFI financial performance.

Other initiatives report on a broader range of performance data but have limited institutional scope. In India, Sa-Dhan has developed a set of reporting standards that broadly adhere to international norms and is actively engaged in promoting them among MFIs through training. Acceptance of these standards still faces advocacy and dissemination challenges. Of the reportedly 800 MFIs operating in India, Sa-Dhan's first *Side-by-Side* publication covered 42 institutions on the full range of performance indicators.

Initiatives / Opportunities

- Support performance monitoring initiatives that
  - have broad coverage
  - adhere to international reporting standards
  - are housed within independent bodies
- Publish and disseminate data to encourage understanding of standards and industry performance

- The Pakistan Microfinance Network (PMN)[12] works with member and non-member MFIs to disseminate best practice reporting norms. Its annual *Performance Indicators Report*
  - Covers almost the entire market
  - Presents data on scale and outreach, financial structure, financial performance, efficiency, productivity and risk
  - Includes a limited trend analysis of individual MFIs that highlights their strengths and weaknesses and provides suggestions for improving performance.

Ratings

India leads the region in the market for microfinance ratings. In light of broad public support for ratings, the market supports two separate ratings firms, M-CRIL[13] and CRISIL[14]. Combined, the two rated nearly 60 Indian MFIs in 2004, over a third of which were undergoing a follow-up rating. SIDBI has contributed significantly to this phenomenon by requiring that its partner MFIs acquire ratings as a condition for funding. Over 40 of them did so in 2004. NABARD has recently decided to promote the use of ratings to increase the flow of bank credit to smaller MFIs, by underwriting a majority of the cost. Indian MFIs are also seeking ratings independently of SIDBI and NABARD. In general, they are seeking ratings at the request of funders. In a highly leveraged sector that relies increasingly on the banking sector and financial markets for financing, ratings enhance investor understanding of an institution's performance.

In Pakistan, microfinance banks are required by law to get rated regularly after two years from the start of operations. Eager to build credibility and get feedback on its performance, First MicroFinance Bank Pakistan sought a rating within just one year of inception. With the extension of new licenses this summer, bringing the total number of microfinance banks in Pakistan to six, ratings will provide an increasingly important source of information on Pakistani microfinance.

Outside of India, microfinance ratings markets are weaker. In places where non-commercial funding capitalizes MFIs, funders are more interested in social outcomes, not market-based financial returns. With the exception of microfinance banks in Pakistan and a handful of Bangladeshi MFIs seeking commercial funding, few institutions have been rated.

Raters in South Asia add to industry knowledge beyond the scope of their credit ratings reports, held privately by investors, underwriters and MFIs. MFIs in frequent contact with raters have better understanding of industry standard performance indicators, increasing their likelihood to track spread on lending, portfolio risk or operating expense ratios. As ratings analyze microfinance operations, multi-purpose NGOs learn to prepare separate accounts that clearly highlight the performance of their microfinance activity. Moreover, both M-CRIL and CRISIL publish periodic sector updates and analyses. CRISIL's *MICROS* and the *M-CRIL Microfinance Review* draw on the respective databases of institutional performance data to provide updates on

[10] CMF's MFI directory is available online at www.cmfnepal.org/.

[11] Until 2004, the CDF Microfinance Statistics was published on a semi-annual basis.

[12] Information on PMN may be found at www.pmn.org.pk.

[13] More information on M-CRIL (Micro-Credit Ratings International Ltd.) is available at www.m-cril.com.

[14] Additional information on CRISIL may be found at www.crisil.com.

trends and developments in the sector. Given the breadth of ratings in the Indian market, these provide the single best, consistent source of information on the performance of Indian microfinance institutions.

Initiatives / Opportunities

- Support access to qualified ratings
- Build local ratings expertise

- In an effort to increase commercial funding in the Bangladeshi sector, SDC decided to guarantee Sonali Bank loans to MFIs. As a prerequisite, MFIs are required to undergo ratings. This initiative
    - Encouraged eight institutions to obtain ratings
    - Allowed the bank to gauge its investment risk and allocate funds accordingly
    - Contributed to long-term funding arrangements between the MFIs and Sonali Bank
    - Prompted Pubali Bank, the largest commercial bank in Bangladesh, to enter into a similar arrangement with SDC.
- Earlier this year, JCR-VIS[15] was accredited as a rating firm for microfinance by the international microfinance Rating Fund[16]. This development has
    - Ensured that the firm's staff are trained in the specifics of microfinance operations
    - Reduced costs and enhanced MFI access to specialized ratings
    - Allowed two microfinance banks and one NGO MFI in Pakistan to obtain ratings.

Regulation and Supervision

Microfinance activities fall under a rainbow of regulatory regimes across South Asia, and no common reporting or monitoring framework exists for the sector as a whole. Within every country in the region, MFIs are registered under different acts that have distinct and often exclusive reporting requirements. In Nepal, microfinance development banks are regulated by the Bank and Financial Institutions Ordinance, whereas financial intermediary NGOs are regulated under the Social Institution Act and the Financial Intermediation Act. Savings and credit cooperatives are regulated by yet another measure, the Cooperative Act. While microfinance development banks and financial intermediary NGOs must report to the central bank, cooperatives and the remaining NGOs must report to the District Administration Office and the District Cooperative Office. Each of these has its own reporting requirements and disclosure norms for financial information. MFI data are thus dispersed among various entities with different reporting requirements that greatly limit performance comparisons across MFIs.

Reporting requirements rarely reflect special conditions of the microfinance industry and are least useful in the case of MFI NGOs. In Pakistan, reports for the Registrar of Societies, which collects data on NGO MFIs, do not contain any important microfinance disclosures and hence do not provide the grounds for any significant analysis of the sector. On the other hand, State Bank of Pakistan (SBP), with supervisory responsibility over microfinance banks, requires more detailed disclosures that cover the balance sheet, profit and loss statement, asset liability maturity and portfolio quality. Besides more stringent reporting requirements, SBP also conducts on-site MFI inspections on a regular basis. Without a common reporting framework for the same activity, current regulatory reporting and disclosure requirements on microfinance provide an uneven, disjointed picture of sector performance.

Initiatives / Opportunities

- Align reporting requirements on common microfinance standards
- Build local ratings expertise

- In Bangladesh, PKSF is working with MRRU at the central bank to develop a common format for financial reporting and a set of disclosure guidelines. These standards
    - Are still a work in progress
    - Should be designed in accordance with international reporting and disclosure norms
    - Would be essential to monitoring sector growth and performance.

Conclusion

South Asian MFIs offer the global microfinance audience models of efficiency and outreach that continue to revolutionize the industry. The Grameen group models of yesterday, widely replicated around the globe, have given way to bank partnerships capable of leveraging the most local service delivery expertise with the vast national – and international – pool of commercial capital. Industry leaders continue to push down the cost of service delivery – in some

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15 Information on JCR-VIS (Japan Credit Rating-Vital Information Services (Pvt.) Ltd.) can be found at www.jcrvis.com.pk/.

16 The Rating Fund is a joint initiative of the Inter-American Development Bank (IDB), the European Union (EU) and the Consultative Group to Assist the Poor (CGAP) and is administered by International Consulting Consortium, Inc. (ICC Inc.) and Appui au Développement Autonome (ADA). More information on the Rating Fund can be accessed on its website at www.ratingfund.org.

cases reducing it to less than five cents on the USD. At the same time, new institutional models boost staff productivity to world records, with field staff in leading MFIs providing a range of services to close to 1,000 clients each.

Significant challenges shackle the growth potential that such efficiency and productivity offer. Even as sectors from Afghanistan to India attract increasing capital – local, global, public and private – profitability remains the reserve of leading MFIs. In India, many institutions outside this reserve continue to plow year-on-year losses into capital bases. As a result, while leading profitable institutions reach the majority of clients across the region, total outreach is significantly constrained.

Diagnosing and overcoming these constraints requires accurate, timely and comparable data. Today's insufficient disclosure on revenues and expenses makes financial performance analysis difficult. This lack of transparency hinders investment potential and – worse – leads to higher sector risk through continued commercial lending to unprofitable institutions.

Like many types of infrastructure, the elements that support microfinance provide an important public good. The potential benefits derived from current initiatives in Pakistan and Bangladesh to improve and standardize financial statement disclosures for microfinance in accordance with international norms certainly spill over: they support MFI managers as they guide their institution, increase the likelihood of appropriate investment in microfinance and improve supervision where the sector is regulated. Public information centers on the performance of microfinance, provided by PMN and other national networks, bring institutional performance analysis to the public eye, enabling the performance comparison that can bring successful models to the surface and increase the supporting environment for microfinance to grow.

Like many public goods, the elements supporting transparency in microfinance often go unnoticed, even as all actors benefit from them. Improving transparency demands focused support and attention on successful initiatives to disseminate reporting standards, improve financial disclosures and build performance information hubs. A supportive transparency environment in South Asia will secure the achievements of microfinance for the region.