



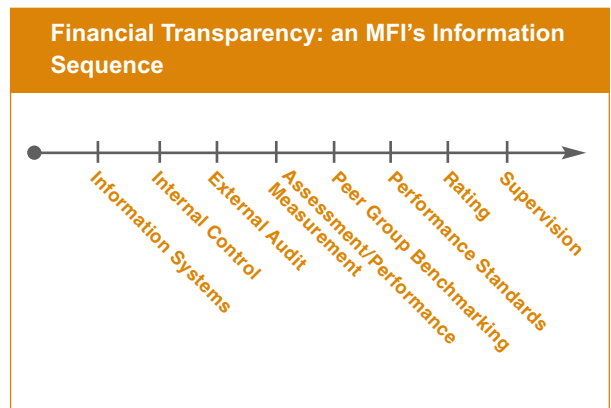
FOCUS ON FINANCIAL TRANSPARENCY: BUILDING THE INFRASTRUCTURE FOR A MICROFINANCE INDUSTRY

Microfinance stands poised to transform itself from a “movement” into an industry that can sustainably meet the vast demand for financial services among the world’s poor. As a key element in this transformation, practitioners, funders, and service providers will have to recognize and embrace the need for transparency about the financial performance of microfinance institutions (MFIs). Transparency means the free flow of publicly available, accurate, and comparable information. It serves two main goals:

- **Improved MFI performance:** Information about an MFI’s own performance enhances managers’ ability and incentive to improve. The incentive to improve increases when managers and outsiders can compare an MFI’s results to the performance of other MFIs, agreed standards, and/or supervisory requirements.
- **Commercialization of microfinance:** Financial transparency in a format understood by the outside world is a precondition for attracting the commercial funds that will allow massive expansion of microfinance services.

This note describes the activities of CGAP—often in collaboration with other industry players—in the area of financial transparency. It is part of a trilogy of CGAP documents on transparency, and should be used in combination with the other two. The *Resource Guide to Microfinance Assessments* compares five microfinance assessment methodologies and describes the challenges facing such assessments. *Financial Transparency: A Glossary of Terms* defines and discusses elements of the transparency process.

Financial transparency is about the production, testing, dissemination and use of information related to an MFI’s financial performance. Beginning with an MFI



gathering and reporting accurate information, the sequence extends to verifying the information, then to analyzing, comparing, and judging the performance described by that information, and finally to supervising the MFI to insure that it complies with applicable standards. The initial steps, management information systems and internal control, are responsibilities of the MFI itself, while the remainder of the steps are done by external parties. External auditors verify the information reported in the MFI’s financial statements. Assessment or rating services analyze and then evaluate or rate MFI performance, sometimes using industry databases to compare the MFI with similar institutions. Supervisors are authorities, usually governmental, responsible for insuring that performance complies with appropriate standards.

The elements of this sequence represent discrete activities, conceptually at least. But they build on each other. For instance, the opinions reached at the rating and supervision end of the sequence depend on clear performance measurement which in turn requires reliable audited financial information.

CGAP, often in collaboration with other industry players, is working to build infrastructure in support of transparency at most of the points along this sequence.

The Consultative Group to Assist the Poorest

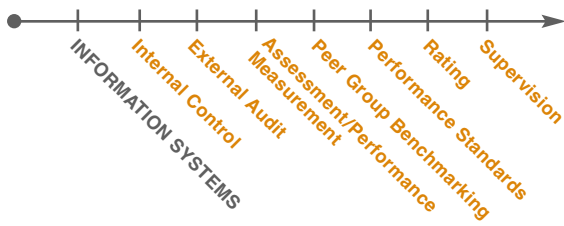
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The following sections describe these programs in more detail and provide web addresses and other resource references where available.



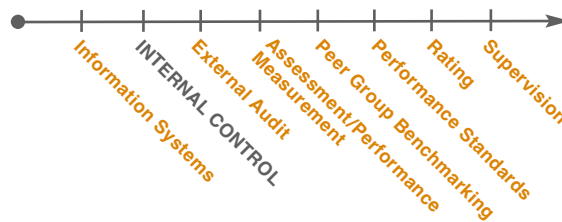
Information Systems

Donors, other investors, and MFI board and management rely on an MFI's financial statements and reports in assessing its performance. However, the systems that produce this information are often weak. In addition, most MFI financial statements do not include sufficient information to allow the reader to do a solid analysis of the state and prospects of the institution's business. These information weaknesses often produce serious consequences. For example, managers may fail to identify operational problems and act on them fast enough. Board members may be unable to focus efficiently on the core financial health of the business, and may thus spend their time on matters that are not only less important but sometimes counterproductive. Banks and other commercial sources may be reluctant to invest in an MFI because they feel they can't rely on the information the MFI gives them.

Information Systems Service. As MFIs scale up their activities, managers become increasingly aware of the need to improve their information systems (IS). CGAP offers a web-based Information Systems Service to help MFI managers select an IS software package that best suits their organizational needs, and to stimulate the development of cost-effective IS solutions for the microfinance industry. The site includes a consumer report section with detailed reviews of commercially available software for microfinance, a helpdesk section with step-by-step suggestions on choosing a software package, and an on-line IS library with links to key documents and websites. This service can be found at http://www.cgap.org/iss_site/.

It complements CGAP's *Handbook for Management Information Systems for Microfinance Institutions*, which is available at http://www.cgap.org/html/p_technical_guides01.html.

Financial Disclosure Guidelines. The *Disclosure Guidelines for Financial Reporting by Microfinance Institutions* indicate the information that MFIs need to include in their financial reporting in order to permit meaningful analysis by a reader of its reports. (The guidelines do *not* prescribe accounting policies or presentation formats.) As a consortium of the principal international donors supporting microfinance, CGAP is a natural forum for obtaining multi-donor endorsement of a single set of consensus guidelines. The CGAP Secretariat developed draft guidelines in consultation with microfinance practitioners and CGAP's member donors. In June 2000, the donors approved an interim version, which is being field-tested. A revised version is expected to be approved in 2002. The draft guidelines can be found at http://www.cgap.org/html/p_technifsg.html.

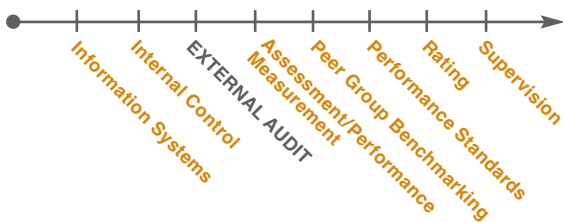


Internal Control

Internal control—institutions' mechanisms to monitor their risks—has not received enough attention in microfinance. Yet such control is particularly important for this industry, because it is a cash-based business where processes need to be streamlined and decisions decentralized in order to keep costs down. The larger the MFI, the more need for internal control systems. MFIs that don't pay enough attention to this area sooner or later run into serious problems, such as outbreaks of delinquency, employee and client fraud, or erroneous financial information that leaves managers and other stakeholders flying blind.

Operational Risk Management Course. The latest addition to CGAP's *Skills for Microfinance Managers* curriculum is a course in Operational Risk Management (ORM). Aimed at helping MFIs improve their internal risk management, the course focuses on systems for prevention, early identification, and control of problems. Through exercises, group discussions, and case studies, participants review topics including fraud, internal control, and internal and external audit. The course will be offered beginning in 2002. For more information on the CGAP training program and its regional hubs, see http://www.cgap.org/html/mfis_skills_microfinance_manag.html.

Microfinance Network's Technical Guide on Internal Control. In 2000 the Microfinance Network, a CGAP-supported association of leading microfinance practitioners, published *Improving Internal Control: A Practical Guide for Microfinance Institutions*. This technical guide offers concrete advice on internal control mechanisms in MFIs of all types and sizes. It gives MFIs step-by-step suggestions for improving management of the five major risks that they face: credit, liquidity, interest rate, operational, and fraud risk. It describes the process of selecting, testing, and implementing cost-effective controls, both *ex-ante* (before operations) and *ex-post* (after operations). A chapter is devoted to branch audits. Successful application of these concepts is illustrated by practical examples from leading MFIs, including BRI (Indonesia), ASA (Bangladesh), ABA (Egypt), and BancoSol (Bolivia). This MFN technical guide can be found at <http://www.bellanet.org/partners/mfn/publications.html>.



External Audit

The various stakeholders in the microfinance industry rely on external audits to ensure the trustworthiness of

MFI financial information. Unfortunately, this reliance is usually misplaced. Normal external audits of MFIs seldom include the tests that are needed to provide meaningful assurance of the fairness of MFI financial statements, especially with respect to the loan portfolio, where most of an MFI's risk occurs. This situation results from several factors, including on one hand a lack of knowledge on the part of donors and MFIs who contract audits, and on the other hand the audit firms' lack of understanding of the microfinance business. A number of reputable audit firms have failed to detect an imminent crisis or large-scale fraud in audited MFIs.

CGAP has published an external audit handbook for auditors and their clients (MFI boards, managers, supervisors, donors, and other investors). Based largely on this handbook, CGAP is building an audit information center and a capacity-building program for external auditors.

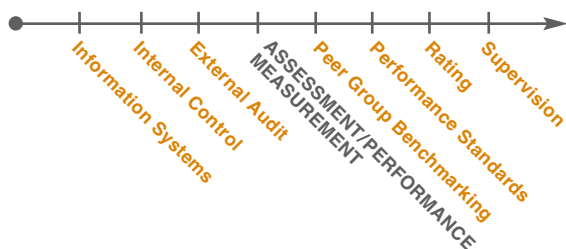
The Audit Information Center (AIC). The Audit Information Center offers web-based information and on-line support on how to contract, conduct, and interpret MFI audits. The service has five main components:

- A Frequently Asked Questions (FAQ) section with 300 topics
- An e-mail helpdesk facility that responds directly to users' specific questions
- An updated documents and links section, including a link to the CGAP external audit handbook
- A discussion center where users can exchange ideas and experience on MFI audit
- A list of recommended consultants who can conduct or advise on MFI external audits

The Audit Information Service can be found at <http://www.ids.ac.uk/cgap/audit/index.htm>.

Capacity Building for Auditors. The key objective of the CGAP capacity-building program for auditors is to develop auditors' awareness and understanding of the unique features of MFIs and their major risk areas, in order to enhance risk assessment and improve the quality and usefulness of MFI audits. This program offers short work-

shops and other resources for local and international auditors in order to build their knowledge and ability to conduct MFI audits. Where possible, this will be done in collaboration with local accounting or auditing bodies. A secondary objective of the program is to build up a cadre of recommended or CGAP-certified auditors and audit consultants.



Assessment and Performance Measurement

Several different methodologies exist for the financial assessment of MFIs, each with its own set of strengths and weaknesses. More important than the particular methodology chosen, however, is the industry's growing recognition that funding decisions should be supported by in-depth, institution-level assessments.

CGAP Format for Appraisal of Microfinance Institutions. CGAP's MFI appraisal format is a template for a detailed review of an MFI's operations, management, and governance. It was originally produced for internal use in appraising MFIs for CGAP funding. However, it has since been published in response to frequent requests from donor agencies, other funders of MFIs, and MFIs themselves (who want it as an instrument for internal diagnosis).

The Appraisal Format organizes information into four sections:

- *Institutional factors:* governance, leadership, human resource management, organizational structure, MIS, internal control and audit.
- *Services/Clientele/Market:* the MFI's financial and non-financial services, the breadth of its outreach, client poverty levels, retention rate, quality of services, and the MFI's market and competition.
- *Strategic objectives:* the MFI's near and mid-term mission and objectives and its plan to fulfill that vision.

- *Financial performance:* adjusted financial statements and financial analysis of profitability, efficiency, portfolio quality, yield on portfolio, cost of funds, leverage, and liquidity management.

The Appraisal Format does not generate scores or conclusions by formula; rather, it is designed as a kind of checklist for an evaluation whose conclusions will depend on the judgement of an experienced analyst. The analyst's judgement will also be critical in determining which of the information requested in the format is materially relevant in a particular situation. The format was originally designed to support multi-million dollar investments. Blanket collection of all the information it requests would be overkill in many situations.

CGAP also recommends appraisal guides from a number of other sources, including the Inter-American Development Bank's *Technical Guide for the Analysis of Microenterprise Finance Institutions* (Washington, D.C.: Inter-American Development Bank, 1994)¹ and Martin Holtmann and Rochus Mommartz's *Technical Guide for Analyzing the Efficiency of Credit-Granting Non-Governmental Institutions* (Saarbrücken: Verlag für Entwicklungspolitik, 1996).² Another useful reference is the SEEP Network and Calmeadow's *Financial Ratio Analysis of Microfinance Institutions* (1995).³

Appraisal and Monitoring Service. CGAP launched a pilot version of this service for member donors in November 2000. Its purpose is to help donors—especially those without a strong team of microfinance technical experts—to identify, appraise and monitor good MFIs.

As presently envisaged, the process will begin with the CGAP Secretariat circulating to the member donors a potential list of institutions to be appraised, drawn from its application process, other contacts of its staff, and recommendations from donors. After receiving expressions of interest in particular MFIs from donors, CGAP would then select the institutions to appraise. CGAP would then

¹ Available from the IDB at <http://www.iadb.org/sds/doc/TechnicalGuideE.pdf>.

² Available from Verlag für Entwicklungspolitik, tel.: [49] 68-93-98-60-94, fax: [49] 68-93-98-60-95).

³ Available from Pact Publications, www.pactpub.com.

invite donors to participate in the appraisal, a funding package based on the appraisal, and/or coordinated monitoring with CGAP. To minimize transaction costs for the MFI, all funders would use the same minimum performance thresholds, reports, annual joint monitoring visit, and external audit per year. Subject to the time constraints of its staff, the Secretariat would also welcome opportunities to facilitate other types of appraisals on behalf of existing donor consortiums.

Resource Guide to Microfinance Assessments. In the last decade, increased interest in the microfinance sector has led to the emergence of a new generation of microfinance evaluators, each with its own distinctive methodology and lexicon. This multiplicity of objectives and performance indicators can create confusion. As a step towards a better understanding of microfinance risk evaluations, CGAP is publishing (as a companion piece to this note) a resource guide analyzing and comparing five of the better known microfinance rating and assessment methodologies, including ACCION International's CAMEL, the World Council of Credit Unions' PEARLS, PlanetRating's GIRAFE, and the methodologies of Micro-Rate and M-CRIL. This guide is intended to help users choose an assessment system whose features are best suited to their needs.

Rating and Assessment Fund. In May 2001, the Inter-American Development Bank and CGAP established a joint Pilot Rating and Assessment Fund that offers partial funding for assessments of MFIs by pre-approved rating and assessment organizations. Its objectives are (1) to encourage demand from MFIs that are interested in external evaluation of their financial performance; (2) to build a supply of competent rating and assessment services at both local and international levels; and (3) enable a greater flow of private sector resources to the microfinance sector by improving the quality and frequency of information on the performance of MFIs.

The Rating and Assessment Fund will finance up to 80 percent of the cost of a first rating/assessment, and will fund subsequent updates on a declining basis (60

percent for the first update and 40 percent for the second). Strong preference is given to MFIs that commit beforehand to full public disclosure of their audited financial statements and of their summary rating/assessment reports.⁴

Microfinance Portfolio Management Tool. Loan portfolio management is the core of most MFIs' business. Weakness in this area is by far the most frequent cause of MFI failure. Client repayment discipline deteriorates, the MFI's systems and reporting fail to identify the problem in time, repayment crises develop and spin out of control. To help MFIs address portfolio management issues, CGAP is developing a tool that will contain stand-alone modules on systems and policies for portfolio management, including:

- dealing with repayment crises
- testing portfolio quality
- measuring portfolio quality (a revision of CGAP's occasional paper on this subject)
- provisioning and write-off of problem loans.

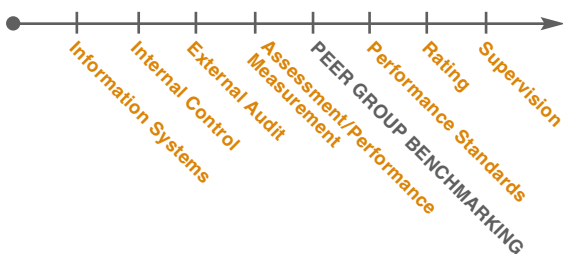
The module on testing portfolio quality will be a substantial expansion of an annex on this subject in CGAP's audit handbook, including step-by-step guidance for several different levels of testing. A draft version of this module should be available on the CGAP website by the end of 2001. A number of CGAP's MFI partners, including Pro-Mujer in Bolivia and Banco do Nordeste in Brazil, have committed to testing this new tool.

Standardization of Financial Ratio Definitions. The proliferation of financial ratios and other indicators in microfinance has produced considerable confusion, especially when the same name is used for indicators that are calculated quite differently. There is an urgent need to agree on the definition of a set of core indicators for use in the industry.

⁴ More information on the Rating Fund can be obtained from http://www.cgap.org/html/mfis_ratingfund.html.

CGAP is engaged with other industry actors in developing a standard set of definitions for key financial indicators. Originally spearheaded by MicroRate, this collaborative effort has included input from CGAP, the Inter-American Development Bank, USAID, M-CRIL, PlaNet Finance, and the *MicroBanking Bulletin*. Once a working draft has been developed, the consultation will be broadened to the microfinance community at large, including regulators and supervisors.

This exercise is not meant to prescribe a standard set of indicators that must be used to the exclusion of others. Rather, its purpose is limited to arriving at a common “default” definition for a few of the most widely used indicators. Anyone wishing to use a non-standard version of an indicator would be free to do so, but would be asked to specify the precise meaning of the indicator being used and to indicate how it differs from the agreed standard definition.



Peer Group Benchmarking

Benchmarking, or the comparison of financial performance within peer groups of MFIs, allows MFI managers to gauge their performance in the marketplace. While the use of benchmarking is growing, the results for individual MFIs are seldom published. As more of this information is made public, it will create a powerful incentive for improving MFI performance, just as it does in many mature industries.

MicroBanking Bulletin. The MicroBanking Standards project is an independent initiative funded by CGAP to help MFIs understand their performance in comparison with their peers, to establish industry benchmarks and performance standards, and to enhance the transparency of financial reporting.

MFIs participate in the *MicroBanking Bulletin* project on a quid pro quo basis. They supply confidential financial information regarding their operations. These self-reported data are adjusted and reported according to a common analytical framework that “corrects” for the effects of inflation, subsidies received, and appropriate provisioning for and write-offs of non-performing loans, so that all MFIs can be compared on a consistent basis. The financial data reported by individual MFIs is kept strictly confidential. This information is fed into a database where similar MFIs are grouped together in “peer groups” based on target clientele, methodology, scale of operation, and geographic region. For each peer group, average performance and degree of variation on various indicators are calculated and published semi-annually in the *Bulletin*. This published data permits benchmarking by the industry at large. Participating MFIs receive a confidential customized performance report comparing their performance with that of their peer institutions.

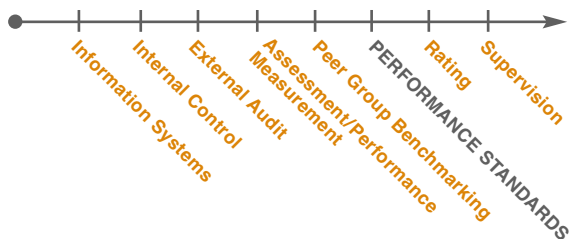
Most of the MFIs that report to the *MicroBanking Bulletin* are among the better performers in their respective regions and share a fundamental concern for achieving full financial sustainability. At present 148 leading MFIs from 48 developing countries report to the project. More than a third of these MFIs are at or near financial self-sufficiency.

The MicroBanking Standards Project also works with national and regional microfinance networks to enhance their affiliates’ reporting as well as the networks’ ability to collect, adjust, and disseminate the reported data. Next year the project will work with local networks to promote the use of the Bulletin format for local regulation/supervision requirements, so that MFIs are not required to complete multiple formats. The *MicroBanking Bulletin* is available at www.microbanking-mbb.org.

SEEP Network Development Project. The Small Enterprise Education and Promotion (SEEP) Network is an association of 56 North American private voluntary organizations that support micro and small enterprise programs in developing countries. SEEP is collaborating with the

MicroBanking Bulletin to assist 16 national MFI networks in monitoring and appraising their members' performance, and eventually setting and enforcing standards.

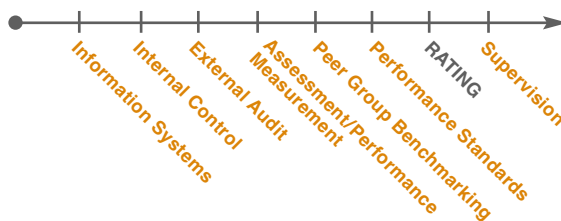
Microfinance Market Databank. CGAP is joining forces with UNCTAD to continue development of a web-based platform offering information on MFIs, donors, and other investors. It is expected to be launched in early 2002. A key portion of the platform was originally developed by UNCTAD as its "Virtual Microfinance Marketplace" linking MFIs and potential investors. The expanded web resource is envisioned as a one-stop shop for information on the market for MFI funding. On the demand side, it will provide a searchable database where MFIs can advertise themselves, choosing among various levels of disclosure of financial and outreach data. On the supply side, the service will provide updated information on donor agencies, apex bodies, and other investors, including their selection criteria, financial instruments, and performance indicators. The platform will also provide country environment data, including macroeconomic and regulatory information.



Performance Standards

Microfinance does not yet have agreed world-wide performance standards. This is not surprising, considering problems with the availability and reliability of performance information, the lack of agreement on how to calculate basic performance measurements, and regional and methodological differences. However, microfinance will need to make progress toward articulating

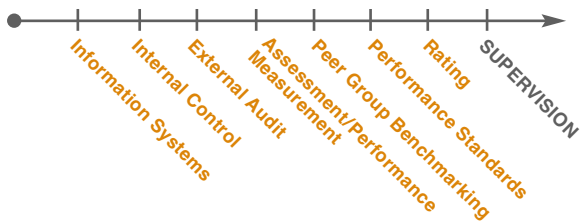
its own set of standards, probably adapted from the Basle standards for conventional banking. The benchmarking work done by CGAP and others lays the empirical foundation for setting performance standards, but CGAP is not directly working on such standards at present. The Inter-American Development Bank and MicroRate recently published a preliminary version of such standards for the Latin American context.⁵ Local efforts in this direction are under way in several countries, most notably the Philippines.



Rating

Microfinance does not yet have true public credit risk rating services that rate the likelihood that an MFI will repay a given debt obligation, and make that rating available to the investing public, using number or letter rating grades that are easily understood by investors outside the industry. However, a number of microfinance assessors have scoring systems similar to an industry rating and others are forging strategic alliances with credit risk rating agencies such as Fitch. The advantage of a rating system is that the "grade" it assigns to an MFI provides a clear and concise summary of the institution's risk profile that can be understood even by an investor who knows little or nothing about the MFI's business. In this way, a rating system could allow MFIs to raise funds more easily and efficiently. CGAP is not currently working in the area of public credit risk rating.

⁵ *Performance Indicators for Microfinance Institutions : a technical guide* is available on the IDB website at http://www.iadb.org/sds/mic/publication_159_e.htm.



Regulation and Supervision

As MFIs move into raising funds from the public and providing deposit services for their poor clients, they will have to move their business into a setting that is licensed, and therefore regulated and supervised, by their national banking authorities. So far, the microfinance industry has very little experience with “prudential” regulation and supervision, where such a governmental authority takes responsibility for protecting the financial health of licensed MFIs. However, new regulatory regimes for microfinance are being considered in many countries, so that it becomes increasingly important to share experiences and articulate good practices in this area.

Consensus Guidelines on Regulation and Supervision. Although some aspects of microfinance regulation are controversial, there are wide areas of agreement about best practice. In early 2001, CGAP initiated the development of consensus guidelines in this area. After initial consultations with experts and CGAP donor members, the next step is preparation and posting of a tentative draft document that will be circulated for comment widely in the industry. Among the questions addressed will be:

- At what point in the development of a country’s microfinance industry is it appropriate to set up special regulations for microfinance?

- Do credit-only MFIs need prudential regulation and supervision?
- What about MFIs that take only forced deposits (that is, deposits made as a condition to getting a loan)?
- Should exemptions be considered for small, community-based MFIs?
- What are the practical issues in supervising microfinance?
- Which banking regulations need to be modified to fit microfinance?

Consultations on Regulatory Issues. CGAP continues working to sensitize influential policymakers within organizations such as the World Bank, the IMF, and the U.S. Treasury Department on issues related to microfinance regulation, and to respond selectively to requests for consultations with local governments.

Training for Supervisors. While there is a great deal of discussion about regulations for microfinance, less attention is being paid to the practical challenges of supervising MFIs. There are likely to be problems in this area, because the tools that supervisors traditionally use to test the quality of conventional bank loan portfolios do not work well when applied to microfinance portfolios. CGAP intends to develop training modules on the mechanics of good microfinance supervision. The above-mentioned portfolio quality assessment tool will be a central element of this training.