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Making Microfinance Transparent

ACCION Policy Paper on Transparency

Financial transparency – the widespread availability of relevant, accurate, and comparable information about an institution – is increasingly recognized as a cornerstone in the evolution of microfinance. Transparency opens the door for microfinance to become integrated into financial systems because the participants and guardians of the financial system demand high quality information to guide their informed judgments about microfinance institutions (MFIs).

ACCION International is committed to promoting transparency in microfinance. It acts on this commitment in two ways:

1. ACCION takes a leadership role in developing, disseminating and applying sound techniques of performance assessment, through its CAMEL instrument.¹
2. ACCION is committed to ensuring that its affiliates and partners meet high standards of transparency in their own provision of financial information.

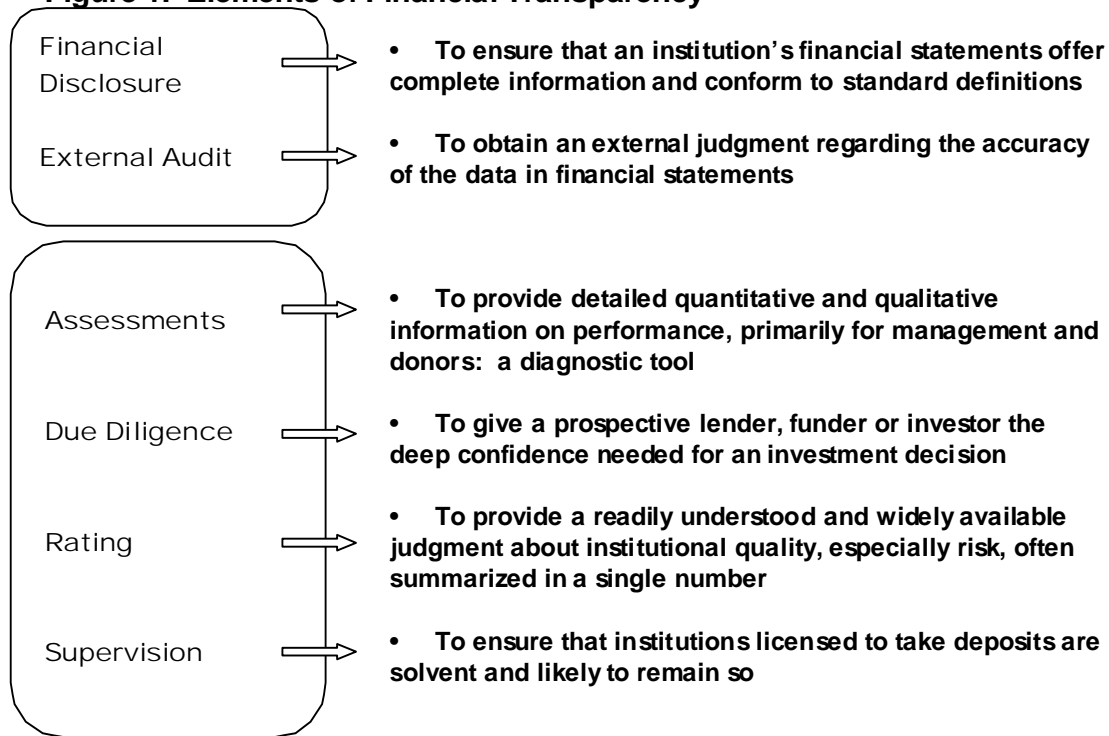
This policy paper describes in more detail how ACCION's commitment to transparency is realized. It addresses both existing ACCION practice and planned or proposed steps. The paper is intended primarily for ACCION's staff and partners, but may also be relevant for the broader microfinance community as an example of how one institution is responding to the challenges of transparency.

A framework for discussing transparency takes into account first the mechanisms for ensuring the quality of data presented by institutions and second the uses to which this information is put. In developing a framework for transparency, it is important to note that the concept involves both the disclosure and the analysis of information, and that the information is provided to various audiences who need it for varying purposes. It is often difficult to establish boundaries regarding which information should be available and to whom. In the case of deposit-taking financial institutions, as different from most other private enterprises, the rationale for full availability of information is

¹ CAMEL is an acronym for Capital, Asset Quality, Management, Earnings and Liquidity. Its origin and use are described more fully below. A detailed description is available in ACCION's publication, *Performance and Standards in Microfinance: ACCION's Experience with the CAMEL™ Instrument* by Saltzman, Rock and Salinger, 1998.

compelling, with depositor rights and protection at the core.² Robert Peck Christen of the Consultative Group to Assist the Poorest (CGAP) has recently made a significant contribution to awareness in the microfinance community of the complexity of transparency issues. The framework shown in Figure 1 is based on his work, with some modifications.

Figure 1. Elements of Financial Transparency



This framework does not include the internal building blocks of financial transparency, namely high quality management information systems (MIS) and strong internal controls, though without them transparency is not possible. We focus here on the use of information outside the institution.

The first two items, financial disclosure and external audit, are separated from the others because they are concerned primarily with the quality of the data published in financial statements rather than with the performance of the institution. Institutions performing very poorly can meet financial disclosure standards and have a clean external audit, provided they accurately reflect their accounts in published data. These two elements result in financial statements that are credible, that reveal a minimum level of essential information about the institution, and that are widely available to any interested party. Unlike the items in the second group, these two elements do not involve interpretation or judgment regarding *performance*. External auditors do exercise judgment and must be highly skilled, but their scope of judgment concerns *accuracy of presentation*, not interpretation of results. However, because the focus of external audit on accuracy in the presentation of financial

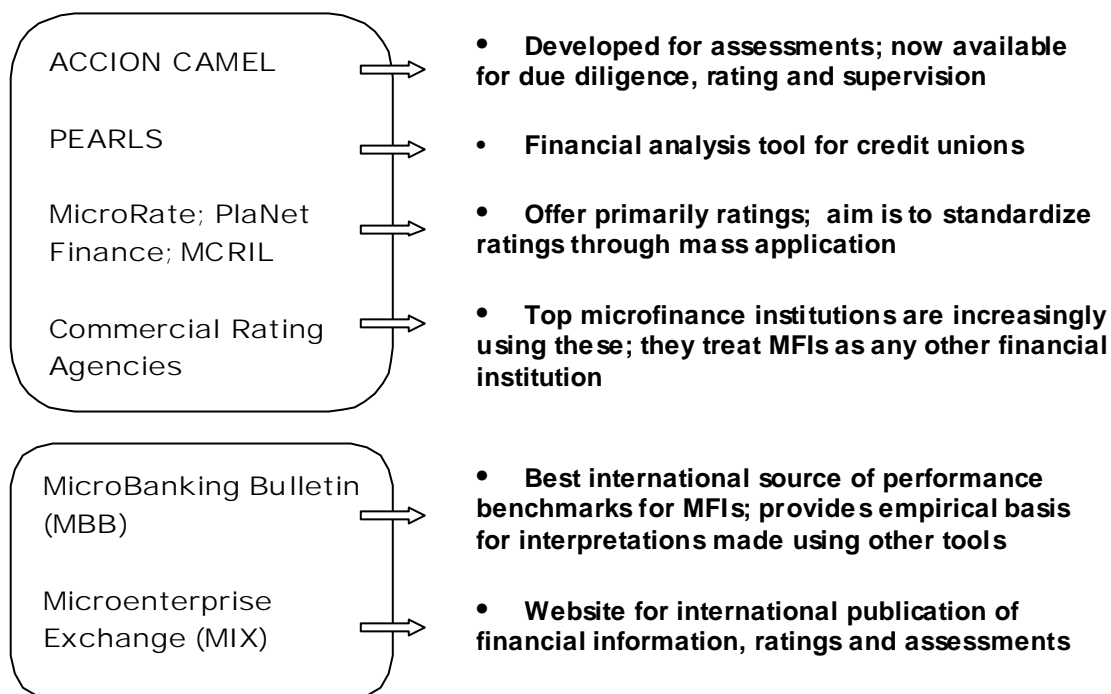
² A particular difficulty in developing an international framework for transparency is noted: microfinance institutions must respond to the laws and regulations of their own countries, which may differ materially from the preferred international standard. In such cases, institutions may find it important to satisfy both standards, despite the added complexity.

statements involves verifying the accuracy of portfolio quality data, external auditors are often pulled into more analytic tasks.

The common link between the items in the second group is that they do involve the analysis of performance. They require the interpretation and judgment of that performance by external experts. These uses all build on the foundation of transparent financial information, made possible by the elements in the first group. They differ from one another, however, along four dimensions: purpose, focus of analysis, depth of analysis, and public availability. The purpose determines the other dimensions. Assessments, intended to guide insiders, are detailed, emphasize qualitative aspects, and are relatively restricted in availability, while ratings traditionally limit themselves to financial indicators, are very brief, and widely published. Supervision is concerned with future risks, specifically risks that might result in insolvency, while due diligence, though also concerned with risk, tends to look not just at the possibility of failure but also at positive returns.

In order to carry out analysis for all these purposes, a number of tools and providers have emerged, as shown in Figure 2. This list is not intended to be exhaustive, but includes many of the major elements.³

Figure 2. Resources for Analysis of Institutional Performance



In the first group are providers of analysis, each with their own tools. The first three sets of providers or tools are microfinance-specific, while the last, the commercial raters, are not. Nevertheless, regulated microfinance institutions are increasingly using commercial raters to gain

³ A more complete treatment of sources, particularly those associated with CGAP, may be found in “Focus on Financial Transparency: Building the Infrastructure for a Microfinance Industry” available from www.cgap.org.

greater legitimacy in the mainstream financial system. Commercial raters tend to look almost exclusively at financial information and omit consideration of the unique features of microfinance.

Among the microfinance-specific providers, it is important to point out that all use a similar analytic framework. The core activity in each case is the application of financial ratio analysis to produce and interpret key indicators. There is widespread consensus not only on the basics of financial analysis, but increasingly on the overall list of core and secondary indicators and on definitions for these ratios. Recent dialogue on ratio definitions is moving from general consensus to a high degree of standardization. And even in the area of analytic framework (i.e. which indicators analysts consider crucial in coming to an overall judgment), the breadth of the consensus is often overlooked. It goes without saying that all analysts agree on portfolio quality, capital adequacy, profitability, efficiency, and liquidity as key areas to examine. Even within each of these areas, there is sufficient agreement that discussions about differences sometimes approach the esoteric.⁴

If we fully agree on ratio definitions and generally agree on which indicators to examine, the most important remaining differences come in interpretation. We seek more consensus in answering the question “What constitutes excellent (or very good, or fair) performance?” Differences arise from several sources. First, the experts carrying out the analysis have varying expertise and go into varying depths in their analysis. Thus, an assessment or rating by one source does not necessarily carry the same weight as an assessment by another. Second, there is no common agreement on the language of rating. In the world of commercial rating, everyone knows what AAA means, and when different raters have different rating systems, published guidelines help readers translate from one nomenclature to another. Microfinance raters have yet to develop such a common language. At present, each source has its own scoring system and linguistic conventions for reporting. Therefore, it is only possible to compare the opinions given by one source against other ratings from the same source.

An essential step towards greater commonality in interpretation is the benchmarking process, represented most prominently by the *MicroBanking Bulletin (MBB)*. The MBB conducts ratio analysis on data reported by a large number of MFIs and presents the results by peer groups of institutions that share characteristics (such as region, age, institutional type, or target market). It does not verify the data itself. As the MBB data base grows deeper, it provides increasing empirical evidence about the ranges of key performance indicators associated with different kinds of institutions. This process aids all those involved in analyzing financial performance of MFIs to be both more precise and more confident in their conclusions. Similar benchmarking processes are taking place within some countries, such as Bolivia and Peru, where supervisory authorities are actively analyzing MFI performance.

Although microfinance has advanced significantly, the infrastructure to support transparency is still in development. The remainder of this paper describes how ACCION is responding to the challenges of transparency, together with its MFI partners and through its own work with the ACCION CAMEL.

⁴ One key area where differences in practice remain that can make a big difference in the results of an analysis concerns adjustments for inflation and subsidies.

Leadership through the ACCION CAMEL

ACCION's decade of experience with the CAMEL has given it a strong basis for contributing to the task of creating a transparent microfinance industry:

- The CAMEL analytic framework, protocol, and scoring system are among the most thorough and rigorous available in microfinance.
- ACCION has a team of experts in applying the CAMEL who have deep experience in evaluating MFIs. The resulting ability to make judgments about MFI performance, particularly in qualitative areas such as management, cannot be readily duplicated.
- The large number of CAMELs constitutes one of the largest bodies of analysis of MFI performance using a single, consistent analytic framework. A total of 43 CAMELs have been performed, on 27 separate institutions. The institutions that have been analyzed tend to be relatively advanced and mature MFIs.
- The CAMEL analytic framework is closely aligned with the MBB framework, paving the way for interactions between the CAMEL and MBB benchmarking process.

The ACCION CAMEL is an adaptation for microfinance of the CAMEL assessment tool originally developed for supervising U.S. banks. When ACCION developed the CAMEL in the early 1990s, it was used primarily as an internal diagnostic or assessment tool to assist management and boards of its partner MFIs. The use of the CAMEL was soon extended to include due diligence for investments and/or guarantees issued by ACCION's internal funds, the Latin American Bridge Fund and the Gateway Fund. More recently, ACCION has been training supervisors and second tier lenders in the use of the CAMEL instrument, and ACCION has taken the decision to move toward using the CAMEL as a rating tool as well. Thus, the CAMEL as an instrument is suitable for any of the four analytic functions listed in Figure 1.

In response to the increasing focus on making assessments of MFIs public, and given the increased demand among a range of audiences for information about MFIs (e.g., from banking authorities, investors, second tier lenders and others), ACCION is building on the CAMEL to broaden its use through the following actions taking place in 2002 and 2003:

- Increase the number of CAMELs carried out per year
 - Maintain and expand the CAMEL team.
 - Provide the traditional diagnostic CAMEL to ACCION partners on an as-needed basis.
 - Use the CAMEL as due diligence for investments by equity funds in which ACCION is an investor.
 - Begin doing CAMELs for organizations beyond the ACCION network starting with a joint project with the Microfinance Network (MFN) to analyze a majority of its members. The MFN is a worldwide network of 25 prominent microfinance institutions with a common commitment to commercial standards of operation. This exercise will expand the CAMEL experience base beyond Latin America to the rest of the world.

- Update the CAMEL analytic framework to reflect developments in microfinance and in regulation and supervision practice
 - Account for a wider range of institutional types in microfinance, especially commercial banks and other deposit takers.
 - Account for a wider range of products offered by microfinance institutions
 - Incorporate into scoring protocols information emerging from MBB and other benchmarking exercises.
 - Review the procedures for the adjustments for loan loss reserves and inflation.
 - Dialogue to ensure consistency of definitions and indicators with MBB and other raters; consult to ensure appropriate fit with new Basle accord which sets international standards for bank supervision.
 - Reflect the trend toward risk-based supervision in an appropriate way.

- Adapt the CAMEL instrument for a wider variety of uses
 - Develop and apply a public CAMEL report which can become the basis for a public CAMEL rating.
 - Add specific modules to the CAMEL to be used in instances where these are useful (e.g. methodology; competition; economic conditions).
 - Develop additional training materials aimed at supervisors and staff of second tier institutions.
 - Develop “CAMEL Lite” format for quickly updating CAMELs for institutions already analyzed.

- Spread the use of the CAMEL tool in a way that maintains quality
 - Develop a process for a limited number of consultants to qualify as ACCION CAMEL providers.
 - Provide training for bank supervisors in the use of the CAMEL and work with banking authorities in the integration of CAMEL principles into supervision protocols.
 - Provide training for second tier lending institutions in the use of the CAMEL.

As this process moves forward, ACCION will continue to participate in the broader industry dialogue about the evolution of standards in microfinance analysis, particularly including common standards and language for benchmarking and rating.

Ensuring that ACCION’s Partners Meet High Standards of Transparency

ACCION and its partners will ensure that they maintain high standards of transparency in their own operations. This process occurs at two levels: locally and internationally. Locally, ACCION’s partners are increasingly licensed institutions operating commercially and are therefore subject to requirements from banking authorities regarding disclosure, external audit, reporting, openness to inspection, and even in some cases the requirement to be assessed or rated in comparison to local mainstream financial institutions. At the same time, as leaders in international microfinance, the institutions should and do participate in the process of developing performance standards and disseminating information on performance for the microfinance industry as a whole. Where local and international standards differ (sometimes dramatically in the case of the accounting standards in some countries), it is necessary for MFIs to be able to respond to both. ACCION will support its partners particularly in responding at the international level, though it may be involved in some

cases through technical assistance in helping its partners respond to local requirements. Among the areas of activity are:

- Internal building blocks and local requirements. MFIs must:
 - Ensure full financial disclosure in audited financial statements at a level that meets both local and international standards.
 - Review the nature of external audits to ensure that auditors have adapted their procedures to the nature of microfinance (for example, that the auditors have incorporated relevant elements from the CGAP audit manual regarding audit of loan portfolios and delinquency management systems).
 - Ensure ability to report fully and regularly to banking authorities (necessary for licensing).
 - Ensure that the MIS generates timely, complete and accurate data on portfolio quality.
 - ACCION may assist partners in ensuring that MIS data, internal control, disclosure, and audit meets international standards, with an increasing practice area in providing technical assistance on transparency.

- Participating in the international movement on financial performance standards:
 - ACCION will continue collecting and analyzing financial and operational indicators in its financial analysis unit on a quarterly basis and making that information available as appropriate. Some indicators will be public, while others will be used for internal analysis or reported in the aggregate.
 - While advocating increasing openness in the use of data, ACCION will always handle the information of its partners in a way that respects the partners' own agreed preferences about the release of information.
 - ACCION will continue to be the conduit for participation of its partners in the MicroBanking Bulletin database and performance standards project.
 - ACCION will urge its partners to participate directly in the Microfinance Exchange by placing financial statements on the MIX Market website and attaching third party assessments and ratings. Such participation represents a significant step toward greater public availability of detailed performance information.

Through processes such as the above, the microfinance industry as a whole is building a framework that will legitimize microfinance in financial systems around the world and contribute to the safety and soundness of the institutions that serve the more vulnerable portions of the population.

This paper was written by Elisabeth Rhyne, ACCION International's senior vice president of African Operations and Research, Development & Policy.

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