FINANCIAL TRANSPARENCY: A GLOSSARY OF TERMS

The Consultative Group to Assist the Poorest

1818 H Street, NW
Washington, DC
20433

Tel: 202 473 9594
ax: 202 522 3744

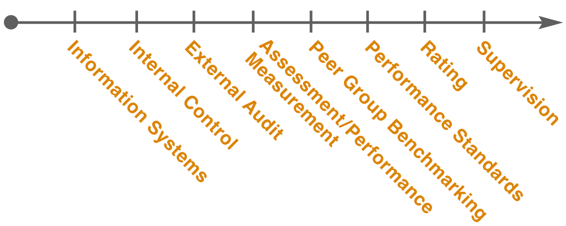
email:
gap@worldbank.org

Web:
www.cgap.org

The last decade has seen a growing focus on transparency in reporting the financial performance of microfinance institutions (MFIS). Along with this focus has come a proliferation of terms. Inconsistent use of these terms sometimes causes confusion both for microfinance insiders and for outsiders trying to understand the industry.

This "glossary" defines and discusses some of the elements involved in the collection, analysis, and disclosure of MFI financial information. It is part of a trilogy of CGAP reports on financial transparency, and should be used in combination with the other two reports: *Focus on Financial Transparency* describes the activities of CGAP and other industry players in this area, while the *Resource Guide to Microfinance Assessments* compares five methodologies commonly used for financial evaluation of MFIS.

Financial Transparency: an MFI's Information Sequence



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 ensure 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 that performance, sometimes using industry databases to compare the MFI with similar institutions. Supervisors are authorities, usually governmental, responsible for ensuring that performance complies with appropriate standards.

The remainder of the note tries to clarify the elements of this transparency sequence.

Information Systems

Microfinance is an information-intensive business. A management information system (MIS or simply IS) gathers, stores, organizes, and retrieves the information generated by the MFI's operations. Raw "data" is processed into usable "information" reported in a form that allows management, staff, and stakeholders to interpret it and act on it. Computer hardware and software allow this system to be automated, but the computer software is not in itself the information system. More basically, the system is the set of policies and practices governing the MFI's data management. When those policies and practices are not well designed and implemented, computerization will not solve the problem, as many MFIS have found to their dismay.

As MFIS grow past a few thousand clients, their managers increasingly feel the need to improve their information systems. For many institutions, the critical constraints to growth at this point are no longer methodology, staff development, or even funding. Instead, the most pressing need may well be for systems that provide timely and accurate tracking of their loan portfolio. The success or failure of lending operations, and thus of the MFI as a whole, depends on the reliability of such systems. Unfortunately, there are not enough appropriate software packages for managers to choose from. This is an area requiring priority attention. In the meantime many MFIS program their own MIS, or customize existing packages. With few if any exceptions, this process turns out to require much more time and money than the MFIS originally anticipate.[1]

Internal Control

An MFI's internal controls are the systems it uses to minimize risk. These controls cover human resources, organization, operating procedures, and information systems. While fraud is a major risk that MFIS need to control, there are others as well, including, for instance, loan delinquency, liquidity problems, or informational error. Surprisingly little attention has been given to internal control, given its importance in microfinance.

Common internal control practices include segregation of duties—requiring two signatures on checks, making sure that cash is never handled by only one individual in the organization, having supervisors immediately visit clients who appear as delinquent on portfolio reports, and reviewing the paper trail on loan origination and documentation.

Especially in a mature MFI, such controls will be located not only in the normal operations but also in an internal audit department. This department supports and tests the internal control environment, and also participates in reviewing the financial statements prepared by the accounting department. Normally, an internal audit department will report directly to

[1] For more information on MIS, see *Handbook for Management Information Systems for Microfinance Institutions* (CGAP Technical Tool Series, No. 1, Washington D.C., 1998) and the online Information Systems Resource Center http://www.cgap.org/iss_site/index.html.

the Board of Directors in order to preserve its autonomy from the institution's management and operations.

Too often, traditional internal auditors share the same bias as external auditors in focusing too exclusively on compliance with formal procedures and documentary requirements. Given the decentralized and streamlined nature of MFIS' business, however, normal paper trail documentation may not reveal or prevent common abuses such as phantom loans, parallel loans, bribery, or stealing of cash from collections in the field. The internal audit function in an MFI should include not only traditional compliance testing, but also frequent field visits by staff who have operational experience.[2]

External Audit

An external audit is a formal independent review of an institution's financial statements, records, transactions, and operations. An external audit is typically performed by professional accountants to lend credibility to financial statements and other management reports, ensure accountability for donor funds, or identify weaknesses in internal controls and systems.

There are many types of external audit, with different objectives and scopes of work. The most common is the financial statement audit, which judges the reliability of the MFI's financial reports in light of accepted accounting principles. Compliance audits test whether legal or contract obligations have been fulfilled. Audits may test particular accounts or departments, or evaluate information systems or the internal control environment. Regardless of its type, an external audit measures whether some process complies with a defined set of standards or procedures.

In general, donors and MFIS alike have assumed that an external audit conducted by a local affiliate of an internationally recognized auditing firm provides a greater degree of credibility than an unaffiliated local firm. However, this assumption may not be true in all cases. In fact, it is very rare that a standard internal audit by either a local firm or an international affiliate includes the kind of testing needed to support a meaningful assurance of the fairness of an MFI's financial statements.

In a standard audit, most of the time and effort go into testing the consistency of the accounting practices. For example, auditors test whether the MFI posts transactions to the correct accounts all of the time, and whether the balances of these accounts can be trusted. A typical test of the petty cash account would involve a surprise reconciliation of the petty cash drawer to see whether the balance shown on the ledger matches the amount present in the drawer. Most of these tests are quite straightforward.

However, there is one area that MFI auditors generally do not test adequately—the series of accounts related to the loan portfolio, where most of an MFI's business risk is centered. In normal formal commercial banking, one typical test of the loan portfolio balance would entail sending out letters to randomly selected borrowers, asking them to confirm whether their balance matches the one in the letter, and if there is discrepancy, to return the letter with a corrected balance to an indicated address. While this is far from fail-safe in formal banks, this kind of test is useless in typical MFIS, whose clients would never receive such letters or would not bother to send them back. Many are illiterate, would not know how to calculate their outstanding balance at a given time, or would not want to upset their loan officer even if they felt there was a discrepancy. Likewise, auditors of normal banks usually test loan collateral to insure that it is valued and registered correctly—a procedure of doubtful relevance in an MFI which places little or no reliance on collateral.

Thus, an MFI's stakeholders should not rely on the typical external audit to provide meaningful assurance about the performance of an MFI's loan portfolio, the largest and riskiest element of its business. An MFI is unlikely to get a good audit unless its board or management is willing to invest substantial time in selecting the auditor and negotiating the scope of the audit.[3]

Assessment and Performance Measurement

Assessments (sometimes called evaluations) include institutional appraisals, rating exercises, investor "due diligence," and other activities aimed at determining how well an institution performs financially and operationally, and how strong the management team is.

Microfinance networks often provide assessments as a management tool for their affiliates. Donors and investors use assessments to assist them in making decisions about whether or not to fund a particular MFI. Due diligence on behalf of a debt investor in the MFI focuses on the investor's credit risk: how likely is the MFI to repay the particular loan? Due diligence for an equity investor will consider factors contributing to value and potential upside returns.

Sometimes an assessment gives the MFI a rating—a letter or numerical score on some scale. Such an assessment is usually a private rating as opposed to a public credit rating. *Credit risk* ratings score the likelihood of a timely debt repayment, and thus go beyond a general assessment of the organization. *Public* credit risk ratings are disclosed to the investing public. (See the later section on ratings.)

Although varied in their type and purpose, assessments share many common analytical elements, both quantitative and qualitative. Most assessments review key financial areas such as capital adequacy, portfolio quality, liquidity, and profitability, along with overall management competence. An assessment is based on many factors, including financial statements, business and funding strategies, the portfolio aging schedule, the governance structure, operations and staffing, and the economic and market environment.

Assessments often also extend to non-financial issues—for example, when evaluators qualify the reliability of an institution's management information systems. An assessment identifies shortcomings in the practices of an institution, and suggests relationships between practices and financial results. Donor assessments often include a focus on the socioeconomic status of the MFI's clientele.

Most assessment formats are tailored for a specific purpose. For example, ACCION International developed its CAMEL eval-

2 For more on this subject, see A. Campion, *Improving Internal Control: A Practical Guide for Microfinance Institutions* (Microfinance Network/GTZ, Technical Guide No. 1, 2000).

3 For a detailed treatment of MFI audits, see *External Audits of Microfinance Institutions: A Handbook* (CGAP Technical Tool Series, No. 3, Washington D.C., 1998) and the online Audit Information Center at http://www.ids.ac.uk/cgap/audit/index.htm.

uation tool to strengthen management and generate a common framework for evaluating and comparing the performance of affiliates across countries, on a confidential basis. The World Council of Credit Unions (WOCCU) developed its PEARLS system to monitor the performance of credit unions within WOCCU, especially for use in its institutional strengthening programs. The U.S. Agency for International Development (USAID) and the Small Industries Development Bank of India (SIDBI) use assessments by MicroRate and M-CRIL prior to making program grants or loans to MFIs. CGAP's Appraisal Format and the Inter-American Development Bank's Technical Guide are published assessment manuals used by those organizations and by other donors in evaluating MFIs for grants or loans.

Microfinance assessment systems face a number of challenges explored in a companion note, *Resource Guide to Microfinance Assessments.* At present most assessments are conducted for public-sector donors and non-profit microfinance networks. They emphasize performance measurement, the quality of management, and the potential for sustainability to expand outreach. They tend to be detailed, costly in time and money, and difficult to update regularly—a serious problem, considering that an MFI's portfolio can break down much more rapidly than a commercial bank's would.

Much of the world's microfinance is relatively informal and unregulated, so that MFI evaluators often do not have access to the kind of reliable standardized financial information that would be available for banks. As a result, the proper interpretation of an MFI's information is not always clear to the evaluator, and the proper interpretation of the evaluator's assessment is not always clear to the end user.

Another result of this situation, and the weakness of MFI audits, is that MFI evaluators often have to go beyond their normal role of analyzing the information, and get into verifying the kind of evidence (such as loan details, client satisfaction, and minutes of boards of directors) that would normally be left to audit firms. This mixing of functions can make the MFI evaluation process and reports lengthy and complicated.

Performance measurement is the process of quantifying MFI results, often expressed in financial ratios that capture loan portfolio quality, staff productivity, efficiency, profitability, capital adequacy, liquidity, etc. By quantifying performance, performance measurement can reveal relationships between various behaviors and financial returns. There is an evolving consensus about performance measurements in the microfinance industry.

This consensus includes analytical adjustments to financial statements that allow comparison among MFIs that operate in different inflationary environments, enjoy differing degrees of subsidy, and use different policies to record non-performing loans and write-offs.

At the same time, a huge proliferation of financial ratios or indicators (more than 170 were identified in a recent CGAP study) has muddled the meaning of many ratios. The same name may be used for ratios that are calculated quite differently. There is a need for key industry players to come to agreement on definitions of a core set of indicators. The purpose would not be to create an exclusive list of indicators, but rather to insure that some of the most common ones are applied consistently.[4]

Peer Group Benchmarking

Benchmarking puts performance measurements in context by comparing an MFI with peer groups based on region, methodology, size, age, clientele, etc. For instance, an MFI might appear inefficient because its 40 percent ratio of administrative costs to portfolio is high in comparison with MFIs generally. But if the MFI is serving particularly poor clients, and thus has loan sizes that are very low in comparison with national per capita income, then a comparison with a peer group that includes similar institutions might show that the MFI is in fact reasonably efficient. In the same way, the costs of an MFI serving sparsely populated rural areas should be compared to costs of other institutions in similar areas; comparison with some other peer group could result in distorted judgments. Collecting MFI performance data and organizing it by appropriate peer groups can establish not only averages but also ranges of variability, and eventually provide empirical grounding for scoring systems that rate MFIs. Commercial bank managers, investors, and supervisors in many markets have access to benchmarking databases that they rely on heavily.[5]

Performance Standards

Performance standards are normative levels set for specific performance measurements. For example, a portfolio quality standard for microfinance might be a maximum of 5 percent portfolio at risk over 30 days, or a leverage standard might be assets of no more than five times equity. But unlike commercial banking with its Basle standards, the microfinance industry does not have widely agreed performance standards.

The process for microfinance would be to agree on key performance measurements, to track those performance measurements through more extensive benchmarking, and then finally to settle on standards for those measurements. These standards may have to vary according to types of microfinance operations, for instance group versus individual loans, or deposit-taking versus credit-only. At this stage, it is difficult to predict the configuration of future performance standards. However, the need for such standards will grow as microfinance becomes integrated into the formal financial sector and falls under the authority of regulators and supervisors.

Rating

The microfinance industry does not yet have true public credit rating services. A public credit rating measures the credit risk of an institution by giving it a specific grade that is published for the use of the investing public. An institution's credit risk is the likelihood of timely repayment of its debts; to assess such risk, the rater must go beyond assessing an institution's financial performance and strength. Ratings such as "AAA" or "BBB" or sub-investment grade ratings send clear signals to

[4] For an illustration of the confusion that can result from imprecise use of indicators, see "Measuring Microcredit Delinquency: Ratios Can Be Harmful to Your Health" (CGAP Occasional Paper No. 3, Washington, D.C. 1999).

[5] The principal benchmarking database in microfinance today, the *Microbanking Bulletin*, is based on self-reported information from 148 MFIs. Some rating services such as M-CRIL and MicroRate have proprietary databases based on their own ratings of institutions.

potential investors, allowing them to factor a company's risk profile into their investment decisions even though they may not understand the business that is being rated.

Commercial banks are generally rated only on credit risk, with the analysis stemming from the bank's fundamentals, its role in the local financial system and the likelihood of government support, and current market trends (e.g., level of market competition, regulatory environment). Quantitative factors used to determine credit risk are driven by capital adequacy, liability structure, liquidity and portfolio quality. Credit policy and operations are also examined. Qualitative factors affecting credit risk include governance (supervision, management, and operations) and the adequacy of systems, processes, and organization. These same elements are relevant for MFIs, even though the some of the methods and standards for assessment would differ substantially from those that are applicable to normal banks.

Regulation and Supervision

Regulation of financial service providers can be defined as a set of rules governing the intermediation of financial resources between savers and borrowers. Governments and other bodies regulate financial service providers when they make rules for them, controlling for instance the safety standards they must meet. Supervision refers to the systematic oversight of such providers to ensure their compliance with the rules.

The main reasons for regulating microfinance are the same reasons that apply to commercial banks—namely to protect an institution's depositors, and to preserve the stability of the wider financial system. There is pressure in many developing countries to regulate microfinance, coming from MFIs, donors, and both financial and non-financial authorities in the government, and driven by a wide variety of motivations. If microfinance is regulated it will also have to be supervised, which may prove challenging on a number of fronts. As noted earlier, many of the conventional standards and tools for judging commercial bank performance do not work very well for microfinance. The stakes are fairly high, because depositors, other creditors, investors, and other government authorities are all relying on the supervisor to judge and control each MFI's degree of risk.

So far there is little experience with regulation and supervision of microfinance. The interest in the topic is recent, and there are few historical precedents to guide the debate. As the industry gains experience, it will eventually generate clearer guidelines on regulation and supervision, based on agreed performance standards.