PERFORMANCE and TRANSPARENCY

A survey of microfinance in South Asia

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Regional Overview

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, and 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.

Yet behind that veil, a diverse set of microfinance institutions breaks productivity and efficiency records to deliver an ever increasing range of financial services to poor and excluded clients. These institutions reach out to commercial banks and draw from client deposits to fund a rapidly growing loan portfolio, even as they strive to become and remain sustainable. But dangers also loom in the sector, as institutions increasingly leverage minimal capital beyond prudent norms, funding loan portfolios of unknown quality. By applying international reporting standards to a broad set of microfinance institutions from across the region, this report seeks to highlight the performance of the sector, both within the region and on the global stage.

Healthy sector growth requires transparency, rather than a veil. Microfinance works best when its performance is measured in order to be understood. A transparent sector promotes common reporting standards, draws on a cadre of experienced auditors and evaluators who know the business of microfinance and disseminates performance results widely. A dearth of information and lack of transparency obscure our understanding of the sector and forestall its development. This work is a first attempt at unveiling the singularities of the microfinance environment in South Asia. In addition to analyzing performance, the following pages 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.

Methodology

This paper combines local knowledge of the sector with international industry reporting norms to explore the performance of South Asian microfinance and describe the factors that contribute to our understanding of that performance.

Local microfinance experts collected data on microfinance institutions (MFIs) and surveyed the local transparency environment for six countries across the region: Afghanistan, Bangladesh, India, Nepal, Pakistan and Sri Lanka. In three of these cases, contributions drew on the work of national associations of microfinance institutions.

This regional overview looks at MFI performance and transparency across the sector. Subsequent chapters survey the state of affairs in each country. The three country chapters on Pakistan, Nepal and India also highlight the work of the national networks and the challenges that they face in supporting transparency in their local environments.

This report provides performance analysis of microfinance institutions. Collectively, this sample includes 125 institutions from across South Asia (See Appendix A) and is compared with the rest of the MIX Market's public database on nearly 600 microfinance service providers worldwide. With the majority of data from the two largest markets – India and Bangladesh – the report also covers most of the Pakistani and Afghani microfinance markets, as well as samples from Nepal and Sri Lanka. This analysis covers data from financial years 2002 and 2003[1], with the exceptions of Nepal and India, where significantly larger samples were available for the subsequent years.

In each case, the analysis uses industry reporting standards, as described in Appendix C of this report, to survey institutional performance in South Asia and to highlight drivers of that performance. The standards used here comply with the latest industry-wide consensus on terms, definitions and ratios as defined by a broad consortium of microfinance actors from around the globe.[2] All the data are self-reported and cross-referenced with audited financial statements where available. The data reported are *not* adjusted to account for the effects of inflation and subsidy or to set minimum provisioning for risk of default.

Beyond presenting simple industry averages, this analysis seeks to highlight key factors contributing to MFI performance. Where sample size permits,

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1 MIX standardizes financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For example, institutions that close on March 31st, 2005 are listed as FY 2004. FY 2003 data are data from institutions whose financial years close between July 1, 2003 and June 30, 2004.

2 CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

regional and country analyses use a **peer grouping framework**, similar to that used in the *MicroBanking Bulletin*, to draw out these differences. For this regional overview, two main factors are considered – scale and profitability – as referenced in Figure 1.

As the local experts sought information from MFIs in their countries, they faced numerous challenges, from confusion over the meaning of standard terms like "portfolio at risk" to audits and other institutional reports that do not provide sufficient detail on key aspects of an MFI's activity. To catalog those challenges and highlight efforts to support industry standard reporting, this paper reviews the state of the **transparency environment** throughout the region, looking at each step in the information chain that supports transparency.

Figure 1: Regional MFI peer group criteria

Category	Group	Criteria
Scale	Small	< 10,000 active borrowers
	Medium	10,000 to 30,000 active borrowers
	Large	> 30,000 active borrowers
Profitability	Profitable	Return on assets > 0%
	Unprofitable	Return on assets ≤ 0%

Performance of South Asian Microfinance Institutions

Performance analysis of microfinance institutions paints a composite picture of the myriad factors affecting service delivery. On the client side, microfinance institutions strive to offer appropriate financial services to an increasing number of clients (outreach). These institutions leverage human resources (productivity) to deliver services at low cost (efficiency) in order to scale outreach while ensuring positive returns (profitability). Such returns form a base for healthy institutions to guarantee continued access to existing products and fund innovation into new services and greater efficiency.

Such analysis is only possible when performance is reported according to common standards and with sufficient disclosure. Applying these standards to a broad range of institutions creates a basis for meaningful analysis through comparable data. The following performance analysis of South Asian microfinance uses the latest industry reporting standards to bridge the gap between different institutions across the subcontinent. Built on a common base of standardized 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. South Asian MFIs stand out by virtue of both breadth and depth of outreach. While serving more borrowers than any other region, they continue to focus on the poorest and most marginalized 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 2 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.

Outreach in South Asia is indeed remarkable, but the data may misrepresent the actual number of clients served. Current standards rely on an institutional basis for counting clients and thus do not account for overlap among MFIs. This situation is acute in markets that are saturated with microfinance providers serving stepped lending sizes that do not always match client needs. In Bangladesh, it is widely believed that overlap constitutes up to a third of reported outreach as clients

Figure 2: MIX Market microfinance coverage

Region	MFIs	Active Borrowers	Voluntary Savers	Gross 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.

often become members of multiple MFIs in order to get the credit levels that they want.[3] In this context and without a national credit bureau, total outreach established on an institution-by-institution basis may grossly overestimate the number of clients served.

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. Low levels of 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.

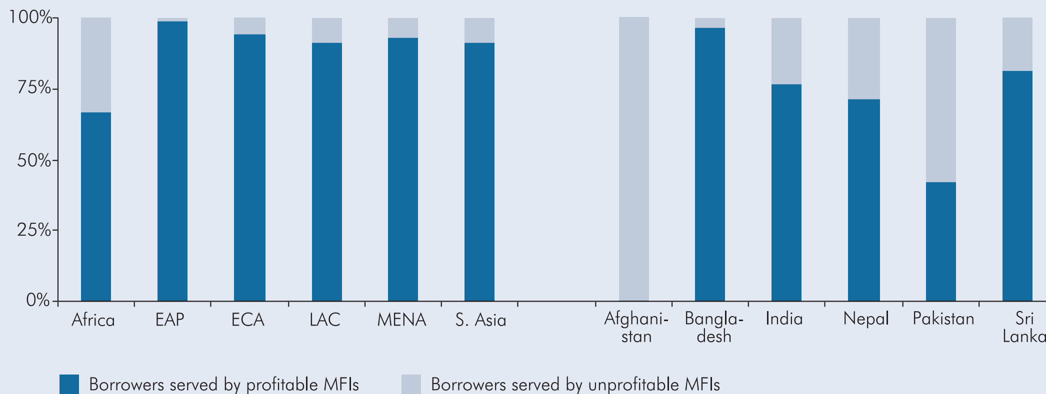
South Asian MFIs do collect customer deposits, but most are either a mandatory part of membership or directly linked to access to loans, whether or not these deposits are formally considered credit collateral. Savings are generally collected at weekly group or center meetings, with some MFIs using community groups to collect and maintain deposits. While these funds are often kept by the MFI itself, they are sometimes placed in local banks under individual or group accounts. Since these savings are either compulsory or facilitated, they are not included in this analysis of voluntary savings services offered by the MFIs.

Sustainability forms the backbone of global outreach. Over 90 percent of savers and borrowers rely on institutions with positive returns to access small scale credit, savings and – increasingly – insurance, transfer and payment services. As Figure 3 shows, in every region around the globe, with the exception of Africa, just two thirds of institutions reach the vast majority of clients; they do so by generating enough revenues to cover all of their costs. This phenomenon amplifies in regions where microfinance has recently arrived. In Eastern Europe and Central Asia, as well as Middle East and North Africa, the sustainable outreach index climbs five points to reach over 95 percent of all clients.

Profitable institutions also 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

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

Figure 3: Sustainability and outreach



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.

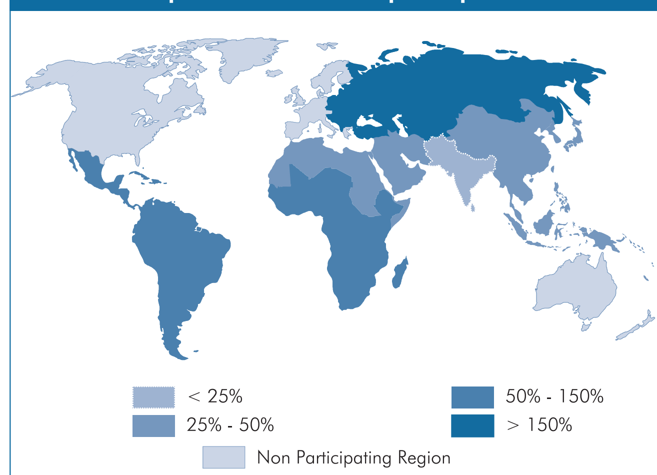
accounted for 96 percent of total outreach. Those that did not cover costs served far fewer clients. In India, Sri Lanka and Nepal, profitable MFIs represent a smaller majority of clients, on average 75 percent of the respective totals.

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, even as they continue to expand. Pakistan's largest microfinance provider, Khushhali Bank, has rapidly expanded access in its four years of operations, faster than it has increased its cost recovery. In the rest of 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. As a result, only 42 percent of Pakistanis covered in this sample had access to sustainable microfinance service providers. Without sustainable institutions, the market will continue to rely on donations to serve an important number of clients.

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 4 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.

Figure 4: Average loan balance per borrower / GNI per capita



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 5 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.

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 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. Moreover rapid growth is widespread, from the small start-up institutions in Afghanistan, to the larger leading Indian MFIs, like Cashpor and Share Microfin Ltd. 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 6 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. 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.

As with total outreach, global growth is concentrated in profitable institutions. A snapshot of 2003 shows that 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, a fact that Figure 7 makes visible. This pattern holds true in every region except Africa. In South Asia, 92

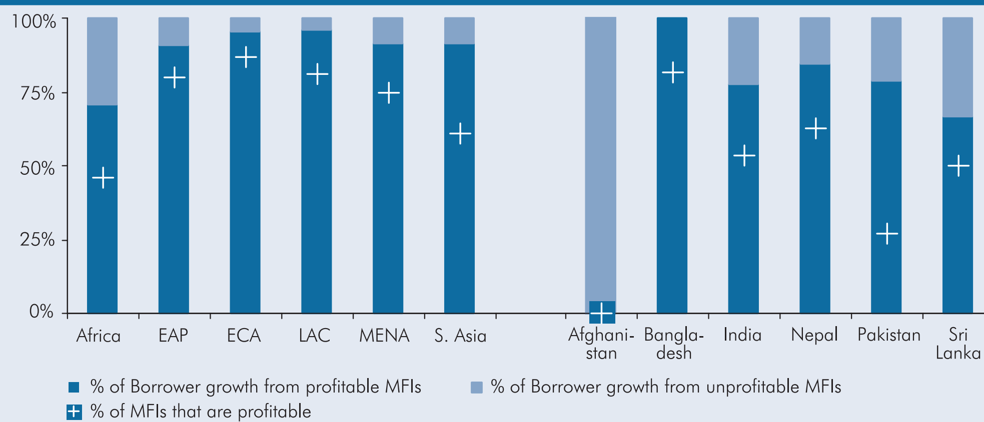
Figure 5: Ten MFIs with the smallest average loan balances

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%

Figure 6: 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

Figure 7: Share of borrower growth from sustainable institutions



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.

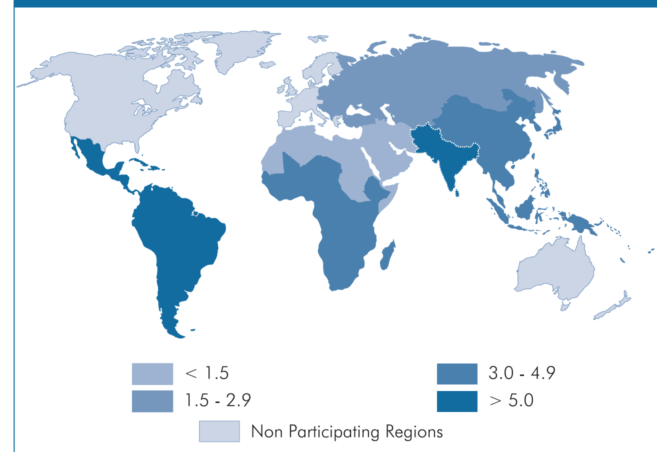
percent of additional borrowers were added through the 62 percent of MFIs that earned positive returns.

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. Given the small samples drawn from Nepal and Sri Lanka, this trend may not be representative of the whole sector. However, 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.

Financial Structure

As MFIs increase outreach, they access a range of funding sources to finance this growth. The type of funding available depends largely on an institution's type and its macro-economic and regulatory environment. NGO MFIs tend to be largely capitalized, whereas cooperatives and formal financial institutions rely more on debt for their funding. 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.

Figure 8: MFI leverage



South Asian MFIs have the highest leverage of any region, funding 80 percent of their assets from loans, deposits and compulsory savings, as Figure 9 demonstrates. Even in Africa and East Asia, where deposits dominate the microfinance service offering, MFIs leverage only two dollars in external funding for each dollar in institutional capital, less than half the

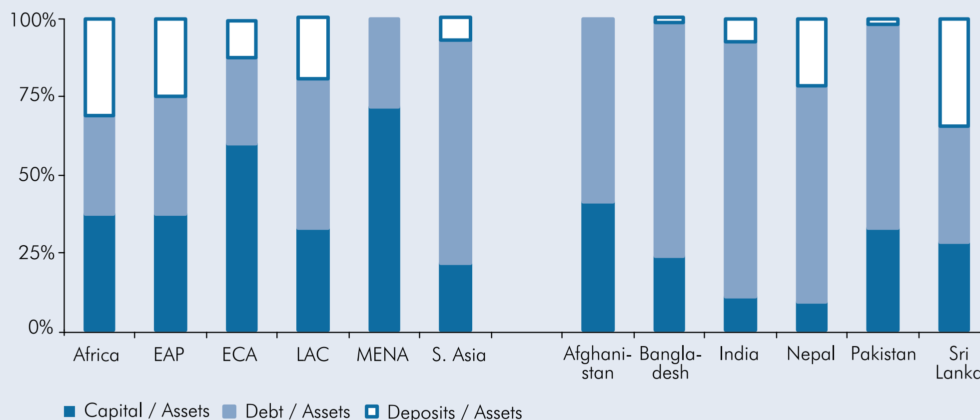
rate of South Asian institutions. NGOs still dominate in Middle East and North Africa, as well as Eastern Europe and Central Asia. These institutions depend mostly on equity financing through donations and retained earnings to fund their assets. The picture in Eastern Europe and Central Asia is gradually 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. In Africa and East Asia, cooperatives and licensed financial intermediaries like banks fund a quarter or more of their assets through a range of voluntary savings products offered clients, with other debt constituting another third of the funding. MFIs in the subcontinent, however, derive relatively little of their financing from voluntary savings products, less than one tenth. Instead, they rely mostly on debt in the form of compulsory savings and loans.

Legal form and organizational methodology determine how funding differs from country to country 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.

Figure 9: Asset funding structure by region



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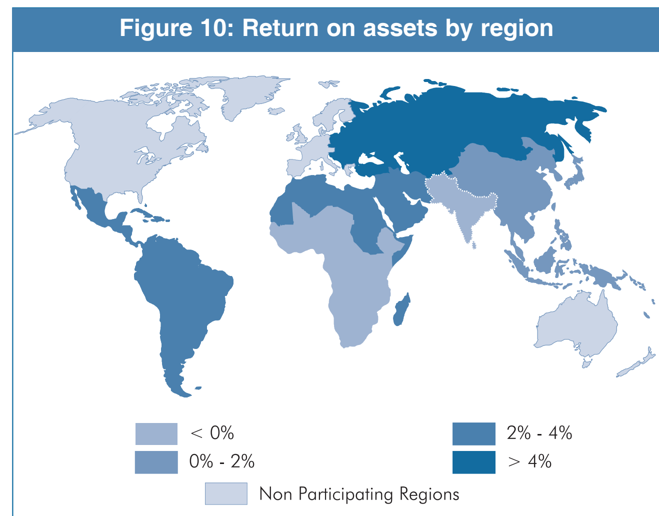
Financial Performance

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.

Figure 10: Return on assets by region



On the whole, South Asian MFIs do not fare as well as their global peers in generating profits, as Figure 10 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.

Regionally, Bangladeshi MFIs earn the highest returns, as Figure 11 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 12 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

Figure 11: 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%

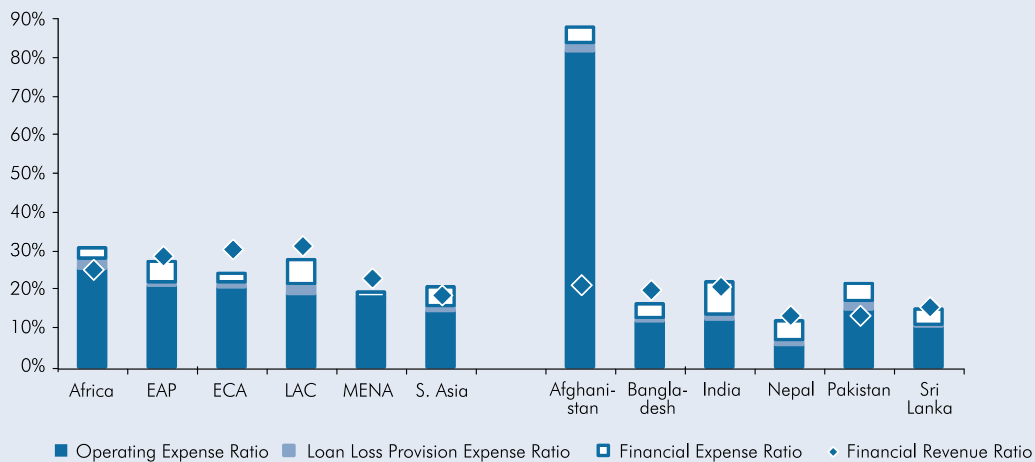
Source: MIX Market 2003 data as of October 21, 2005. Data presented are totals.

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. Similarly, past studies from the *MicroBanking Bulletin* have shown that South Asian MFIs typically pay less for qualified personnel, averaging three times local annual income levels. In comparison, regions like Africa pay average salary levels 13 times local per capita income, significantly raising costs of delivering financial services. 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. Financial expenses are higher in South Asia than in Middle East and North Africa or Eastern Europe and Central Asia, where young sectors and the prevalence of not-for-profit institutions means that little funding comes from deposits or loans. Latin American MFIs, however, incur the highest financial expense, with the cost of debt reaching six percent of the average asset base. South Asia's lower financial expenses highlight a reliance on cheaper sources of funds from customer deposits, including compulsory savings, and government-backed funds.

Within South Asia, funding structures and costs of funds vary greatly from country to country. Bangladeshi MFIs, enjoying one of the lowest levels of financial expense in the region, depend on customer deposits, most in the form of compulsory savings, and concessional credit lines from development finance institutions like Palli Karma Sahayak Foundation (PKSF)[4]. Limited access to commercial banks and formal financial markets has thus far kept financial costs down for Bangladeshi MFIs to 3.5 percent of average assets. 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

Figure 12: Breaking down return on assets



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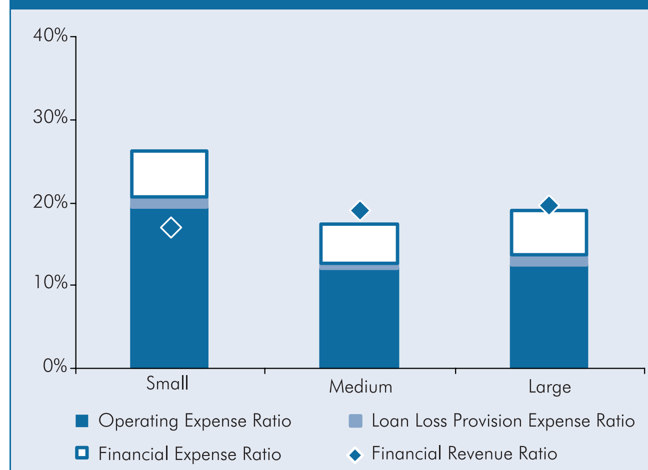
4 PKSF is an apex fund supporting the Bangladeshi microfinance sector. Information on PKSF may be found at www.pksf-bd.org.

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.

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 13 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.

Figure 13: South Asian return on assets by scale



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

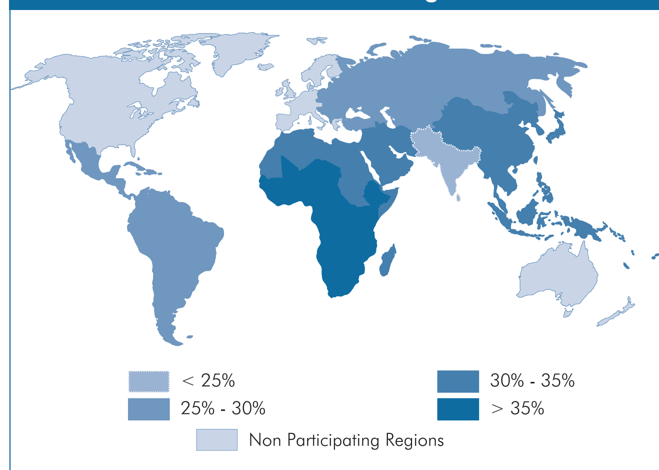
Strikingly, one cost does increase with institutional outreach: the cost of funds. Larger institutions in South Asia would seem to tap more into commercial markets to fund their growing portfolios, squeezing their existing margins without any noticeable gains in operational efficiency.

Poor financial disclosures make it generally difficult to ascertain MFI sustainability in South Asia. While the majority of MFIs are required to produce audited financial statements on a yearly basis, these rarely follow appropriate disclosure guidelines for microfinance. Limited information on costs and revenues hampers analysis of institutional reliance on soft loans and donations, while integrated accounts prevent the separation of microfinance operations from other activities of the institution. As the sector continues to grow, it will become increasingly important to enhance transparency and ensure that the poor have access to reliable and sustainable financial services.

Efficiency and Productivity

Efficient institutions minimize the cost of delivering services. The efficiency of an MFI can be calculated in various ways; this study analyzes costs per borrower and costs per saver as indicators of efficiency. Productive MFIs, on the other hand, maximize services with minimal resources, including staff and funds.

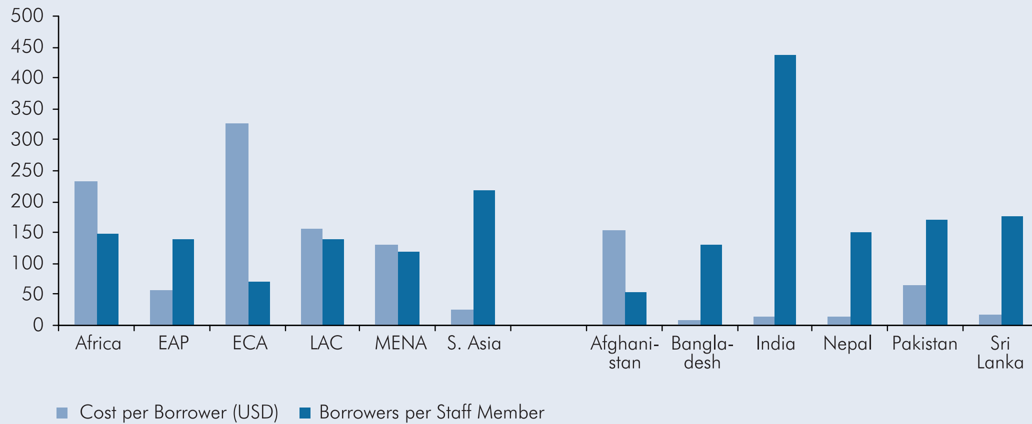
Figure 14: Operating expense per dollar in loans outstanding



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 15 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 dollar 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 dollars 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

Figure 15: Efficiency and productivity: two sides of the same coin



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.

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.

Despite little regional variation in expenses, operating costs – per borrower and per dollar outstanding – run highest in Pakistan and Afghanistan. In both cases, start-up institutions cast a long shadow over the results. A recent start-up, First MicroFinance Bank Pakistan incurs high delivery costs for its relatively small lending operations. As one of the few licensed microfinance intermediaries in the country at the time of study, this MFI also registers higher costs in collecting deposits for a range of savings products.

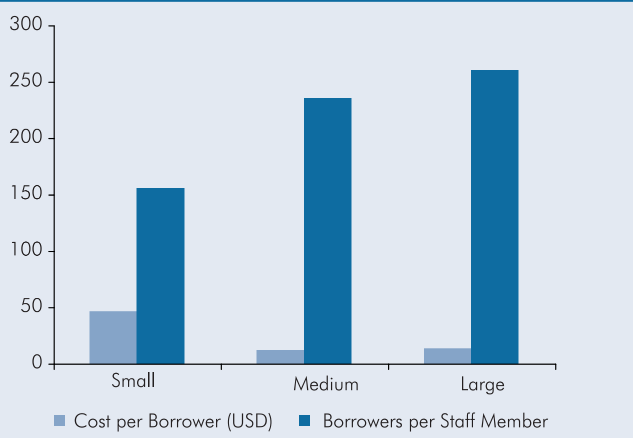
Operational models and industry learning have made significant impacts on Indian microfinance. Indian MFIs boast the highest productivity rates in the MIX database, and, as Figure 16 shows, eight of the ten most productive institutions in the region are based in the country. Several Indian MFIs make 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.

Figure 16: 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 17 demonstrates the clear impact of economies of scale on the efficiency and productivity of South Asian MFIs. For a region of large scale MFIs, the threshold for such economies starts notably low, at

Figure 17: Efficiency and productivity in South Asia by scale



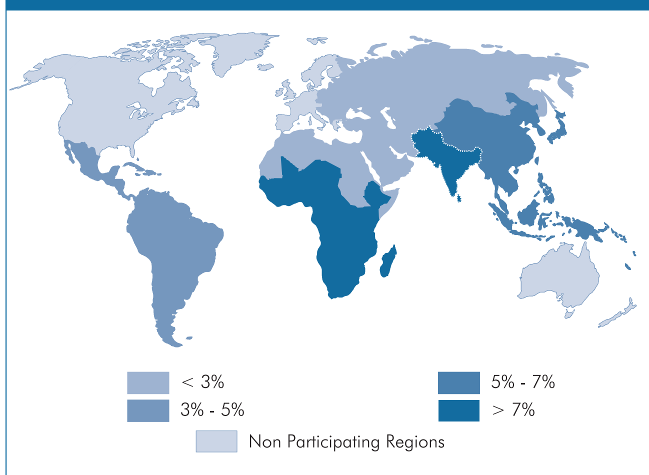
Source: MIX Market 2003 data as of October 21, 2005. Data presented are averages.

10,000 clients. Institutions above that mark experience similar average costs per borrower, whether at 20,000 or 200,000 clients. This efficiency in delivery stems from high productivity levels – 60 percent higher for medium outreach institutions than small ones. Higher staff productivity helps MFIs leverage existing investment in personnel without increasing costs.

Portfolio Quality

The loan portfolio is an MFI's most important asset. Measured as portfolio at risk, portfolio quality tracks the risk of loan default, which can undermine an institution's revenues, decrease its portfolio, and sap its ability to increase outreach and serve existing clients.

Figure 18: Portfolio at risk > 30 days

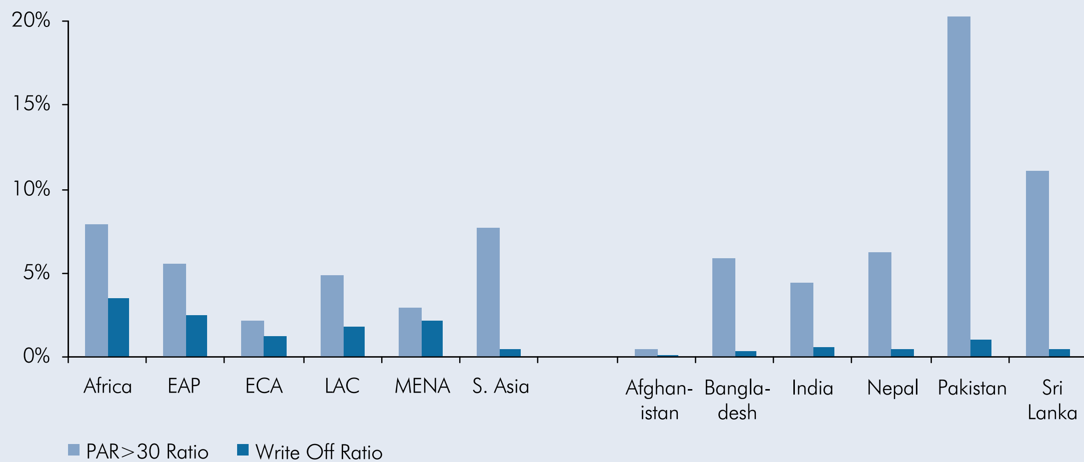


Portfolio risk weighs more in South Asia than in almost any other regional portfolio. MFIs in this data set generally bear true to the idea that microfinance can be profitable by mastering client risk. However, as Figure 19 depicts, South Asia, along with Africa, carries risk levels almost twice as high as those in other regions – above seven percent. This risk refers to loans with late payments above 30 days. Notably, 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 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. The rest of the region holds good portfolio quality and has provisioned well over double the outstanding balance at risk over 30 days. Only Nepalese institutions provision little for default – less than 100 percent of portfolio at risk over 30 days – and few of these institutions carry formal write-off policies.

As with outreach, sustainability cuts across portfolio risk in the region. Profitable MFIs carry portfolio risk that is half the regional average and, at three percent, compares favorably with most other regions. Moreover these MFIs achieve profitability despite strong provisioning (expensing) for risk – three and a half times risk over 30 days. Profitable MFIs in South Asia, like their global peers, master client risk as a key ingredient to their financial success.

Figure 19: Portfolio risk and write-offs



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.

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. The data set captures a significant share of the markets in Bangladesh, Afghanistan, and Pakistan, but does not fully portray the Indian, Nepalese and Sri Lankan sectors. Divergent reporting standards and weak financial disclosures impede data collection and performance comparisons. In India alone, counting active clients in an interlocking web of institutions and service delivery proves challenging. While myriad arrangements exist to finance loans to clients through self help groups, few actors actually track the underlying number of people accessing that credit, obscuring any analysis of outreach. In this environment, measuring financial viability proves even more difficult.

A wealth of information on microfinance in the region thus continues to escape analysis. Portfolio quality remains uncertain, and the level of dependence on soft loans and donations is largely unknown. Healthy sector growth, however, requires transparency in the form of "full, accurate, and timely disclosure of information"[5]. Reliable data on the health of MFIs fosters growth by improving institutional management, promoting an enabling legal environment and channeling more funds to the sector. 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 overview examines the state of transparency in South Asia, highlighting achievements and opportunities to overcome remaining challenges.

[5] David L. Scott, Wall Street Words: An A to Z Guide to Investment Terms for Today's Investor, Boston: Houghton Mifflin Company, 2003.

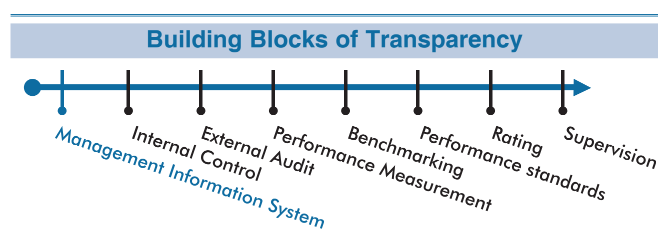
State of Transparency across South Asia

All actors in microfinance require access to timely, accurate and meaningful data on the performance of microfinance institutions. Directors and managers of MFIs rely on them to plan institutional growth, avoid potential pitfalls and improve operations. For investors and donors, such information allows them to identify potential partners, make sound investment decisions and track performance once the money is disbursed. Industry analysts and promoters depend on such metrics to map sector performance, provide necessary support to healthy institutional growth and – in the case of regulators – establish appropriate prudential norms. As access and choice improve, clients may also use performance data to determine the safest place for their savings or the most reliable provider of other financial services.

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

An MFI's management reporting system is the starting point for creating a transparent microfinance environment. The data collected and reported feed into monitoring by the institution's board and management, form the basis of external audits and evaluations and inform regulators of an institution's health.



State and Challenges

- Survey data readily available on volume and scale of microfinance
- Standard performance information confined to leading MFIs
- Project indicators still widespread practice
- Lack of clarity on portfolio quality measures

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. Without clear tracking of such metrics, institutions may be more aware of the viability of lending to their clients than they are of an investor lending to them.

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. Microfinance,

however, is more than the extension of a single loan. Its success relies on its ability to provide sustainable access on diverse financial services to an increasing number of poor and excluded people. Measuring success in microfinance means clear metrics in each of these areas. By focusing on cumulative measures, however, project-based indicators fail to capture the extent to which microfinance is successfully breaking barriers to financial services. Instead, these indicators cloud analysis and do not further understanding of the outreach, efficiency or sustainability of an MFI's operations.

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.[6]

Given these difficulties in generating raw data, MFIs are often unable to follow reporting standards that make it possible to accurately analyze financial performance. MFIs have many risks to manage, some related to financing (liquidity, interest rate or foreign exchange risk) and others to operations, like the risk of client loan default. The importance of this last risk is commensurate with the size of an MFI's loan portfolio, averaging nearly three quarters of total assets in South Asia. Interest and fees earned on the loan portfolio comprise the lion's share of an MFI's operating revenue. Serving an existing client base with credit and expanding to new borrowers both rely on timely repayment of existing loans. Knowing the risk associated with lending activities is thus critical to sound management and industry growth.

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. Of the eight Nepalese MFIs included in this study, only three were able to produce their portfolio at risk over 30 days. Almost all also claimed to have no formal policy for writing off bad debt. In Bangladesh, confusion reigns on the very definition of portfolio at risk. Credit and Development Forum (CDF), the local network, reports on outstanding balances past due without clarifying how late the installments are. 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,

[6] 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.

providing central managers with an accurate and timely picture of Spandana's financial health.[7]

> **Initiatives / Opportunities**
> - Expand training on industry standard reporting and its practical use by MFI management
> - Require reporting based on standard metrics

To better monitor their performance, MFIs require guidance on what indicators to track and training in best practice reporting norms. Industry stakeholders should support practical training that demonstrates the importance of analyzing standard performance indicators to an MFI's management in order to guide operations, mitigate risks, plan for the future and communicate institutional performance to potential investors.

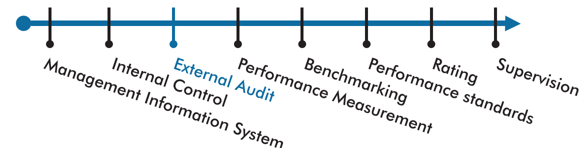
Several such efforts are already underway. Faced with a diversity of operating models and legal forms, Sa-Dhan[8], the MFI network association in India, drafted a set of minimum reporting standards in keeping with the spirit of international best practice that would allow performance comparisons across MFIs. Working in close collaboration with its members, Sa-Dhan identified an appropriate set of financial indicators covering the areas of sustainability, risk, efficiency and productivity. In September 2003, the association published a technical manual to explain and disseminate the standards throughout the sector. Sa-Dhan has since organized workshops to train MFIs in the production of these data and encourage compliance with these reporting norms. Since September 2004, it has disseminated the results of its data collection in two issues of its industry analysis publication, *Side-by-Side*. Today, as the small but growing level of participation in the publication would indicate, the standards are still in the advocacy stage. Further training will be required to extend the reach of these standards in India.

As a large source of funding with a developmental objective, donors and development finance institutions also contribute to the dissemination of industry standard reporting through the reporting requirements linked to their funding. The Microfinance Investment Support Facility for Afghanistan (MISFA)[9] requires that its partner institutions collect and report standard performance data as a condition for funding. MISFA stipulates that its partner MFIs operate on a sustainable basis within five years of inception and uses these data to monitor their progress. The MFIs that currently operate in Afghanistan are for the most part international NGOs that have significant exposure to global reporting norms and actively use standard performance data for institutional management. Nevertheless, as the industry matures and local, less experienced MFIs take the stage, MISFA's reporting requirements will be essential to fostering transparency and promoting the health of the sector.

External Audits

An external audit of an MFI's accounts provides one of the most important third party sources of data on MFI performance, specifically financial performance. Its systems for testing the soundness of an MFI's accounts provide readers with higher quality assurance of the financial data presented.

Building Blocks of Transparency



> **State and Challenges**
> - Most MFIs are regularly audited
> - Only audits of leading and regulated institutions follow appropriate financial disclosure guidelines related to:
>   - Costs and revenues
>   - Portfolio
> - Integrated NGO service providers do not have separate audits for their microfinance activity

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

[7] MIX interviews, July 1 and 14, 2005.
[8] More information on Sa-Dhan may be found at www.sa-dhan.org.
[9] More information on MISFA may be accessed at www.misfa.org.

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 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

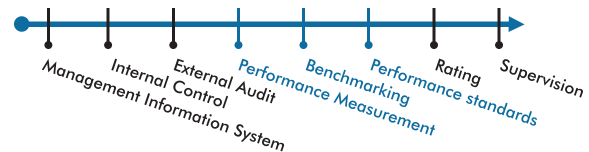
Improvement in MFI audits requires access to appropriately skilled auditors. Such firms should have knowledge of microfinance and be familiar with microfinance disclosures. In Bangladesh, PKSF is working to improve financial statements produced by its partner MFIs. To ensure quality audits, PKSF has trained auditors in the specifics of microfinance reporting and established a panel of firms that can be employed by its partner MFIs. Most Bangladeshi MFIs included in this study produced audits with separate disclosure of microfinance operations.

The Swiss Agency for Development and Cooperation (SDC) and the European Commission are currently working with the Securities and Exchange Commission of Pakistan (SECP) and the Institute of Chartered Accountants of Pakistan to develop a common framework for financial statement presentation to be followed by all MFIs registered under SECP and the Society's Act. The draft disclosure guidelines produced by the program taskforce follow international microfinance industry norms. This common format will not only allow for better performance comparison across MFIs but will also make disclosures more relevant to the microfinance industry.

Performance Monitoring

Performance monitoring centers and projects collect, analyze and disseminate data on microfinance institutional performance. By applying common standards to a broad set of institutions, such initiatives allow for meaningful performance comparison. As data sets grow over time, benchmarking analysis can allow users to establish performance standards based on industry experience.

Building Blocks of Transparency



State and Challenges

- Several national performance monitoring initiatives exist
- Performance data sets of national development finance institutions are not public domain
- Available data cover a limited number of institutions or only survey variables

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)[10], 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.

[10] 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[11] 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[12] 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

Of all the country associations, the Pakistan Microfinance Network (PMN)[13] has been the most successful in promoting financial transparency among MFIs. PMN has worked with both members and non-members to disseminate best practice reporting norms and compile standard performance data in an annual report that provides a clear and accurate picture of the institutions operating in the sector. PMN's 2004 *Performance Indicators Report* includes fourteen MFIs that together account for 60 percent of active borrowers in Pakistan. With the recent addition of Khushhali Bank to international industry standard reporting, sector coverage is now almost complete. The data featured in this report comply with international reporting standards and cover scale and outreach, financial structure, financial performance, efficiency, productivity and risk. Data are presented at the institutional level and are organized by peer groups, providing the context for more meaningful comparisons across institutions. The report also includes a limited trend analysis of individual MFIs that highlights their strengths and weaknesses and provides suggestions for improving performance. PMN is currently working to capture a more complete picture of microfinance through a new country sector report expected to come out in early 2006. This report will cover a much larger sample of institutions than the *Performance Indicators Report* but will be more qualitative, covering only basic sustainability indicators.

In the nascent Afghani microfinance sector, MISFA and the Afghanistan Microfinance Association have approached PMN about publishing performance reports that track the progress of this industry. While MISFA has encouraged the adoption of best practice reporting norms in Afghanistan and successfully collected data on its partner MFIs on a regular basis, it is perhaps not the best candidate for this data collection role moving forward. As the microfinance sector continues to grow and MFIs begin to access other sources of funds, Afghani microfinance will require an independent source of data on microfinance performance, not tied to any particular funder. To ensure buy-in from the sector as a whole, dissemination of standards and data collection should be undertaken by a national association that operates

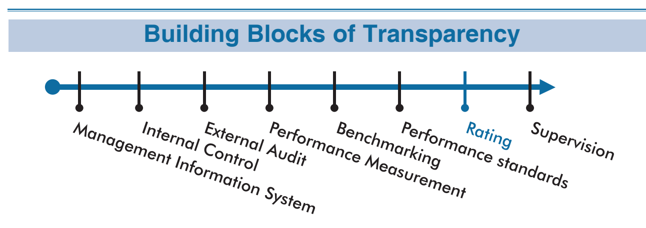
[11] CMF's MFI directory is available online at www.cmfnepal.org/.
[12] Until 2004, the CDF Microfinance Statistics was published on a semi-annual basis.
[13] Information on PMN may be found at www.pmn.org.pk.

on behalf of MFIs. MISFA and the MFIs currently operating in the sector could work with the Afghanistan Microfinance Association to ensure a neutral focal point for industry data in the country.

Ratings

Rating agencies evaluate MFI performance and provide institutions with information that investors can use to guide their investment decisions. In microfinance, many of these ratings go beyond simple creditworthiness scores, providing in-depth assessments of an MFI's management and governance, systems and staffing, products and client markets, as well as the standard financial performance indicators.

Building Blocks of Transparency



State and Challenges
- Local microfinance expertise
- Strong Indian ratings sector demand, with public support
- Limited coverage in other countries
- Contributions to sector knowledge and understanding of performance

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[14] and CRISIL[15]. 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 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

[14] More information on M-CRIL (Micro-Credit Ratings International Ltd.) is available at www.m-cril.com.
[15] Additional information on CRISIL may be found at www.crisil.com.

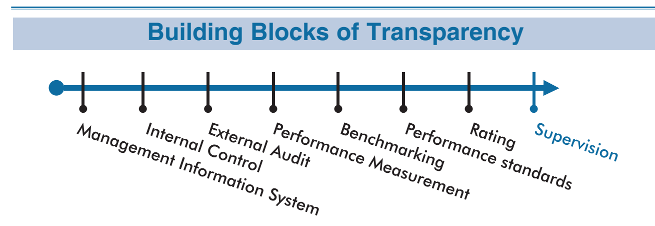
South Asia is already ahead of most microfinance markets in its access to and use of ratings. Given high ratings costs relative to investment potential, ratings will likely continue to require public support or underwriting. Creating a cadre of local ratings firms with microfinance experience will also help reduce costs.

SDC started an initiative to increase commercial funding to Bangladeshi MFIs which has substantially increased access to ratings. Eight institutions have thus far obtained ratings in the context of this initiative to link MFIs with Sonali Bank. Even though SDC guarantees the bank loans to participating MFIs, Sonali Bank requires that these MFIs obtain a credit risk rating before accessing loans. These ratings allow the bank to gauge its investment risk and allocate funds accordingly. The eight MFIs have since entered into a long-term funding arrangement with Sonali Bank. The success of this initiative prompted Pubali Bank, the largest commercial bank in Bangladesh, to enter into a similar arrangement with SDC, thus further expanding the pool of commercial funds available to MFIs.

Earlier this year, JCR-VIS[16] was accredited as a rating firm for microfinance by the international microfinance Rating Fund[17]. The firm's staff have been trained in the specifics of microfinance operations and have already rated two microfinance banks and one NGO MFI in Pakistan. This development has enhanced MFI access to specialized ratings for microfinance and substantially reduced cost. Given the firm's reputation in the corporate sector, JCR-VIS ratings may substantially increase the potential to access commercial funding.

Regulation and Supervision

Regulators support financial transparency by establishing industry standards and disclosure guidelines that build the basis for performance comparison and sector analysis. Their reporting requirements determine the production and availability of performance data.



State and Challenges
- Multiple regimes for the same activity
- No common framework for MFI regulatory reporting

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

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

[17] 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.

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
- Promote reporting frameworks that look at microfinance as a whole

In order for regulatory reporting requirements to improve the quality of information on microfinance, the sector will need to create a common reporting framework that includes microfinance-specific disclosures and aligns with common industry reporting standards. 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. If the Bangladeshi government decides to regulate the sector in the near future, such a framework would be essential to monitoring sector growth and performance. The current standards are still a work in progress and should be in accordance with international reporting and disclosure norms to allow performance comparison of Bangladeshi institutions with MFIs across the globe.

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 cases reducing it to less than five cents on the dollar. 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. Measuring efficiency depends on clear identification of all costs and actors in the service delivery chain. Apart from a few institutions, however, a multitude of non-specialized NGO MFIs does not separate out microfinance costs from those of other activities, relegating real efficiency analysis to specialized case studies and other one-off reports. Similarly, productivity analysis requires accurate measures of resources and clients served. Yet for India's single largest delivery model, self help groups, no consistent framework exists for looking at all the actors involved in making the model possible, and little realistic data are available on the number of end clients reached.

A small and growing number of initiatives are beginning to pierce the veil around MFI performance in the region. In the most highly leveraged sector – India – expert ratings offer investors an accurate picture of performance and investment potential in microfinance. Beyond the private returns, these ratings provide a public good as well, increasing the dissemination and up-take of global reporting standards and performance indicator tracking that promote healthy sector growth. 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.

Afghanistan

Microfinance institutions have been active in Afghanistan since the establishment of the new government in 2002. Twenty-five years of conflict had ruined the economy and wiped out the formal financial sector, leaving people no choice but to rely on informal credit providers, often opium traders. Advances against the purchase of opium crops made the latter particularly attractive to small farmers with a weak asset base. In 2001, however, drought and a Taliban opium ban led to widespread crop failure and eradication, resulting in high levels of indebtedness among the population.[1] Faced with a weak legal environment and the need to rebuild the economy, the government identified microfinance as a key instrument for social protection and employment generation.[2] In 2003, the government launched the Microfinance Investment Support Facility Afghanistan (MISFA) to provide funds and capacity-building support to microfinance institutions across the country.

The first players that emerged to provide microfinance services were NGOs. Donor and government interest in rapidly launching and scaling up operations boosted support for international institutions with prior microfinance experience. BRAC and the Aga Khan Development Network (AKDN), both of which had considerable knowledge of South Asian microfinance, were thus the first to enter the market, followed by NGOs with experience working in post-conflict environments. Today, the sector is dominated by nine institutions supported by MISFA.

Despite the need for a variety of financial services, credit currently dominates the microfinance market. Microfinance institutions employ both group and individual lending methodologies and have restructured their traditional loan products to comply with local needs and Islamic lending requirements. Most institutions focus on working capital loans, but they are increasingly diversifying their products to meet the special needs of vulnerable populations, namely small farmers with high opium debt, nomadic people, people with disabilities and demobilized fighters. Savings services are limited and are generally collected as a mandatory condition for access to loans. Two institutions have set up revolving funds whereby groups use institutional funds to add to their own savings and make loans to members; here savings are a compulsory condition for membership. Some institutions have established credit unions, but these services remain limited in scope.

The market for microfinance services is currently estimated at one million households.[3] As microfinance providers diversify their products, however, demand will likely grow and exceed this level. With its focus on rapid growth, MISFA expects that its partner institutions will be able to reach 600,000 clients as early as 2008.

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1 David Mansfield, "The Role of Opium as a Source of Informal Credit in Rural Afghanistan", Rural Finance in Afghanistan and the Challenge of the Opium Economy, Report on a two-day workshop, Kabul: World Bank, 2005.

2 Martin Greeley, "Why Good Microfinance Matters", July 2005 (unpublished paper written for MISFA).

3 Stephen F. Rasmusssen and Sanjay Sinha, "Year of Micro Credit Synthesis Paper: Afghanistan", October 2005 (unpublished paper for Year of Micro Credit).

The Afghan microfinance sector has greatly benefited from existing sector experience and heavy international involvement. It has built on global industry experience to quickly expand outreach and follow best practices from the start. Institutions have focused on establishing sound operations to ensure sustainability of service delivery while MISFA has fostered a transparent environment where institutional performance can be easily monitored. The following chapter examines the state of transparency in Afghanistan and uses standard performance data to analyze this nascent microfinance industry.

Methodology

Nine microfinance institutions (MFIs) provided data for this analysis. Except for First Microfinance Bank - Afghanistan (FMFB), all institutions receive funding from MISFA and are either NGOs or NGO projects. The sample MFIs represent most of the market and serve over 95 percent of active clients. While there are a few other microfinance providers in Afghanistan, these were not able to provide information since they had just started operations at the time of data collection and were still finalizing agreements with MISFA.

The Pakistan Microfinance Network (PMN), with active support from MISFA, collected institutional performance data for the years 2003 and 2004.[4] Data were self-reported and cross-referenced with audited financial statements where available. All institutions had been operational for at least one year and submitted data for 2004, though four were able to provide multiple years of information. Standard performance data were readily available due to MISFA's requirement that partner MFIs provide monthly financial statements according to international reporting norms.

Performance of Afghan Microfinance Institutions

The Afghan microfinance sector has achieved spectacular growth and reached an impressive number of clients in the few years since its inception. While credit dominates the service offering, microfinance providers are increasingly diversifying their products to meet the needs of various population groups. High start-up costs, however, are posing serious challenges to institutional sustainability. The sector is as yet unable to generate sufficient revenues to cover exceptionally high personnel costs and is thus running at a significant loss. However, as local capacity improves and staff gain more operational experience, the sector will be able to build on strengths such as superior portfolio quality to become profitable and provide the poor with sustainable access to financial services.

Outreach

With donor and government emphasis on rapidly scaling up outreach, the Afghan microfinance sector has reached a remarkable number of clients in the short number of years since its inception. At year end 2004, microfinance institutions served 70,625 active borrowers and collected deposits from 117,325 compulsory savers. As Figure 1 illustrates, BRAC dominated the market, serving 79 percent of borrowers and 62 percent of compulsory savers. AKDN's Afghanistan Rural Microfinance Program (ARMP) was the next largest MFI, but at seven percent of total borrowers, its outreach paled next to BRAC.

BRAC's sector dominance may have stemmed from its early entry into the market as well as a vision of microfinance that allowed it to attract and retain qualified staff. In addition to having greater access to

[4] MIX standardizes financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For example, institutions that close on March 31st, 2005 are listed as FY 2004.

Figure 1: Client outreach

Indicators	Afghanistan	BRAC
Number of active borrowers	70,625	55,572
Number of compulsory savers	117,325	72,804
Gross loan portfolio (USD)	9,189,871	3,600,533

Source: MIX Market 2004 data as of October 19, 2005. Data presented are totals.

funding, BRAC was able to capitalize on experienced management staff that were familiar with its Bangladeshi operations and could successfully transplant its group loan methodology to Afghanistan. Moreover, BRAC's focus on Kabul and surroundings gave it an edge over MFIs such as FINCA that are working in areas with poorer infrastructure.

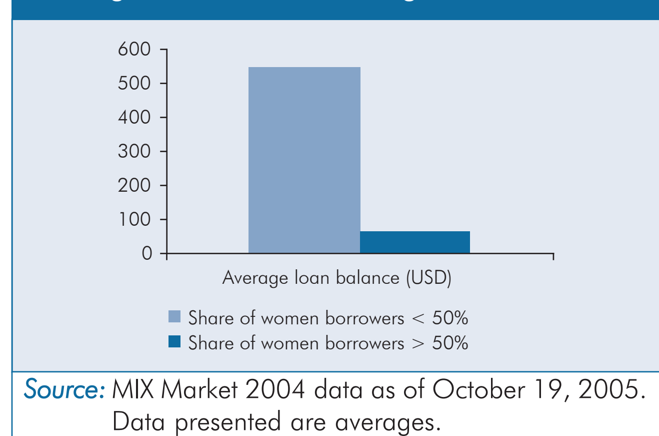
Given its youth and small initial base, the Afghan microfinance sector registered exceptional growth. Between 2003 and 2004, the number of active borrowers more than tripled, and the gross loan portfolio increased seven-fold. While new entrants to the market contributed to growth in outreach, BRAC alone added 78 percent of new borrowers.

The increase in the gross loan portfolio was accentuated by a rise in average loan balance per borrower – from USD 84 to USD 289. This rise was partly due to clients graduating from one loan cycle to the next, thereby qualifying for higher loan sizes. Product diversification, however, may have played a greater role. New players such as CHF International and FMFB have targeted the higher end of the market with average loan balances of USD 360 and USD 1,110, respectively. Unlike BRAC, which manages an average loan balance of just USD 65, these institutions employ individual lending methodologies that are more flexible in meeting client credit demands and thus tend to provide larger loans. Moreover, while MFIs have been reaching out to vulnerable population groups, the market has thus far prioritized breadth over depth of outreach.

Further pointing to the emphasis on expansion over depth, women represented just a little over half of total borrowers in the sample. At 61 percent, the share of women borrowers was towards the lower end in South Asia, where women average 83 percent of borrowers. This number, however, was up by five percentage points from the previous year, suggesting that microfinance providers may be increasingly directing their attention towards more vulnerable population groups.

An interesting feature of the market, made evident by Figure 2, is that MFIs that predominantly cater to women carry significantly lower average loan balances. The Micro Finance Agency for Development (MoFAD), which focuses exclusively on women, has an average loan balance of just USD 61. FMFB, on the other hand, counts only 13 percent women among its borrowers and manages loan balances that far outstrip those held by any other institution. Group loans across South Asia tend to focus more on women and have little appeal for men, who prefer larger, enterprise development loans. It is therefore not surprising that institutions that have lower loan balances also serve a higher percentage of women.

Figure 2: Gender and average loan balance



Source: MIX Market 2004 data as of October 19, 2005. Data presented are averages.

Financial Structure

With 35 percent of assets funded by capital, Afghan MFIs tend to be more capitalized than their South Asian counterparts, which on average hold 21 percent of assets in capital funds. For every dollar of equity, then, Afghan MFIs leverage 2.8 dollars in debt, namely from MISFA. In keeping with its age, the sector relies heavily on donor grants (from MISFA) for its equity. Given the predominance of international

NGOs, a number of microfinance providers also benefit from grants made by the parent organization. To date, retained earnings have not contributed to the balance sheet as MFIs are running significant operational losses.

The level of capitalization varies significantly across Afghan MFIs. The most highly capitalized institution, Parwaz, has a capital-to-asset ratio of 76 percent, compared to just 0.4 percent in the case of Women for Women International - Afghanistan. The majority of institutions, however, fall in the middle range and average 42 percent in capital assets.

Financial Performance

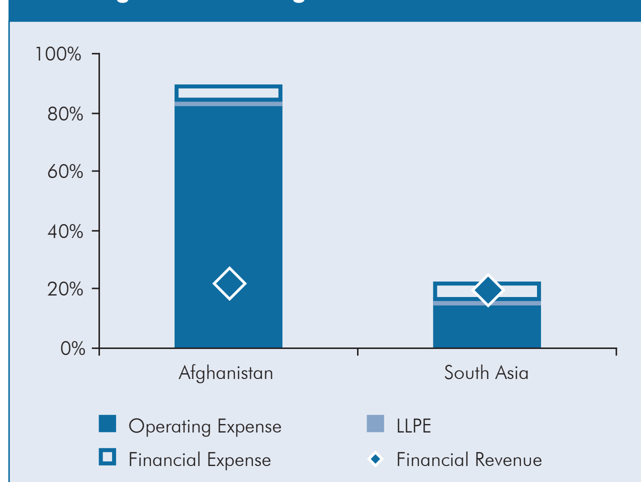
With an average operational self-sufficiency of 19 percent, the Afghan microfinance sector is running significant losses and must rely on non-operational revenue, namely donations, to finance its credit activities. At present, institutions cover less than a quarter of their operational expenses with the operational revenue that they generate, regardless of their average loan balances. Providing higher loan sizes generally reduces transaction costs per dollar outstanding while increasing an institution's financial revenue. Microfinance providers in Afghanistan, however, are at similar low levels of sustainability regardless of their loan methodology and average loan balance. ARMP alone stands out from the rest of the sample with an operational self-sufficiency of 73 percent.

Afghan MFIs are losing 67 cents for each dollar of assets invested, but these heavy losses are not unusual for such a young sector, particularly in light of the push to rapidly scale up operations. While recognizing the need for considerable initial investment in the sector, MISFA only funds institutions that demonstrate the potential to become fully sustainable by the fifth year of operations. Between 2003 and 2004, operational self-sufficiency increased from 17 to 33 percent, with ARMP experiencing the greatest improvement – from 15 to 73 percent.

Part of the reason why ARMP is able to attain a higher level of self-sufficiency is that it is more efficient than its peers in quickly channeling funds into loans, investing 81 percent of assets in its loan portfolio. The loan portfolio is an MFI's most productive asset, yet on average, Afghan institutions devote only half of their assets to their credit activities. Given that institutions are still solidifying their operations, it is not surprising that they would allocate a smaller portion of their assets to their loan portfolio. Nonetheless, four institutions devoted over 60 percent of their assets to their credit activities, while the remaining five invested under half. Between 2003 and 2004, asset allocation to the loan portfolio actually declined by nine percentage points. This drop, however, does not point to growing inefficiencies within the sector and is the result of the long time it takes to convert funds into loans while building infrastructure.

The sector's cost and revenue structure suggests that while poor asset utilization may have contributed to lower levels of profitability, high operating expenses are the main obstacle to institutional sustainability. Afghan MFIs generate slightly higher financial revenues as a percentage of total assets than the average South Asian MFI – 21 percent compared to 19 percent. Their cost structure, however, is significantly higher, as Figure 3 indicates. While the average South Asian MFI spends 14 percent of its asset base on operational expenses, Afghan institutions spend 82 percent. Expansion is expensive and has significantly driven up costs in the Afghan sector as MFIs hire and train large numbers of

Figure 3: Breaking down return on assets



Source: MIX Market 2004 data as of October 19, 2005. Data presented are averages.

personnel to increase outreach; personnel costs thus run very high in Afghanistan. Moreover, since local capacity is limited, MFIs have had to rely on expatriate staff and international consultants to launch operations, thus increasing institutional overhead charges. One of MISFA's main objectives, however, is to ensure that microfinance providers develop local microfinance managerial expertise and become registered Afghan entities within five years of operation.[5] Personnel expenses should therefore decline in the next few years as MFIs build local capacity and reach economies of scale, hence improving their profitability.

Efficiency and Productivity

Afghan institutions are far less efficient and productive than the average South Asian MFI, but they are also younger and less experienced. As Figure 4 indicates, managing one dollar of loans costs almost six times as much in Afghanistan as it does in South Asia, despite the country's higher average loan balance. The cost per borrower is also much higher in the Afghan microfinance sector, but this figure is in line with the regional average in Latin America and the Caribbean, where MFIs focus on individual loans and manage similarly high average loan balances. Afghan MFIs currently incur high operating expenses, but these are largely driven by start-up costs. Once the necessary infrastructure is in place, the sector will likely experience improvements in efficiency and move closer to the regional mean.

Figure 4: Efficiency and productivity indicators

Indicators	Afghanistan	South Asia	LAC
Operating expense / Loan portfolio	126.7%	22.0%	26.5%
Cost per borrower (USD)	152	25	155
Average balance per borrower (USD)	289	113	788
Borrowers per staff member	60	219	139

Source: MIX Market 2004 data as of October 19, 2005. Data presented are averages. LAC: Latin America and the Caribbean.

Of the four institutions for which 2004 efficiency data were available, BRAC had the lowest cost per borrower while ARMP incurred the lowest cost per dollar of loans outstanding. BRAC's group-based lending allows it to significantly expand outreach while minimizing staff hours, transportation costs and other expenses related to servicing clients. ARMP, on the other hand, gains in efficiency by providing higher loan sizes, hence reducing transaction costs per dollar outstanding.

As in the case of sustainability, efficiency in the Afghan sector is largely hampered by high start-up costs. As local capacity increases and institutions become Afghanized, operating costs will drop, making it cheaper to manage each dollar in loans outstanding. Since several Afghan microfinance providers are already working at the higher end of the market, raising loan sizes would not be an optimal means for enhancing efficiency. Instead, institutions should focus on improving credit technologies and reducing the cost per borrower.

In addition to being less efficient, Afghan MFIs have not realized the full productivity of their young staff, serving under one third as many borrowers per staff member as the average South Asian institution. Low population density and poor infrastructure make it difficult for staff members to reach the same number of borrowers as institutions in other parts of the region. Moreover, the Afghan sector is significantly younger, and staff members are less experienced. Institutions are still operating in start-up mode and have therefore not yet reached their full productivity potential. As local capacity builds up and institutions solidify their operations, the sector can expect to see improvements in both productivity and efficiency. Of the four institutions that provided data for 2003 and 2004, two have already begun to experience improvements in the number of active borrowers per staff member.

Portfolio Quality

Afghan MFIs manage loan portfolios of outstanding quality, especially given the "newness" of microfinance

[5] Stephen F. Rasmusssen and Sanjay Sinha, "Year of Micro Credit Synthesis Paper: Afghanistan", October 2005 (unpublished paper for Year of Micro Credit).

methodologies in the country. In 2004, only one percent of the portfolio was at risk over 30 days, and just 0.1 percent of loans were written off. Of the nine institutions in the sample, six reported no late installments over 30 days. The sector can certainly capitalize on this strength to allocate more funds to the loan portfolio and bolster its financial revenue, thus increasing profitability and growth in the short term.

Conclusion

Afghan MFIs have made significant accomplishments in the areas of outreach and portfolio quality, but challenges lie ahead on the road to sustainability. High operational expenses continue to drain efficiency and hamper sustainability to the point that no institution is able to generate enough revenues to cover its expenses. The sector's relatively poor financial performance, however, is not unusual for its age, particularly in light of twenty-five years of conflict that drastically reduced local capacity and largely destroyed the country's infrastructure. Over the next few years, it will be essential to monitor institutional development and ensure that the sector is moving in a direction that will ensure its sustainability.

Transparency Environment in Afghanistan

Performance data on microfinance institutions are widely available in Afghanistan, making monitoring the sector a fairly simple task. The early involvement of key international actors in microfinance, both donors and microfinance institutions, has enabled the sector to set appropriate performance targets and adopt best practice reporting norms. Institutional data on financial, social and outreach indicators thus follow standard definitions and are readily available from MISFA. However, as with any sector, there remains room for improvement.

State of Transparency

The Afghan microfinance sector largely consists of international NGOs with significant exposure to performance standards for microfinance. These institutions recognize the importance of quality data and have set up vibrant and robust information systems to track their operations. While they are required to submit regular performance reports as a condition of receiving funding from MISFA, MFIs also value the use of this information in keeping management informed of the institution's performance and ensuring that decisions build on an accurate understanding of operations.

Through its reporting requirements, MISFA has significantly contributed to the transparency environment in Afghanistan. This apex agency requires that its partner institutions submit monthly performance reports that adhere to international reporting norms for microfinance[6], both in terms of production and interpretation of data. As mentioned earlier, one of MISFA's primary objectives is to ensure that its partner MFIs become sustainable within five years of operation. Financial statements collected by MISFA thus accurately portray the institution's financial position, clearly indicating its dependence on grants and soft loans and allowing profitability calculations to adjust for the level of subsidy.

Despite the quality of data production and collection, data analysis is somewhat lacking. Initially, MISFA monitored its partner institutions on both social and financial performance indicators; its monitoring and evaluation department analyzed outreach and credit data while the finance department was in charge of financial analysis.

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[6] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

However, an institutional assessment in 2005 suggested that MISFA hire a chief finance officer who would report to the steering committee. Since then, the finance department has ceased to analyze MFI financial performance, and sector reports only cover outreach and credit indicators. In any case, while these reports help keep MISFA and the Ministry of Rural Rehabilitation and Development (MRRD)[7] informed of sector developments, they are not published more broadly.

External audits are an essential element for building transparency in the sector, but most institutions are in the very early stages of their operations and have not undergone external audits. However, four institutions in the sample did provide audited financial statements. These MFIs sought audits to comply with either requirements of their parent organizations or MISFA conditions. Integrated institutions, in particular, are required to submit separate audited accounts for their microfinance operations in order to qualify for a loan renewal after the first year. These institutions also realize that in addition to being effective instruments for control, audits may improve their image in the eyes of public registries, donors and investors. While Afghanistan lacks indigenous audit firms, several firms from neighboring countries have opened offices in Kabul. Moreover, MFIs often hire audit firms from the host country where the parent organization is registered. Existing audits reviewed from at least one audit firm contained appropriate financial disclosures for microfinance.

Currently, there is no regulation that dictates prudential and reporting requirements for microfinance providers. Only one MFI is registered as a bank and is regulated as such. The other institutions are essentially non-regulated and are either registered as NGOs or are simply projects of international NGOs. The government, however, is in the process of finalizing a draft law and regulatory framework to establish non-bank financial institutions in Afghanistan. Since this framework would be better suited to MFI operations, many microfinance providers are waiting for the passage of this law to register under it. Reporting requirements that may come into effect under this law have the potential to significantly enhance transparency in the sector.

Successful Initiatives in Building Transparency

MISFA is actively involved in both data collection and promoting best practices in presentation formats, disclosures and publication of audited accounts for microfinance providers. MFIs are additionally exploring the possibility of using their network association to promote transparency through the production and publication of regular performance reports that follow international standards. To this end, MISFA and the Afghanistan Microfinance Association have requested the assistance of the Pakistan Microfinance Network (PMN), which has been publishing its Performance Indicators Report since 1999.

Opportunities for Building Transparency

MISFA has devoted significant resources to ensuring that microfinance providers submit reports that accurately portray the state of their operations. Integrated programs are therefore required to prepare separate financial statements for their microfinance programs, and financial statements are expected to provide a complete picture of the institution and not simply cover MISFA funds within the MFI. As the sector continues to grow and new, local actors enter the market, these requirements will be a very useful tool for improving transparency and strengthening MFI management. To ensure that these efforts achieve their full potential, audited reports should not only comply with International Accounting Standards but also with financial disclosure guidelines for microfinance.

Despite MISFA's achievement in collecting MFI data on a monthly basis, it may not be the most adequate institution for monitoring sector performance as the sector grows and diversifies. As MFIs begin to access various sources of funding, it becomes increasingly important to establish a neutral focal point for performance monitoring and ensure that data reporting is not limited to funding requirements. MISFA may therefore consider entrusting the Afghanistan Microfinance Association with this task.

[7] MISFA comes under the aegis of MRRD.

Having a network association monitor sector performance ensures greater neutrality as well as better representation of the sector, making it more likely that institutions will follow reporting requirements.

Conclusion

Despite its youth, the Afghan microfinance industry has made significant strides towards financial transparency. All microfinance providers are able to generate financial, credit and outreach information according to international standards and are eager to make their data publicly available online. Through its reporting requirements, MISFA has made a significant contribution to transparency and should ensure that new entrants are able to abide by the same conditions.

Currently, the biggest challenge to transparency is to ensure that smaller MFIs are able to hire high quality auditors. Local audit capacity must be built, and auditors should be trained in microfinance-specific financial disclosures. It is also important that the sector determine whether MISFA or the network association will be responsible for taking the transparency initiative forward as duplication of efforts will simply waste resources and create confusion. The new regulatory framework should facilitate growth and ensure that microfinance providers follow prudent norms that enhance sustainability.

Bangladesh

The microfinance industry in Bangladesh was born prior to the 1970s with the establishment of cooperative societies throughout the country. Despite active support from the Bangladesh Rural Development Board, cooperatives failed to become self-sufficient and suffered from significant deposit losses and loan defaults. In 1976, Professor Muhammad Yunus began an experimental project that would revolutionize lending to the poor and demonstrate that it was a sustainable activity. The Grameen Bank Project showed that credit providers could ensure high repayment rates even in the absence of collateral, namely by capitalizing on social networks through group liability and requiring borrowers to deposit a portion of their loan in the form of compulsory savings. This concept received widespread attention and led to a proliferation of NGOs employing Grameen methodology to extend loans to poor clients. Despite today's continued dominance of working capital loans and compulsory savings, Bangladeshi microfinance institutions are increasingly diversifying their products to include individual loans, housing and education loans, voluntary savings and microinsurance. Leading institutions are additionally beginning to explore the use of their networks to provide international money transfer services.

The Government of Bangladesh estimates that 12.2 million families are living in poverty.[1] After adjusting for both loans to non-poor clients and client overlap among service providers, outreach numbers suggest that microfinance institutions are currently serving 70 percent of poor households. Close to 1,000 NGOs account for the bulk of loans outstanding, followed by Grameen Bank and government microcredit programs.

The following chapter analyzes the performance of microfinance institutions in Bangladesh, highlighting achievements and challenges that lie ahead. In addition, it examines the factors that facilitate or impede our understanding of that performance, providing a sketch of the transparency environment in the country.

Methodology

Leading microfinance institutions, along with the Pakistan Microfinance Network (PMN), the World Bank office in Dhaka and the Palli Karma Sahayak Foundation (PKSF) provided data on 48 microfinance institutions (MFIs) representing 90 percent of the microfinance market in Bangladesh. With the exception of Proshika, all major MFIs are included in this sample. Self-reported data on outreach and financial performance were collected for the years 2002 and 2003.[2] Despite challenges in reclassifying

[1] Stephanie Charitonenko and S. M. Rahman, Commercialization of Microfinance: Bangladesh, Manila: Asian Development Bank, 2002.

[2] These years are listed according to MIX standard financial years. For MFIs closing accounts in June, this means June 2003 and 2004. For MFIs closing in December, these refer to December 2002 and 2003. All December closing MFIs also provided data for 2004; however, no data were available for June 2005 for comparison.

financial accounts to meet international reporting standards, MFIs were eager to share information and provided audited financial statements for cross-referencing.

Where appropriate, the following analysis examines MFI performance by peer groups. Institutions are classified by age and outreach as indicated in Figure 1.

Figure 1: MFI peer group criteria

Category	Group	Criteria
Age	Mature	Established before 1990
	Young	Established 1990-
Outreach	Small	< 10,000 active borrowers
	Medium	10,000 to 100,000 active borrowers
	Large	> 100,000 active borrowers

Performance of Bangladeshi Microfinance Institutions

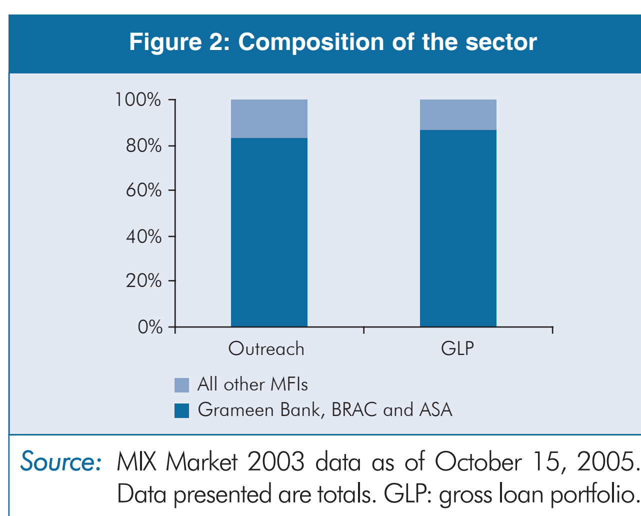
Despite its maturity, the Bangladeshi microfinance sector continues strong growth. The number of clients reached continues to increase at exceptional rates, even as MFIs attain large scale and expand into new lines of products and services. While evidence suggests that the sector may be experiencing some declines in profitability, an overwhelming majority of MFIs sampled succeeds in covering costs from operating revenues.

One striking feature of the industry is its homogeneity. Capital and cost structures hardly vary across MFIs and point to the structuring role that PKSF, as the main source of funds, has had on the sector.

Outreach

Despite the large number of MFIs operating in Bangladesh, four colossal institutions dominate the microfinance market. With 8.5 million borrowers in 2003, Grameen Bank, BRAC and ASA served over 80 percent of total borrowers in the sample.[3] Outreach for other institutions ranged between 1,500 and 257,000 borrowers and paled in comparison to the average 2.8 million served by each of these MFIs. As Figure 2 illustrates, these three institutions also managed a disproportionate share of the loan portfolio.

Figure 2: Composition of the sector



Source: MIX Market 2003 data as of October 15, 2005. Data presented are totals. GLP: gross loan portfolio.

Having satisfied 70 percent of demand for microfinance services, the microfinance industry continues to grow at a remarkable rate. Between 2002 and 2003, the number of active borrowers and the gross loan portfolio grew by 22 and 25 percent, respectively. A deeper analysis indicates that growth in the market was primarily driven by large MFIs, as Figure 3 makes evident. High growth rates, combined with a large client base, allowed

Figure 3: Growth by peer group

Outreach	Growth in Borrowers (Nb)	Average Growth in Borrowers (%)
Large	1,669,367	27.9%
Medium	99,787	23.1%
Small	7,710	76.3%

Source: MIX Market 2002 and 2003 data as of October 15, 2005.

3 The fourth major MFI, Proshika, was not included in the sample.

these institutions to gain a substantial number of additional borrowers. Of the 1.8 million borrowers added in 2003, these MFIs counted 1.7 million, or 94 percent of all new borrowers.

Despite significant expansion in credit outreach, average loan size has remained roughly the same. Between 2002 and 2003, the average loan balance per borrower grew from USD 63 to just USD 66. Average loan balance is a proxy indicator for clients' socio-economic level and amounts to just 15 percent of per capita income in Bangladesh. The data thus indicate that as Bangladeshi MFIs have grown in size, they have continued to target the lower end of the market and serve clients with very low incomes.

Average loan balances do not significantly vary by MFI age or size. Small and young institutions manage average loan balances that are five and twelve dollars higher than those managed by their peers, respectively. These disparities, however, dissipate when taking into account local income levels. While average balances do increase from older to younger institutions, they do so in a narrow band from 15 to 17 percent of local per capita income. The data thus indicate that as Bangladeshi MFIs mature, they remain focused on their original client group and do not move "up market", serving larger loans to better off clients. Moreover, as young institutions compete with older ones and seek to carve a niche for themselves, they too refrain from moving "up market".

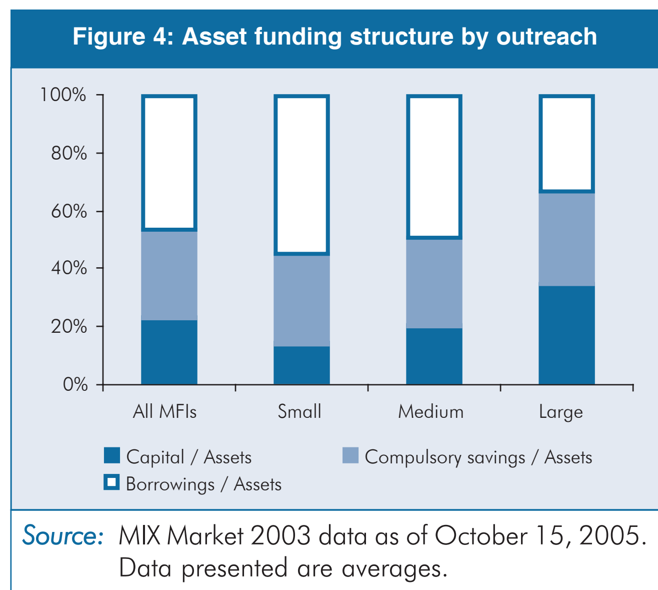
As the largest funder of Bangladeshi MFIs, PKSF has played an important role in maintaining low average loan balances across the sector. When extending loans to MFIs, PKSF requires that the maximum size of the first loan not exceed USD 68, except in the case of special microcredit programs.[4]

In addition to average loan balance, the percentage of women clients can also be used to gauge depth of outreach, or the extent to which MFIs are reaching poor, vulnerable population groups. Since its revival in the mid 1970s, the microfinance sector in Bangladesh has heavily targeted women. In 2003, women represented 94 percent of active borrowers in the sample, though differences do exist across institutions. As MFIs increase in size, the share of women borrowers declines from 99 percent in the case of small MFIs to 94 and 90 percent for medium and large MFIs, respectively. While women still constitute a large majority of clients, there is evidence that male clients are steadily gaining in importance, particularly as MFIs grow and diversify their product offering. Overall, the share of women borrowers declined by three percentage points between 2002 and 2003. This change in client composition, however, does not necessarily reflect a shift in the sector's target group and may instead be a byproduct of service diversification since men are more likely to benefit from enterprise development loans.

Financial Structure

MFIs in Bangladesh rely on a variety of sources of funds to finance their credit activities. A glance at the balance sheet structure indicates that MFIs are consistently leveraged, funding just 23 percent of assets with capital. As Figure 4 illustrates, the sector finances most of its assets through borrowings from banks and PKSF (46 percent) and through compulsory savings (30 percent). Except for

Figure 4: Asset funding structure by outreach



Source: MIX Market 2003 data as of October 15, 2005. Data presented are averages.

[4] PKSF, Annual Report 2004, http://www.pksf-bd.org/annual_report2004/annual_report_cont.html. The maximum amount for a first loan is Tk. 4,000 (approximately USD 68).

Grameen Bank, all MFIs in the sample are NGOs and lack formal shareholder structures, limiting their equity financing to capitalized donations and retained earnings.

Institutions established prior to 1980 are the most capitalized and fund 34 percent of their assets through equity, whereas those that were created in the 1980s and 1990s rely on equity for just 21 and 17 percent of their assets, respectively. Older MFIs benefited from significant access to grants and donations in their early years and were able to augment their equity base by capitalizing these funds. Younger institutions, however, experienced greater difficulty in accessing grants and had to rely more heavily on borrowings and compulsory savings. While donors continue to provide funds to the Bangladeshi microfinance sector, these funds are now largely channeled in the form of subsidized loans through PKSF, the apex financing institution.

Since its inception in the early 1990s, PKSF has become the largest source of funds for the Bangladeshi microfinance sector and has played a significant role in homogenizing financial structures. Despite rigorous loan requirements, including capital requirements for large MFIs, all but two institutions in the sample sought and obtained loans from PKSF. PKSF's below-market interest rates and large credit lines make it particularly attractive to MFIs that are looking to grow and significantly expand outreach. Other funding alternatives remain limited, and given the sector's shift away from grants, MFIs must increasingly rely on retained earnings to build their capital base and attract more debt.

Financial Performance

Overall MFI performance suggests the existence of a profitable microfinance industry. Almost without exception, MFIs in the sample generate sufficient revenues from their financial services to cover their costs. Operational self-sufficiency (OSS) ranges from 95 percent to 170 percent, with an average of 126 percent within the sample. The return on assets (ROA) averages four percent, with only three MFIs operating at a loss. Two institutions stand out by reason of their exceptional performance – ASA (OSS 267 percent, ROA 16 percent) and PMK (OSS 262 percent, ROA 14 percent). Excluding these two MFIs from the analysis, however, does not significantly alter the profitability picture.

MFI profitability persists across age and size, as Figure 5 clearly demonstrates. This positive performance has encouraged banks to increase lending to the sector, either directly or through the MFI network association, Credit and Development Forum (CDF). This rise in commercial linkages has significantly expanded the pool of funds available to MFIs and is likely to stimulate more growth in the sector, which may in turn fuel additional improvements in profitability.

MFIs generate profits when their revenues exceed their expenses. One way that MFIs can boost their financial revenue is to allocate a greater portion of their assets to the loan portfolio, their highest yielding asset. Regardless of age and size, Bangladeshi MFIs invest a significant share of their assets in their credit activities – about 76 percent on average – slightly surpassing the 74 percent regional mean.

MFIs can also improve profits by reducing costs. MFIs in Bangladesh are very similar to microfinance

Figure 5: MFI profitability

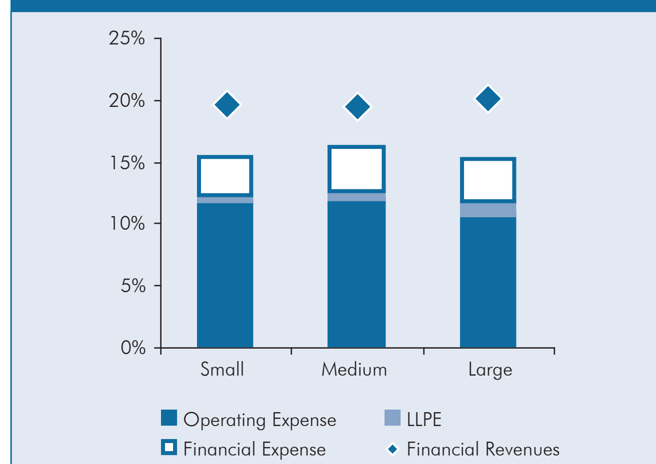
Indicators	Total	Outreach			Age		
		Large	Medium	Small	Pre 1980	1980s	Post 1990
OSS	125.7%	133.7%	123.7%	126.2%	122.4%	125.7%	128.9%
ROA	3.6%	5.0%	3.2%	4.1%	2.5%	3.3%	5.5%
ROE	17.2%	19.7%	18.8%	10.8%	12.6%	14.0%	28.3%

Source: MIX Market 2003 data as of October 15, 2005. Data presented are averages. OSS: operational self-sufficiency; ROA: return on assets; ROE: return on equity.

service providers worldwide in that operational expenses comprise two thirds of their total cost structure. Operational expenses are nonetheless rather low and average 10 to 12 percent of total assets. Good staff productivity and low personnel costs both help keep operational expenses at these low levels. Two MFIs in the sample benefit from particularly low operational cost structures – ASA (six percent) and Grameen Bank (seven percent). Significantly, Bangladeshi MFIs have also been able to access cheaper sources of funds than their global counterparts through compulsory member savings and PKSF loans. Access to these heavily subsidized sources has boosted profitability, maintaining MFI financial cost at slightly over three percent of assets. Grameen Bank alone stands out, with a financial cost of six percent. While it is widely acknowledged that Bangladeshi MFIs enjoy exceptionally low cost structures, these low levels may be somewhat exaggerated. The cost structure of the sector is likely skewed as a result of widespread under-provisioning for credit risk; on average, the loan loss expense is only 0.8 percent of average total assets, compared to 4.2 percent in South Asia. The lack of clear loan loss provisioning policies distorts the profitability picture and clouds performance analysis, hindering transparency in the microfinance sector.

Nevertheless, as Figure 6 illustrates, Bangladeshi MFIs of all sizes generate financial revenues in excess of total expenses. As with financial structure, a closer look at the breakdown of revenues and expenses reveals remarkable homogeneity across the industry. Given the sample's heavy reliance on PKSF for funding, it is not surprising that institutions across peer groups face very similar financial expenses as a percentage of total assets. Financial revenues also remain rather constant across MFIs. The predominance of standardized loan products may have contributed to this phenomenon. Moreover, PKSF has begun to take a more active role in its partner institutions' loan products, encouraging them to reduce interest rates from 15 percent to 12.5 percent and thus further reinforcing sector homogeneity.[5]

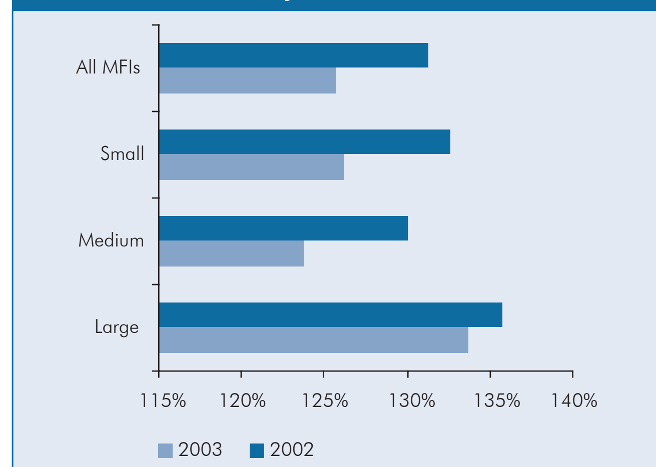
Figure 6: Breaking down return on assets by outreach



Source: MIX Market 2003 data as of October 15, 2005. Data presented are averages. LLPE: loan loss provision expense.

Two years of data permit very limited trend analysis, but as Figure 7 shows, there is evidence that profitability may be declining across different peer groups. Overall operational self-sufficiency declined from 131 to 126 percent, with medium MFIs experiencing the most significant drop. This decline in profitability is driven by a joint drop in financial revenue and an increase in total

Figure 7: Trends in operational self-sufficiency by outreach



Source: MIX Market data as of October 15, 2005. Data presented are averages.

5 PKSF, Annual Report 2004, http://www.pksf-bd.org/annual_report2004/annual_report_cont.html.

expenses. Financial revenue as a percentage of total assets dropped from 22.4 percent in 2002 to 19.8 percent in 2003 at the same time that the total expense ratio rose from 15.8 to 16.1 percent.

Efficiency and Productivity

With 132 borrowers for every staff member and an overall operating efficiency ratio of 16 percent, MFIs in Bangladesh are generally efficient and productive. On average, large MFIs are both the most productive and the most efficient in managing their loan portfolio.

Figure 8 illustrates some clear patterns; Bangladeshi MFIs are more efficient than their South Asian peers. While they are on average less productive, the three institutions that dominate the sample each serve more borrowers per staff member than MFIs across South Asia. Increasing loan size is one route for enhancing efficiency as it reduces the cost per dollar outstanding. In the case of Bangladesh, however, efficiency does not come at the expense of depth of outreach, and MFIs continue to serve the lower end of the market, holding average loan balances that are less than two thirds of the regional mean. Lower operating expenses thus appear to have played a critical role in the sector's higher efficiency levels. In addition to low personnel costs, high population density allows staff members to serve a large number of clients at lower transportation costs and with fewer staff hours. Moreover, the majority of the sector has reached maturity so that systems are now standardized, staff are well-trained and MFIs have achieved economies of scale. This is further substantiated with the fact that older MFIs are more efficient and productive than younger institutions.

Portfolio Quality

Portfolio quality in Bangladesh is poor but compares favorably to most of South Asia. Portfolio at risk over 30 days averages 5.8 percent among Bangladeshi institutions, twice as high as the regional average for Eastern European and Central Asia (2.1 percent) or Middle East and North Africa (2.9 percent). At 7.6 percent, however, the regional average for South Asia runs even higher. The Bangladeshi figure, while already high, likely underestimates the actual risk level since many institutions in Bangladesh do not track portfolio at risk before maturity, which is usually 52 weeks. Moreover, the majority of the sector lacks formal loan write-off policies to clean the loan portfolios from bad debts.

Portfolio at risk over 30 days varies by MFI size.[6] At 4.7 percent of GLP, medium scale institutions appear to have the best portfolio quality, followed by large MFIs (5.9 percent). With 7.0 percent of their portfolio at risk, small MFIs suffer from the worst portfolio quality. Some of the more prominent MFIs, however, maintain outstanding portfolio quality – ASA (0.4 percent) and Buro Tangail (2.0 percent).

Figure 8: Efficiency and productivity indicators

Indicators	Outreach			ASA	BRAC	Grameen Bank	South Asia
	Large	Medium	Small				
Borrowers per staff member	214	110	101	264	258	242	219
Operating expense / Loan portfolio	14.9%	16.2%	15.3%	7.1%	14.8%	10.4%	22.0%
Cost per borrower (USD)	9	10	10	6	8	11	25
Average balance per borrower (USD)	63	67	68	83	58	99	113

Source: MIX Market 2003 data as of October 15, 2005. Data presented are averages.

6 In this section, size refers to the loan portfolio in USD. Small: < 750,000; Medium: 750,000 - 2 million; Large: > 2 million.

Between 2002 and 2003, MFIs of all sizes experienced slight declines in their portfolio quality. This deterioration, however, has had no impact on MFI policies, and they continue to provision for loan loss at just 0.8 percent of average total assets. One potential reason why institutions are not adapting their policies to account for higher risk is because they largely lack the systems to accurately track loan delinquencies prior to maturity.

Conclusion

MFIs in Bangladesh are viable and profitable. They draw their strength from highly efficient operations and exceptionally low cost structures, which they translate into gains by directing a significant portion of total assets to their credit activities.

The Bangladeshi microfinance sector has thus far benefited from heavily subsidized sources of funds that have maintained financial costs at low levels and contributed to widespread profits. As the sector continues to expand, competition over subsidized funding will increase, driving microfinance providers towards new sources of funds, such as commercial debt or voluntary deposits. As the sector becomes increasingly reliant on these sources of funds, financial expense will rise, and profitability will decline – unless microfinance products are re-priced. In order to attract commercial debt, institutions must run sustainable operations and generate profits under competitive market conditions.

Bangladeshi MFIs, however, continue to face challenges. A key area for improvement is portfolio quality. MFIs need to develop a more accurate understanding of their credit risk and provision against it accordingly. While doing so may raise costs in the initial year, these costs will eventually level off, and knowledge of risk will improve. MFIs also need to develop clear write-off policies that will lead to clean portfolios over time.

Transparency Environment in Bangladesh

While information on outreach and funding of microfinance is readily available, data on MFI financial performance are limited. Widespread confusion about financial terms makes performance analysis difficult and hinders comparisons across institutions. As mentioned earlier, lack of clarity on portfolio risk measures and loan write-off policies makes it difficult to accurately gauge portfolio quality in the Bangladeshi microfinance sector. Profitability is also difficult to ascertain; many MFIs provide other services in addition to microfinance, but their financial statements do not always segregate accounts into the various activities, making it difficult to accurately analyze microfinance operations. The following sections will explore the transparency environment in Bangladesh, highlighting initiatives that have contributed to our understanding of the microfinance sector and the obstacles that continue to obscure its performance.

State of Transparency

There is a large amount of information available on the microfinance industry in Bangladesh, but this information does not always adhere to international reporting standards[7] and does not fully capture the financial performance of microfinance institutions. Two main actors gather and publish data on the microfinance sector: CDF, an umbrella organization representing microfinance NGOs, and the Microfinance Research and Reference Unit (MRRU) at the central bank. CDF collects basic data on market coverage, funding sources and product details for 720 institutions and publishes these on an annual basis in hard copy.[8]

[7] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

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

The *CDF Microfinance Statistics* is publicly accessible and widely disseminated among donors, government, researchers, microfinance providers and others inside and outside of the country. These audiences refer to the reports in laying the landscape for the growth and development of the microfinance sector.

The Bangladeshi microfinance sector is the oldest and one of the most referenced in the world, but the microfinance community finds few reports with standard measures of institutional performance that cover more than a handful of Bangladeshi MFIs. *CDF Microfinance Statistics,* as is the practice with many retail institutions in the sector, presents data relevant to measuring credit projects, such as outflows (disbursements) and inflows (repayments) of credit to clients. Such measures do not begin to paint a picture of microfinance institutions or their health. Tellingly, *CDF Microfinance Statistics* covers no measures of institutional performance such as portfolio yields, operational efficiency or profitability. Figure 9 presents a summary of standard performance data availability in Bangladesh.

Only a few, mostly leading, institutions follow best practice reporting. With the exception of a handful of MFIs, there is very little to no knowledge of international reporting standards. In order to disseminate best practice reporting norms among institutions, it is essential that data collection agencies make performance monitoring a priority. Currently, CDF focuses more on policy issues and capacity building for small MFIs than it does on building transparency. CDF has recently begun to include an analytical chapter in its annual bulletin. While the analysis goes in depth into the composition and outreach of the sector, it does not address financial performance and glosses over portfolio quality. Its large membership, coupled with limited capacity and funding, make it unlikely that CDF will be able to reform its data collection process to meet international norms in the near future.

Figure 9: Availability of standard performance data

Data	CDF	MRRU	Comments
Outreach	Yes	Yes	Data are available on the number of clients served as well as the loan portfolio. While data for outstanding clients and loan portfolio are available, many statistics are in cumulative form and focus on disbursements and repayments.
Financial structure	No	No	CDF provides information on funds for the loan portfolio but does not provide a complete picture of an MFI's financial structure.
Cost structure	No	No	
Revenue structure	No	No	
Portfolio yields	No	No	
Operational self-sufficiency	No	No	
Profitability	No	No	
Efficiency	No	No	
Productivity	Yes	Yes	CDF and MRRU provide information on staff productivity and credit officer productivity.
Portfolio quality	No	No	While CDF and MRRU both report portfolio quality, these measures do not adhere to international standards. CDF reports recovery rates, whereas MRRU provides cumulative recovery rates.

MRRU, on the other hand, is moving in the direction of performance analysis and standardized information. The unit intends to collect standardized audited financial statements covering NGOs' microfinance programs and use the data to compute performance ratios. At this stage, it is important that MRRU take into account international best practice norms on financial statement presentation and reporting of indicators. Doing so would enable institutional performance comparisons on a national as well as global scale.

In keeping with general practice in the sector, all the MFIs in the sample have had their financial accounts audited. These reports, however, do not always fully portray an institution's financial position. Some financial statements, for example, limit performance analysis by not separating microfinance operations from the institution's other activities, such as health or training services. Audits are generally conducted to comply with PKSF and donor requirements. To satisfy the requirements of different funders, MFIs must sometimes produce multiples audits and in some cases, even close their books twice a year.[9] The production of multiple audit reports creates an additional strain on limited resources and generally results in only a partial picture of the MFI since donors tend to ask for audits that cover only their funds within the institution. PKSF, however, is moving towards consolidated audited accounts on the microfinance operations of its partner MFIs. To remedy the situation, PKSF has established a panel of audit firms that can be accessed by its partner MFIs and is currently working to build capacity and improve the quality of audited accounts.

Many MFI audit reports do not adhere to some basic principles of international accounting standards (IAS-1). However, there are a few institutions like Buro Tangail, BRAC and ASA that produce financial statements of high quality. Buro Tangail, along with a few other institutions, goes a step further and follows international disclosure guidelines for microfinance in their audited accounts. BRAC, while it is an integrated program, produces reports that draw out its microfinance operations from the overall picture and could be a model for other integrated programs to follow.

Another key aspect of financial transparency is the availability of ratings that evaluate institutions' credit risk. There is no rating agency in Bangladesh. The two rating agencies from India, M-CRIL and CRISIL, occasionally conduct ratings of individual MFIs. Ratings are not a legal requirement and are often carried out in the context of transactions between MFIs and commercial banks, like Sonali Bank. Donors such as the Swiss Agency for Development and Cooperation (SDC) sometimes require MFIs to undergo formal ratings when building commercial links, and CDF conducts its own assessment of MFIs before on lending credit to its members through commercial loans received from banks. PKSF also conducts assessments when determining whether to lend to an institution.

In the absence of collateral, ratings build investor confidence and make commercial loans available to MFIs. Ratings played a critical role in enabling Buro Tangail and Shakhti Foundation to access commercial credit lines through Sonali Bank and SDC. Since the motivation for ratings is to build initial commercial links or meet donor requirements, MFI ratings are not updated on a regular basis as in the corporate world. Moreover, these ratings are kept confidential, and only those conducted by M-CRIL and CRISIL follow international best practice for microfinance. As MFIs begin to diversify their funds, however, there may be a shift away from PKSF assessments to formal ratings.

In line with current moves to regulate the microfinance sector in Bangladesh, MRRU has established a committee to examine regulatory standards. This committee is working to establish common financial statement formats and develop guidelines for accounts and financial reports that would help in churning out standardized performance measures. Having comparable data will enable MRRU to better track performance within the sector, but the usefulness of the data collection process will largely depend on

[9] Two MFIs in the sample, VARD and RIC, close their books twice a year to meet donor requirements.

the indicators that institutions are required to track. Today, the only option for NGOs wanting to convert to formal financial institutions is to convert into commercial banks, whose requirements are not always in line with microfinance operations. With the exception of Grameen Bank, which was established by special ordinance, and a few government programs, all microfinance service providers in Bangladesh continue to be NGOs.

Successful Initiatives in Building Transparency

MRRU and PKSF's recent initiative to standardize accounts and financial statements and to develop common performance indicators is a step in the right direction. The two have worked together to develop operational reporting guidelines that cover four areas of MFI operations: governance and management structures; management information systems; financial disclosures; and performance indicators and standards. In addition, the guidelines establish terms of reference for internal as well as external auditors. These efforts, however, need to be fine tuned with international best practice norms, including financial statement disclosures and standard reporting terms.

Ratings allow investors to better comprehend the risk associated with their investments and enable MFI managers to receive feedback on the performance of their institution. SDC's challenge fund with Sonali Bank has encouraged a number of MFIs to seek ratings from M-CRIL and resulted in the opening of commercial sources of financing for MFIs. Under the agreement, Sonali Bank extends a loan to an MFI subject to personal guarantees of its board and SDC. The MFI, however, is also required to undergo a credit rating. As a result of this project, Sonali Bank provided loans to two medium size and six small institutions. This initiative has resulted in a longer term arrangement between MFIs and Sonali Bank despite completion of the SDC project. SDC is now entering a similar partnership with Pubali Bank, the largest commercial bank in Bangladesh. SDC will provide USD 380,000 in loans to MFIs, which the bank will match with USD 760,000. MFIs are again required to undergo an independent credit rating before applying with Pubali Bank. Demand for these loans has been so high that SDC is considering increasing its contribution to the total funding.

Opportunities for Building Transparency

While building on local accounting standards, MRRU and PKSF's work to standardize financial statements should follow international accounting standards and internationally accepted microfinance disclosure guidelines. Doing so would increase the number of indicators for which data is available, provide a better picture of the financial position of MFIs and enable performance comparisons on a global scale.

MRRU should require that MFIs prepare consolidated audited financial statements for their microfinance operations, focusing on the full financial position of the institution. Within these consolidated statements, institutions can provide sufficient detail to allow donors and other funders to track the use of their funds within the MFI. BRAC's audited reports provide a prime example of how to portray the full financial position of an institution and still break down accounts according to different activities. MRRU should also develop appropriate loan loss provision and write-off guidelines to be followed by the entire sector and not just PKSF partner institutions. These guidelines should follow international best practice in order to accurately represent the financial health of the institution and the risk associated with its portfolio.

While CDF has successfully mapped the microfinance sector, it is suggested that it actively work towards collecting and reporting data on members' financial performance. To ensure healthy sector development, it is essential for institutions to gauge their financial performance using international standards as these will provide a more complete and accurate picture of their position. Institutions would also benefit from an information hub that publishes regular performance reports in which MFIs can be benchmarked against their peers, both nationally and globally. Despite limited capacity and funds, CDF is better suited for this role than a funder, such as PKSF. As an MFI association, it is in direct contact with a much lager number of institutions and has more leverage to collect this information. Moreover, since MFIs are the decision-makers within CDF, MFI buy-in would be more likely. Undertaking this initiative, however, will not be without challenges. CDF will have to train staff and

raise awareness on the importance of standard reporting across the sector. If it is to take on this role, CDF will require significant donor support and funding, particularly in light of the large number of MFIs operating in the sector.

Conclusion

With the microfinance sector poised to grow further, it is worthwhile to take stock of the state of the transparency environment in Bangladesh.

Over the last few years, the sector has made a number of accomplishments in improving transparency. Audits are increasingly taking into account the specifics of microfinance operations while more and more MFIs are producing consolidated financial reports that better represent their financial position. The SDC project has increased the number of ratings and enabled institutions to diversify their funding.

But weaknesses remain, namely in the area of reporting. Few microfinance providers follow international reporting norms, and existing efforts to collect and monitor performance data are not aligned with best practice. There is much duplication in data collection efforts by CDF and MRRU, and few MFIs follow international standards in preparing accounts and evaluating performance. The limited capacity to produce standard performance data is an issue that needs to be addressed.

It is suggested that the microfinance association CDF should move towards preparing sector performance reports that adhere to international standards. MFIs should be encouraged to create and publish profiles on the MIX Market, and MRRU must develop best practice guidelines that create a facilitating environment for the industry. PKSF should not be a regulator but a provider of financing to MFIs and a catalyst for linkages between MFIs and the commercial sector. Improved knowledge of MFI performance will allow them to address their weaknesses and build their strengths, tremendously helping the sector on the way forward.

India

The microfinance industry in India emerged in the 1970s to provide poor people with access to credit without resorting to the usurious interest rates fixed by informal moneylenders. Because of their weak asset base, poor people are generally unable to fulfill loan guarantees requested by traditional banks and remain trapped in a vicious circle of low income, low investment and low revenue. In 1974, SEWA Cooperative Bank was established to help low income women escape this trap and reduce their dependence on moneylenders. Much like Grameen Bank in Bangladesh, SEWA Bank relied on peer pressure groups to ensure high loan repayment rates. Through its success, SEWA Bank proved that the poor were bankable and helped pave the way for the emergence of hundreds of microfinance institutions during the 1980s and 1990s.

The microfinance market in India is not uniform and relies on a diverse set of legal, regulatory and organizational systems to provide the poor with access to financial services. The microfinance institutions that currently operate in the market include not-for-profit institutions such as societies and trusts, mutual benefit cooperative societies, for-profit non-bank finance companies and local area banks. These institutions use a variety of lending models to deliver microfinance services. Many microfinance institutions fund loan portfolios through borrowings from commercial and state finance institutions. Such refinancers include the National Bank for Agriculture and Rural Development (NABARD) and the Small Industries Development Bank of India (SIDBI) as well as a number of state and commercial banks. Many other microfinance institutions, however, do not provide direct microfinance services and instead facilitate the formation of self help groups that generate internal funds and link with formal banks for additional financing.

The self help group (SHG) model is unique and distinct to India and constitutes the chief mode of microfinance service delivery in the country. SHGs are self-selected groups of ten to twenty persons that mobilize member savings and provide need-based loans out of the pool of funds created. Members determine the rules and norms of the group (e.g. loan size and interest rate) and rely on microfinance institutions for training and support services. Once internal transactions are strengthened, groups are linked with formal banks for supplementary financing, usually through the intermediation of microfinance institutions. In 1992, NABARD launched the SHG Bank Linkage Program to assist microfinance institutions with the formation of SHGs and increase the amount of bank loans available to the latter. Between 2003 and 2004, 361,731 new SHGs were formed and received USD 412 million in bank loans in the context of the program. SHGs often organize into federations to obtain external funds in bulk and hence lower their cost of funds.

While dominant, the SHG model is not the sole mode of microfinance delivery in India. Microfinance institutions also provide credit through individual loans, Grameen model groups and joint liability groups. Unlike SHGs, these last two groups are not independent entities, but simply serve as a delivery means for the microfinance institution.

Microfinance providers are gradually diversifying their services to include microinsurance and money

transfers. Savings are a crucial service for the poor and constitute the second most important source of funds for SHGs after bank loans. The majority of Indian microfinance institutions, however, are not authorized to mobilize savings. Only banks, member-owned institutions and a few non-bank finance companies are allowed to raise deposits from the public. Despite regulatory constraints, most microfinance institutions collect savings as a condition for membership or access to credit. There is, however, an increasing trend among institutions not to hold deposits and instead assist savings groups in creating and maintaining savings accounts directly with local banks.

It is estimated that 35 percent of India's one billion inhabitants are living below the poverty line[1], with 80 percent based in rural areas. A large part of their credit, savings and insurance demand is currently unmet by the microfinance industry. Annual microcredit demand is estimated at USD 12 billion[2], but a very conservative estimate suggests that, at most, just 20 percent of all poor people have access to financial services from formal financial institutions, microfinance institutions and other such service providers.[3] While it has substantially increased the poor's access to financial services, the recent upsurge in outreach has concentrated in South India and left most areas of the country underserved. As with credit, demand for savings and insurance services remains largely unfulfilled as well.

While a late entrant into microfinance, the Indian sector is characterized by a diversity of legal entities that are using different approaches in providing financial services to the poor. The growth of these institutions and the policy attention they have received have facilitated the systematic entry of commercial capital into the microfinance sector, fueling even greater growth in client outreach and loans outstanding. As partnerships between banks and microfinance institutions continue to strengthen, they will provide an enhanced environment for financial reporting and transparency across the sector. The following chapter examines the growth and development of the microfinance sector and sheds light on the transparency environment in which microfinance institutions operate.

Methodology

This study builds on outreach and financial data provided by leading microfinance institutions (MFIs) and Sa-Dhan, the MFI network association in India. The sample includes 28 MFIs and covers the years 2003 and 2004[4]. MFIs were targeted on the basis of their outreach to ensure the largest possible market coverage within the sample. All data were self-reported and cross-referenced with audited financial statements where available. Financial data were furthermore reclassified according to international reporting standards. The sample institutions capture the sector's diversity and include societies,

[1] Human Development Reports Statistics, "India Country Sheet", http://hdr.undp.org/statistics/data/countries.cfm?c=IND. Between 1990 and 2003, it was estimated that 35 percent of the Indian population lived under $1 a day PPP.

[2] Vijay Mahajan, Bharati Gupta Ramola and Mathew Titus, "Starting Microfinance in India," 1998, http://www.microfinancegateway.com/content/article/detail/20133.

[3] Y. S. P. Thorat and Graham A. N. Wright, "Microfinance: Banking for the Poor, Not Poor Banking", The Hindu Business Line, 15 Mar. 2005.

[4] MIX standardizes financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For example, institutions that close on March 31st, 2005 are listed as FY 2004.

trusts, cooperative societies, non-bank finance companies and local area banks. Due to the lack of standard performance data, SHGs were not included in the study.

The following analysis uses overall averages to provide a general picture of the state of the market and builds on a peer group framework to draw attention to trends within the sector. As Figure 1 indicates, institutions are classified by age and scale.

Figure 1: Peer group criteria

Category	Group	Criteria
Age	New	Established after 1995
	Young	Established between 1990 and 1995
	Mature	Established before 1990
Scale	Small	GLP < USD 1 million
	Medium	GLP = USD 1-5 million
	Large	GLP > USD 5 million

GLP: gross loan portfolio.

Performance of Indian Microfinance Institutions

Indian MFIs have recently made significant strides in improving the efficiency of their operations. Driven largely by securing operational depth in existing locations and enhancing the management and deployment of funds, institutions have sustained remarkable growth rates both across clients and portfolios. Yet much remains to be done to ensure that the poor have reliable access to financial services. MFI sustainability is contingent on maintaining the quality of service to an increasing number of clients while charging a competitive price and maintaining operational efficiency.

Outreach

In 2004, the institutions sampled served over 1.5 million borrowers. Outreach, however, varied significantly across institutions. With an average of 148,317 active borrowers, large scale institutions served four and ten times as many borrowers as medium and small institutions, respectively, as Figure 2 indicates. The group of large scale MFIs, which includes just seven institutions, dominated the market, managing 81 percent of the overall loan portfolio and serving 67 percent of borrowers. The three largest institutions, which alone covered 54 percent of borrowers, are all non-bank finance companies that are based in South India. Medium and small scale MFIs, on the other hand, span the range of institutional forms, are spread across the country and tend to provide a variety of services, including non-microfinance services.

Figure 2: Average MFI outreach by scale

Scale	Average GLP (USD)	Average Number of Active Borrowers
Large	18,870,488	148,317
Medium	2,562,681	35,180
Small	504,053	13,884

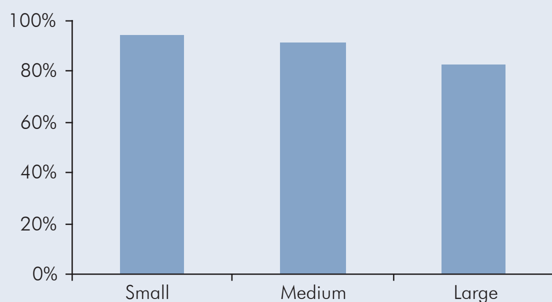
Source: MIX Market 2004 data as of October 18, 2005. Data presented are averages. GLP: gross loan portfolio.

Over the period studied, outreach in the sector more than doubled; the number of borrowers served grew by 108 percent while the loan portfolio increased by 139 percent. Young institutions, established between 1990 and 1995, grew the fastest, expanding their number of borrowers by 160 percent on average. New and mature institutions also grew, albeit at more modest rates of 60 and 53 percent, respectively. Large MFIs, by age, mostly fall in the middle-age group. These institutions counted some of the fastest growing MFIs in the sample and added over half a million new borrowers (i.e. 72 percent of new outreach).

The share of women borrowers in the sample provides evidence that the Indian sector remains very targeted in its service delivery. At 90 percent, MFIs are heavily focused on women clients. Among new MFIs, virtually all clients are women. For the other age groups, the percentage of women borrowers is around 85

percent, suggesting that as institutions age they tend to broaden their coverage. As Figure 3 illustrates, the share of women borrowers also varies by scale, decreasing from 94 and 92 percent for small and medium scale institutions, respectively, to 85 percent for larger ones. Variations in loan products and service methodologies may help explain differences across peer groups. In particular, as larger scale institutions begin to diversity their product offering, including individual loans which generally attract more male clients than group loans, the resulting concentration in women borrowers drops. Regardless, Indian MFIs still remain highly focused on women borrowers, by both regional and global standards.

Figure 3: Share of women borrowers by scale



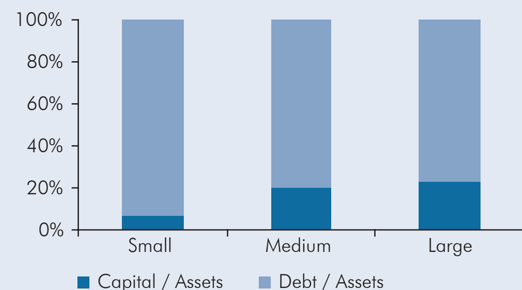
Source: MIX market 2004 data as of October 18, 2005. Data presented are averages.

Financial Structure

Sources of MFI funds have changed significantly with growth. Many MFIs started with small core funds provided by donors. As in many other countries, most of the organizations engaged in microfinance evolved from the voluntary or NGO movement, hence the use of donor grants to capitalize initial microcredit services. The Indian sector, however, began to shift toward borrowings when SIDBI started providing loans to MFIs. Growth and policy incentives additionally drew commercial capital into the sector. Today, banks are aggressively providing loans to MFIs based on organizational robustness and financial performance.

With just 11 percent of assets funded by equity in 2005, MFIs mainly operate on borrowed funds, as Figure 4 makes evident. Large institutions are the most capitalized and fund 21 percent of assets with equity. Most of these institutions are non-bank finance companies and thus possess formal shareholder structures that allow them to attract equity investments and lower their cost of capital. Moreover, they are generally profitable and are able to capitalize retained earnings. Nonetheless, they too rely on loan funds for most of their financing.

Figure 4: Funding structure by scale



Source: MIX Market 2004 data as of October 18, 2005. Data presented are averages.

Such funds are available from a variety of refinance institutions and wholesale providers such as Friends of Women's World Banking, which also provides capacity building support. The involvement of these institutions in the microfinance sector has undergone a sea change over the last five years. Initially, only a few MFIs could access funds from these sources, particularly commercial banks. Over time, however, perceptions of lending to MFIs began to change as bank managers realized that it could be a profitable way to fulfill their priority sector targets. Along with SIDBI and other refinancers, commercial financial institutions have become the predominant providers of bulk funds to MFIs.

The upsurge in partnerships between banks and MFIs has led to numerous innovations in financing arrangements. ICICI Bank, for example, provides partner institutions with funds to manage on its behalf, so that the MFI manages credit operations while the portfolio continues to be owned by the bank. Such arrangements allow MFIs to significantly expand outreach while lowering their cost of funds and not impacting their balance sheets.

Savings are a less important source of funds in the Indian microfinance sector, namely because few institutions are authorized to collect deposits. Those that do, however, rely heavily on savings. Pushtikar, a cooperative, finances 71 percent of its assets through member savings. As mentioned earlier, a few MFIs, registered as societies, collect mandatory savings as a condition for membership or access to loans. Some, however, have discontinued this practice and are beginning to help clients deposit their savings with banks.

Financial Performance

MFIs manage their assets well and, on average, invest more than four fifths of their total resources in the loan portfolio, their most productive asset. While small institutions do not generate sufficient revenues to cover costs, both large[5] and medium institutions have attained profitability and sustainability. As Figure 5 indicates, there is a clear correlation between MFI profitability and scale. While most MFIs are close to attaining full operational self-sufficiency, large institutions have exceeded the mark. Unlike their peers, large MFIs concentrate on providing credit services, which has enabled them to shore up their sustainability. Institutions that have clearly defined their products and have streamlined field staff functions with strong internal systems have been able to attain financial sustainability.

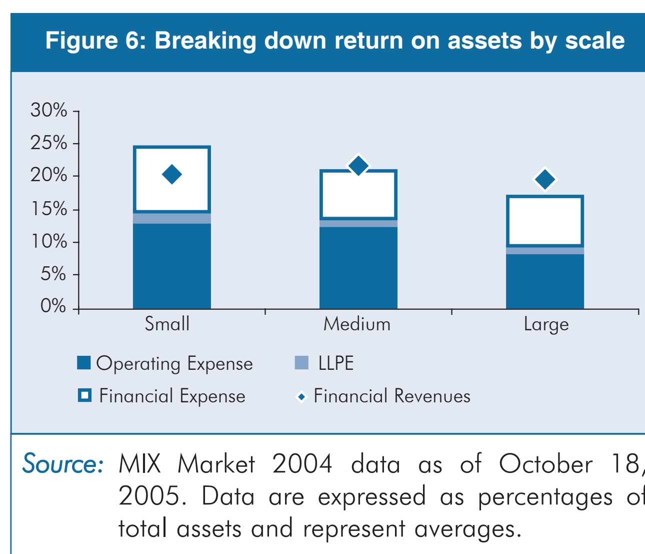
Figure 5: Sustainability by scale

Scale	Return on Assets	Return on Equity	Operational Self-Sufficiency
Large	2.3%	21.0%	123.0%
Medium	0.7%	26.0%	104.8%
Small	-4.3%	-56.6%	83.7%

Source: MIX Market 2004 data as of October 18, 2005. Data presented are averages.

MFI revenue and cost structures help shed light on variations in financial performance. A quick glance at Figure 6 shows that while financial revenues hardly vary across MFIs, large institutions benefit from lower expense structures than the rest of the sector, allowing them to generate more profits. Medium institutions generate higher financial revenues than large institutions, but their operational costs are significantly higher, suggesting that strengthening their operational systems and reining in costs are key to enhancing their profitability. Small MFIs, on the other hand, would greatly benefit from allocating more of their assets to the loan portfolio since, at 81 percent, their asset utilization is less efficient than that of large institutions, which allocate 89 percent of assets to credit activities.

Figure 6: Breaking down return on assets by scale



Source: MIX Market 2004 data as of October 18, 2005. Data are expressed as percentages of total assets and represent averages.

Efficiency and Productivity

The Indian microfinance sector is among the most efficient and productive in South Asia. In 2004, the average Indian MFI spent less than two thirds of the amount that it cost the average South Asian institution to serve each borrower. Moreover, whereas the average South Asian MFI served 219 borrowers per staff member, Indian institutions reached 439 borrowers per staff member.

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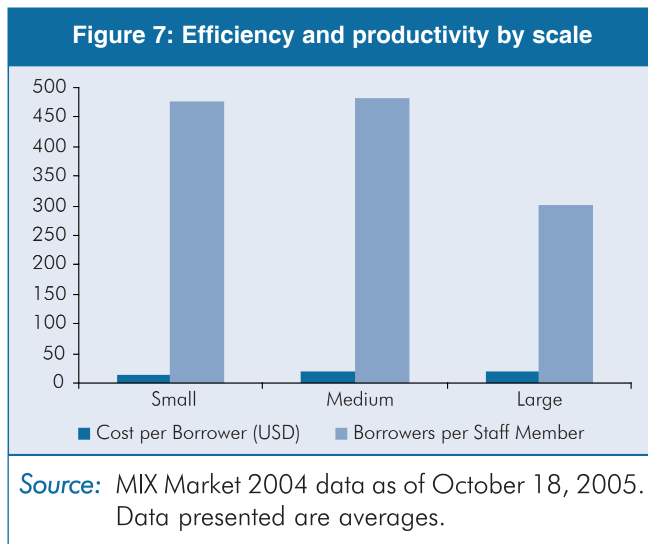
5 One large outlier institution was dropped from the analysis on financial performance.

Figure 7: Efficiency and productivity by scale



Source: MIX Market 2004 data as of October 18, 2005. Data presented are averages.

As Figure 7 indicates, medium institutions are the most productive, serving 481 borrowers per staff member. Large institutions are less productive due to their greater focus on individual credit, which requires that staff members allocate more time to serving individual clients. Individual loans, however, tend to be of larger sizes, thus allowing large institutions to reduce their cost per dollar outstanding. In 2004, these institutions spent just 13 cents to maintain one dollar in loans outstanding whereas medium and small institutions spent 17 and 16 cents, respectively. Small institutions, however, had the lowest cost per borrower, as Figure 7 illustrates. By relying on group loan methodologies, these institutions were able to reach a large number of borrowers while minimizing personnel, transportation and other related costs.

In brief, while smaller institutions had higher productivity and lower costs per borrower, the data indicate that large MFIs were able to manage their costs more effectively. MFIs can significantly enhance their financial performance by minimizing idle funds, limiting operational costs and improving portfolio quality.

Portfolio Quality

With four percent of their portfolio at risk over 30 days, Indian MFIs maintain good portfolio quality. Within the sector, portfolio quality improves with scale. Institutions with better portfolio quality benefit from longer credit history of clients and better operational systems to monitor loan clients. As operational systems tend to improve with scale, so does portfolio quality. At three percent, large institutions thus display the best portfolio quality, followed by medium institutions (four percent) and small institutions (five percent).

Across MFIs, large or small, bad loans are provided for through write-offs and loan loss reserves. These practices are driven by funders such as SIDBI and banks as well as through credit risk ratings. Knowledge of best practices in maintaining portfolio quality is also being strengthened by Sa-Dhan, the national MFI network association, through its work on performance standards and disclosures.

Conclusion

Tighter management has enabled MFIs to significantly expand outreach while improving efficiency in their operations. This is being achieved by securing operational depth in existing locations and optimizing use of funds and staff. Improved performance across the sector has encouraged mainstream financial institutions such as banks to increasingly collaborate with MFIs by providing them with bulk funds. Access to a larger pool of funds has fueled additional growth in the sector and provided MFIs with more incentives to improve management and performance.

But challenges remain. The immediate challenge is to reduce operational costs and increase capitalization, especially as MFIs continue to grow. MFIs have proved to be efficient delivery channels, but as institutions, they still need to improve operational efficiency, namely by reducing costs. Early evidence is demonstrating that financial and operational costs are declining, but the challenge is to reduce expense levels among medium and small MFIs, making them more comparable to large, profitable institutions.

In the long term, a more appropriate regulatory framework would enable MFIs to better meet the demands of the poor for credit as well as savings, insurance and remittance services. Such a framework would also enable prudential and non-prudential norms to be practiced with increased uniformity across MFIs, hence improving the scope of performance comparisons across institutions.

Transparency Environment in India

Indian microfinance is characterized by a diversity of operating models, legal forms and financing arrangements, resulting in significant variation in the depth and breadth of financial disclosure across institutions. While a representative picture exists of MFI outreach and geographical coverage, little is known about the sector's overall financial performance. In the case of SHGs, even basic information on outreach is unavailable. Outside of leading institutions, few MFIs follow global financial disclosure guidelines for microfinance. Efforts, however, are underway to improve financial reporting and increase knowledge of institutional performance in the sector. Sa-Dhan has been working on enhancing transparency in the sector through the promotion of standards and improved financial reporting norms. Low penetration rates, however, suggest that these standards are still in the advocacy and dissemination stage; of the 42 institutions that provided data for this study, fourteen were excluded from the analysis due to unreliable or incomplete financial data.

The following sections outline the main features of the transparency environment in the Indian microfinance sector, highlighting achievements and opportunities for further improvement.

State of Transparency

The dissemination of global industry reporting norms[6] has been largely successful among leading institutions with significant international exposure. In an attempt to further transparency throughout the sector, Sa-Dhan pioneered the establishment of financial performance standards for MFIs, addressing the three core areas of sustainability, asset quality and efficiency. Sa-Dhan has published a technical manual explaining the concept and practice of these standards and has since been actively engaged in promoting them among institutions.

While many institutions find it difficult to comply with these guidelines, large MFIs are already benchmarking their performance to Sa-Dhan recommended financial standards. These institutions are able to provide Sa-Dhan with analytical data covering essential aspects of their financial performance. In the case of smaller MFIs, however, Sa-Dhan must extract financial performance ratios from their raw data.

Sa-Dhan's initiative has nonetheless contributed to the adoption of financial standards by a number of MFIs, propelling the network to start publishing MFI data from both members and non-members. Sa-Dhan's annual report, *Side by Side - A Slice of Microfinance in India*, covers financial and program features of MFIs and presents results in aggregate form. Since its initial publication in 2004, Sa-Dhan has expanded coverage from 53 to 62 institutions.[7] In improving transparency, Sa-Dhan aims to enhance loan terms and increase the pool of commercial funds available to MFIs. Its reports also feed into policy and advocacy work for the sector and raise awareness among policymakers, government officials and other stakeholders.

CARE India, a support institution for MFIs, also publishes performance reports. The organization works to enhance MFI performance and facilitate linkages with banks. In covering outreach and core financial data of its 25 partner institutions, CARE India draws indicators from Sa-Dhan recommended financial performance standards.

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[6] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

[7] Of the 53 institutions covered in the September 2004 report, only 42 were included in the analysis of financial performance. The March 2005 report did not cover the same set of financial indicators, but of the 62 participating institutions, 52 provided information on risk management.

The most extensive information on the microfinance sector, however, is held by neither Sa-Dhan nor CARE India, but by refinance institutions and credit risk rating firms. NABARD and SIDBI both collect basic survey data on their partner MFIs such as location, outreach and gross loan portfolio. SIDBI covers a little over 40 institutions while NABARD collects data on hundreds of institutions involved in its SHG Bank Linkage Program. SIDBI's data collection, however, is more thorough and extensive as it requires that its partner institutions undergo ratings in order to access funds. While neither institution provides public access to its database, both include microfinance aggregate data as a component of their annual reports.

Through its funding requirements, SIDBI has significantly contributed to demand for ratings by microfinance institutions, thus enhancing transparency in the sector. NABARD has recently followed suit with the establishment of the MFI Grading Scheme, whereby it agrees to fund ratings of small and medium-sized institutions with the purpose of increasing the amount of bank credit available to them. For a rating to be meaningful there must be a common standard that is uniformly applicable to all MFIs, and the methodology and results should take into account the nuances of the field. M-CRIL and CRISIL staff have been trained in the specifics of microfinance operations and are both accredited by the international microfinance Rating Fund. In addition to using global standards to evaluate financial performance, these firms also delve into management and governance structures. Given the large number of institutions seeking ratings, M-CRIL and CRISIL hold a wealth of information on MFI performance in India which they build on to produce their sector reports. Ratings have moreover contributed to the dissemination of best practice reporting norms. Institutions that have undergone regular ratings are able to better track their portfolio quality and produce statements that separate their microfinance operations from other activities.

Audited financial reports constitute an additional source of information on MFI performance and

Excerpts from Budget Speech of 2005 by the Finance Minister, Government of India[8]

The programme of linking Self Help Groups (SHGs) with the banking system has emerged as the major micro-finance programme in the country. 560 banks including 48 commercial banks, 196 RRBs [regional rural banks] and 316 cooperative banks are now actively involved in the programme. I propose to enhance the target for credit-linking in the next fiscal from 2 lakh SHGs to 2.5 lakh[9] SHGs.

At present, microfinance institutions (MFIs) obtain finance from banks according to guidelines issued by RBI. MFIs seek to provide small scale credit and other financial services to low income households and small informal businesses. Government intends to promote MFIs in a big way. The way forward, I believe, is to identify MFIs, classify and rate such institutions, and empower them to intermediate between the lending banks and the beneficiaries. Commercial banks may appoint MFIs as "banking correspondents" to provide transaction services on their behalf. Since MFIs require infusion of new capital, I propose to re-designate the existing Rs.100 crore Micro Finance Development Fund as the "Micro Finance Development and Equity Fund", and increase the corpus to Rs.200 crore[10]. The fund will be managed by a Board consisting of representatives of NABARD, commercial banks and professionals with domain knowledge. The Board will be asked to suggest suitable legislation, and I expect to introduce a draft Bill in the next fiscal year.

I propose to request RBI [Reserve Bank of India] to open a window to enable qualified NGOs engaged in microfinance activities to use the External Commercial Borrowing (ECB) window. Detailed guidelines containing necessary safeguards will be issued by RBI.

[8] Union Budget & Economic Survey, http://indiabudget.nic.in/ub2005-06/bs/speecha.htm.
[9] 2 lakh and 2.5 lakh are 200,000 and 250,000, respectively.
[10] Rs. 100 crore and Rs. 200 crore are Rs. one billion (USD 23 million) and Rs. two billion (USD 46 million), respectively.

provide an institutional insight into financial assets and operations of an organization. Indian MFIs are incorporated institutions, and one of the conditions of incorporation laws is that qualified public accountants audit the institutions' annual accounts. Reporting requirements, however, vary significantly by legal form. Non-bank finance companies and banks are supervised by the central bank, the Reserve Bank of India (RBI), and must follow rigorous reporting requirements. They thus produce financial statements of generally better quality than other MFI types and include disclosures that more accurately portray their financial position. In addition to statutory requirements, donors and refinance institutions selectively specify a separate set of disclosure requirements based on their respective institutional needs. Presently, disclosure norms are not adequately attuned to the specifics of the microfinance sector. While these norms cover basic financial information, disclosures that capture the essence of microfinance operations are not publicly mandated. The proposed regulatory initiative of the government is expected to fill this gap.

India does not have an umbrella body for regulating the microfinance sector, partly explaining why audit quality varies significantly by MFI legal form. As incorporated institutions, MFIs are institutionally regulated under law, but they come under the supervision of various bodies, including RBI and the Company Law Board. Recently, however, there has been some movement to create a uniform body of regulation for MFIs. The latest annual budget speech of the finance minister gives an indication to this effect.

Successful Initiatives in Building Transparency

Sa-Dhan's initiative to develop MFI-specific financial performance standards and reporting norms is expanding the scope of transparency. The manual on financial standards is being widely used in the microfinance sector as a set of best practices, and MFIs are coming forward to share data according to their norms. A few MFIs are additionally able to benchmark their financial performance against industry standards and compare their performance to other institutions. Currently, Sa-Dhan is actively working with RBI and commercial banks to facilitate the adoption of best practices in management policies and bank-MFI partnerships.

NABARD has recently established the MFI Grading Scheme in partnership with CRISIL. In the context of this initiative, small and medium-sized MFIs and their potential bank partners are reimbursed for the professional fee of obtaining an MFI grading from CRISIL. The institution must serve at least 1,000 active clients or have a loan portfolio of no less than INR 5 million and no greater than INR 50 million.[11] In addition to increasing the flow of bank credit into the microfinance sector, this scheme aims to improve institutional knowledge of strengths and weaknesses and contribute to MFI management.

Opportunities for Building Transparency

The standardization of data management is the ultimate challenge to increased transparency in the sector. The diverse nature of data collection and processing arises from the diversity of the sector. Standardizing data collection and analysis would help MFIs process their data in less time and allow for institutional comparisons across the sector as well as on the global stage. This standardization would require enhancing the management information systems (MIS) of a large number of institutions in order to capture necessary data for reporting requirements. Moreover, staff would require training in data analysis to ensure accurate and regular interpretation of data. The greatest challenge, however, is to capture the institutional and operational diversity of the sector while producing performance data in a uniform manner.

In India, the statutory provisions frame institutional disclosures and transparency; audit disclosures largely stem from statutory provisions. For non-bank finance companies, for example, RBI regulations provide specific disclosure guidelines on issues such

[11] INR 5 million = USD 114,700 ; INR 50 million = USD 1,145,050.

as loan loss provisioning and appropriation of surpluses, providing the framework for more informative financial statements. The government is actively engaged in exploring a regulatory framework specific to MFIs which could have the potential to improve financial statement disclosure and reporting.

Conclusion

The issue of transparency is especially important in the Indian microfinance context. The sector is expanding at a fast rate, banks are increasingly building partnerships with microfinance providers, and MFIs are being managed with increasing professionalism. MFIs should build on their programmatic strengths to improve practices relating to both prudential and non-prudential aspects of their operations.

Transparency within the sector would secure better understanding by the government of the issues and contribution of MFIs in alleviation of poverty. Operationally, transparency would result in better terms and tenure of partnerships with banks and investors.

The government, statutory bodies, apex development financial institutions and networks can undertake distinct roles to help MFIs perform optimally. The government could provide a specific regulatory framework that addresses the particular needs of microfinance providers; statutory bodies could provide supervisory guidelines and establish reporting requirements that adhere to global industry standards; apex institutions and banks could provide MFIs with better partnership terms and conditions, allowing them to better manage their costs, revenues and operations; networks could more actively pursue advocacy work related to the regulatory and supervisory environment while building MFI capacity and facilitating sustainability.

Clearly, the scores of unreached poor provide the greatest challenge to the microfinance industry. Improved transparency at the sectoral and institutional levels would provide an enabling environment for MFIs to operate on a sustainable basis and meet the challenge of reaching India's poor.

Nepal

Formal microfinance emerged in Nepal in 1956 as cooperatives began to provide savings and microcredit services to their members. Recognizing the larger need for microfinance services, the government soon became actively involved in promoting the sector. In 1974, Nepal's central bank, Nepal Rastra Bank, directed the then two state-owned commercial banks to invest at least five percent[1] of their total deposits in small scale finance. Shortly after, the Agriculture Development Bank of Nepal launched the Small Farmers Development Project, which was the first to introduce the concept of group guarantee as an alternative to physical collateral in Nepal. During the 1990s, the number of microfinance providers operating in the country increased dramatically as local NGOs and microfinance development banks entered the market.

Today, there are three major types of microfinance institutions in Nepal: savings and credit cooperatives, NGOs and microfinance development banks. As of July 2004, Nepal counted 2,345 savings and credit cooperatives. Twenty of these institutions received approval from Nepal Rastra Bank to provide financial services beyond credit and savings, but only to members. In addition to cooperatives, thousands of NGOs operate in the microfinance sector. Rather than provide direct financial services, these institutions facilitate the formation of small groups that generate internal resources through member savings and use the funds to make loans to members. NGOs will occasionally provide seed money to the groups, but that is the extent of their financial support. The groups often disintegrate when the NGO programs that promoted them come to an end and cease to provide necessary training and technical assistance. Some, however, are able to become sustainable and generally transform into savings and credit cooperatives. A small set of NGOs, forty-seven in all, are registered as financial intermediary NGOs and provide direct microfinance services to clients. Twenty-two development banks currently operate in Nepal, and eleven focus exclusively on microfinance services. Within these eleven, two provide wholesale lending to MFIs and nine provide retail services. Of the retail microfinance development banks, five were promoted by the government in each of the development regions in Nepal, while the remaining four were promoted by private individuals or institutions.

All microfinance institutions in Nepal provide credit and two types of savings services – mandatory and voluntary savings. Mandatory savings are collected as a condition for membership or access to credit. Most microfinance development banks offer between four and ten standardized loan products whereby clients move from cycle to cycle with increased loan amounts in every subsequent cycle. In the case of cooperatives and financial intermediary NGOs, the practice is also to start from smaller loans and move on to higher amounts, but loan products are generally not standardized. Microfinance development banks and cooperatives have recently introduced microinsurance services, and a handful of microfinance institutions have started providing money transfer services as well.

The model of service delivery employed differs from region to region. In the plain, low-land area, where population density is high, Grameen methodology

[1] Currently, Nepal Rastra Bank requires commercial banks to invest three percent of their total deposits in "deprived sector" lending.

and group loans are dominant. In remote hill areas, self help groups and individual loans become more prevalent. To obtain individual loans, clients are sometimes required to provide physical collateral or a guarantor.

It is estimated that over 2.1 million[2] households in Nepal live near or below the poverty line and require microfinance services. While it continues to fall short of demand, microfinance supply grew significantly over the last decade and reached nearly 700,000 clients by 2003.[3] Estimates of current household microcredit needs vary by region but are believed to average USD 100, making the effective unmet demand for credit roughly USD 140 million.

Methodology

The Centre for Micro Finance (CMF) collected data on eight leading microfinance institutions (MFIs) for this study. The sample covers the three dominant types of institutions and includes one savings and credit cooperative, one financial intermediary NGO and six microfinance development bank – two state-owned and four private. MFIs were targeted on the basis of outreach and had to be capable of providing most, if not all, of the information needed for performance analysis. Since microfinance development banks were better able to provide necessary data, they are overrepresented in the sample. Self-reported outreach and financial data were collected for 2003 and 2004.[4] Financial data were then reclassified according to international reporting standards for microfinance and cross-referenced against audited statements. CMF also conducted on-site visits to the institutions to ensure data consistency.

Data-gathering remains a cumbersome process in Nepal. MFIs use different accounting practices and management information systems packages, so they do not produce data in a similar format. Moreover, auditors are generally not familiar with best practice reporting for microfinance. Despite these challenges, data collection for this study went smoothly as participating MFIs were highly positive and willing to share data and provide further details when necessary.

Performance of Nepalese Microfinance Institutions

The Nepalese microfinance sector has reached one third of estimated demand for microfinance services and has built on external borrowings and client deposits to fund a steadily growing loan portfolio. Despite its high leverage, the sector continues to benefit from low cost structures, namely on account of high staff productivity and government provisions requiring that commercial banks invest a portion of their deposits in small scale finance. Today, the main challenge to future growth stems from poor portfolio quality.

Outreach

The eight MFIs selected for this analysis cover a substantial share of the current microfinance

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2 In its March 2005 Quarterly Economic Update, the Nepal Resident Mission of the Asian Development Bank estimates that 38 percent of Nepal's 24.8 million people are living below the poverty line. Given that the average family size is 5.6 members, these figures amount to 1.7 million poor households that may be in need of microfinance services. An additional 0.4 million families living near the poverty line may also require these services, raising effective demand to 2.1 million households.

3 Centre for Micro Finance, Directory of Microfinance Institutions (MFIs): http://www.cmfnepal.org/mfdirectory/index.html.

4 MIX standardizes financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For MFIs closing accounts in July, this refers to July 2003 and July 2004.

market. Of the overall 700,000 clients reached by the sector, the institutions in the sample served 190,000 clients, representing one third of total outreach in Nepal. Since savings are often tied to membership or access to loans, the microfinance industry served more savers than borrowers, though outreach to the latter was also significant. The sample MFIs managed over USD 17 million in loans outstanding, covering almost one third of the USD 62 million in total loans outstanding[5].

Cooperatives tend to be much smaller than microfinance development banks or financial intermediary NGOs. As Figure 1 indicates, outreach within the sample ranges from 2,136 clients for VYCCU Cooperative to an average of 30,064 in the case of microfinance development banks. Cooperatives may register with as little as twenty-five members and generally have fewer than 100 members. Hence, compared to the average cooperative, VYCCU is fairly large. The sample NGO is the second smallest in outreach, but with 7,380 clients, it is one of the largest financial intermediary NGOs in Nepal. Microfinance development banks are similar in size except for younger, recently-established ones, which tend to be smaller.

Between 2003 and 2004, the number of active borrowers and the overall loan portfolio both increased by seven percent. As a group, private microfinance development banks grew the most, with their total number of borrowers and savers increasing by fifteen and nineteen percent, respectively. In the case of state-owned institutions, outreach actually declined, albeit slightly – both in the number of borrowers and the number of savers. This drop was mainly due to increasing competition from other microfinance providers and especially from private microfinance development banks.

As Figure 2 shows, the highest growth took place in CBB (private microfinance development bank) and NSSC (financial intermediary NGO). CBB's number of borrowers increased by 75 percent while the number of savers grew by 59 percent. NSSC's growth was somewhat slower, but nonetheless remarkable: a 58 percent increase in the number of borrowers and a 64 percent rise in the number of savers. NSSC promoted the formation of CBB, and the two MFIs continue to work in close coordination with each other. Both institutions are relatively young and are able to attain higher growth by operating in more remote geographical areas where competition is less intense.

Figure 1: MFI outreach

MFI	Institutional Type	Number of Active Clients / Savers	Number of Active Borrowers	Gross Loan Portfolio (USD)
CBB	Private MFDB	11,682	9,043	998,269
DD Bank	Private MFDB	12,640	10,036	1,187,516
Nirdhan	Private MFDB	44,862	32,678	3,734,041
SBB	Private MFDB	34,031	26,322	2,588,121
MGBB	State-owned MFDB	37,198	36,242	3,255,864
PGBB	State-owned MFDB	39,972	36,645	4,611,116
NSSC	FINGO	7,380	5,747	526,876
VYCCU	Cooperative	2,136	1,411	430,326

Source: MIX Market 2004 data as of October 24, 2005. MFDB: microfinance development bank; FINGO: financial intermediary NGO.

5 Nepal Rastra Bank, "Banking and Financial Statistics", http://www.nrb.org.np/ > Statistics, Mid January 2004.

Figure 2: Growth trends in outreach

MFI	Institutional Type	Number of Active Borrowers			Number of Active Clients / Savers		
		2003	2004	Growth	2003	2004	Growth
CBB	Private MFDB	5,158	9,043	75.3%	7,327	11,682	59.4%
DD Bank	Private MFDB	7,916	10,036	26.8%	10,362	12,640	22.0%
Nirdhan	Private MFDB	27,457	32,678	19.0%	34,817	44,862	27.3%
SBB	Private MFDB	27,275	26,322	-3.5%	33,948	34,031	0.2%
MGBB	State-owned MFDB	36,274	36,242	-0.1%	37,351	37,198	-0.4%
PGBB	State-owned MFDB	38,941	36,645	-6.0%	40,140	39,972	-0.4%
NSSC	FINGO	3,639	5,747	57.9%	4,512	7,380	63.6%
VYCCU	Cooperative	1,317	1,411	7.1%	1,906	2,136	12.1%
Overall Sample		**147,977**	**158,124**	**6.9%**	**170,363**	**189,901**	**11.5%**

Source: MIX Market data as of October 24, 2005. MFDB: microfinance development bank; FINGO: financial intermediary NGO.

The data suggest that microfinance development banks and NGOs target their services more so than cooperatives, as Figure 3 makes evident. Their average loan balance per borrower centered around 35 to 46 percent of per capita gross national income, compared to 117 percent in the case of the cooperative. Microfinance development banks and the three largest NGOs offer standardized loan products with ceilings for each cycle whereas cooperatives do not impose such restrictions. Moreover, cooperatives tend to be more geographically based and provide services to the local community regardless of individuals' wealth status. In the case of savings, the cooperative also holds the highest balance per saver – USD 206 compared to USD 3 to 38 for the other institutions. Cooperatives, more so than other institutions, primarily draw their resources from member savings.

Figure 3: Depth of outreach

MFI	Institutional Type	Average Balance per Borrower (USD)	Average Balance per Borrower / GNI per capita	Average Balance per Saver (USD)	Average Balance per Saver / GNI per capita
CBB	Private MFDB	110	42.5%	25	9.5%
DD Bank	Private MFDB	118	45.5%	18	6.9%
Nirdhan	Private MFDB	110	42.2%	3	1.1%
SBB	Private MFDB	98	37.8%	38	14.6%
MGBB	State-owned MFDB	90	34.6%	30	11.4%
PGBB	State-owned MFDB	126	48.4%	30	11.7%
NSSC	FINGO	92	35.3%	26	9.9%
VYCCU	Cooperative	305	117.3%	206	79.4%

Source: MIX Market 2004 data as of October 24, 2005. MFDB: microfinance development bank; FINGO: financial intermediary NGO; GNI: gross national income.

Most microfinance development banks use participative wealth ranking as a tool for targeting very poor clients. Three large financial intermediary NGOs that replicate Grameen methodology also employ this targeting tool for screening purposes. Cooperatives, on the other hand, and some of the smaller NGOs do not generally use any targeting tools. In principle, cooperatives cannot deny membership on the basis of wealth; many NGOs are also reluctant to refuse individuals from joining the group on the basis of wealth. Hence, these MFIs often have larger average loan balances and must refer to individual loan sizes to determine the amount of their portfolio that is composed of microloans.

Women generally lack access to formal financial services, but, except for VYCCU, all MFIs in the sample target women. At 99 percent, the share of female borrowers is exceptionally high in this study and does not reflect the general situation in Nepal. All Grameen-replicating microfinance development banks, both private and state-owned, focus exclusively on women. While some cooperatives are owned and managed by women, the large majority have mixed membership. Financial intermediary NGOs also serve both genders. These MFIs do not distinguish between men and women in terms of loan size, interest rate or repayment schedule. However, individual loans are often inaccessible to women as these sometimes require physical collateral that poor women generally lack.

Financial Structure

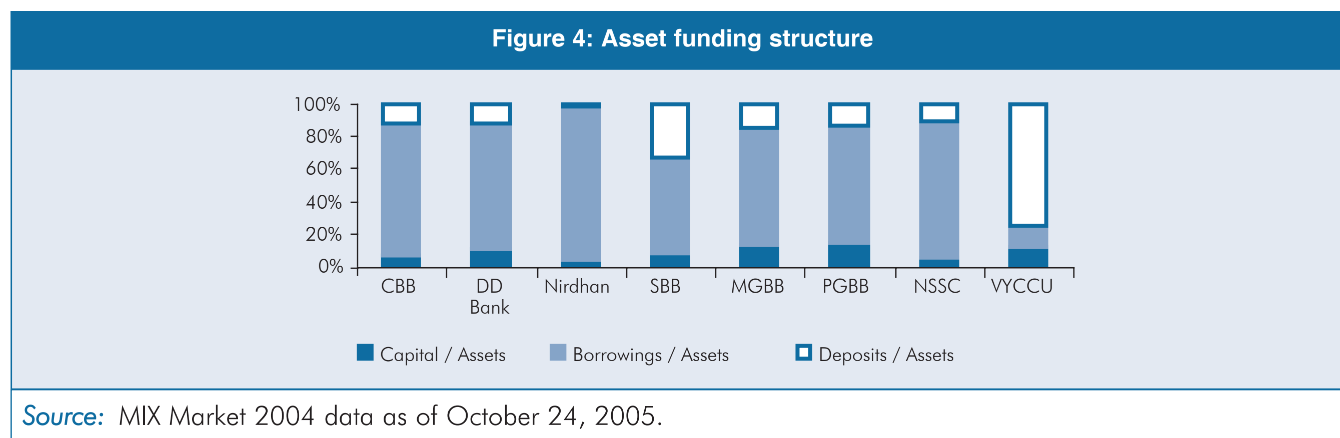
All institutions in the sample are leveraged and rely heavily on borrowings and client savings to finance their activities. While MFIs around the world tend to depend on equity, Nepalese MFIs obtain 91 percent of their funds through liabilities, as Figure 4 indicates. On average, MFIs fund 70 percent of their assets through borrowings from banks and wholesale institutions and 21 percent through client deposits. Of all MFI types, cooperatives rely the most on member savings, whereas NGOs and microfinance development banks tend to obtain the bulk of their funds from borrowings. All borrowings come from either wholesale lending institutions or from Nepalese commercial banks that lend to MFIs in order to fulfill their "deprived sector" lending requirements.

Financial Performance

Most MFIs cover costs before taxes irrespective of institutional type. There is very little variation in operational self-sufficiency, which is over 100 percent for all MFIs but one – CBB (97 percent). The average return on assets is one percent, with three MFIs operating at a slight loss. Institutions that generate higher returns on assets do so in very different ways. SBB relies on higher interest rates to generate higher financial revenues, while VYCCU Cooperative benefits from a lower cost structure that allows it to generate positive returns. Because of lower personnel costs, cooperatives are able to generate positive returns on assets while maintaining interest rates at very low levels. Cooperatives also tend to invest more of their resources in their most productive asset, their loan portfolio.

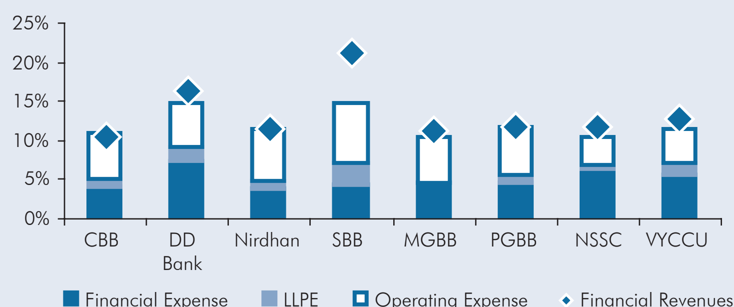
Revenue and expense structures are strikingly similar across MFIs, as Figure 5 illustrates. With two exceptions, financial revenues constitute between 11

Figure 4: Asset funding structure



Source: MIX Market 2004 data as of October 24, 2005.

Figure 5: Breaking down return on assets



Source: MIX Market 2004 data as of October 24, 2005. Data are expressed as a percentage of total assets.

and 13 percent of average assets while the expense ratio ranges from 11 to 15 percent. The institution with the highest revenue not only charges a higher interest rate but also invests more of its assets in the loan portfolio (66 percent) than the average sample MFI (52 percent). Operating expenses remain the highest costs for MFIs, followed by financial expense and loan loss provision expense.

There are no legal restrictions on the interest rate that MFIs can charge on their loans. Cooperatives are usually found to charge lower interest rates than other microfinance providers, largely because they pay their staff below market rates and are thus able to maintain low operating costs. Moreover, members of cooperatives tend to exert significant pressure on their boards to further lower rates, hence preventing them from reaching levels charged by other institutions. Their financial expense, however, tends to be rather high as they generate most of their funds through member savings and pay higher interest rates on deposits than commercial banks do.

Through their better access to share capital, state-owned microfinance development banks are able to lower their financial costs. Thanks to significant state investments, these institutions are less dependent on commercial borrowings than their privately-owned peers and thus have lower financial costs. Private microfinance development banks are nonetheless able to borrow at below market rates as there is a provision for commercial banks to invest three percent of their total deposits in "deprived sector" lending.

Since most microfinance development banks operate in similar geographical areas, their costs of delivering services do not vary significantly. Cooperatives tend to operate in remote areas, but their costs are not high as they often employ members on a voluntary or part time, partial pay basis. It would thus appear that differences in cost structures across institutions are the result of differences in staff productivity.

Efficiency and Productivity

Nepalese microfinance providers are both productive and efficient in managing their resources. Nepalese MFIs serve fewer borrowers than the average South Asian MFI – 152 compared to 219 – but their productivity exceeds that of other regions, where staff members reach an average of 124 borrowers. As a group, private microfinance development banks are the most productive, as Figure 6 indicates. Organizational culture distinguishes these institutions from their state-owned peers, where a large equity base and state ownership provide staff with significant job security and make them somewhat complacent. In the case of private institutions, jobs are tied to staff performance, hence the drive to attain higher productivity. State-owned institutions, however, are increasingly realizing the need to improve productivity.

In addition to being productive, the Nepalese microfinance sector is also efficient and surpasses the region in minimizing the cost of service delivery. It costs the sample institutions just twelve cents to maintain one dollar in loans outstanding, compared to twenty-two cents for the average South Asian MFI. With the exception of VYCCU Cooperative, the MFIs in the

Figure 6: Efficiency and productivity					
MFI	Institutional Type	Clients / Savers per Staff Member	Borrowers per Staff Member	Cost per Borrower (USD)	Operating Expense / Loan Portfolio
CBB	Private MFDB	220	171	18	15.7%
DD Bank	Private MFDB	258	205	9.6	8.3%
Nirdhan	Private MFDB	179	131	14	12.8%
SBB	Private MFDB	218	169	10.1	10.2%
MGBB	State-owned	148	144	12.1	13.4%
PGBB	State-owned	171	157	15	12.0%
NSSC	FINGO	172	134	12.8	13.9%
VYCCU	Cooperative	153	101	16.5	5.7%

Source: MIX Market 2004 data as of October 24, 2005. MFDB: microfinance development bank; FINGO: financial intermediary NGO.

sample have similar costs per dollar outstanding. VYCCU is able to achieve higher efficiency as a result of its lower operating costs and larger loan sizes.

Portfolio Quality

It is difficult to determine portfolio quality in Nepal since most MFIs do not track portfolio at risk until loans are three months overdue; global industry reporting norms suggest that loans be considered at risk once an installment is 30 days overdue. Moreover, financial intermediary NGOs and the smaller cooperatives generally lack the management information systems (MIS) capacity to track the aging of their portfolio. Hence, three of the eight MFIs in the sample were unable to provide their portfolio at risk over 30 days. Over the last few years, however, the industry has become increasingly aware of the importance of tracking portfolio risk and some institutions have started to track this information manually.

Average portfolio at risk over 30 days among the five MFIs that were able to provide these records is rather high (6.2 percent) but compares favorably to the regional average (7.6 percent). With an average five percent of their portfolio at risk, private microfinance development banks are faring better than the state-owned institution that provided this data (8.4 percent). As with productivity, organizational culture may be a key determinant of portfolio quality.

Writing off delinquent loans currently remains a taboo practice in Nepal among microfinance providers. As a result loan loss rates reported by most institutions likely understate actual portfolio loss. There is a fear among microfinance managers that once a loan is written off, it cannot be recovered. MFI managers do not understand that write-offs are a simple accounting treatment to clean the portfolio and provide an accurate picture of the institution's assets. Among the MFIs in the sample, only one has declared writing off its overdue loans. Loan loss reserves maintained by MFIs also reflect the inadequate treatment of risk and are generally very low. However, after strict instruction from Nepal Rastra Bank (NRB), MFIs have started making provisions to a limited extent.

Conclusion

MFIs in Nepal have been successful in increasing outreach and maintaining healthy levels of returns thanks to extremely low cost structures. But challenges remain. Little is known about portfolio quality, indicating that financial performance may be overstated. Considering that a large portion of demand for microfinance services is still unmet, there is a significant opportunity for MFIs to further increase the number of clients served. As MFIs continue to grow, however, it is important that they adhere to best practices and develop a better understanding of their portfolio risk.

Transparency Environment in Nepal

As the size of the sample and the previous issues raised suggest, data on Nepalese MFIs are limited. While there is a clear picture of who the different actors are, there is little to no publicly available information on their social and financial performance and no ratings to indicate their health. Outreach and financial data on microfinance development banks are readily accessible and are published on an annual basis by NRB, but these data only include balance sheet items and do not provide a complete picture of the institutions' financial position. Even less is known about financial intermediary NGOs and savings and credit cooperatives. MFI annual reports sometimes include data on social indicators, but these are not publicly available.

With the coordination of CMF and as a result of this study, seven leading institutions published their outreach and financial data on the MIX Market according to international reporting standards[6]; the eighth institution, Nirdhan, has been posting its profile along these lines since 1999. Most of the MFIs did not previously share their data on this global platform because they were either not aware of this opportunity or were reluctant to adjust their data to international reporting standards. To date, no institution collects and publishes standard performance data that provide a comprehensive picture of MFI activity in Nepal. While CMF's online Directory of Microfinance Institutions only covers general survey data on outreach, volume and funding sources, it does include a large number of institutions and provides the most extensive information on the microfinance industry in the country.

State of Transparency

Standard performance data on the Nepalese microfinance sector are generally unavailable. CMF's Directory of Microfinance Institutions makes mapping of the sector possible, but it does not provide any details on MFI financial performance or portfolio quality. Available data thus do not reveal the level of risk in the sector and preclude any analysis of institutional sustainability or staff productivity. Moreover, CMF has not been able to thoroughly update its directory since its initial publication in July 2003, namely due to the challenge of collecting data from NGOs and cooperatives. As mentioned earlier, many of these institutions lack the capacity to track standard performance indicators. Their reporting does not include portfolio aging or quality indicators, or any adjusted performance results, such as financial self-sufficiency. In the case of savings, for example, institutions are generally unable to classify these amounts into their mandatory and voluntary components, hence limiting their understanding of their true outreach to savers and the extent of their dependence on client deposits. While they do not track voluntary savings separately, either, microfinance development banks do have better management information systems than other MFIs and are able to generate data that tend to follow best practice reporting norms for microfinance. Whereas portfolio quality is generally not reported according to international standards, efficiency and productivity can be extracted from their reports. Their financial data are also readily accessible in print from the appropriate government offices.

Annual external audits are a requirement for all three institutional types. Auditors, however, are not usually familiar with international guidelines for microfinance and simply ensure that financial statements meet local legal requirements, which may not follow global industry norms. Hence, while the reports include the amount of loans outstanding and general provisions for bad debt – not based on portfolio analysis – they do not provide portfolio aging schedules that would indicate the level of risk that an MFI is carrying.

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[6] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

Smaller institutions do not have the same access to quality audits as larger MFIs. The Auditor General of Nepal licenses auditors and classifies them into different groups according to their qualifications and experience. Auditors in the lower categories may only audit companies with a low volume of transactions – each classification of auditors has a separate specified ceiling. Hence, the financial reports of smaller MFIs are usually prepared by auditors who have lower qualifications than those accessed by larger institutions.

MFI reporting generally does not fit international standards and often lacks information on quality of the portfolio (portfolio at risk or repayment rates), loan and savings products, staff productivity (overall and branch wise), and rates of return. This information has to be extracted from the raw data, some of which exist in the MFI's MIS and some of which do not exist.

As with external audits, the rigor of regulation varies across MFIs. While all microfinance providers in Nepal are regulated, they are registered under different acts and have to report to different entities. Microfinance development banks are regulated under the Bank and Financial Institutions Ordinance while savings and credit cooperatives are regulated by the Cooperative Act. Financial intermediary NGOs are in turn regulated under both the Social Institution Act and the Financial Intermediation Act. Despite the distribution of microfinance providers across multiple entities, the supervising institutions have not been able to properly supervise the MFIs.

Compliance with reporting requirements varies by MFI type and helps explain the differential in data availability. Microfinance development banks are required to report to NRB and generally comply with this obligation. Financial intermediary NGOs are also required to report to NRB, but only nine of the forty-seven abide by this requirement on a regular basis. Of the 2,400 cooperatives, twenty have obtained permission from NRB to conduct limited banking activities and must report to it. All twenty cooperatives comply with this requirement, and NRB publishes their data every year. However, the data published by NRB lack many indicators that are necessary to provide a clear picture of an MFI's financial position and are limited to information on sources and uses of funds. The remaining NGOs and cooperatives have to report to the District Administration Office (DAO) and the District Cooperative Office (DCO), but they generally do not follow this requirement. Moreover, any information that is submitted to DAO and DCO is not published and is very difficult to access.

NRB has recently established a task force to develop a Second Tier Institution (STI) which may supervise all microfinance providers in the country. STI is still a work in process and has not yet become functional, so no formal information exists on this supervisory entity. However, STI will probably be under the control of NRB and will receive approval to undertake monitoring and inspection of MFIs.

Successful Initiatives in Building Transparency

CMF has been actively involved in promoting transparency in the Nepalese microfinance sector. In 2003, this network undertook a project to create and publish the first MFI directory in Nepal. For this project, CMF had access to secondary data but was also required to collect primary institutional data, particularly in the case of small MFIs. CMF staff visited a number of institutions and District Cooperative Offices to collect data on savings and credit cooperatives and financial intermediary NGOs, hence expanding coverage beyond microfinance development banks. Today, the MFI directory provides general survey data on 1,848 retail microfinance providers throughout the country. CMF has not been able to thoroughly update this database, largely due to the unavailability of basic data on cooperatives and financial intermediary NGOs. More recently, however, CMF published the profiles of seven leading institutions on the MIX Market, further enhancing transparency in the sector.

Opportunities for Building Transparency

Overall, MFIs are open to being transparent in Nepal and are willing to share their data. To a certain extent, they are willing to pay for the training and technical assistance in this area. Hence, if the sector can cover the cost of ratings and the training of auditors in best practice reporting guidelines, the microfinance

movement of Nepal could become substantially more transparent. CMF could support this move to transparency by playing the role of technical assistance provider for Nepalese MFIs. CMF would be able to leverage its informal networking relationships with MFIs to design reporting formats and train MFIs on reporting; for institutions with limited capacity, CMF would provide on-the-spot technical assistance on extracting such information from raw data. The network would also train auditors on microfinance-specific guidelines to ensure that financial statements include all necessary disclosures to accurately portray an institution's financial position. Finally, CMF would expand its MFI directory by regularly collecting, compiling and publishing MFI data.

NRB's initiative to develop STI has the potential to significantly enhance transparency, namely by establishing common reporting norms under a single framework. Microfinance providers would begin to produce data according to the same format, hence enabling performance comparisons across institutional types. MFI performance data, however, should be published and the reporting norms made consistent with international standards in order to facilitate global comparisons and allow Nepalese institutions to benchmark their performance against that of their peers worldwide.

Conclusion

Little is consistently known about MFI performance in Nepal, but many of the building blocks are there to make it happen. Some of the leading MFIs comply with NRB reporting requirements and produce audited financial reports that contain appropriate disclosures for microfinance. Eight of these institutions, covering about a third of total outreach, have shared their data with the MIX and made it publicly available.

Challenges, however, remain. Most MFIs lack the capacity to generate standard performance data, and regulatory authorities have yet to internalize and apply best practices. Moreover, what little data do exist are currently scattered across different agencies. Hence, there is a significant opportunity for actors such as CMF to assist both MFIs and regulatory authorities in developing further transparency in the sector. Compared to other parts of the world, MFIs in Nepal have received very limited grants for capacity building and are often unable to even cover costs associated with opening new branches. The support of external institutions is thus essential to promoting the transparency environment in this country.

Pakistan

Government programs began to provide microfinance services in Pakistan as early as the 1950s. The modern microfinance movement, however, did not emerge until 1982, when a local NGO established the Orangi Pilot Project. Within the same year, another NGO launched the Aga Khan Rural Support Programme (AKRSP), an integrated rural development program that would become the most influential microfinance model in Pakistan. AKRSP spawned the rural support movement that today accounts for approximately 70 percent of NGO outreach in microfinance and includes some of the largest providers in the country. Using participatory rural appraisal, rural support programs establish village-level community organizations that undertake development projects based on community priorities. While these organizations generally focus on infrastructure and irrigation projects, microfinance constitutes an important set of services. During the 1990s, a variety of other NGOs began to offer microfinance services as well. Much like rural support programs, these institutions were usually engaged in activities that extended beyond microfinance. With its establishment in 1996, Kashf Foundation became the first of only two Pakistani NGOs to exclusively provide microfinance services.[1]

A major shift in the microfinance landscape occurred under the current administration; with the onset of military government in 1999, a new agenda for Pakistan was drafted. One of the key agenda items was poverty alleviation, and the government highlighted microfinance as a critical tool for achieving that objective. A previously planned apex institution, the Pakistan Poverty Alleviation Fund, became operational in 2000 with government and World Bank funding. The government also established Khushhali Bank, a microfinance bank set up through special ordinance. This initiative was followed in late 2001 by the Microfinance Institution Ordinance that allowed for the creation of additional specialized microfinance banks under the supervision of the central bank, State Bank of Pakistan. At the time of writing, six microfinance banks had been granted license under the ordinance, and four had already initiated operations, with one, Khushhali Bank, now the largest microfinance provider in the country.

Pakistan continues to be a single product market, with the majority of microfinance institutions focusing on credit delivery. Credit products include loans for agriculture, livestock, trading and consumption. With rural support programs serving the largest chunk of the market, the most widespread credit methodology is a hybrid model where clients are organized into community organizations but loans are made to individual members and are tracked individually. In urban areas, however, institutions generally follow solidarity group models. Microfinance institutions are increasingly diversifying their product offering, and innovations have begun in enterprise loans, housing finance and personal loans. In addition, microfinance providers have begun to explore deposit, insurance and remittance services. A small number of leasing companies have also entered the microfinance market and established separate microfinance

[1] Asasah, the only other NGO in Pakistan that focuses exclusively on microfinance services, was established in 2003.

product lines. Savings in the Pakistani microfinance sector are largely compulsory and are required of all members of community organizations established by rural support programs. Since only banks are legally authorized to mobilize public deposits, these savings are intermediated by rural support programs but deposited with commercial banks.

With 33 percent of the population living below the national poverty line[2], it is estimated that six million Pakistani households are in need of microfinance services. This demand, however, remains largely unfulfilled. As of June 2005, microfinance institutions publicly sharing performance data through the Pakistan Microfinance Network or the Microfinance Information eXchange served 718,000 total borrowers and held USD 99 million in loans outstanding, covering less than twelve percent of the potential market in terms of outreach.[3] The number of savers was substantially higher since most microfinance providers collect compulsory savings from members, regardless of their access to credit. Microfinance institutions thus counted one million mostly compulsory savers and managed USD 20 million in mandatory deposits.

As the supply of microfinance services expands to meet demand, it becomes increasingly important to monitor sector growth and ensure healthy institutional development throughout the industry. In addition to analyzing the performance of microfinance institutions in Pakistan, the following pages examine the transparency environment in the country, highlighting the factors that affect the availability of accurate and reliable information on the microfinance market.

Methodology

It is estimated that 40 microfinance institutions (MFIs) currently operate in Pakistan. While this study only covers fifteen MFIs, these institutions capture almost 99 percent of the microfinance market. The sample includes a diverse set of institutions and provides a rich picture of the microfinance sector in Pakistan. Of the four operational microfinance banks, two are included in this analysis. One of these institutions is the largest microfinance provider in the country and focuses exclusively on credit services. The other has more limited outreach but provides a wide range of products, from loans and deposits to insurance and remittance services. The sample also includes one commercial bank and one leasing company, both of which offer separate microfinance product lines. In addition, the analysis covers two specialized NGOs that provide credit, compulsory savings and insurance products as well as nine integrated institutions that also collect mandatory savings but offer non-financial services in conjunction with microloans.

The following analysis builds on outreach and financial performance data for 2003 and 2004[4]. All data are self-reported and have been cross-referenced with audited financial statements where available. One MFI reports directly to the MIX Market, whereas the remaining fourteen report to the Pakistan Microfinance Network (PMN). Their data are classified according to global industry reporting norms and are featured in PMN's annual *Performance Indicators Report*.

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[2] Human Development Reports Statistics, "Pakistan Country Sheet", http://hdr.undp.org/statistics/data/countries.cfm?c=PAK. The figure for demand is based on a population of 150 million and an average family size of eight members.

[3] Data for Khushhali Bank are as of December 2004.

[4] MIX standardizes financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For example, institutions that close on June 30, 2004 are listed as FY 2003. Pakistan data, however, are presented according to calendar year.

While data collection for these institutions is relatively smooth, challenges remain, namely in reporting portfolio aging schedules and allocating resources across different activities of integrated institutions. These challenges, along with the initiatives to overcome them, are discussed throughout the subsequent sections on performance and transparency.

In addition to providing overall averages, the following analysis uses a peer group framework to reveal trends within the industry. Institutions are classified by age, outreach and scale as indicated in Figure 1.

Figure 1: MFI peer group criteria

Category	Group	Criteria
Age	Old	Established between 1990 and 1995
	Young	Established after 1995
Outreach	Small	< 5,000 active borrowers
	Medium	5,000-20,000 active borrowers
	Large	> 20,000 active borrowers
Scale	Small	GLP < USD 1 million
	Medium	GLP = USD 1-5 million
	Large	GLP > USD 5 million

GLP: gross loan portfolio.

Performance of Pakistani Microfinance Institutions

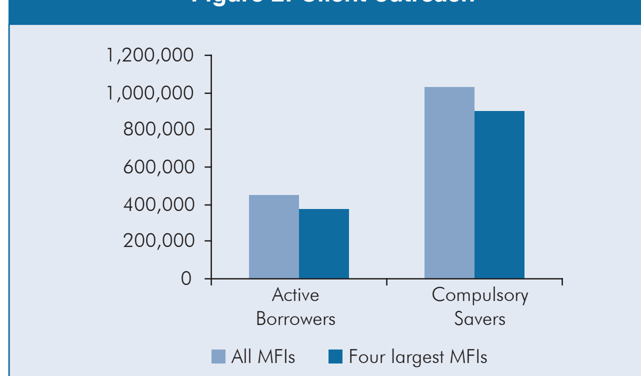
Despite low market coverage, the microfinance industry in Pakistan is growing at a remarkable rate to reach an ever-increasing number of clients. Future growth, however, is significantly compromised by the sector's high dependence on subsidized funds to cover costs and maintain operations. To ensure the sustainability of the industry, Pakistani MFIs should build on their exceptionally low cost structures and consider re-pricing their products and services to enhance their financial revenues and become self-sufficient.

Outreach

With 451,324 borrowers in 2004, microfinance providers covered just a sliver of demand for microcredit services in Pakistan. A much larger number of clients received savings services – 1 million – but these savings were largely compulsory. Rural support programs require that all members of community organizations deposit savings, regardless of access to loans. While members are allowed to save over the amount required by MFIs, the voluntary savings component constitutes a small share of total deposits. Nonetheless, since savings are generally a prerequisite for access to loans, there is an immediate potential to further increase outreach in terms of savers.

An interesting feature of this market, made evident by Figure 2, is that most clients are served by just a handful of institutions. The credit and savings markets are each dominated by four microfinance providers that together count over 80 percent of all clients reached. The set of dominant MFIs, however, is slightly different for borrowers and savers. An overwhelming share of borrowers receives loans from Khushhali Bank, NRSP, Kashf and PRSP while the majority of savers maintain deposits through NRSP, PRSP, SRSP and TRDP. Whereas the former group represents a heterogeneous set of institutions consisting of one microfinance bank, one specialized NGO and two rural support programs, the latter group is entirely composed of integrated rural support programs that collect mandatory savings.

Figure 2: Client outreach



Source: Performance Indicators Report 2004 and MIX Market data for calendar year 2004 as of October 27, 2005. Data presented are totals.

Most microfinance clients, be they borrowers or savers, are rural-based. The general belief in Pakistan is that poverty lies in rural areas, hence the dominance of rural support programs and the focus on serving the rural poor. The picture, however, may be changing in the microcredit market. Khushhali Bank, which currently serves over one third of total borrowers, is growing at astounding double digit rates and caters to a largely urban clientele. Moreover, an increasing number of institutions are initiating operations in urban centers, namely the newly licensed microfinance banks and two district-level banks working in Karachi, which, with a population of 15 million, provides significant growth potential to urban microfinance outreach.

In terms of gender mix, Pakistan is one of few countries where the share of women borrowers is less than half. At 45 percent, the 2004 figure is a slight improvement over 2003, when it stood at 42 percent. Only three MFIs target women exclusively, and all three are based in Lahore, an urban area. Strangely, institutions that work in rural settings have, on average, less than 30 percent women borrowers. Societal and religious norms discourage women from working outside of the home, significantly limiting their access to financial services. Some MFIs, however, contend that female participation rates in other countries mask the fact that a large number of loans issued to women are in fact being managed by male members of the household. According to this argument, Pakistan's low share of women borrowers would thus be in line with realities elsewhere.

With an average loan balance that amounts to just 30 percent of local per capita income, Pakistani MFIs are serving the low end of the market. First Microfinance Bank and commercial institutions such as Bank of Khyber and Orix Leasing manage average loan balances on the higher side – USD 450 compared to the average USD 150 served by other MFIs. Unlike their peers, these three institutions focus on loans for fixed assets and primarily work with individual clients, hence their higher loan balances. Despite the entry of an increasing number of commercial institutions into the microfinance sector, MFIs have continued to serve their initial target group. Over the period studied, overall average loan balance actually declined from 36 percent of local per capita income to 30 percent, indicating that growth in outreach was driven by rising client numbers rather than a shift towards higher loan sizes.

The microfinance industry in Pakistan grew considerably over the last few years, as Figure 3 clearly shows. Between 2003 and 2004, the number of active borrowers and the loan portfolio increased by 36 percent and 41 percent, respectively. While significant, this growth barely made a dent in microfinance demand. Given its current low base, microfinance supply will have to expand at an even faster rate if it is to satisfy demand in the near future.

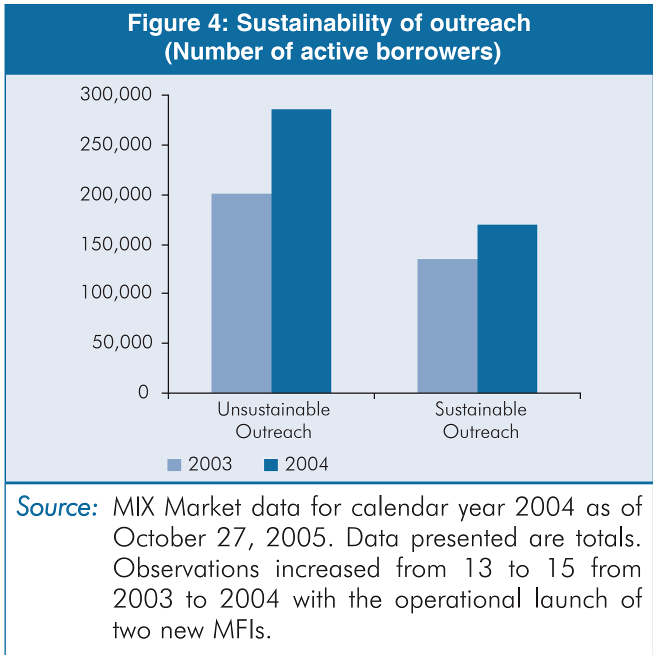
One alarming feature of current sector growth is that it is being led by unsustainable institutions that are heavily subsidized. The poor require regular and reliable access to financial services, but the majority of MFIs are unable to generate sufficient revenues to cover their cost of operations. As Figure 4 indicates, growth in the number of borrowers between 2003 and 2004 was largely driven by unsustainable institutions. Unsustainable institutions enjoyed some

Figure 3: Outreach growth trends

Product	Indicators	2004	2003	Growth (%)
Credit	Number of active borrowers	451,324	332,548	35.7
	Gross loan portfolio (USD)	67,209,490	47,662,053	41.0
Savings	Number of savers (compulsory and voluntary)	1,024,401	887,475	15.4
	Savings (USD)	18,613,668	17,000,421	9.5

Source: MIX Market data as of October 27, 2005. Data presented are totals.

Figure 4: Sustainability of outreach (Number of active borrowers)



Source: MIX Market data for calendar year 2004 as of October 27, 2005. Data presented are totals. Observations increased from 13 to 15 from 2003 to 2004 with the operational launch of two new MFIs.

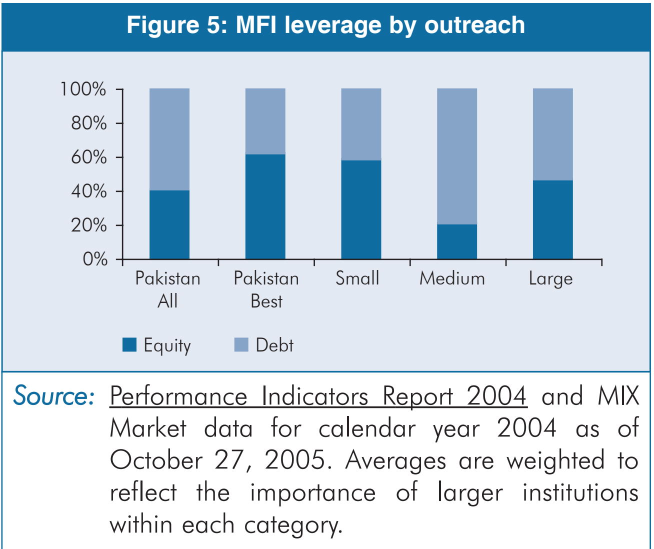
of the highest growth rates in the sample; the number of borrowers served by Khushhali Bank, an unsustainable institution, grew by 84 percent. Given its young age and the substantial backing that it receives from the government, this institution will likely continue to dominate growth in the near future. Moreover, one of the largest institutions moved down the slab from 105 percent operational self-sufficiency to 90 percent, becoming unprofitable over the sample period. Declines in yields of government securities held by this institution have significantly hurt its financial revenue; unless it allocates a greater portion of its assets to the loan portfolio, its revenues will continue to suffer, and its unsustainable condition will likely persist.

Financial Structure

With an average capital to asset ratio of 41 percent, Pakistani MFIs tend to be underleveraged. A glance at the financial structure indicates that most institutions rely on donor grants for their capital and only one institution has retained earnings from operations. What borrowings the sector does have are largely in the form of subsidized debt since banks are generally reluctant to lend to MFIs. In order to access commercial credit lines, two large programs (NRSP and PRSP) were required to pledge their full endowments as collateral, an option that is unavailable to most institutions since they lack similar amounts of liquid assets.

As Figure 5 illustrates, MFIs with medium outreach are the most leveraged. Unlike their counterparts, these institutions rely heavily on credit from the Pakistan Poverty Alleviation Fund (PPAF) for their financing. Small MFIs, on the other hand, are the most capitalized, largely because two of these MFIs are commercial institutions that are using head office equity to fully finance their microfinance operations. This group additionally includes a transformed bank with very high capitalization. Large MFIs are also highly capitalized, but unlike small institutions, they rely on donor grants and government endowment funds to build their equity base. Pakistan's best performer[5], Kashf Foundation, is the only institution that contributes to its capital through positive retained earnings. This MFI is highly capitalized and is actively seeking to diversify its financing to include a range of commercial sources.

Figure 5: MFI leverage by outreach



Source: Performance Indicators Report 2004 and MIX Market data for calendar year 2004 as of October 27, 2005. Averages are weighted to reflect the importance of larger institutions within each category.

With the exception of First Microfinance Bank, MFI debt profiles consist entirely of subsidized credit lines through PPAF or the Asian Development Bank. Additionally, MFIs enjoy significant access to grants. These funds continue to grow without any focus on transparency or sustainability of microfinance

5 Throughout the document, Pakistan Best refers to Kashf Foundation.

operations, making MFIs largely complacent to performance disclosure; the only real pressure to improve operations comes from PMN's annual performance report showing the exact position of MFIs. Whereas microfinance providers in other countries are increasingly drawing on commercial debt to finance growth, Pakistani MFIs continue to rely on subsidized funds. Instead of NGOs moving towards commercial sources of funding, the sector is in fact witnessing quite the opposite as commercial institutions that have entered the microfinance market increasingly build relationships with subsidized sources of financing.

Moreover, the asset side of the balance sheet shows that MFIs are using their assets inefficiently. At 41 percent[6], Pakistani MFIs devote a lower share of assets to the loan portfolio than microfinance providers across South Asia (74 percent) and are thus not able to optimize their asset yield. The Pakistani market reveals an interesting feature: asset allocation to the loan portfolio decreases with institutional scale, so that large MFIs optimize least their asset yields. Small scale MFIs invest 78 percent of their assets in the loan portfolio, compared to just 48 percent in the case of large scale MFIs. Two of the largest institutions, NRSP and PRSP, hold significant government endowment funds that they are not allowed to use towards operations, hence restricting their investments in the loan portfolio. On the other hand, small MFIs' seemingly more efficient use of assets is partly driven by accounting issues. Two institutions in this group only report the amount of their loan portfolio when segregating their microfinance portfolio from their other activities, while another has a very high loan loss reserve. For these three MFIs, the share of assets invested in the loan portfolio is thus over 100 percent.

There are several reasons why MFIs do not optimally utilize their resources. Across the country, microfinance is regarded as a charitable activity. Institutions thus charge exceptionally low interest rates and do not regard their credit operations as a significant means to raise revenue. Moreover, financial returns on government securities tended to be historically very high – above 18 percent – thus increasing the opportunity cost of investments in microfinance operations. The government, however, has recently reduced these rates and barred institutions from investing in such financial instruments, significantly reducing MFI incentives to invest in external assets. More importantly, many institutions have thus far lacked the necessary information to make decisions on their asset allocation; until recently, the majority of MFIs did not produce financial statements that separated their microfinance operations from other activities. PMN only began covering balance sheet items with its 2003 performance report and has since been working with integrated institutions to make their financial reporting more transparent. As institutions gain access to more reliable data and begin to make more informed decisions, they will likely increase investments in the loan portfolio since it is generally the highest yielding asset. Before they can improve their asset allocation, however, MFIs need to build their human and technical resources, particularly since portfolio quality is currently poor and the majority of institutions lack adequate loan tracking systems.

Financial Performance

With the exception of five MFIs, all the institutions in the sample are running losses. The sector as a whole registers highly negative returns on assets, suggesting that the industry is running on an unsustainable basis. While the average South Asian MFI also generates negative returns, it nonetheless succeeds in covering operational costs. As Figure 6 illustrates, average operational self-sufficiency across South Asia is 106 percent, compared to just 80 percent in Pakistan. The country's best performer, however, exceeds regional figures and even surpasses some of the better performing regions, such as Latin America and the Caribbean, or Eastern Europe and Central Asia.

Pakistani microfinance providers benefit from low cost structures and generally productive operations, but they are nonetheless unable to cover operational

6 This figure was weighted to reflect the importance of larger balance sheets. A simple average yields 67 percent, suggesting better asset utilization.

Figure 6: MFI profitability

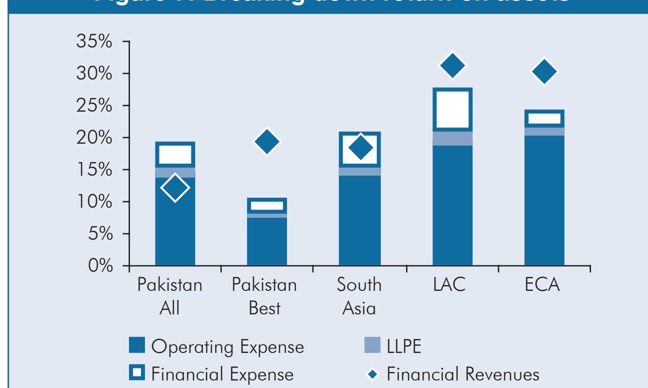
Indicators	Pakistan All	Pakistan Best	South Asia	LAC	ECA
OSS	79.6%	187.0%	105.5%	115.8%	128.9%
ROA	-6.8%	9.0%	-2.3%	2.9%	5.3%

Source: MIX Market 2004 data as of October 27, 2005. LAC: Latin America and the Caribbean; ECA: Eastern Europe and Central Asia; OSS: operational self-sufficiency; ROA: return on assets.

costs and fail to generate profits. As Figure 7 illustrates, MFI expenses in Pakistan are on par with regional norms and significantly lower than other parts of the world. While institutions in other regions face higher cost structures, they also benefit from significantly higher financial revenues that allow them to cover expenses. The challenge to MFI profitability in Pakistan thus appears to stem from a charitable vision of microfinance that has adverse effects on product pricing, asset allocation and credit risk throughout the sector. MFIs are averse to charging sustainable interest rates since these are perceived as usurious and counter to the movement's mission of alleviating poverty. Microfinance providers thus wind up on a low cost low yield curve, running heavily subsidized programs.

A few MFIs, however, have been successful in becoming self-sufficient. These MFIs have similar cost levels as the rest, but their financial revenues are higher. The best performing institution not only

Figure 7: Breaking down return on assets



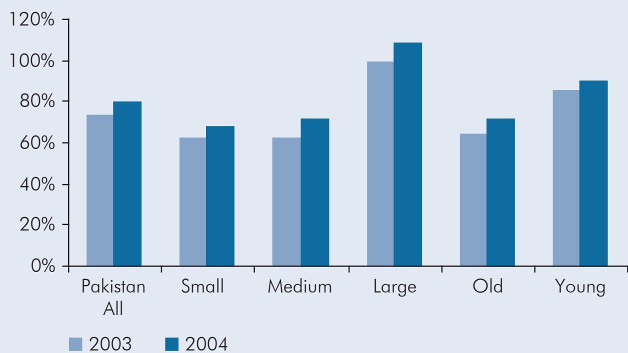
Source: MIX Market 2004 data as of October 27, 2005. Data are expressed as a percentage of total assets and represent averages. LLPE: loan loss provision expense; LAC: Latin America and the Caribbean; ECA: Eastern Europe and Central Asia.

generated significantly higher revenues than the rest of the sector but also benefited from an exceptionally low cost structure. Given that overall expenses are already very low, it is unlikely that they will decline much further in the near future. The path toward sustainability therefore begins with higher financial revenues. Paksitan's self-sufficient MFIs have a radically different vision than their peers and aim to provide the poor with sustainable microfinance services. Their managers place significant weight on the health of their institutions and are not deterred from charging sustainable rates that allow them to maintain their operations without exploiting the poor. Better management has also allowed these MFIs to maintain better portfolio quality and allocate a larger share of assets to their loan portfolio, thus optimizing their revenues.

Despite widespread losses, operational self-sufficiency in the Pakistani microfinance sector improved over the period of analysis, from 73 percent to 80 percent. As Figure 8 shows, this trend persists across outreach as well as age groups. While medium MFIs registered greater improvements in profitability, large institutions remained by far the most profitable. The more favorable results for both large and young institutions are largely driven by Kashf Foundation, which not only outperformed all other MFIs in the sample but also saw its profitability jump by 50 percent from one year to the next.

Between 2003 and 2004, both expenses and revenues declined as a percentage of total assets, with the former experiencing a somewhat higher drop. This decline was widespread and persisted across different peer groups; it also held true for each component of expenditure. As MFIs grow and achieve operational efficiencies, their operating

Figure 8: Trends in operational self-sufficiency by age and outreach



Source: MIX Market data for calendar year 2004 as of October 27, 2005. Data presented are averages.

expenses decline as a percentage of total assets, allowing them to benefit from increasingly low cost structures. Pakistani MFIs benefited from this progression as well as external factors that lowered interest rates. The government's move to reduce yields on publicly-issued securities caused a general decline in interest rates in the formal financial sector as well as the microfinance market, reducing interest expense for MFIs. While interest income also dropped, this decline was somewhat milder than the drop in expenses. In the case of the best-performing MFI, financial revenue actually increased by two percentage points of total assets. This improvement was largely the result of an increase in the share of assets allocated to the loan portfolio, pointing once again to the importance of sound financial management in an institution's quest for sustainability.

Efficiency and Productivity

MFIs in Pakistan are quite efficient and benefit from low salary levels, high staff productivity and an integrated approach to credit delivery, all of which work to maintain cost structures at current low levels. As Figure 9 shows, microfinance providers have not boosted efficiency by increasing loan sizes but have instead relied on lower cost structures and higher productivity. Indeed, average loan balance is only slightly higher than the regional average for South Asia and significantly lower than figures for Africa or Latin America and the Caribbean. Evidence also suggests that the sector is becoming more efficient and productive over time and that institutions are gaining in efficiency as they gain in scale. Given the dominance of rural support programs, however, efficiency and productivity figures may be exaggerated.

An initial analysis suggests that integrated institutions may be more efficient than specialized ones. Their operating expense is only 16 percent of their loan portfolio, compared to 28.5 percent in the case of specialized MFIs.[7] Not only do they pay less for every dollar that they maintain in the loan portfolio, but their cost per borrower is also lower (Integrated: USD 24; Specialized: USD 39). These numbers, however, are somewhat misleading and relate more to

Figure 9: Efficiency and productivity patterns

Indicators	Pakistan All	South Asia	LAC	Africa
Average balance per borrower (USD)	178	113	788	509
Average loan balance / GNI per capita	29.7%	22.2%	53.3%	113.4%
Borrowers per staff member	175	219	139	149
Operating expense / Loan portfolio	33.6%	22.0%	26.5%	60.6%
Cost per borrower (USD)	45	25	155	232

Source: MIX Market 2004 data as of October 24, 2005. LAC: Latin America and the Caribbean

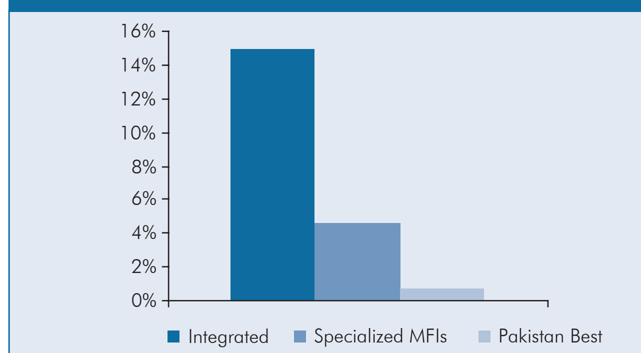
7 Figures are weighted to reflect the importance of larger loan portfolios in each category.

accounting issues than actual efficiencies. In the case of integrated institutions, microfinance service delivery occurs within the context of other structures so that groups that receive MFI loans are often created as part of a broader community development effort. Synergies with other programs allow expenditures incurred by microfinance operations to be distributed across other activities, thus understating the cost of microfinance delivery and inflating efficiency.

Portfolio Quality

With portfolio at risk (PAR) over 30 days of 9.3 percent[8], the microfinance sector in Pakistan reports almost one tenth of the portfolio as delinquent. This high rate, along with a very low 1.1 percent loan write-off ratio indicates that either risk is concentrated in the earlier ages of MFIs or that institutions are not following prudent write-off policies. As Figure 10 illustrates, integrated institutions bear higher risk levels than specialized MFIs – over three times as much – suggesting that a clearer vision of microfinance allows MFIs to better manage their loan portfolios.

Figure 10: Portfolio at risk > 30 days by MFI type



Source: Performance Indicators Report 2004. Averages are weighted to reflect the importance of larger institutions.

Figure 11, on the other hand, indicates that portfolio risk is concentrated in old institutions. This result, however, is largely driven by three MFIs that account for most of the risk in the sample and carry an average PAR over 30 days of 75 percent. These institutions are also driving high levels of risk among medium and small MFIs. However, evidence suggests that MFIs in all peer groups are increasingly reining in portfolio risk, with low write-offs indicating recovery of delinquent loans.

Conclusion

The microfinance industry in Pakistan has realized significant growth and achieved low cost structures but has fallen short of demand and continues to be unprofitable. Low financial revenues, combined with low leverage, limited intermediation of savings and a highly skewed asset structure stand in the way of sustainability and force the sector to rely on heavily subsidized sources of funds. One first step towards improved performance is for MFIs to start pricing products based on their cost structure and risk. At this stage, the main challenge for the sector is to formulate a vision of microfinance as a commercially driven social business that can serve the poor while ensuring sustainability.

Figure 11: Portfolio at risk > 30 days by age and outreach

Year	Large	Medium	Small	Young	Old
2003	8.6%	31.6%	24.9%	6.5%	32.5%
2004	7.9%	30.1%	21.4%	4.9%	32.4%

Source: MIX Market data for calendar years 2003 and 2004 as of October 27, 2005. Data presented are averages.

[8] This figure is weighted to reflect the importance of larger loan portfolios. A simple average yields portfolio at risk >30 days to 21 percent.

Transparency Environment in Pakistan

The Pakistan microfinance sector enjoys a significant degree of financial transparency. The main players in the sector can all produce data on both outreach and financial indicators that follow international standards and have demonstrated willingness to do so via their participation in PMN's yearly transparency work, making their data widely available both online and in print. PMN has played a major role in furthering transparency through its performance monitoring reports and continues to expand its coverage, opening up its membership to the newly operational microfinance banks. In its regulating capacity, the State Bank of Pakistan (SBP) has also contributed to transparency by requiring microfinance banks to undergo ratings within two years of operation, hence further enriching data availability for microfinance.

State of Transparency

The institutions represented in this study include MFIs that have good management information systems. These systems, however, are concentrated towards production of credit information rather than overall financial performance. The problem lies not in the ability to churn out financial statements but in institutional structure. Larger specialized institutions, be they NGOs or microfinance banks, are able to produce indicators that adhere to international reporting standards[9] on a regular basis. Integrated programs, while they can also produce credit information on a monthly basis, are only able to track the whole institutional analysis of their microfinance operations once a year, when reporting to PMN.

Indeed, one of the greatest challenges to transparency in the sector is the production of financial statements that accurately portray an institution's microfinance operations. Integrated institutions that provide services in addition to microfinance must distribute account items across various activities, often resulting in reports that understate MFI costs and greatly limit the ability of stakeholders to conduct performance analysis. Only one third of the sample MFIs provide separate audited accounts for their microfinance operations. Of the nine integrated NGOs, only one produced a separate audit report that provided a full and accurate picture of its microfinance operations.

In Pakistan, all MFIs are audited on an annual basis to fulfill regulatory and donor requirements. These audits follow International Accounting Standards and vary according to the regulatory framework under which institutions are registered. Given greater ease to generate information, specialized MFIs often follow international guidelines for microfinance. Whereas financial statements do not generally list donations separately, some institutions, like Kashf Foundation and First Microfinance Bank, do report grants after calculation of net profit from operations. This item, if not separately listed on the income statement, results in overstatement of profit; should Pakistani MFIs include grants under other revenues they would suddenly appear to be profitable. Poor disclosure practices thus reduce the ability of an institution's management or board to monitor performance and make informed decisions that could lead to more sustainable operations.

Three external organizations collect and analyze institutional data from microfinance providers: PPAF, SBP and PMN. PPAF covers the largest number of institutions, but for the most part, these are not the major players in the sector. Moreover, PPAF's data collection efforts largely focus on credit outreach and do not address financial performance. While the organization does collect vouchers and quarterly statements of expenditure, these mostly assist in

[9] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

project management and do not contribute to financial analysis. SBP, on the other hand, has more rigorous and comprehensive data reporting requirements but only collects information on microfinance banks. PMN alone strikes a balance between sector coverage and depth of information. This national network collects information on an annual basis to track the performance of members, as well as a few non-members, and analyze both overall market trends and individual institutional developments. PMN aims to enhance information symmetry so that MFIs can improve their performance and better guide their decision-making process. Its annual *Performance Indicators Report* is thus made publicly available and is widely circulated among microfinance actors. PMN will soon be publishing a new report that presents less extensive performance data but builds on partnerships with provincial networks to provide greater coverage. In making data transparent, PMN's efforts have not only helped enhance performance within the sector but have also allowed the industry to essentially self-regulate. With financial performance of MFIs publicly available, SBP has refrained from intervening in the operations of non-bank MFIs.

Credit risk ratings also play a significant role in performance monitoring and have become increasingly important in the Pakistani microfinance sector. As per regulation, microfinance banks are required to be rated within two years of commencement of business. Thus far, two of these institutions have been rated by an accredited rating firm based in Pakistan. In fact, First Microfinance Bank underwent a rating within just one year of commencement of business, largely in order to build its credibility within commercial markets and improve its access to low cost credit. NGO MFIs are fully aware of the benefits of ratings and have consulted with domestic and international rating firms, JCR-VIS and M-CRIL, to determine which institutions are ready for ratings and which must first undergo assessments. In this context, two NGOs have been rated. Kashf Foundation was rated by JCR-VIS as its primary objective was to build local credibility and access commercial credit lines at low cost. NRSP, however, underwent a rating with the purpose of understanding its strengths and weaknesses and benchmarking its performance against regional peers; instead of JCR-VIS, NRSP opted for M-CRIL's services.

All MFIs in Pakistan are regulated, but under different laws. Commercial banks and microfinance banks are regulated by SBP. Leasing companies and a few NGO MFIs are regulated by the Securities and Exchange Commission of Pakistan (SECP), while the majority of NGOs are registered under the Societies Act. The level of regulation, both in terms of supervision capacity and reporting requirements, is at its lowest with the Registrar of Societies, improves with SECP and is at its best with SBP. Data collected by the Registrar of Societies and SECP follow a generic format that has little relevance to the microfinance industry per se and include a basic audited report. SECP further requires institutions to provide an annual return that presents governance structure and examines board and management changes over the year. SBP, on the other hand, requires more elaborate information on either a bi-weekly or quarterly basis. This information includes balance sheet items, profit and loss statements, asset liability maturity and a portfolio quality report. In addition to conducting on-site visits, SBP requires microfinance banks to publish their audited accounts within three months of the close of financial year in national scale newspapers, making this information widely accessible for analytical purposes.

Successful Initiatives in Building Transparency

PMN has been publishing its *Performance Indicators Report* on an annual basis since 1999. This report went through different stages of evolution before reaching the point of defining, reporting and calculating performance indicators according to international standards. The first issue included just seven institutions and covered four basic performance areas: profitability, savings, portfolio quality and efficiency. Since then, the number of MFIs has risen to 14, and the report covers a more extensive set of standard performance indicators. In disclosing MFIs' financial performance and presenting both industry and institutional trends, the *Performance Indicators Report* has had significant impact on the microfinance sector. This performance monitoring initiative has pushed MFIs of all types to

provide information to the network for public disclosure. At the institutional level, the report has helped MFIs understand their weaknesses and enabled them to make decisions to improve performance. With data now easily available, PMN has begun to prepare *Customized Performance Reports* that benchmark individual institutions against different peer groups and provide MFI managers with even more thorough information on their institution.

Another successful initiative in building transparency is this year's accreditation of JCR-VIS by the Rating Fund as a microfinance rating firm for South Asia. JCR-VIS staff have been acquainted with key national and international microfinance actors and have been trained in the specifics of microfinance operations. The accreditation of a local rating firm has significantly lowered ratings costs for microfinance institutions and enhanced their access to high quality microfinance ratings. To date, the firm has rated two microfinance banks and one NGO MFI. Since most NGOs are not ready to undergo ratings, the market for JCR-VIS remains limited to operational microfinance banks.

Opportunities for Building Transparency

PMN is currently working to improve the quality of audits produced by microfinance providers. In addition to developing a panel of audit firms that can be accessed by its members, PMN is promoting the adoption of international disclosure requirements specific to microfinance. The network is also assisting integrated institutions to produce separate audits for their microfinance programs; SUNGI and SAFWCO have already begun this process while others like TRDP and NRSP plan to do so in the near future. As financial statement disclosures improve, more institutions will be able to provide audited reports that rival those of First Microfinance Bank, which was recently named the second best MFI in terms of audit disclosures.

SECP and the Institute of Chartered Accountants of Pakistan (ICAP) are working with the Financial Sector Strengthening Program (FSSP), a joint project of the European Commission (EC) and the Swiss Agency for Development and Cooperation, to develop a common presentation format for financial statements of MFIs registered under SECP and the Societies Act. This initiative began in February 2005 and is currently in the final phase. Draft guidelines that follow international reporting norms have been prepared by a task force comprising representatives from SECP, ICAP, FSSP and EC and discussed with PPAF and PMN representatives. NGO MFIs, whether specialized or integrated, will be required to follow these guidelines in addition to the statutory requirements of regulators under which they are registered. The guidelines are expected to be approved by SECP and ICAP in the first half of calendar year 2006. In promoting international standard risk evaluations norms within microfinance, SBP has hired microfinance specialists to develop on-site monitoring tools to evaluate microfinance banks' financial performance and risks according to international reporting standards and the requirements of Basle II.

Conclusion

The microfinance industry in Pakistan, while not profitable, is quite transparent. The sector has been able to clarify and standardize terms and ratios to meet international reporting norms, and performance data are presented on a regular and accurate basis in PMN's annual report. Understanding of performance is gaining ground at all levels, and several initiatives are underway to further enhance the state of transparency. Microfinance actors, from managers to donors and market facilitators, should capitalize on the wealth of available information to closely monitor performance and drive the industry towards healthy and sustainable growth, ensuring that the poor in Pakistan have regular and reliable access to microfinance services.

Sri Lanka

The microfinance movement in Sri Lanka emerged in the early 1950s, when cooperatives began to mobilize savings and provide credit to their members. The poor additionally maintained savings accounts with post offices acting as a service outlet of the National Savings Bank. Today, the microfinance industry counts a number of different players. In addition to co-operative societies, NGOs and development banks have emerged as the major providers in the industry. Private, for-profit companies are playing an increasingly larger role in the sector, though commercial bank involvement continues to be limited. Community-based organizations and international NGOs also engage in microfinance activities, and government-backed programs continue to be prevalent. While informal moneylenders continue to exist, formal and semi-formal institutions now dominate the provision of financial services to the poor.

Formal financial institutions include banks and finance companies regulated by the Central Bank of Sri Lanka. In addition to providing direct microfinance services, this group also provides wholesale bulk funds to the sector. The Central Bank itself is involved in the implementation of two major microfinance programs – the Small Farmers and Landless Credit Project (SFLCP - ISURU)[1] and the Poverty Alleviation Microfinance Project (PAMP). Rather than engage in direct microfinance service delivery, the Central Bank provides funds to regional development banks and a few other microfinance institutions which then extend credit to small groups or village societies promoted by NGOs. In 1986, the government of Sri Lanka established 22 rural development banks to better reach remote areas and poor clients. These institutions were later consolidated into six regional development banks and given greater management autonomy.[2] Along with one private sector development bank (Sanasa Development Bank), these institutions cover 18 of the 25 districts in the country. Commercial bank involvement, on the other hand, remains limited to small credit programs that are negligible relative to banks' total operations and as compared to other microfinance providers in the market.

Most microfinance providers in Sri Lanka are in fact semiformal institutions that are legal bodies but not regulated by authorities. This group includes approximately 200 NGOs, 1,476 cooperative rural banks, over 8,400 thrift and credit cooperative societies (some of which are inactive), the private sector and a few government microfinance programs.[3] In addition to being registered under a diversity of legal frameworks, these institutions vary significantly by level of operations, from grass-root village banking organizations that serve under 1,000 clients to large institutions with regional or national coverage serving over 100,000 clients in a number of districts. As per the 2002 national microfinance survey, the semi-formal sector accounted for over 50 percent of the microfinance industry in Sri Lanka and continued to expand its market share with every year.[4]

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1 SFLCP came to an end in 1997, but the Central Bank continues to provide indirect funding to the Isuru village societies created in the context of the program.
2 Richard Gant et al, National Microfinance Study of Sri Lanka: Survey of Practices and Policies, Colombo: AusAID and GTZ, 2002.
3 Stephanie Charitonenko and Dulan de Silva, Commercialization of Microfinance: Sri Lanka, Manila: Asian Development Bank, 2002.
4 Richard Gant et al.

Microfinance products in Sri Lanka vary from savings to credit and insurance. Savings and credit continue to be the most common while insurance services are limited to a few specialized organizations. Microfinance providers generally offer two types of savings products, compulsory and voluntary. NGOs may only collect savings from members and must obtain written permission from the Central Bank in order to do so. Many, however, lack this authorization yet maintain savings as a requirement for membership or access to loans. Credit, on the other hand, is commonly available for the general public and includes loans for consumption, income subsistence, micro-enterprise start-up and expansion as well as small business start-up and formalization. Loans are provided both with and without physical collateral, with pawning a common and popular form of collateral-based credit.

Sri Lankan microfinance providers employ a variety of lending methodologies to deliver financial services to the poor, including individual, small group and village banking models. In the individual lending model, microfinance institutions provide financial services directly to the client, often with guarantees from two other individuals. Microfinance institutions also employ the small group model, whereby a group of 5 to 30 members serves as an access point to clients and loans are guaranteed by members. One of the most common methodologies among NGOs and cooperatives, however, is the village banking model. Microfinance institutions promote the establishment of independent, community-based organizations that generally register as societies or cooperatives. These institutions then operate as village banks, mobilizing savings and borrowing external funds from microfinance institutions in order to onlend to members. While microfinance services are largely delivered under the group mechanisms, microfinance institutions are increasingly employing individual lending models.

The 2002 national microfinance survey found that there was one microloan for every two families in the country in addition to four savings accounts. The maximum potential demand for microcredit services has been estimated at USD 255 million, with supply currently standing at USD 202 million.[5] One of the limitations in analyzing microfinance supply is the lack of country-wide, updated information on sector performance. The following pages build on local knowledge of the sector to examine the factors that limit or facilitate our understanding of microfinance in Sri Lanka. In addition, outreach and financial data from eight microfinance institutions are analyzed to shed light on the performance of Sri Lankan microfinance providers.

Methodology

Standard performance data on eight microfinance institutions (MFIs) were collected for the years 2002, 2003 and 2004.[6] The key consideration when selecting the sample was to get a representative set of institutions that captures the diversity of the sector in terms of legal structure, geographical coverage and clientele. Hence, the sample includes two development banks (Ruhuna and Sabaragamuwa), one private, for-profit company (Lakjaya) and five NGOs (ACCDC, Arthacharya, SEEDS, WDFH and Wilgamuwa). SEEDS stands out from its peer group as the largest NGO MFI in the country as well as the most commercialized. Due to the lack of reliable data, no cooperative society was included in this study. In terms of geographical coverage, SEEDS, Arthacharya and ACCDC serve clients on a national scale whereas Ruhuna, Sabaragamuwa and Lakjaya operate at the regional

5 Stephanie Charitonenko and Dulan de Silva.

6 These years are listed according to MIX financial years to incorporate data from institutions that close their books on various dates around the calendar year. The financial year listed by MIX is the calendar year that contained the greatest number of months of the MFI's own financial year. For example, institutions that close on March 31st, 2005 are listed as FY 2004.

level. WDFH and Wilgamuwa, on the other hand, are local initiatives. These last two institutions, moreover, serve women clients only while the other MFIs cater to a mixed clientele.

Audited financial accounts for all three years were available at all MFIs except Wilgamuwa, where the accounts were not audited for the year 2003. Audit report formats varied across institutions, and the reclassification of data according to international standards required a number of consultations with MFI staff. Some financial statements lacked consistency across the years, and in certain instances, they did not provide sufficient information to allow the collection of all performance data; only four institutions, for example, were able to provide their portfolio at risk for all three years under study. Moreover, data corresponded to different risk levels, such as portfolio at risk over one day and portfolio at risk over 90 days.

Performance of Sri Lankan Microfinance Institutions

Over the last few years, Sri Lankan microfinance providers have built on strengths such as high efficiency and staff productivity to significantly increase outreach even as they continue to serve some of the poorest clients in the country. Institutions in this sample are moreover increasingly attaining profitability through the pursuit of cost reduction strategies. Portfolio quality, however, is rather poor and may pose significant challenges to the sector.

Outreach

In 2004, the sample institutions served 865,997 clients, of which 374,320 were active borrowers benefiting from USD 78 million in loans outstanding. Regional development banks were by far the largest and accounted for 73 percent of all clients. With an average of 314,020 clients, these institutions were twice as large as SEEDS and reached 15 times as many clients as the average NGO with small outreach.[7]

Over the period studied, the outstanding loan portfolio grew by 74 percent. The growth in active borrowers, on the other hand, was only 22 percent, indicating a dramatic increase in average individual loan balance over the two years. Institutions may have increased loan size to adjust for inflation and currency devaluation. Additionally, the lending methodologies that they employ tend to allow clients to access incrementally larger loans, causing average loan balance to rise as institutions mature and clients graduate from one loan cycle to the next. While average loan balance did increase from USD 105 to USD 144, it barely changed as a percentage of local per capita income, rising from 11.8 percent to just 12.3 percent. Hence, while many MFIs do not conduct systematic assessments of client poverty level, their average loan balance indicates that they have continued to serve the lower end of the market while expanding outreach.

Evidence suggests that while NGO MFIs are reaching rather poor clients, regional development banks and for-profit MFIs serve clients in the upper segment of the microfinance market. As Figure 1 indicates, Wilgamuwa managed the lowest average loan balance (USD 26), followed closely by other small NGOs with local or regional coverage (WDFH and Arthacharya). SEEDS, however, held the highest average loan balance in the sample, partly as a result of product diversification. Over the last couple of years, SEEDS has been devoting an increasingly larger share of its loan portfolio to renewable energy loans for the purchase of solar home systems, thereby

[7] Small: outreach < 100,000 clients; large: outreach > 100,000 clients.

raising its average balance per borrower. Average savings balance paints a similar picture, with Wilgamuwa holding the lowest balance per saver and SEEDS holding the highest.

Figure 1: Average balance per borrower (USD)

MFI	Institutional Type	2002	2003	2004
Ruhuna	Development bank	169	198	245
Sabaragamuwa	Development bank	104	117	129
Lakjaya	For-profit company	94	136	143
SEEDS	NGO (large)	297	329	446
ACCDC	NGO	87	102	81
Arthacharya	NGO	24	36	38
WDFH	NGO	19	41	44
Wilgamuwa	NGO	46	34	26

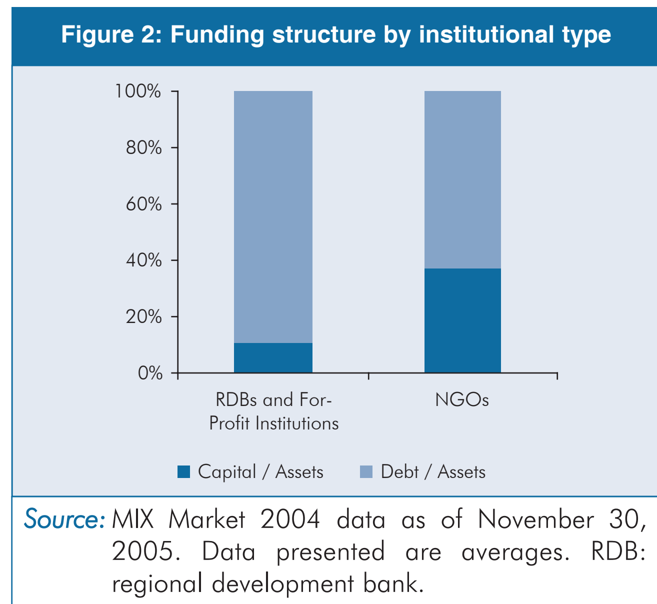
Source: MIX Market data as of November 30, 2005.

On average, over 75 percent of borrowers in the Sri Lankan microfinance sector are women[8], compared to 68 percent among the sample institutions. While the majority of MFIs serve both men and women, there are specialized organizations, such as women's development federations that focus exclusively on women clients; WDFH and Wilgamuwa are two such institutions. In addition to serving more women borrowers, these institutions also manage lower loan balances than their peers.

Financial Structure

With greater access to donor granted equity and lower dependence on savings, NGOs tend to be more capitalized than development banks or for-profit institutions. A glance at Figure 2 reveals that whereas NGOs fund one third of their assets with capital, development banks and Lakjaya rely on equity for just one tenth of their funds. Capitalization within the latter group is rather consistent, ranging from seven to 13 percent of assets. Variance among NGOs, however, is somewhat higher. With a capital-to-asset ratio of just 12 percent, SEEDS' financial structure more closely resembles that of development banks and for-profit institutions than that of other NGOs.

Figure 2: Funding structure by institutional type



Source: MIX Market 2004 data as of November 30, 2005. Data presented are averages. RDB: regional development bank.

While commercial borrowings remain negligible, MFIs have ample access to subsidized, development-oriented credit lines through various government programs and agencies, especially the National Development Trust Fund (NDTF). Its seven percent interest rate on loans makes these funds attractive to institutions, particularly if they are looking to reduce their dependence on donations. NDTF may thus have significantly contributed to the ongoing shift away from donor grants towards borrowings. Data suggest that as institutions mature, they become increasingly dependent on debt for their financing. Within the sample, the average share of capital dropped from 41 percent of assets in 2002 to just 27 percent in 2004. Except for two institutions, all MFIs became less capitalized over the period studied, indicating greater commercialization of the sector.

8 Richard Gant et al.

Financial Performance

Except for two institutions, all MFIs generate sufficient revenues to cover costs before taxes. As Figure 3 suggests, development banks are the most profitable, as a group. The group of small NGOs, on the other hand, includes both the most and least profitable institutions. Over the period studied, the sample MFIs made significant improvements in profitability, with average operational self-sufficiency increasing by twenty percentage points to 106 percent.

Figure 3: Profitability indicators

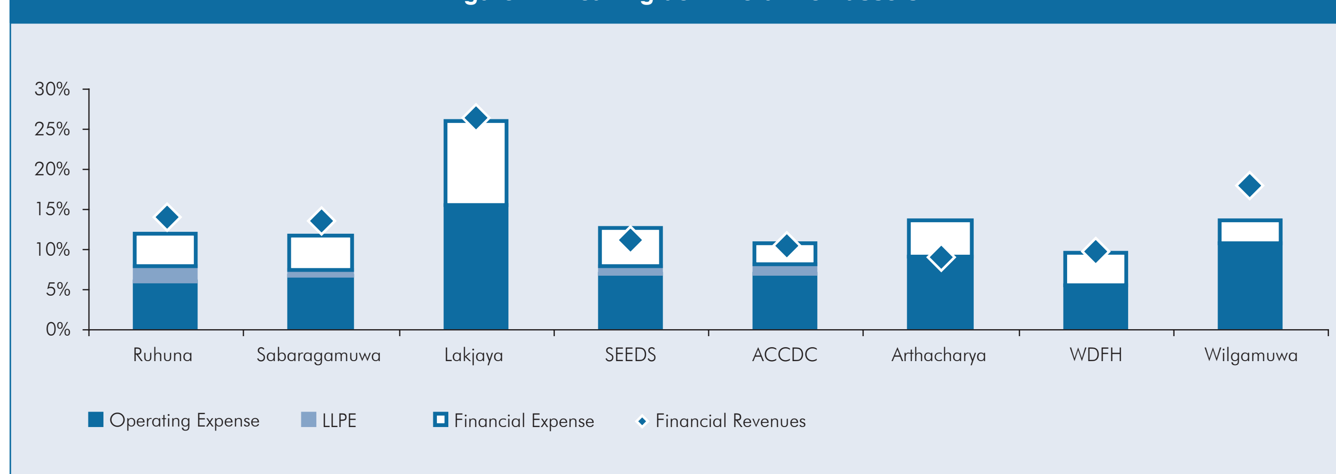
MFI	Institutional Type	OSS	ROA	ROE
Ruhuna	Development bank	121.8%	0.5%	3.6%
Sabaragamuwa	Development bank	118.3%	1.4%	17.7%
Lakjaya	Private company	102.7%	0.7%	4.9%
SEEDS	NGO (large)	90.1%	-1.4%	-9.9%
ACCDC	NGO	100.0%	0.0%	0.0%
Arthacharya	NGO	68.5%	-4.2%	-11.1%
WDFH	NGO	105.5%	-0.9%	-2.5%
Wilgamuwa	NGO	140.9%	5.5%	7.1%

Source: MIX Market 2004 data as of November 30, 2005. OSS: operational self-sufficiency; ROA: return on assets; ROE: return on equity.

A glance at revenue and cost structures helps shed light on differences in profitability across institutions. As Figure 4 indicates, MFIs generated profits in different ways, either by reducing costs or enhancing revenues. The two development banks both generated average financial revenues but maintained tight control over their expense structures. On the other hand, both Lakjaya and Wilgamuwa relied on higher financial revenues. Lakjaya, which had to cover a higher cost of funds than any other institution, allocated 90 percent of its assets to its credit activities in addition to charging higher interest rates on its loans.

Overall, the sample institutions devote two thirds of their funds to their loan portfolio, falling somewhat short of the regional average for South Asia (74 percent). With the exception of WDFH and Arthacharya, however, all institutions allocate at least 70 percent of their assets to their credit activities. In addition to having a higher cost structure than most other MFIs, Arthacharya invested just 43 percent of its assets in its loan portfolio, generating the lowest financial revenues and becoming the least profitable institution in the sample.

Figure 4: Breaking down return on assets



Source: MIX Market 2004 data as of November 30, 2005. Data are expressed as percentage of total assets. LLPE: loan loss provision expense.

Profitability may be over-estimated in the case of some MFIs. Three institutions, including the most profitable one in the sample, did not make any provisions for loan defaults, hence artificially reducing their cost structures. Should these institutions take into account risk levels in their portfolios and provision against them accordingly, their profitability would decline.

Efficiency and Productivity

The Sri Lankan microfinance sector is generally efficient and productive. In 2003, the average Sri Lankan MFI spent USD 16 per borrower – just two thirds of what it cost the average South Asian institution. Moreover, it only cost Sri Lankan MFIs 19 cents to maintain each dollar in loans outstanding, compared to 22 cents across South Asia. Sri Lankan staff productivity, however, was somewhat lower than the regional average. Sri Lankan microfinance staff on average served 175 borrowers each, compared to 219 borrowers in the average South Asian institution.

As Figure 5 illustrates, development banks, as a group, are generally more efficient as well as more productive than their peers, hence their lower cost structures. Whereas these institutions expend fewer funds to maintain each dollar in loans outstanding, small NGOs are more efficient in terms of cost per borrower. As mentioned earlier, development banks largely focus on providing large, individual loans, which reduce their costs per dollar outstanding but do not allow them to reach as many borrowers relative to their operational expenses as group lending methodologies more common among small NGOs, hence the latter's lower cost per borrower.

Figure 5: Efficiency and productivity indicators

MFI	Institutional Type	Operating Expense Loan Portfolio	Cost per Borrower (USD)	Borrower per staff Member
Ruhuna	Development bank	7.6%	17	307
Sabaragamuwa	Development bank	8.5%	10	545
Lakjaya	For-profit company	16.8%	24	211
SEEDS	NGO (large)	9.0%	35	81
ACCDC	NGO	8.1%	7	47
Arthacharya	NGO	18.3%	7	102
WDFH	NGO	29.4%	12	32
Wilgamuwa	NGO	14.7%	4	162

Source: MIX Market 2004 data as of November 30, 2005.

The data suggest that the sector is becoming more efficient and profitable over time. The cost per dollar outstanding declined from 19 to 14 cents between 2003 and 2004 while productivity increased from 175 to 186 borrowers per staff member.

Portfolio Quality

Portfolio quality is rather low in Sri Lanka, with 11 percent of the portfolio at risk over 30 days in 2003, compared to eight percent across South Asia. Data on portfolio quality, however, are not entirely reliable. Only four institutions in the sample were able to provide this information for all three years under review, although the number increased to six institutions in 2004. Moreover, measures of portfolio quality vary significantly across institutions. Many formal institutions track the non-performing loan ratio, which is equivalent to portfolio at risk over 90 days. While some institutions do calculate portfolio at risk, they do not always do so after 30 days, with some tracking this variable after just one day and others waiting for six months.

Where they do exist, the data suggest that portfolio quality has been improving over the years. Between 2002 and 2004, average portfolio at risk in the sample declined from 26 percent to just 7 percent. In 2004, Lakjaya and SEEDS had the highest portfolio quality in the sample, with only 0.5 and 1 percent of their portfolios at risk, respectively

Conclusion

Over the past decade, the Sri Lankan microfinance sector has made significant achievements in reaching poor and disadvantaged segments of the population while improving profitability and productivity. Today, the sector faces the challenge of consolidating these

achievements and ensuring sector growth. Institutions should pay particular attention to improving their portfolio quality and making adequate provisions for bad loans. In addition, adequate regulations are needed to protect savings and create a proper legal environment for the recovery of MFI loans. As growing demand for microfinance services and greater access to capital markets fuel more growth in the sector, it becomes increasingly necessary to establish a conducive policy environment that ensures healthy maturity of the industry. Equally important, however, the sector must generate standard performance data that allow it to develop an accurate picture of its performance. As the sector gains a better understanding of its performance, it will be better able to address weaknesses and build on strengths to ensure a more reliable supply of microfinance services.

Transparency Environment in Sri Lanka

Thousands of organizations are engaged in microfinance service delivery in Sri Lanka, but little is known about their operations. Despite several decades of experiments in microfinance, the sector has failed to emerge as an industry. Clients receive financial services through a variety of methodologies from a diverse set of actors that work independently and neither network nor interact with one another. Even the few large institutions have failed to come together as one industry on any issue pertaining to the sector.

Sector data reflect this fragmentation and are largely unavailable. Even basic survey data on outreach and loan portfolios are unavailable, making it difficult to assess level and sustainability of operations in the sector. While the dearth of information partly reflects the lack of standard reporting requirements, most institutions lack adequate management information systems (MIS) and are unable to accurately track their loan portfolios and other performance measures. What little data are available rarely adhere to international standards and instead track cumulative indicators which do not accurately capture institutional performance.

State of Transparency

Data on microfinance activity in Sri Lanka are largely limited to the institutional level and vary significantly across MFIs. Few institutions are familiar with international reporting standards for microfinance[9], and while some track their performance according to these norms, others have not adopted them as they provide a negative reflection of their performance. Most institutions, however, have not been exposed to international reporting standards, largely as a result of language barrier, geographical isolation and lack of advocacy for these norms. Hence, available performance data do not always comply with standards and are often inconsistent across institutions. Few microfinance providers, for example, track profitability, productivity and efficiency indicators. As mentioned earlier, measures of portfolio quality often vary across institutions, with some measuring portfolio at risk after one day and others tracking this indicator after 90 days. Portfolio at risk, however, is not commonly known or used, and institutions prefer to track repayment rates despite the international acceptance of portfolio at risk over 30 days as a better measure of portfolio quality.

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[9] CGAP, Microfinance Consensus Guidelines: Definitions of Selected Financial Terms, Ratios, and Adjustments for Microfinance, Washington, DC: CGAP, 2003.
Richard Rosenberg et al, Microfinance Consensus Guidelines: Disclosure Guidelines for Financial Reporting by Microfinance Institutions, Washington, DC: CGAP, 2003.
SEEP Network, Measuring the Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring, Washington, DC: SEEP Network, 2005.

Despite the presence of international donors, these have not significantly enhanced transparency and the dissemination of global reporting standards. While a few donors and research organizations have undertaken studies of the microfinance sector, these were largely in the form of institutional-level impact studies that neither collected nor analyzed data according to international norms. Moreover, these studies were conducted on an ad hoc basis and did not establish any mechanisms for regular reporting. In 2002, the Australian Government Overseas Aid Program (AusAID) and the German Agency for Technical Cooperation (GTZ) conducted an extensive study mapping the sector. While the survey contributed to general knowledge of the sector, it contained very little institutional performance data and did not adhere to globally accepted indicators, reporting instead on cumulative variables.

Lack of standard performance data makes it difficult to gauge MFI performance and hinders the dissemination of best practices in the sector. One of the consequences of inadequate measures of portfolio quality is that loan loss provisioning does not adequately cover risk levels in the sector. Many institutions do not make provisions for bad loans; those that do often provide a general provision or follow commercial banking practices which commence provisions only after six months from delinquency. These practices relate to collateral-based lending and hence do not apply to most microfinance providers. In understating portfolio risk and expenses, low levels of loan loss provisioning among Sri Lankan MFIs artificially inflate profitability. In general, institutions have very little understanding of microfinance management and are not aware of best practices in financial, portfolio and asset management.

One of the greatest weaknesses in the sector thus appears to be the absence of a central actor to disseminate standard practices, build MFI capacity and monitor sector performance. The Microfinance Network is a loose, informal network that mostly provides microfinance practitioners with a forum to discuss current issues and build partnerships.[10] This network is not representative of the sector and does not currently address MFI needs such as dissemination of standards, capacity building, performance monitoring and policy advocacy. NDTF, which currently provides funds to 160 MFIs, holds limited information on its partner institutions and could be a starting point for data collection in the sector. Although data reporting is a requirement for funding, NDTF collects information on a limited number of ratios that do not fully comply with international standards. Moreover, reporting requirements are sometimes relaxed to increase the flow of funds to the sector. The Department of Cooperatives also collects data on the institutions registered under it, but it generally focuses on cumulative numbers. While it also requires MFIs under its authority to provide regular audited financial statements, these are generally of poor quality and do not significantly enhance knowledge of institutional performance.

Most microfinance providers are required to undergo external audits by regulators or funders, but their financial statements do not always provide sufficient detail for thorough and accurate performance analysis and do not consistently track expenses over the years. Interest income, for example, is often consolidated into one item with no notes to indicate how much was generated on the loan portfolio or through other investments. It is therefore rarely possible to calculate portfolio yield. Moreover, donor grants are often treated as part of income with no distinction between operational and non-operational revenues, making it difficult to assess operational sustainability. Financial statements rarely include an aging analysis of the loan portfolio; MFIs either do not provide for bad loans or do so without an accurate understanding of their risk levels, often overstating profits. Finally, interest income is accrued. If interest is accrued, it is very important to monitor accruals and ensure that interest that is not collected is reversed. This practice, however, is largely

[10] Richard Gant et al.

neglected, and income keeps increasing over time, even on delinquent portfolios.

Quality and frequency of audits both tend to vary by institutional type and size. Established MFIs carry out annual external audits on a regular basis and have access to more qualified auditors. Most institutions, however, do not undergo audits in a timely manner. Audits of cooperative institutions, for example, are not conducted on a regular basis and often contain errors on basic accounting issues (e.g. balance sheet not tallying). Poor audit quality among these institutions is largely due to limited resources in the Department of Cooperatives. For instance, in one district there are over 900 cooperative banks to be audited by less than 10 auditors. In addition to limited resources, various factors contribute to poor audit quality in the sector. These include lack of understanding of microfinance operations by auditors, lack of MFI commitment, the perception of audits as fault finding, the lack of an effective monitoring mechanism and insufficient attention on the part of donors. Development banks, for example, are regulated by the Central Bank and as such are required to submit thorough, financial statements on a regular basis. Their reporting requirements, however, are based on accepted practices for the banking sector and not on best practices for microfinance. For instance, development banks only provide for loan losses once loans are six months overdue, hence underestimating risk and inflating portfolio quality for typical microfinance loans.

Although rating agencies provide an important source of information on the formal financial sector, they are absent from the microfinance sector in Sri Lanka. M-CRIL, one of the leading microfinance rating agencies in South Asia, rated one institution a few years ago. MFI management sought the rating after gaining knowledge of the Consultative Group to Assist the Poor (CGAP) and the cofinancing of MFI ratings that it offers through the Rating Fund[11]. By undergoing the rating, the institution expected to receive more recognition and perhaps increase its access to funds. The rating score, however, did not meet management expectations. Finding little usefulness for the exercise and given the costs involved, the MFI chose not to undergo further ratings. While ratings help investors understand institutional credit risk, they also allow MFIs to better understand their performance and address their weaknesses accordingly. The Sri Lankan microfinance sector, however, may not be ready to undergo extensive ratings at this time. Not only are most institutions unable to provide necessary information, but there are currently no creditors that will use an MFI rating score to finance the institution. In order for ratings to be effective, they must be preceded with awareness building on international best practices for reporting and less rigorous assessments that allow MFIs to gain better understanding of their operations without conferring a score.

The Sri Lankan microfinance sector is largely unregulated and subject to little supervision. For instance, the Banking Act prevents NGOs from mobilizing savings without written permission from the Central Bank, but as mentioned earlier, there are many NGO MFIs that collect savings without authorization. The Asian Development Bank (ADB) is currently working with the government to develop appropriate regulation for the sector. A draft act is in progress, and policymakers are keen to take it to the next step. The Central Bank is proposing to conduct a census of microfinance providers to gain a better understanding of operations before introducing legislation. However, there is a lot of debate as to the effectiveness, timeliness and appropriateness of intended microfinance regulation.

Opportunities for Building Transparency

While the 2002 national microfinance survey did not collect standard performance data, it did help map the sector and enhance knowledge of microfinance

[11] 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.

institutions. Currently, there are two new donor-funded projects addressing sectoral issues in microfinance, one funded by ADB and the other by GTZ. Both projects are capacity building initiatives that intend to introduce best practice to the sector. While previous attempts were made to introduce best practice in accounting and MFI audit reports, these were generally limited in scope and failed to enhance transparency. One challenge for the projects underway is to avoid duplication, particularly as both are very similar and work with the same partners.

The Microfinance Network has the potential to become a neutral information focal point for the industry. Currently, however, the network is not institutionalized, and few practitioners are actively involved in it. While it creates a forum for the exchange of ideas and experiences, the network does not currently contribute to transparency. To improve its effectiveness, the network would need to be formally registered and managed by microfinance experts who can better adapt its services to meet the needs of microfinance providers and hence expand its membership. By shifting its focus to advocacy, capacity building and performance monitoring, the Microfinance Network could significantly enhance the availability of performance data on the sector. At this stage, it is important to raise awareness of standard practices at all levels. A series of workshops for policymakers, donors, practitioners and other stakeholders could be an important starting point.

Conclusion

There is much room for improving the transparency environment in Sri Lanka. While formal organizations and a few large institutions have made significant strides in improving their reporting standards, these achievements are limited in scope. The main weaknesses are a lack of awareness and commitment to transparency on the part of all stakeholders, particularly the leadership. Pervasive government presence, inappropriate donor interventions and the absence of a formal industry network have exacerbated these weaknesses. Government programs, for instance, are often subject to political influence. Donors, on the other hand, tend to exert pressure on organizations to disburse an increasing number of loans with little regard to institutional capacity.

The first step in improving transparency is raising awareness. All stakeholders should be made aware of the advantages of improved transparency. Standard performance data allow microfinance managers to gain a better understanding of their operations and hence improve performance. Better data can improve risk awareness and increase the flow of funds to the sector, hence fueling growth. Armed with good data, networks carry more clout in their advocacy efforts and regulators can better supervise the industry. Once stakeholders realize the benefits of transparency, it is important to develop a strategy for building institutional capacity to ensure that MFIs are able to produce these data and that they are interpreted appropriately.

Appendices

Appendix A: List of Participating South Asian MFIs

The following institutions were included in the South Asia data sample. Of the 125, 102 provided multiple years of complete financial data. These are marked (*) and comprise the core data set for the financial performance analysis. With the exception of the five Afghani institutions without complete 2003 outreach data, the 125 were all used in the scale and outreach analysis.

The full, multi-year data set, including recent updates to the data, can be found at www.mixmarket.org > Demand.

Acronym		Name
		n=125 (102*)
Afghanistan		**n=9 (4*)**
AFSG	*	Ariana Financial Services Group (Mercy Corps)
AMI		Afghanistan Microfinance Initiative (CHF International)
ARMP	*	Afghanistan Rural Microcredit Programme (Aga Khan Development Network)
BRAC - AFG	*	BRAC Afghanistan
FINCA - AFG		FINCA Afghanistan
FMFB Afghanistan		First MicroFinance Bank - Afghanistan
MoFAD		Micro Finance Agency for Development (CARE)
Parwaz	*	Parwaz MicroFinance Institution
Women for Women - AFG		Women for Women - Afghanistan
Bangladesh		**n=48 (43*)**
AF	*	Annesha Foundation
Annesa		Annesa Somaj Unnayan Songstha
ASA	*	Association for Social Advancement
ASOD	*	Assistance for Social Organization and Development
ASPADA	*	Agroforestry Seed Production Development and Association
BASA	*	BASA
BDS	*	Bangladesh Development Society
BEES	*	Bangladesh Extension Education Services
BRAC	*	Bangladesh Rural Advancement Committee
BURO Tangail	*	BURO Tangail
CCDA	*	Centre for Community Development Assistance
COAST Trust		Coastal Association for Social Transformation Trust
CODEC		Community Development Centre
CSS	*	Christian Service Society

Acronym		Name	n=125 (102*)
DDJ	*	Dak Diye Jai	
DESHA	*	DESHA	
DIP	*	Center for Development Innovation and Practices	
EWF	*	Eskander Welfare Foundation	
GJUS	*	Grameen Jano Unnayan Sangstha	
Grameen Bank	*	Grameen Bank	
GUP	*	Gono Unnayan Prochesta	
HEED	*	HEED Bangladesh	
HFSKS		Hilful Fuzul Samaj Kallyan Sangstha	
ICDA	*	Integrated Community Development Association	
IDF	*	Integrated Development Foundation	
JCF	*	Jagorani Chakra Foundation	
NGF	*	Nowabenki Gonomukhi Foundation	
NUSA	*	Naria Unnayan Samity	
PBK	*	Pally Bikash Kendra	
PDIM	*	Participatory Development Initiatives of the Masses	
PMK	*	Palli Mongal Karmosuchi	
PMUK	*	Padakhep Manabik Unnayan Kendra	
POPI	*	People's Oriented Program Implementation	
PPSS	*	Palli Progoti Shahayak Samity	
RDRS	*	RDRS Bangladesh	
RIC	*	Resource Integration Centre	
RRF	*	Rural Reconstruction Foundation, Jessore	
Saint		Saint Bangladesh	
SBD	*	Swanirvar Bangladesh	
SDC	*	Society Development Committee	
SDS	*	Shariatpur Development Society	
SSS	*	Society for Social Services	
ST	*	Sangkalpa Trust	
TMSS	*	Thengamara Mohila Sabuj Sangha (TMSS)	
UDDIPAN	*	United Development Initiatives for Programmed Actions	
UDPS	*	Uttara Development Program Society	
VARD	*	Voluntary Association for Rural Development	
Wave	*	Wave Foundation	
India		**n=37 (28*)**	
AAMBA		Amber Ashrayee Mahila Benefit Association	
ADARSA		ADARSA	
AID		Asmita Institute for Development	
AMMACTS	*	Acts Mahila Mutually Aided Coop Thrift Society	
ASSIST		A Society for Integrated Rural Development	
Bandhan	*	Bandhan	
BASIX	*	Bhartiya Samruddhi Finance Limited	
BIRDS	*	Bharti Integrated Rural Development Society	
BISWA	*	Bharat Integrated Social Welfare Agency	
Bodhana	*	Tiruvalla Social Service Society	

Acronym		Name	n=125 (102*)
BWDA	*	Bullock-Cart Workers Development Association	
Cashpor MC	*	Cashpor Microcredit	
GK	*	Grameen Koota	
Guide	*	Guide	
GV	*	Grama Vidiyal	
IASC	*	Indian Association for Savings and Credit	
Janodaya	*	Janodaya Public Trust	
KBSLAB	*	Krishna Bhima Samruddhi Local Area Bank Limited	
Kotalipara	*	Kotalipara Development Society	
KRUSHI		KRUSHI	
LEAD	*	League for Education and Development	
Mahasemam	*	Mahasemam	
PSS		Pragathi Sewa Samiti	
Pushtikar	*	Pushtikar Laghu VPBSSS Ltd	
PWMACS	*	PWMACS	
RGVN	*	Rashtriya Gramin Vikas Nidhi	
Sanghamitra	*	Sanghamitra Rural Financial Services	
Sarvodaya Nano Finance	*	Sarvodaya Nano Finance Limited	
SEVA Microfoundation		SEVA Microfoundation	
SHARE	*	SHARE Microfin Ltd.	
SKS	*	Swayam Krishi Sangam	
Spandana	*	Spandana (Society and NBFC)	
SYA		Star Youth Association	
TCT	*	Thirumalai Charity Trust	
VCD		Vikas Center For Development	
VSKSU	*	Vivekananda Seva Kendra-o- Sishu Uddyan	
VWS	*	Village Welfare Society	
Nepal		**n=8 (8*)**	
CBB	*	Chhimek Bikas Bank Ltd.	
DD Bank	*	Deprosc Development Bank, Ltd.	
MGBB	*	Madhyamanchal Grameen Bikas Bank Ltd.	
Nirdhan	*	Nirdhan Utthan Bank Ltd.	
NSSC	*	Chhimek Samaj Sewa Sanstha (Neighbourhood Society Service Centre)	
PGBB	*	Western Region Grameen Bikas Bank	
SBB	*	Swabalamban Bikas Bank Ltd.	
VYCCU	*	VYCCU Savings and Credit Cooperative Society Ltd.	
Pakistan		**n=15 (11*)**	
Asasah		Asasah	
Bank of Khyber	*	The Bank of Khyber - Microfinance Division	
DAMEN	*	Development Action for Mobilization and Emancipation	
FMFB - Pakistan	*	First MicroFinanceBank Ltd - Pakistan	
Kashf	*	Kashf Foundation	
Khushhali Bank		Khushhali Bank	
NRSP	*	National Rural Support Programme	

Acronym		Name	n=125 (102*)
Orangi	*	Orangi Pilot Project	
Orix Leasing		Orix Leasing - Microfinance Division	
PRSP	*	Punjab Rural Support Programme	
SAFWCO	*	Sindh Agricultural and Forestry Workers' Coordinating Organization	
SRSP	*	Sarhad Rural Support Programme	
Sungi		Sungi Development Foundation	
Taraqee	*	Taraqee Foundation	
TRDP	*	Thardeep Rural Development Programme	
Sri Lanka		n=8 (8*)	
ACCDC	*	All Ceylon Community Development Council	
Arthacharya	*	Arthacharya Foundation	
Lakjaya	*	Lakjaya Thrift & Credit Foundation Limited	
Ruhuna	*	Ruhuna Development Bank	
Sabaragamuwa	*	Sabaragamuwa Development Bank	
SEEDS	*	Sarvodaya Economic Enterprise Development Services	
WDFH	*	Women Development Federation Hambantota	
Wilgamuwa	*	Women Development Federation Wilgamuwa	

Appendix B: Performance Indicators by Region and Country

Indicators	Africa	EAP	ECA	LAC	MENA	S. Asia	Afghanistan	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Scale and Outreach												
Number of Active Borrowers	14,968	97,905	6,162	24,162	19,165	107,875	15,489	221,099	44,031	19,766	24,179	43,347
Gross Loan Portfolio	3,960,419	48,220,723	10,395,162	19,829,124	5,360,530	9,467,381	1,543,763	15,872,904	5,647,202	2,148,174	3,490,386	7,370,274
Percent of Women Borrowers	62.1%	76.5%	53.4%	58.0%	65.6%	83.3%	67.0%	94.0%	90.4%	90.5%	47.8%	65.8%
Average Balance per Borrower	509	291	1,902	788	512	113	216	66	134	131	175	124
Average Balance per Borrower / GNI per capita	113.4%	38.6%	187.0%	53.3%	28.3%	22.2%	26.9%	15.3%	21.6%	50.4%	33.1%	12.8%
Number of Savers	40,140	814,176	9,980	12,826	225	32,791	-	56,685	4,056	22,784	5,084	106,168
Voluntary Savings	3,995,671	86,210,649	9,061,083	14,049,333	-	2,962,383	-	5,682,724	236,530	607,200	303,747	5,682,913
Average Savings Balance per Saver	127	164	1,328	2,424	n/a	64	n/a	15	121	47	146	33
Average Savings Balance per Saver / GNI per capita	43.8%	34.3%	78.3%	140.0%	n/a	13.7%	n/a	3.7%	19.6%	18.1%	31.0%	3.4%
Financial Structure												
Capital / Asset Ratio	37.3%	37.6%	60.0%	32.8%	71.5%	21.3%	41.1%	23.5%	10.6%	9.2%	32.9%	28.1%
Debt / Equity Ratio	4.2	3.0	2.9	5.8	1.1	29.8	3.0	(1.5)	122.8	12.3	(19.7)	4.2
Deposits to Loans	122.0%	37.6%	20.5%	26.2%	0.0%	14.0%	0.0%	3.0%	8.4%	37.4%	24.6%	61.7%
Deposits to Assets	31.2%	24.7%	11.8%	19.7%	0.0%	7.1%	0.0%	2.2%	7.1%	21.3%	1.7%	34.4%
Gross Loan Portfolio / Assets	64.2%	70.5%	78.1%	79.9%	69.5%	73.6%	66.1%	75.8%	83.0%	52.3%	65.2%	67.5%
Profitability and Sustainability												
Return on Assets	-5.7%	0.9%	5.3%	2.9%	3.6%	-2.3%	-66.7%	3.6%	-1.5%	1.0%	-8.2%	-0.1%
Return on Equity	-37.6%	5.9%	14.6%	8.1%	5.0%	-6.6%	-226.8%	17.2%	-10.2%	12.1%	-32.3%	3.5%
Operational Self-Sufficiency	97.7%	117.5%	128.9%	115.8%	117.2%	105.5%	33.2%	125.7%	98.5%	110.0%	73.6%	101.3%
Revenue												
Financial Revenue Ratio	25.2%	28.6%	30.4%	31.2%	22.7%	18.5%	21.2%	19.8%	20.7%	13.3%	13.2%	15.5%
Profit Margin	-37.3%	1.9%	6.2%	8.4%	-13.6%	-19.6%	-319.2%	15.3%	-7.8%	7.9%	-90.7%	-15.8%
Expense												
Total Expense Ratio	30.7%	27.2%	24.3%	27.6%	19.0%	20.7%	87.9%	16.1%	22.0%	12.0%	21.4%	15.1%
Financial Expense Ratio	2.8%	5.0%	2.4%	6.3%	1.0%	5.1%	4.2%	3.4%	8.5%	5.1%	4.3%	4.3%
Loan Loss Provision Expense Ratio	2.2%	1.2%	1.1%	2.2%	-0.1%	1.2%	2.0%	0.8%	1.3%	1.2%	2.3%	0.5%
Operating Expense Ratio	25.7%	21.0%	20.7%	19.1%	18.2%	14.4%	81.7%	11.9%	12.3%	5.7%	14.8%	10.4%
Efficiency												
Operating Expense / Loan Portfolio	60.6%	32.1%	28.4%	26.5%	35.1%	22.0%	126.7%	15.8%	15.5%	11.5%	34.6%	19.3%
Cost per Borrower (USD)	232	58	326	155	130	25	152	10	14	14	67	16
Productivity												
Borrowers per Staff Member	149	139	72	139	120	219	54	131	439	152	171	175
Savers per Staff Member	206	179	27	95	-	81	-	12	115	186	28	369
Portfolio Quality												
PAR>30 Ratio	7.9%	5.6%	2.1%	4.8%	2.9%	7.6%	0.4%	5.8%	4.4%	6.2%	20.5%	11.1%
Loan Loss Reserve Ratio	6.9%	3.7%	2.0%	5.0%	3.4%	4.2%	2.6%	3.9%	1.6%	4.7%	9.6%	5.4%
Risk Coverage Ratio	139.5%	5660.8%	413.4%	255.5%	155.8%	315.5%	585.4%	277.5%	482.6%	89.5%	180.6%	116.3%
Write Off Ratio	3.5%	2.5%	1.2%	1.8%	2.2%	0.5%	0.1%	0.3%	0.5%	0.5%	1.0%	0.4%

Appendix C: MIX Market Indicators

SCALE AND OUTREACH	Definition
Number of Active Borrowers	Number of active borrowers with loans outstanding
Gross Loan Portfolio	Gross Loan Portfolio
Percent of Women Borrowers	Number of women borrowers / Number of Active Borrowers
Average Loan Balance per Borrower	Gross Loan Portfolio / Number of Active Borrowers
Average Loan Balance per Borrower / GNI per Capita	Average Loan Balance per Borrower/ GNI per Capita
Number of Savers	Number of savers with voluntary savings accounts
Savings	Total value of voluntary savings accounts
Average Savings Balance per Saver	Savings / Number of Savers
Average Savings Balance per Saver / GNI per Capita	Average Savings Balance per Saver / GNI per Capita
FINANCIAL STRUCTURE	
Capital / Asset Ratio	Total Equity / Total Assets
Debt / Equity Ratio	Total Liabilities / Total Equity
Deposits to Loans	Savings / Gross Loan Portfolio
Deposits to Total Assets	Savings / Total Assets
Gross Loan Portfolio / Total Assets	Gross Loan Portfolio / Total Assets
PROFITABILITY AND SUSTAINABILITY	
Return on Assets (ROA)	Net Operating Income, net of taxes / Average Total Assets
Return on Equity (ROE)	Net Operating Income, net of taxes / Average Total Equity
Operational Self-Sufficiency (OSS)	Financial Revenue / (Financial Expense + Loan Loss Provision Expense + Operating Expense)
REVENUE	
Financial Revenue Ratio	Financial Revenue / Average Total Assets
Profit Margin	Net Operating Income / Financial Revenue
EXPENSE	
Total Expense Ratio	(Financial Expense + Loan Loss Provision Expense + Operating Expense) / Average Total Assets
Financial Expense Ratio	Financial Expense / Average Total Assets
Loan Loss Provision Expense Ratio	Loan Loss Provision Expense / Average Total Assets
Operating Expense Ratio	Operating Expense / Average Total Assets
EFFICIENCY	
Operating Expense / GLP	Operating Expense / Average Gross Loan Portfolio
Cost per Borrower	Operating Expense / Average Number of Active Borrowers
PRODUCTIVITY	
Borrowers per Staff Member	Number of Borrowers / Number of personnel
Savers per Staff Member	Number of Savers / Number of personnel
PORTFOLIO QUALITY	
Portfolio at Risk > 30 Days	Outstanding balance, loans overdue> 30 Days / Gross Loan Portfolio
Loan Loss Reserve Rate	Loan Loss Reserve/ Gross Loan Portfolio
Risk Coverage Ratio	Loan Loss Reserve/ PAR > 30 Days
Write-off Ratio	Write Offs for the 12-month period / Average Gross Loan Portfolio

Pakistan Microfinance Network (PMN) is a network for organizations engaged in retail microfinance and dedicated to improving the outreach and sustainability of microfinance in Pakistan. Since 1999, PMN has worked to achieve its mission by promoting an enabling environment, building the capacity of stakeholders, especially retail microfinance institutions, and improving transparency and accountability by promoting the publication and widespread use of performance measures and standards related to the work of these institutions. www.pmn.org.pk

Centre for Micro Finance (CMF) in Nepal was established on July 21, 2000 to strengthen the institutional capacity of microfinance institutions and enable them to provide savings, credit and other financial services to the poorest families and especially women. CMF offers a rich mix of programs and services designed to meet the emerging needs of individual microfinance institutions as well as consultations to the sector as a whole. In promoting the sector, CMF engages in a myriad of activities, including training, technical assistance, consultancy services, research, publication and documentation, dissemination of best practice and networking in partnership with national and international organizations. www.cmfnepal.org

Sa-Dhan, an association of community development finance institutions in India, was established in 1998 to help build the microfinance sector and assist its members and associate institutions to better serve low-income households. To this end, the association has been actively involved in promoting an enabling legal and regulatory environment for the expansion of microfinance services to the poor. Sa-Dhan also works to build institutional capacity and has developed and disseminated a set of industry standards to ensure good governance, management, reporting and transparency within the sector. www.sa-dhan.org

Indrajith Wijesiriwardana and Anura Athapattu are independent consultants specializing in microfinance and business development services. Their combined experience extends over 20 countries and covers technical assistance to microfinance institutions in capacity building, project design, product development, evaluations, appraisal and training. Mr. Wijesiriwardana and Mr. Athapattu have worked with Sri Lankan organizations as well as leading international development agencies, including the Consultative Group to Assist the Poor (CGAP), the United States Agency for International Development (USAID), the World Bank, the Department for International Development (DFID) of the British Government and Women's World Banking in New York.

About the MIX...

The Microfinance Information eXchange (MIX) is a not-for-profit private organization dedicated to reducing one of the key constraints of the microfinance industry: the lack of reliable, timely, comparable and publicly available information on the financial and social performance of microfinance institutions (MFIs). Improving financial transparency is critical to the development of the market for microfinance services. The MIX accomplishes this through two primary services: the MIX Market and the MicroBanking Bulletin.

MIX Market

The MIX Market is the global microfinance information marketplace created to promote greater investment flows to retail MFIs and help MFI managers improve their institution's performance. (www.mixmarket.org)

MicroBanking Bulletin

The MicroBanking Bulletin is the premier benchmarking source for the microfinance industry. Its benchmarks are widely used by investors, donors and other service providers to facilitate greater standardization and a better understanding of the development of the microfinance sector. (www.mixmbb.org)

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