Financial Performance of Selected Microfinance Institutions

Benchmarking Progress to Sustainability

by Michael Tucker

Abstract: A few microfinance institutions (MFIs) have implemented best business practices and made the transition to fully regulated financial institutions. Many more are in the process of undertaking this transformation or at least considering it. Rising competition among growing numbers of MFIs for both funding and clients has made improved financial performance a necessity for most if not all MFIs. Financial ratios of 17 Latin American MFIs are compared to benchmark performance ratios for the industry and with commercial Latin American banks. This small sample of data, while useful, also underlines the need for more widespread MFI reporting. Complicating reliance on financial comparisons is a complete lack of standardized measures on how well the poor are being served.

Introduction

With initial and ongoing subsidization, microfinance institutions (MFIs) have been able to operate for years without too much pressure to comply with the best or most profitable operational strategies. An increase in competition and the emergence of an ability to compare the financial performance

of MFIs with each other and to benchmarks is beginning to create greater concentration on improving business practices. Realization that more efficient and financially sustainable MFIs may also in the end lead to the assistance of a greater number of the poor has served to link improving business practices with social mission. A shift in defining that social mission may, however, be underway at some institutions as profits grow in importance. Measuring and comparing the performance of MFIs has been difficult due to both a lack of publicly available financial information and differences in reporting in a mostly nonregulated industry. Data used in this overview has been limited but it does indicate movement toward some standardization and the emergence of the ability to make benchmark comparisons.

Financial Sustainabilty

As more of MFI financing has come in the form of loans at below market interest rates instead of outright grants, the providers of low interest loans have found that their fiduciary responsibilities necessitated greater scrutiny of the financial practices of recipients. Even for NGOs still providing outright grants, the task of determining which MFI to fund becomes more of a business decision as the number of MFIs has grown. Social goals may be more efficiently and effectively met by MFIs familiar with best business practices as well as willing to adhere to free market norms of making their operations transparent to would-be lenders or donors. In the absence of standardized, well-reported indicators of how well MFIs serve the poor, the only measures available are financial ratios.

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If an MFI is examined by a competent auditor verifying the accuracy of financial information, it is then possible to compare its performance with that of other MFIs. Benchmarks as a means of comparing how well individual MFIs are functioning within their peer groups is a useful tool for MFI management and potential lenders or investors. The *MicroBanking Bulletin* and MicroRate in conjunction with other organizations provide comparisons on a variety of ratios across regions of the world as well as categories of MFIs. These benchmarks are a means of comparing the performance of MFIs on their ability to use funds efficiently. Whether or not targeted clientele are funded has not been as clearly a focus of data gathering, though at least the level of poverty of clients can be deduced from the size of the average loan.

Not all MFIs may want to publicly reveal their financial data, particularly those that are less efficient or perhaps less capable of complying with reporting standards. There is a reluctance to supply data to create and expand a benchmark reporting system that is in its infancy. This reluctance to participate by the vast majority of MFIs means that the data that is reported is skewed toward more successful and usually larger MFIs. Larger MFIs with better financial performance and/or more accurate record keeping would likely be more motivated to respond to data gathering. The September 2000 *MicroBanking Bulletin* (Calmeadow, 2000) had data from only 114 institutions out of several thousand. Among the missing MFIs is the very large Grameen Bank with over 2.5 million clients. Only 23 out of the 114 that did report were willing to release their individual figures on a disaggregated basis to the public. A considerable number of those institutions were regulated and already legally required to release their financial figures.

Incremental costs in time and money to comply with reporting requirements are likely one barrier to reporting. Another is the lack of requisite data maintenance and administrative skills. One way that low participation rates might be

addressed would be for NGOs to compel the participation of their client MFIs. Since most NGOs that either loan or provide grants to MFIs usually require periodic audits, it would seem to be a fairly straightforward step to insist that client MFIs report data to independent rating or data compilation services in order to be eligible for funding. Greater transparency would create a more open market for funding allocation, enabling the most efficient MFIs to survive. A danger in this strategy is that the social mission could be compromised. Serving the poorest is more expensive than servicing the poor or the near poor. At the very least, making available demographics of the client base along with financial performance would allow either for data gathering groups to make adjustments to take the poverty of those served into account or for NGOs to make their own allocation decisions with a full complement of information. It may also be possible for institutions not seeking financial sustainability to take the initiative to develop a different set of benchmarks derived from social audit data. This standardized data would assist NGOs in allocating funding to MFIs that more clearly meet their goals.

Competition

Competition for grant and loan funds has increased as the number of MFIs has steadily grown. A more recent form of competition has been the pursuit of clients. This coincides with the growth in the number of MFIs. Attracting clients involves marketing to their needs rather than simply distributing money to the next customer.

Somewhat taken for granted as an inexhaustible resource, clients were seen as readily available if the MFI had the funds to loan. In an economic environment where MFIs were few, they did not compete with each other but rather allocated territory and/or clients if more than one MFI was in the same geographical area. With the profusion of MFIs this type of collusion is no longer viable and may even be construed as illegal in countries seeking more open markets. As MFIs strive to

become financially sustainable, market share is increasingly important. For profit making businesses, gaining market share has been the most certain route to economies of scale while simultaneously overcoming the competition. In the MFI world, this can be accomplished by attracting more clients, increasing the size of average loans, or both.

With the entry of banks as lenders to the poor as well as MFIs making the transition to regulated financial institutions, interest rate competition to attract clients and profits to lure investors are important operating considerations. In 1995 the poor in Latin America were virtually ignored by regulated entities who obtained nearly 100% of their credit from non-regulated MFIs. By 2000, 53% of clients who would have been customers of unregulated MFI are now customers of regulated MFIs or banks (Christen, 2001). In that interim period several MFIs made the transformation into regulated institutions or banks, taking their clients with them. PRODEM in Bolivia became Banco Sol and took on more expensive unsubsidized credit from banks. The size of Banco Sol's average loan increased, reflecting an attempt to become more cost efficient. A new lending requirement was also instituted that mandated borrowers would not be eligible for loans unless they were in business for one year or longer (Cerven, Ghazanfar, and Source, 1999).

The average loans made by regulated MFIs in Latin America are greater than loans made by unregulated institutions: $803 for regulated MFIs versus $322 for unregulated MFIs (Christen, 2001). Larger loans made to more prosperous clients in an effort to achieve cost effective operations support the notion that mission drift is occurring; i.e., the original goal of service to the poorest may be undergoing a transformation by a very real need to become both financially sustainable and competitive. Lending small amounts of money is time and cost intensive. The cost of a loan to a first-time borrower, including attracting that borrower, has been estimated to be from $55 to

$237 for Latin American MFIs (Gheen, Jaramillo, and Pazmino, 1999).

Increasingly banks have recognized the possibility of profits in microfinance and have expanded their retail services to include lending to the poor (Baydas, Graham, and Valenzuela, 1997). Individual MFIs are faced with competitive pressure from above coming from banks expanding into their markets seeking their better clients. Competition from below for the poorer clients is coming from new or expanding MFIs. In the third quarter of 1999, 163% of the Bolivian MFI market had been reached (Christen, 2001). The only explanation is that market saturation has led some borrowers to borrow from more than one MFI. Competition on both quality of service and the cost of delivering that service are major factors in some MFI markets. A shakeout of less efficient MFIs is underway. Those that survive are likely to be the ones that are more client centered.

In Nicaragua MFI interest rates are typically 30% to 40%, considerably higher than commercial bank rates of less than 17%. In 2001, an election year, a new law was passed mandating that MFIs charge rates no higher than those of commercial banks. Regulated financial services are not constrained by the interest rate ceiling, obviating the need in Nicaragua for MFIs to become more efficient where possible, compete for more prosperous clients and more seriously seek to become regulated financial institutions (personal communication with F. Barquero, consultant to Wisconsin Coordinating Council of on Nicaraugua, 2001). A key requirement of a regulated financial institution is that it must demonstrate the ability to earn a profit. Regulated financial institutions must also meet timely reporting requirements, use acceptable accounting practices, and are submit to periodic audits. These are all difficult goals for fledgling MFIs that may lack the personnel to achieve them. Technology can assist to some extent.

Technology

Servicing ever increasing numbers of clients demands more sophisticated management information systems (MIS). Many MFIs have struggled with outdated software, often locally made without documentation or adequate support. Acquiring software to run a larger organization can be expensive—one of the more highly rated software packages, SIEM, is priced from $2,000 to $20,000 (CGAP, 2001). Keeping hardware up-to-date and training expenses increase the outlay. In addition, the need for more highly skilled personnel raises the salary base. In a competitive market, failing to obtain such software can be the equivalent of surrendering market share to the competition. Clients that do not receive timely approvals and updates have the freedom to take their borrowing needs elsewhere. NGOs that are unable to verify what the MFI is doing because of poor reporting may cut off funding.

The introduction of smartcards, a credit card with an embedded microprocessor, represents an effort to both facilitate customer service and streamline record keeping. Loan officers can update accounts in the field when visiting clients through smartcard readers and either directly transmit transactions to a central computer or gather data to be efficiently and accurately entered into the system at a later time. Individual loan officers can attend to more clients and provide information to them more quickly. Using this technology involves additional costs but differentiates an MFI from its competitors. Palm pilots are also being used in the field to electronically process loan applications and in some cases provide applicants with virtually instantaneous approval through programmed credit scoring and a series of pertinent questions. While these innovations are not currently widespread, their availability and potential to have a major competitive impact makes their introduction more likely.

Field staff compensation accounts for 50% to 70% of administrative costs (Gibbons and Meehan, 2000). A minimum target clientele for each loan officer is 300 borrowers. Both

smartcards and palm pilots increase the efficiency of loan officers and can reduce administrative costs. Achieving a positive return on the sizeable initial investment required to introduce these technologies necessitates a large client base and a requisite level of sophistication of employees. Larger MFIs already having achieved some economies of scale and sufficient funding to invest in more sophisticated technology will pressure competitors to do the same even as they find it necessary to continuously upgrade.

Collecting and maintaining records electronically can improve the accuracy of record keeping, but without the ability to compare overall aggregated institutional performance with other MFIs an individual MFI is less aware of areas in need of improvement. Ideally an MFI should be able to compare its performance not only with other MFIs but with acknowledged leaders. In the developed world continuous improvement is closely linked with benchmarking performance to those companies or institutions identified as the best. Industry or institutional leaders that have adopted the best practices and achieved superior performance make that performance public. Institutions that fall short of the best know that their performance will be compared to leaders in the industry. The microfinance industry is beginning to establish benchmark comparisons—industry levels that all MFIs should strive to attain.

Benchmark Ratios

Inter-American Development Bank (IDB) and MicroRate solicited and obtained financial information from 17 MFIs in Latin American to compile benchmark financial ratios for the Latin American area. Of these 17, 9 were regulated institutions and 8 were not. The MFIs ranged from BancoSol in Bolivia with nearly $75 million in outstanding loans to FINCA in Nicaragua with a $935,000 loan portfolio (Jansson and Taborga, 2000). Table 1 shows the results of the survey, including IDB/MicroRate recommended benchmarks gleaned from

Table 1

Latin America Finance Industry Ratios (1998)

	MFI Benchmark	Nonregulated MFIs (8)	Regulated MFIs(9)	Comm'l Banks
ROA (adjusted)	2-5%	0.80%	0.20%	n/a
ROA (unadjusted)	4-8%	12.10%	3%	1.20%
ROA (adjusted)	10-15%	-3%	-3.90%	n/a
ROA (unadjusted)	20-30%	21.30%	19.90%	6.90%
Gross Fin'l Margin (adjusted)	20-30%	31.50%	21.50%	n/a
Gross Fin'l Margin (unadjusted)	25-35%	39.70%	20.10%	5.50%
Debt/Equity	3:1 to 8:1	0.9:1	5.3:1	10.2:1
Equity/Gross Portfolio	25-35%	86%	23.70%	26.62%
Portfolio at Risk (>30 overdue)	1-3%	4.70%	4.40%	1.16%*
Loan Loss Reserves/Loans>30 days overdue	75-125%	104.30%	163.40%	228.3%*
Write-offs/Avg Gross Portfolio	<2%	0.60%	0.30%	n/a
Cash & Mktble Securities/Total Assets	10-25%	18.30%	14.50%	28.90%
Gross Loan Portfolio/Total Assets	70-90%	75.50%	80.30%	48.50%
Loans per Credit Officer	>300	280	608	n/a
Gross Portfolio per Credit Officer	$200,000-$400,000	$91,000	$220,000	n/a
Optg Expenses/Average Assets	>15%	28.10%	15.20%	8.90%
Optg Expenses/Average Gross Loan Portfolio	>20%	38.90%	19.80%	18.70%
Optg Expenses/Average Number of Loans	>$125	$87	$157	n/a
Growth of Total Assets	>15%	19.10%	17.90%	19.40%
Growth of Gross Portfolio	>15%	24.60%	17%	26.80%
Growth of Equity	20-40%	44.20%	21.80%	41.50%
Average Loan Size	n/a	$356	$957	n/a

*(>90 days)

the best performers among the 17 institutions, performance on the same ratios obtained from the nine regulated MFIs and the eight nonregulated MFIs, and ratios of commercial banks from Latin America and the Caribbean. Adjustments were made to audited data to account for differences between countries. Gross financial margin, return on assets (ROA), and return on equity (ROE) are ratios subject to distortion because of sources of funding, i.e., outright grants or subsidized loans. A separate calculation is provided that adjusts data used to compile these ratios by removing subsidies. Target benchmarks were also calculated based upon the measures of the better performing MFIs in the group of 17.

Unadjusted return on assets (ROA) and return on equity (ROE) for the MFIs are considerably greater than adjusted measures, reflecting that on average these MFIs still receive substantial subsidies. Removal of the subsidies to produce adjusted data shows borderline financial sustainability. The averages are also below benchmarks set by the better performing cohort. Individual MFI goals may vary but since nine of these MFIs are already regulated and many of the remaining eight aspire to become regulated entities, performance levels approaching the MFI benchmarks are more appropriate to both attaining and maintaining regulated status. MFIs that are borderline performers are likely to be judged as more risky by any institution or NGO providing funding, which can either result in denial of funding or the imposition of higher interest rates on that funding.

Gross financial margin, returns on assets exclusive of non-financial operating expenses, needs to be high since MFIs typically have high operating expenses that need to be covered with those returns. Charging high interest and maintaining near perfect collection policies can be key to surviving. Both adjusted and unadjusted gross financial margins are high for the MFIs and well above that obtained by the commercial banks. The ability of commercial banks to succeed with lower gross financial margins may be due to the economies of scale possible at

larger institutions. Greater utilization of technology could lower nonfinancial operating costs and enable MFIs to lower interest rates on loans. There would still be the greater risk involved in making loans that are not collateralized to less educated borrowers in need of greater servicing. This would still entail the maintenance of higher gross financial margins than commercial banks.

Commercial banks do show their economies of scale by widely outperforming MFIs on operating expenses as a percentage of assets. Regulated MFIs in turn achieve economies of scale superior to unregulated MFIs as shown by their operating expenses to assets ratio of 15.2% vs. 28.1% for nonregulated institutions and operating expenses to total loan portfolio of 19.8% vs. 38.9%. Regulated MFIs incur greater operating expenses per loan, $157 vs. $87 for nonregulated institutions, but again this is overshadowed by the $957 average loan vs. $356 for nonregulated MFIs.

The debt-to-equity ratio of nonregulated MFIs is below 1.0, indicating either an inability or a reluctance to use leverage to finance operations and expand loan portfolios. Regulated MFIs have an average D/E ratio half as great as the commercial banks. Access to capital markets is certainly an issue for MFIs. Regulated MFIs with better reporting and the security of government oversight would have better access to capital markets for funding but may pay higher rates than commercial banks. Nonregulated MFIs would depend more on NGO financing, often subsidized and outright equity, which is why their D/E ratio is so low. Equity as a percentage of gross portfolio is also quite high for nonregulated MFIs, again reflecting predominately equity sources of financing and thereby constraining potential growth. Regulated MFIs are quite close to commercial banks on this measure.

Portfolio at risk (PAR) is comparable between both groups of MFIs, averaging over 4% in both cases, and above the high range of the recommended benchmark of 3%. Commercial banks at 1.16% are performing comparably even better than

this low ratio indicates because their PAR represents loans overdue by 90 days vs. 30 days for MFIs. Different reporting standards on PAR can make comparisons difficult. One version of this ratio is calculated as (gross loans outstanding overdue more than 30 days)/(total loan portfolio). This measure does not take into account distortions that arise from including new loans that have not been outstanding for over 30 days in the denominator, thus biasing this ratio downward to a performance better than might actually be occurring. The downward bias can be more substantial in newer MFIs with more rapidly growing portfolios and larger proportions of their portfolios loaned out in the past 30 days. Using an adjusted ratio calculated as (gross loans outstanding overdue more than 30 days)/(total loan portfolio outstanding *more than 30 days*) provides a clearer picture of portfolio performance (Rosenberg, 1999). Standardizing reporting of PAR to this measure would enhance comparability.

Nonregulated MFIs have lower loan loss reserves than regulated MFIs and commercial banks, though still within the recommended benchmark. The use of an aging schedule to arrive at loan loss reserves, i.e., weighting overdue loans by the probability of collection multiplied by days outstanding, can vary across institutions. Regulated institutions would be required to adhere to more standardized guidelines. Nonregulated MFIs are also motivated and able to dress up their income statements by minimizing loan loss reserves in order to continue to have access to NGO capital.

Timing is everything when it comes to calculating write-offs as a percentage of a portfolio outstanding. Some institutions may prefer to carry nonperforming loans on the books, viewing write-offs as negative performance indicators. This tactic instead creates higher PAR, a negative indicator. MFIs in the survey were all below the 2% benchmark. Both regulated and unregulated MFIs were surprisingly low: 0.30% and 0.60% respectively. The practice of refinancing nonperforming loans to avoid writing them off could also be a factor.

Liquidity as measured by cash and marketable securities as a percentage of total assets should not be above or below the benchmark performance band of 10% to 25%. Too much liquidity means assets are not being loaned out, and too little places the institution in danger of failing to meet pending obligations. Commercial banks are the most conservative of the three groups, with liquidity above the levels recommended for MFIs. One explanation for this is that commercial banks have demand deposits, which are somewhat unpredictable obligations necessitating greater liquidity. Deposits are typically missing from the asset mix of most MFIs. Commercial banks are also more conservative in lending out their assets that is reflected in the 48.5% gross loans to total assets, percentage, much below that of the MFIs. Again, this is likely a function of the need to service depositors as well as more investments in fixed assets such as buildings.

There is a large distinction in operating performance as measured by loans serviced per credit officer. Nonregulated MFIs are just below the benchmark of 300 while regulated MFI credit officers serviced 608 loans in 1998. Superior efficiency of regulated MFIs may be in part due to multiple loans to the same borrower as well as better technology support. Gross loans per credit officer are also considerably greater for regulated MFIs ($220,000) as compared to nonregulated MFIs ($91,000), that is partially explained by more loans per officer but also amplified by the smaller average nonregulated MFI loan of $356 vs. the regulated MFI average of $957.

Nonregulated institutions with lower base figures against which to measure growth exceed regulated MFIs in both growth in assets, growth in portfolio, and growth in equity. Interestingly, commercial banks also exceed regulated MFIs on all three measures and are roughly equivalent to nonregulated MFIs on all three indicators. With a larger base from which to grow, a superior growth rate may reflect the ability of commercial banks to better participate in an overall economic

expansion by loaning directly to larger businesses or the government.

This is a small sample of MFIs from Latin America. The *MicroBanking Bulletin* has a larger global sample, but unlike the study presented by IDB and MicoRate, there is no attempt to define benchmarks but rather averages. These are also informative except for the fact that here too there is a dearth of data on individual institutions, just 23 from all countries versus the IDB and MicroRate study of 17 just from Latin America. It is a start to bringing some comparability to a fledgling industry making a transition from charitable recipients to real businesses. In order for the transition to continue and to succeed, more data with which to make comparisons is needed. Likewise, it will be necessary to devise some across-the-board measures that report the degree to which social mission is accomplished. Without these additional measures, differentiating MFIs from commercial banks on any measure other than financial is a difficult task.

Establishing benchmark financial performance targets is a viable goal. MFI reporting of data is essential for the analysis, understanding, and dissemination of practical suggestions on how to attain those benchmarks. Databases representing different kinds of institutions from diverse geographic areas will enable the creation of different benchmarks applicable to varying situations. Social performance can be taken into account in comparing benchmarks if and only if standardized measures are employed and reported across institutions. It will be to all participants' benefit and even more so to the benefit of potential clients to systematize reporting and make data public.

Conclusion

Comparisons with benchmarks can alert management and those that fund MFIs to how well or poorly an MFI is performing. By revealing weaknesses, benchmark measures can be used as a guide to focus resources and upgrade management practices. The best MFIs achieve superior performance by

employing superior business practices. MFIs at the lower end of the performance scale may have management less familiar with superior or even standard business practices, such as using management information systems to the greatest advantage, projecting future cash flows, and planning. These basic practices done well are certainly requirements of a high performing MFI.

To reach a level of operational excellence required to become a financially self-sufficient MFI requires well-trained, honest, and motivated management. But personnel skilled in business may be difficult to attract and retain in a developing country where such skills are in short supply and are well rewarded in the profit sector of the economy. This is a dilemma that can only partially be remedied by finding people sufficiently dedicated to be willing to reject higher compensation because of a dedication to serving the poor.

Becoming a regulated institution with concomitant access to capital markets is the goal of many unregulated MFIs. Meeting regulatory requirements entails reaching financial self-sufficiency. Achieving profitability may mean increasing the size of loans in order to focus more on profits. Service to the poorest that borrow small sums at considerable expense to an MFI may decline. In the IDB study Latin America's regulated MFIs had much higher average loans than those that were not regulated.

The initial vision of Grameen to provide the poorest an entry point into the economy with loans instead of handouts has inspired the creation of thousands of MFIs worldwide. Instead of the initial poor clients eventually taking their business to banks as they prospered, Grameen and other MFIs have found that becoming banks or quasi-banks is an effective strategy for retaining clientele and reaching financial self-sufficiency. The MFIs not making the transition face the more daunting task of surviving while serving the remaining poorest who may not in the aggregate be able to use loaned funds as effectively and efficiently as previous borrowers. These MFIs

that are less likely to attain financial sustainability need to develop a standardized set of benchmarks that demonstrate their attainment of their mission of servicing the poorest of the poor. Measures derived from social audits would be the most likely source of such benchmarks.

Competition among MFIs will inevitably lead to failures, possibly consolidation, and also service concentrating on specialized market niches such as the more difficult niche of the poorest of the poor. Donors and investors will need to carefully examine their own goals and differentiate among the available MFIs, particularly when deciding on subsidies or outright grants. Comparisons with benchmarks will be useful for all MFIs. A different way of sorting out the MFIs by mission rather than region and size alone may be necessary for those providing funding to make the most appropriate decisions.

Transparency and availability of quality data is crucial to making informed decisions. The thousands of MFIs that report only to those that provide funding make the trickle of publicly available data less representative. Those failing to report publicly are probably the least efficient. When they do seek funding and present their performance figures to NGOs they may end up being compared with the more efficient reporting MFIs, making it increasingly difficult for them to obtain funding. Perhaps this is just another way that an ongoing process of eliminating the weakest performers will move forward.

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