

# Transparency and Performance:

## Seeking sustainability and depth in a complex environment

The effectiveness of institutions in providing financial services to low-income clients can be seen from a number of angles. These include the following:

- Breadth of outreach—the extent to which low-income families are able to obtain financial services
- Depth of coverage—the extent to which coverage actually reaches the poor and poorest sections of the population
- The scope and quality of services offered by providers—the extent to which they are able to provide appropriate types of services and whether the needs of clients are met
- Sustainability—the longevity of financial services provision to low-income clients as determined by the sustainability of institutions providing such services.
- The relationship between depth of outreach and sustainability in serving the financial needs of low-income clients.

Breadth of outreach and some broad indication of depth of coverage were discussed in chapter 2. The fourth and fifth angles (sustainability and relationship between depth of outreach and sustainability) are discussed in this chapter. More detailed coverage of depth of outreach and the methodology for collection of data on this indicator are discussed in the following chapter on the impact of microfinance. Chapter 7 also covers means of obtaining feedback on client satisfaction and determining the scope and quality of services offered by microfinance providers.

But first to transparency: judgments of the effectiveness of institutions engaged in providing microfinance services can be made only if information on the performance of institutions is readily available in a usable form. This chapter begins with a discussion of the state of transparency in South Asia before discussing sustainability and depth of outreach.

### Transparency <sup>77</sup>

All stakeholders in microfinance may need (or use) product and performance information:

- Directors and managers to improve operations and planning institutional growth
- Investors and donors to make sound investment decisions and tracking subsequent performance
- Regulators to assess and ensure prudential performance

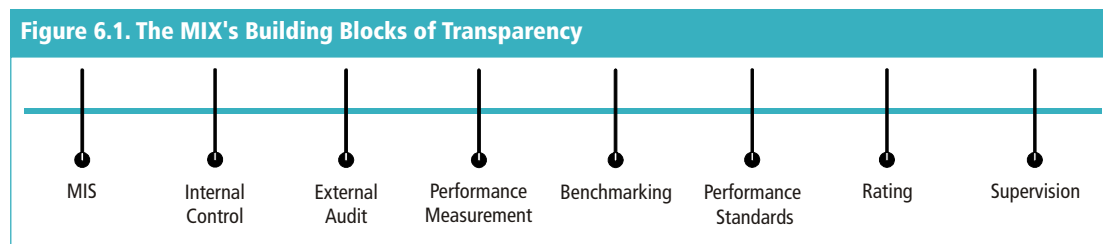
- Clients to determine the most reliable and convenient provider of financial services
- Industry analysts to map sector performance, make interinstitutional comparisons, and establish performance benchmarks.

The MIX Market has identified a continuum of information systems and processes that provides for the production, testing, dissemination, and use of information about

<sup>77</sup> The discussion in this section is based on The MIX 2006. This document emerged from a major initiative to document the state of transparency in the region sponsored by the World Bank as part of the Year of Microcredit Initiative in South Asia.

the performance of MFIs. The components of the transparency spectrum are the essential building blocks of standard reporting and disclosure. Figure 6.1 illustrates this spectrum from (1) primary information generation through the management information system, (2) quality assurance through internal controls,

which are validated by (3) external audits, leading to (4) performance measurement. This facilitates (5) benchmarking against (6) performance standards and risk assessment through (7) rating along with (8) supervision for risk management within reasonable limits.



Source: The MIX 2006.  
Note: MIS = management information system.

## Industry reporting

Microfinance service providers in South Asia monitor their expansion in terms of numbers of clients, disbursements, loan volumes, and funding sources. M-CRIL's experience, however, shows that even here borrower numbers and client numbers (in terms of numbers of people who conduct deposit or credit transactions with MFIs) are often confused by inconsistencies in recording and monitoring dropouts. This confusion is combined with a lack of consistent data on institutional performance (only the leading MFIs tracking it consistently). As in the bank-SHG link program, an undue emphasis is placed on cumulative measures, following a project-based approach that fails to track the process of financial inclusion in an effective manner.

## External audits

External audits generally are regular to comply with the requirements of donors or commercial funders. However, these audits are useful only for assessing the extent to which appropriate accounting policies are followed and not for understanding the MFI's financial position.

Audited statements fail to provide disclosures in keeping with international reporting norms, although this is not the case for the leading MFIs, such as those registered as microfinance banks in Pakistan and NBFCs in India.

## Performance monitoring initiatives

Performance monitoring initiatives in South Asia are undertaken by national networks and apex finance institutions. The latter publish only aggregate data on outreach and portfolios with institutional data kept out of the public domain. This is the case for PKSF in Bangladesh (with its 200 plus partners) and SIDBI in India with more than 40 partners. The MFI networks do collect and compile MFI data, but the quality and coverage varies greatly. These data include the directories of the Nepali and Bangladeshi networks, the more analytical but limited effort of Sa-Dhan, the Indian network, and the more comprehensive effort of the PMN's *Performance Indicators Report*, although this covers a much smaller microfinance sector.

The situation of rating and regulation in the region is discussed in chapter 8. As The MIX's transparency report concludes,

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.<sup>78</sup>

According to the report, initiatives in Pakistan and Bangladesh to improve and standardize financial statement disclosures for microfinance (1) support MFI managers in

improving the performance of their institutions, (2) increase the likelihood of appropriate investment, and (3) improve supervision by investors and regulators (where applicable). As the report argues, these initiatives have a public and a private goods element and greater support needs to be made to improve transparency because better financial disclosures and information hubs “will secure the achievements of microfinance for the region.”<sup>79</sup>

## Sustainability

As the above discussion indicates, the leading microfinance service providers in the region are also “best practice” institutions. Rather like outreach, there is a substantial concentration of sustainable operations in a few, usually large, institutions. Each country has relatively few institutions that provide microfinance services on a sustainable basis. In general, the sustainable institutions are also the largest institutions in which substantial proportions of the microfinance clients in each country are concentrated.

As discussed earlier, microfinance in [Afghanistan](#) has been promoted by a multidonor facility known as the Microfinance Investment Support Facility for Afghanistan (MISFA). The capital base for MFIs in the country has been created using MISFA (and international NGO partners) grants to cover start-up costs and operating expenses. The long-term vision of this process is to reduce grant funding gradually and for MFIs to cover expenses increasingly through operating profits. MISFA has been operating only since late 2003 and the trend so far has been encouraging: grant funding of operating expenses averaged about 70 percent of the combined income of assisted MFIs in the first year and 50 percent in the second year, and should decline to less than 25 percent during

2006. Two MFIs reached the level of having sustainable operations during 2006 and the overall indicators are quite positive with good portfolio quality—most MFIs have a PAR of less than one day (less than 1 percent) and a sufficient service charge (32 to 50 percent) to cover expenses and become sustainable within five years of beginning their operations. Only 1 of the 12 NGOs that have been funded so far by MISFA, however, can be said to be an Afghan organization managed by Afghans. All the MFIs plan to become Afghan organizations as soon as appropriate laws are in place and all of them are investing in the development of Afghan staff.

Evidence on sustainability from [Bangladesh](#) is encouraging. Much of Bangladesh's reputation as the home of microfinance (certainly in Asia) is based on the dramatic outreach achieved by the four large organizations and by the large numbers of MFIs (more than 700) in the country. Based on a sample of 16 MFIs (including ASA and BRAC and 14 other small- and medium-size NGO-MFIs), a recent study confirms the picture of overall good performance.<sup>80</sup> The study, using information reported by the 16 MFIs found that the following:

<sup>78</sup> Ibid.

<sup>79</sup> Ibid.

<sup>80</sup> Rasmussen, Alamgir, Ahmad, and Ahamed 2005.

- Average loan sizes have increased over time, leading to greater efficiency and profitability.
- Operations are efficient with a cost ratio (total expenses divided by total amount disbursed in a year) of 9 to 10 percent (weighted average). ASA leads the way with a cost ratio of only 3 percent.
- Portfolio quality appears to be good and consistent over time (on-time recovery rates exceed 97 percent).
- All the MFIs have profitable operations even after adjusting for subsidies—
  - ▶ Return on assets (ROAs) for most MFIs are in the range of 5 to 7 percent (adjusted ROAs of 3 to 4 percent), and
  - ▶ Financial self-sufficiency (FSS) of 120 percent or higher (ASA greater than 170 percent).

The difficulty of using self-reported information, however, is that definitional and accounting variations across organizations can cause result a more favorable impression to emerge than may be appropriate. An analysis of information from 14 MFIs undertaken by M-CRIL using information collected and verified by its analysts (mainly during 2003 and 2004) presents a modified picture. The 14 Bangladeshi MFIs rated or assessed by M-CRIL demonstrated the following characteristics:<sup>81</sup>

- A high weighted average OSS of 92 percent, with 5 of the 14 having OSS less than 80 percent. This indicates that the three best performing MFIs were also the largest, serving (among them) more than 70 percent of the number of total clients.
- A relatively high degree of subsidy, which is indicated by their average FSS being 71 percent (and only two, Manabik Shahajya Sangstha [MSS] and BURO, with FSS higher than 100 percent).
- Average *unadjusted* ROAs of -5.1 percent with only five reporting positive returns.
- Portfolio quality, measured by the PAR ratio (more than 60 days) at fairly good levels with just 5 of the 14 having PAR<sub>60</sub> in excess of 5 percent.

The M-CRIL information consists of weighted averages and does not cover the big four MFIs in Bangladesh, but it does include a number of the next-level MFIs (in terms of size), including BURO Tangail, Shakti Foundation, Ashrai, MSS, and Bangladesh Extension Education Services (BEES).

Essentially, the MIX report and the M-CRIL data described above confirm the overall impression that Bangladeshi microfinance has made substantial progress over the years in terms of improved performance. The excellent performance of three of the big four institutions as well as that of some of the next-level institutions like BURO Tangail, Shakti Foundation, and MSS, indicates that some 75 percent of microfinance clients in Bangladesh are served by sustainable institutions. It is also true, however, that relatively high levels of subsidy still underpin many of the hundreds of MFIs in that country. This poses a challenge to achieve full sustainability in Bangladeshi microfinance and points to the unnecessary support of a number of less viable, loss-making institutions.

More clearly, the performance of the microfinance sector in [India](#) is less encouraging if viewed from the perspective of the typical MFI, but the largest institutions that account for the bulk of the clients perform a lot better. By late December 2004, M-CRIL had undertaken 206 ratings of 131 MFIs in India. The average portfolio size of these MFIs was \$1.1 million (Rs 50 million) and the average loan size to clients was \$90 (Rs 4,029). Using a sample of 73 Indian MFIs rated between January 2002 and December 2004, the performance of typical Indian MFIs, become apparent:

- MFIs following the Grameen and individual lending models are close to reaching OSS with an average of 95 percent and 101 percent, respectively. Those working with SHGs perform less well. The average OSS of a typical MFI is 78 percent, indicating that many MFIs are not able to cover their expenses. The average OSS of SHG

<sup>81</sup> Information from the M-CRIL database. This sample does not include BRAC or ASA.

MFIs<sup>82</sup> is low at 61 percent but shows improvement from a year ago (48 percent in June 2003).

- The older (mature) MFIs following the Grameen model are most likely to feature among the commercially viable MFIs. Also, the older MFIs with links to NGOs are among the most profitable (because most of the group promotion and support costs are absorbed by the NGO).
- Although there are a large number of loss-making MFIs and relatively few viable ones, one-third of the MFIs earn profits (*unadjusted* ROA less than 0) and four have returns greater than 5 percent of their total assets. The largest MFIs account for more than 70 percent of MFI clients in India.
- As the portfolio size increases, MFIs become more capable of covering their costs through revenues and their dependence on grants and other subsidies tends to decrease.
- Political and social restrictions have constrained many MFIs from setting cost-recovering interest rates, which affects their performance. MFIs with small loans (less than \$100) are unable to achieve sustainability at the 18 to 24 percent APRs typically charged.
- There are encouraging trends over time, because rating updates reveal a picture of a mature and increasingly professional microfinance sector—
- Substantial increase (46 percent) in the outreach of MFIs during the 18 months or so between ratings;
- An increase in staff productivity and portfolio quality during this period results the following in increased profitability:
  - ▶ Improved portfolio quality (PAR<sub>60</sub> declined from 16 to 12 percent),
  - ▶ Portfolio per staff member increased from \$6,600 to \$13,700, although the average number of clients per staff member decreased from 336 to 311, and
  - ▶ OSS increased by 23 percent and FSS increased significantly by an average of 34 percent between ratings.

Although many MFIs in India have a weak equity base, their sustainability is being considerably enhanced by the aggressive tactics of some of the leading private Indian and foreign banks, which are providing them with substantial funds to manage portfolios that are carried on the banks' balance sheets. This “partnership model” enables the MFIs to increase their incomes substantially and circumvent the prudential concern of mobilizing sufficient equity to maintain an acceptable (~15 percent) CAR.<sup>83</sup>

A recent overview of the microfinance sector in Nepal found an equally difficult situation relative to sustainability.<sup>84</sup> The nine RRDBs and the microcredit development banks (MCDBs) together account for half of the total number of clients reached by MFIs in the country. The four MCDBs are profit-making institutions with ROAs on the order of 1.5 to 2.0 percent, while three of the five RRDBs are also making profits, albeit partly on the back of fund arbitrage—that is, “deprived sector” borrowing from commercial banks that is then reinvested in banks or finance companies at higher rates of interest—resulting in a positive ROA on the order of 1 percent. The midwestern and far-western banks, however, are reported to be in dire straits, although these banks are much smaller with borrower outreach at less than 10,000 each. Despite their profits, the retail development banks are struggling against deteriorating portfolio quality (necessitating increasing loan loss reserves now in excess of 5 percent) and stagnating outreach as the political situation in the country takes its toll. The financial intermediary NGOs (Financial Intermediary Nongovernmental Organizations [FINGOs]) and SCCSs report varied performance: a number of these organizations are experiencing losses and situations deteriorated as defaults increased along with the worsening political situation in 2003.

<sup>82</sup> These MFIs channel microfinance services through SHGs. The quality and performance of SHGs as a group of institutions is equally an issue but cannot be definitively discussed for lack of detailed data.

<sup>83</sup> For a further discussion of the issue of equity and leverage in Indian MFIs, see M-CRIL 2005a.

<sup>84</sup> ADB 2004.

The context and history of Pakistan have made the provision of microfinance on a sustainable basis particularly challenging, partly because of considerable pressure from government officials, elected representatives, and the press to have low interest rates. Whatever interest rates MFIs might say they are charging, nominal yield on gross portfolio numbers from 2004 for the larger MFIs shows that only three (all NGOs) had yields that were as high as commonly found in Bangladesh. The others had yields below 18 percent, a level that is more than 10 percent below that typically found in Bangladesh. At this level, it is quite difficult for MFIs to cover all their costs. Recent analysis of performance trends in the sector from 1999–2005 shows that the main factor that must change if MFIs are to become financially sustainable is to increase yields on portfolios to levels that will allow for sustainability.<sup>85</sup>

Another issue with respect to sustainability, which is more pronounced in Pakistan than in many countries, is that almost all the NGOs have multidimensional programs that provide a range of services to poor people. This often makes it difficult to allocate costs among functions to analyze financial performance by each function.

The only MFI that, to date, has become fully sustainable, with a positive adjusted ROA, is the Kashf Foundation. Kashf had a clear vision from the beginning that it would focus on microfinance only, be managed mainly by women for women, and target financial sustainability within five years of starting up. It became financially sustainable in its fifth year. This is in contrast to the larger, older organizations, including AKRSP (converted into First MicroFinanceBank in 2001) and the Orangi Pilot Project, which still have not achieved financially sustainable microfinance operations.

Donors also influence sustainability. Relative to

market size, more subsidized donor funds have gone into the sector in Pakistan over the past five years, if not even before that, than perhaps in any other country in South Asia. This is a function of the relatively early stage of development of microfinance in Pakistan. Nevertheless, most MFIs have not used these funds wisely to build sustainable operations from the start, so that subsidies were recycled into their own equity to build strong organizations over time. Most of the subsidy has, instead, been passed on to borrowers through the relatively low interest rates.

In Sri Lanka, the more than 1,500 CRBs and 7,400 registered primary societies of the TCCSs account for nearly half the market in terms of numbers of active borrowers, but many of these banks are unsustainable. The CRBs are regarded as among the more commercialized microfinance providers in the country and 80 percent of these are apparently estimated by the cooperative department to be profitable and to supply about one-third of the country's total microcredit. A “substantial proportion of the primary societies of the TCCSs (which collectively supply about 15 percent of the total outstanding microloans) provide microfinance on a profitable basis.”<sup>86</sup> However, while “many of the larger and more established cooperatives have achieved profitability, most remain small and financially fragile.”<sup>87</sup> Accounting practices in such institutions are not standardized, and it is not known how many of these institutions would be profitable after appropriate adjustments for loan loss provisions, write-offs, and subsidies are made.

The other large microfinance program is the Samurdhi Programme, the government's main poverty reduction activity. This is partly a conventional government lending program operated by state-owned banks, and it suffers from the usual weaknesses of government programs: subsidized interest rates and high default rates (of 30 to 50 percent). This results

<sup>85</sup> Burki, Bano, and Chen 2006.

<sup>86</sup> Charitonenko and de Silva 2003.

<sup>87</sup> Ibid.

from the high degree of political influence in the credit decision-making process. The other part of this program consists of the approximately 1,000 SBSs with some 1.8 million members. The scheme as a whole is reported to have an impressive number of active loans (some 350,000) and high on-time recovery rates, and to charge interest rates of around 3 percent per month, which should cover operating costs. Although recovery rates are uneven, the scheme has a credit guarantee scheme and two insurance schemes to secure its operations.<sup>88</sup>

Overall for South Asia, the MFI level is variable. All countries have high levels of subsidy from foreign donors (Afghanistan, Bangladesh, and Pakistan) or from governments (Sri Lanka and, to some extent, India) and eroding net worth of cooperatives (India and Nepal). Problems with efficiency in microfinance service delivery, particularly in terms of ineffective management and control systems as well as poor recovery performance, are compounded throughout the region by “social control” of interest rates. Politicians (and bureaucrats) in all countries are known periodically to raise the bogey of “high” interest rates in microfinance without reference to the clear economies of scale in microfinance service delivery.

Currently, action against MFIs resulting largely from the interest rate bogey has become a major impediment to the growth of microfinance in India's leading state of Andhra Pradesh and is an area of concern in other countries of the region as well. Pressure on microfinance interest rates has come in recent years from politicians in Bangladesh and Pakistan and from the Maoist insurgents in Nepal. In this context, it is perhaps not surprising that there is no flagship commercial bank in the region, such as Bank Rakyat Indonesia, Khan Bank of Mongolia, or ACLEDA Bank of Cambodia.

To the extent that achieving an overall reduction in interest rates in microfinance is a

desirable objective, the evidence suggests that this cannot be effectively or efficiently accomplished simply by imposing interest rate caps—whether mandated or socially imposed. The usual response of microfinance service providers to perceived limits on interest is to maximize their yield on portfolio by introducing complex variations in pricing,

- Establishing methods of calculating the interest rate—reducing balance or flat charge
- Charging upfront fees such as loan processing fees or passbook charges
- Varying the payment frequency—monthly, fortnightly, weekly—which affects the effective yield obtained from the loan
- Expecting security deposits from clients for which they pay low or no interest

In practice, therefore, while attempts to impose such caps have created some downward pressure on the pricing of microfinance loans, the actual effect has been limited. Thus, although MFIs in India have, for a number of years, felt the pressure to reduce their nominal interest rates and certainly to limit such rates to around 20 percent per year, M-CRIL's database shows that, across 89 of the leading MFIs, the effective interest rate charged is in the range 12 to 36 percent with the typical MFI charging 24.6 percent and the weighted average effective interest rate amounting to 25.2 percent per year.

In Bangladesh, in January 2005 the apex wholesaler (PKSF) capped on-lending interest rates for its MFI partners at a 12.5 percent flat rate compared with the country's average flat rate for microfinance of 15 percent. All except PKSF's two largest partners, BRAC and ASA, accepted the new ceiling. Together, however, these two large MFIs constituted almost two-thirds of PKSF's portfolio and more than 40 percent of the overall market in Bangladesh. The net effect of this has been the emergence of a three-level interest rate structure in that country, with Grameen Bank at the lowest rate of 10 percent flat, PKSF partners at 12.5

<sup>88</sup> Ibid.

percent flat, and BRAC and ASA at 15 percent flat.<sup>89</sup> The 14 Bangladeshi MFIs rated by M-CRIL typically charge an effective rate of 32 percent with a weighted average of nearly 29 percent in the range (24 to 45 percent).

Although the average interest rate charged has declined slightly in Bangladesh as a result of PKSF's cap, there has not been a significant decline in the overall interest rate paid by clients. The most likely result of the interest rate cap (expected by Bangladeshi MFI leaders) is that MFIs will fail to reduce the number of service providers in the market. This would result in the average MFI in Bangladesh being larger and more efficient but lacking a guarantee that the benefits would be passed on to clients in terms of lower rates. According to the MFIs interviewed for the CGAP Focus Note, "do not expect microcredit interest rates to decline much in the next five years."<sup>90</sup>

Essentially, Bangladesh is a market with substantial competition and heavy overlapping of operational areas, but relatively little price competition. However, the CGAP study concludes that price is not the only consideration for clients who place a lot of value on quality of service, flexible product characteristics, and the availability of small loans.

Imposed price controls are risky because they limit the flexibility of providers to offer appropriate products to a diverse range of clients. Indeed, if prices are set too low, providers are likely to avoid making smaller loans to poorer clients or to exit the market altogether.<sup>91</sup>

The Focus Note's analysis of competition in three markets, Bolivia, Uganda, and Bangladesh, indicates that "to achieve a sustained interest rate decline, *sufficiently large providers must have sufficient incentive and*

*sufficient ability to reduce rates*" in terms of the relationship between their yield and operational efficiency.<sup>92</sup>

Despite the impression of culpability created by their problems with interest rate pressure, South Asian MFIs do, in fact, charge rates that are low by international standards. This is in line with their historical and philosophical poverty reduction agenda. In the context of sustainability, therefore, these microfinance practitioners can draw some encouragement from a recent survey undertaken by the Washington-based MIX Market. Information collected from 121 MFIs by the MIX is presented in figure 6.2. The survey shows that, based on the information submitted by MFIs,

as with total outreach, Bangladeshi MFIs lead the sector in profitable outreach, and profitability is not confined to a few market leaders. In a sample of 43 institutions, 35 earned positive returns, representing 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.<sup>93</sup>

According to the MIX survey,

In Pakistan and Afghanistan, the majority of clients in this sample lack access to sustainable institutions. 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, even though one—BRAC Afghanistan—currently has a large, growing national base of clients... (where as) only 42 percent of Pakistani MFI (clients) covered in this sample had access to sustainable microfinance service providers.<sup>94</sup>

<sup>89</sup> Porteous 2006.

<sup>90</sup> Ibid.

<sup>91</sup> Ibid.

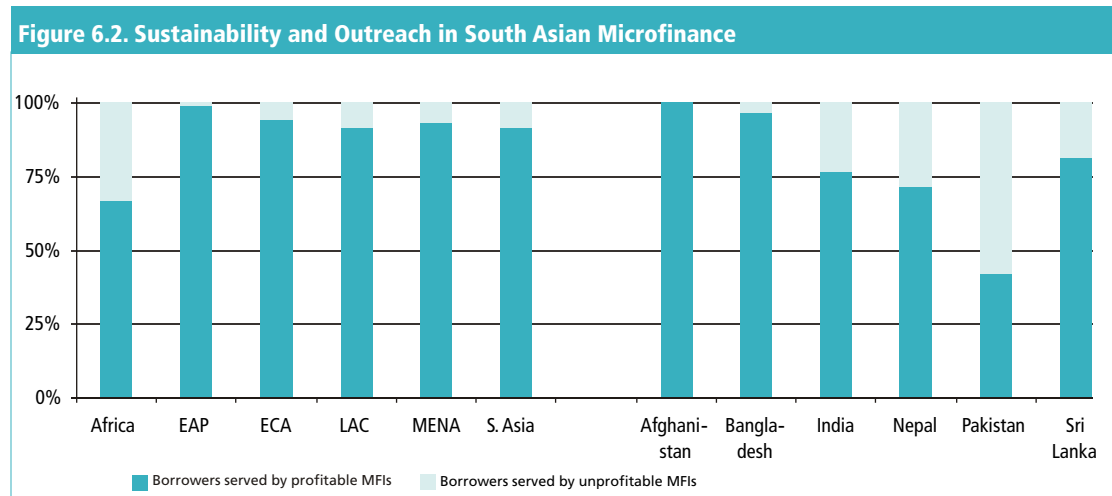
<sup>92</sup> Ibid.

<sup>93</sup> The MIX 2006.

<sup>94</sup> Ibid.

Thus, although the performance at the individual MFI level may be problematic, perhaps inevitably it is the more sustainable

MFIs that are achieving substantial growth and serving larger and larger proportions of MFI clients over time.



Source: The MIX 2006.

Note: EAP = East Asia and Pacific; ECA = Europe and Central Asia; LAC = Latin America and the Caribbean; MENA = Middle East and North Africa.

Information on three of the big four MFIs in Bangladesh—available from the MIX and presented in table 6.1—shows ASA and BRAC reporting excellent performance, while even that for Grameen Bank indicates positive returns. Information for leading MFIs from other countries of the region is also presented in the table. Most of the leading independent microfinance service providers in the region are sustainable and performing well. Both Khushhali Bank and NRSP in Pakistan are government-related institutions, constrained by political compulsions, while SEEDS in Sri Lanka operates in a political environment that is even more highly charged than elsewhere in the region. In each country, these are not only the largest MFIs but also among the fastest growing institutions accounting for significant proportions of the overall clientele. The picture of financial health emerging from this table, therefore, puts the future of microfinance in a number of countries of the region in a positive perspective.

Based on information emerging from an intimate knowledge of most of these institutions,<sup>95</sup> it becomes apparent that the key to their success lies in an interplay of factors, including the quality of leadership, governance, and management, on the one hand, and the nature of the political and regulatory environment, on the other. Without a supportive political and regulatory environment, it is impossible for MFIs to provide sustainable financial services. MFI leaders must have the vision to aim for growth and sustainability as well as the capability to oversee the development of the products and systems necessary to handle larger numbers of clients and volumes of funds in an effective and efficient manner.<sup>96</sup>

<sup>95</sup> Based on ratings conducted by M-CRIL in all five countries, evaluation and appraisal studies of BRAC, and considerable exposure to the activities of ASA.

<sup>96</sup> Such systems include MIS, tracking of overdue loans, internal audits, and other controls, cash management, and financial planning.

**Table 6.1. Performance Indicators for the Leading MFIs in South Asia**

Name of MFI	No. of Borrowers (thousands)	Portfolio (million US\$)	Growth of Outreach	PAR (30 days)	OSS	ROA	OER
<b>Bangladesh</b>							
ASA	2773	201.1	30%	1.7%	269%	15.0%	6.0%
BRAC	3994	243.1	14%	8.3%	117%	3.3%	11.5%
Grameen Bank	3700	337.7	29%	8.0%	101%	0.2%	6.0%
<b>India</b>							
BASIX	90	13	53%	4.8%	103%	0.0%	15.1%
SML	369	39.1	87%	0.3%	117%	3.2%	15.9%
Spandana	386	54.6	251%	0.0%	193%	8.4%	3.7%
SKS	74	7.4	197%	4.6%	104%	1.3%	12.1%
<b>Nepal</b>							
Nirdhan Bank	46	5.1	53%	10.3%	106%	-0.2%	12.7%
SBB	40	3.6	22%	3.0%	130%	4.1%	12.5%
<b>Pakistan</b>							
NRSP	126	20.7	43%	3.2%	85%	-2.4%	9.2%
Khushhali Bank	168	23.5	84%	6.4%	53%	-4.6%	8.2%
Kashf Foundation	68	8.1	14%	0.7%	187%	9.0%	7.7%
<b>Sri Lanka</b>							
SEEDS	63	28	11%	1.1%	90%	-1.4%	6.6%

Source: Authors' compilation.

Note: ASA = Association for Social Advancement; BASIX = Bhartiya Samruddhi Investments and Consulting Services Ltd.; MFI = microfinance institution; NRSP = National Rural Support Programme; OER = operating expense ratio; OSS = operational self-sufficiency; PAR = portfolio at risk; ROA = return on asset; SBS = Samurdhi Banking Society; SEEDS = Sarvodaya Economic and Enterprise Development Services; SKS = previously Swayam Krishi Sangam; SML = SHARE Microfin Limited.

To conclude, in the practice of microfinance, the lessons from the South Asian experience are that a reliance on subsidized funding is inevitable in the early stages of the activity (as indeed are start-up losses in any new venture). Based on the performance of hundreds of MFIs in the region, if the environment and leadership conditions (indicated above) are in place, an MFI is most likely to become profitable after some three years' operations, serving some 20,000 clients and resulting in a portfolio between \$2 and \$3 million. The overall performance of MFIs in the region is

improving as the awareness of the concept of sustainability in microfinance grows. However, the speed of the improvement varies among countries at different points in time and is dictated by political pressures and the regulatory environment as much as by the awareness of good practices. Over the next few years, because the effort to create awareness of good practice is well advanced, the immediate challenge for microfinance in the region is posed by the political environment. This issue is discussed further in later chapters.

## Depth of Outreach and Sustainability

Data on the poverty profile of microfinance clients are not readily available because definitions and measures of poverty are not so clear. Most analysis has relied on proxy indicators (such as loan size) or rested on the assumption that all those outside the formal financial sector are the target group for microfinance.

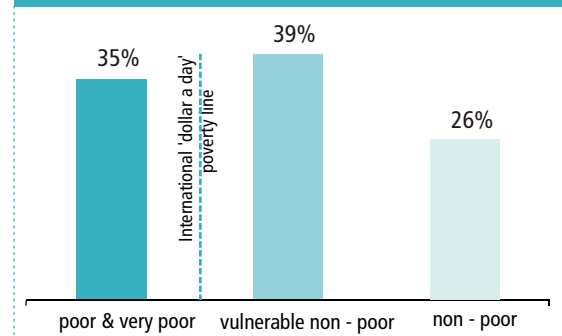
The Rural Financial Access Study commissioned by the World Bank in India examined data from SHGs in the two states of Andhra Pradesh and Uttar Pradesh. Based on statistical analysis, the study concluded that there was a “positive relationship” between poorer households—the second and third quintile from the bottom—and SHG membership. It also found a positive relationship between SHG membership and the poorest households (although this was not statistically significant).<sup>97</sup>

Another major study of the impact of MFI operations in India used qualitative (participatory rural appraisal [PRA] wealth ranking) and quantitative methods (index-based ranking, income estimate) of poverty assessment to report on the poverty profile of recent clients (less than two years old) from 20 MFIs across 9 Indian states.<sup>98</sup> A little over one-third of client households were estimated to be living below the international “dollar a day” poverty line (see figure 6.3). MFIs in India were reaching a mixed clientele that included poor and non-poor in similar proportions as reflected in the local community profile (for example, in a sample village, where 22 to 28 percent of the households are poor, around 25 percent of the MFIs clients in that village are poor).

For MFIs seeking sustainable poverty outreach, the strategy to diversify into poor and non-poor households is practical. As more MFIs commercialize and scale up their services, the

critical question will be to determine the optimum proportion of clients of different poverty levels that ensures long-term sustainability and the mission to include the poor.

**Figure 6.3. Poverty Profile of Recently Joined Microfinance Clients in India**



Source: Sinha and Brar 2005.

Financial sustainability and poverty outreach data collected from 20 MFIs in India (in 2002 and 2003) as part of the Rural Financial Access Study and 6 MFIs in Bangladesh during 2004 are presented in figure 6.4. Poverty outreach is shown in percentage terms (as a proportion of recent clients). The quadrants are shown with FSS at 75 percent or “near financial sustainability” and poverty outreach at 40 percent. The data, excluding the outliers, do not show a significant correlation between FSS and depth of outreach.<sup>99</sup>

Extending financial services to the poor does not appear to affect FSS adversely, because at least 8 of the 26 MFIs are approaching financial sustainability and have deep outreach. Five of these MFIs are Grameen model MFIs (four from India and one from Bangladesh). The remaining three are SHG model MFIs from India.

From this perspective, it is interesting to consider what factors support an effective combination of poverty outreach and sound

<sup>97</sup> Srivastava and Basu 2004.

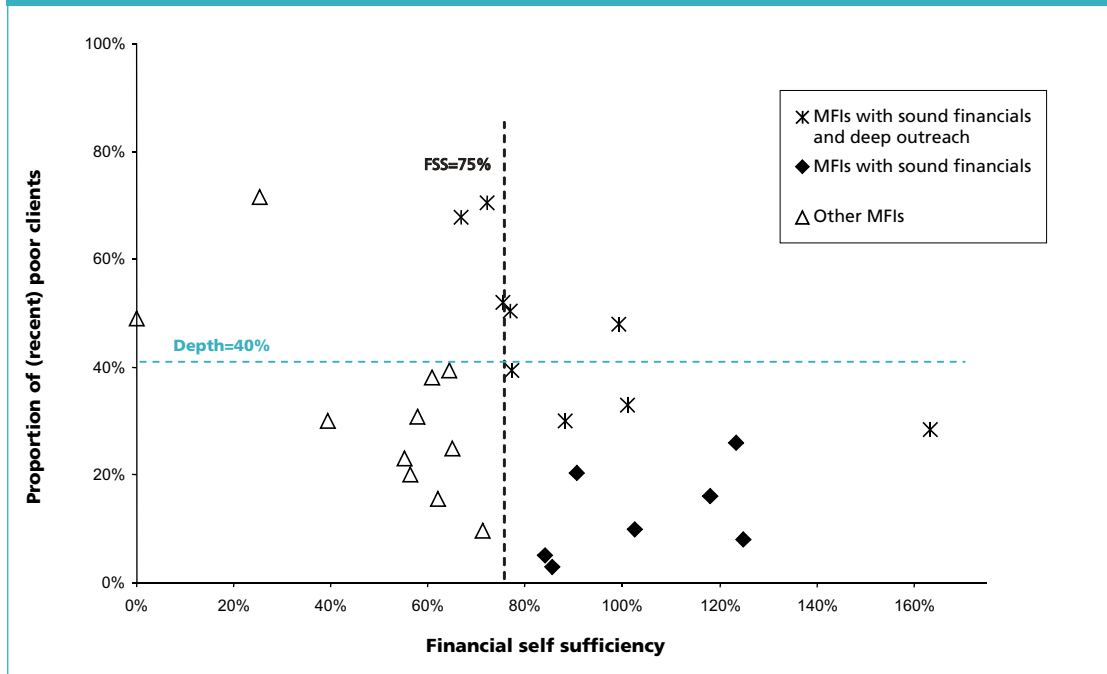
<sup>98</sup> EDA 2004.

<sup>99</sup> This discussion is extracted from Sinha and Brar 2005.

financial performance. As discussed earlier, the economic profile of an MFI's clientele tends to reflect the local community profile. MFIs with a high proportion of poor clients are located in poorer regions, or, if located in a more developed region (such as the south of India), their focus is on poorer rural areas or urban slums. The two MFIs with the deepest outreach are located in two of the poorest regions of north/northeast India (Eastern Uttar Pradesh and Assam).

Alternately, large MFIs (more than 50,000 borrowers) serve substantial numbers of poor clients (more than 5,000) by virtue of their size of operations. These MFIs may not have specific targeting criteria but succeed in including poor as well as non-poor among their clients. In the above sample, three such organizations (two Grameen model and one SHG model) have 9,000 to 15,000 poor clients.

**Figure 6.4. Comparing Depth of Outreach and Financial Sustainability**



Source: Sinha and Brar 2005.

Note: FSS = financial self-sufficiency; depth = 40 percent poor or an estimated total number of poor clients greater than 5,000.

Table 6.2 summarizes the key operational parameters for the three categories of MFIs included in figure 6.3. The data show that MFIs that combine deep outreach and strong financials, on average, charge higher interest rates to their clients (with an average APR of 29 percent compared to an average APR of 22 percent for other MFIs). This is combined with more efficient operations (a high staff productivity ratio and, consequently, a lower operating expense ratio with a larger clientele) and excellent portfolio quality.

Thus, M-CRIL's data from MFIs in India and Bangladesh indicate the following:

- There is no clear trade-off between FSS and poverty outreach. A number of MFIs are close to reaching financial sustainability without achieving this level of poverty outreach. At least an equal number have achieved—or are close to achieving—both, especially if the numbers of poor likely to be served by larger programs are included.
- Two different MFI strategies appear to enhance depth of outreach: the location of operations in poorer areas and scaling up to include a substantial number of poor clients within a large overall program; (criteria for household targeting does not appear to be implemented consistently enough to make a difference).
- Small loan sizes and lower interest rates do not ensure poverty outreach; and, because the majority of households in South Asia do not have access to formal financial services, this lack of access by itself is not a strong enough indicator of poverty.
- MFIs that balance poverty outreach with sound financial performance can run efficient operations with excellent portfolio quality.

**Table 6.2. Comparing Key Operational Parameters**

Parameters	Overall	Strong Financials and Deep Outreach	Strong Financials	Other MFIs
Number of MFIs	26	8	7	11
Annual percentage rate (APR)	26.2%	29.0%	29.9%	21.8%
Staff productivity ratio	117	320	132	101
Operating expense ratio (OER)	20.0%	15.1%	17.0%	26.1%
Portfolio at risk (PAR) greater than 60 days	10.4%	4.3%	8.9%	15.8%
Number of borrowers	14,129	25,528	15,285	5,104

Source: Sinha and Brar 2005.

It is apparent from this discussion of the link between depth of outreach and financial sustainability suggests that the view often held by government, some donors, and the public that reaching poorer people requires subsidies may not always be true. In fact, well-managed profitable organizations (such as BRAC and Kashf) that are committed to the double bottom line are doing more to increase the depth of outreach than other MFIs, even those with substantial subsidies. Ultimately, what may be required to increase the depth of outreach are not subsidies, generally and indiscriminately applied to large poverty reduction programs, but rather “smart subsidies” that can be used by efficient MFIs to cross-subsidize services specifically designed to serve the poorest families.

Equally important, is the provision of all the types of services that low-income clients need (deposits, insurance, money transfers, pensions, or, indeed, credit) and the appropriate design of such services to serve those needs in a way that makes a real contribution to improving client's lives and livelihoods. Efforts to determine the extent to which this takes place and the extent to which low-income clients are actually reached are made through studies of the impact of microfinance programs. The world of microfinance is increasingly focused on conscious measures to assess and improve the social impact of these programs. Experience with impact studies and social performance measures is discussed in chapter 7.