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**Transparency and disclosure in the global microfinance industry:
Implications for practice and policy makers**

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1. Introduction

In this chapter, we discuss transparency challenges in the global microfinance industry. The issue of transparency not only is on the agenda of listed companies and regulated banks in mature markets but is also hotly debated in regard to firms operating in emerging markets and development agencies. Moreover, several actors in the microfinance industry have recently been accused for having low standards of transparency (Pocantico 2008). Thus, we argue that the issue of transparency in the global microfinance industry serves as an interesting case with both theoretical and practical implications.

Microfinance is the provision of financial services, such as savings, insurance and loans, to micro-entrepreneurs and low-income families. The growth of the microfinance market has been remarkable. Soon, the microfinance sector will become the world's largest banking market in terms of number of customers. It is estimated that microfinance institutions (MFIs) serve more than 200 million loan customers (Maes and Reed 2012). Furthermore, more than 500 million poor families have savings accounts (Christen, Rosenberg et al. 2004), and 135 million poor families have some type of micro insurance policy (Lloyd's, 2012).

Within the microfinance industry, the issue of transparency and disclosure of information is important because MFIs operate in a market with many extremes. First, the financial clients are typically poorly educated and demand financial services in small increments, commonly with deposits of a few dollars or loans ranging from \$50 to \$1000 US dollars. Second, these clients often live in areas with poor infrastructures in low-income countries that have national financial authorities with weak regulatory capacity (Armendariz and Morduch, 2010). Third, the industry has a short history; the average age of its institutions is approximately nine years (in the global data set of Mersland et al., 2011), and a significant portion of the founders are still active (Randøy et al., 2013). This lack of professionalism limits the industry's ability to provide information. Fourth, the industry has received an abundance of international attention (www.cgap.org) and international investments (Mersland et al., 2011), which have helped in the creation of policies and institutions that facilitate better disclosure of information, such as dedicated rating agencies specialised in assessing MFIs.

It is notable that MFIs represent a type of financial institution with an unusual number of common characteristics across a large number of countries. In this chapter, we will discuss

how the microfinance industry has been shaped by various issues concerning transparency. Specifically, we discuss how the supply and demand of information works in relation to the key stakeholders in the microfinance industry: customers, donors and owners.

2. Transparency and disclosure among microfinance stakeholders

The word transparency is widely used in the microfinance industry, but it has different meanings to the various stakeholders in the industry. We argue that the extent to which transparency has become a buzzword in microfinance has made it politically impossible for stakeholders to make rational arguments about the optimal level of transparency and the costs of disclosing information (by actors such as MFIs, rating agencies or capital providers). In this chapter, we adopt a more rational approach to this issue by considering both the costs and the benefits of transparency and disclosures.

One reason for the significant interest in transparency in the microfinance industry concerns the donors, a stakeholder group usually absent in other financial industries. Because access to microfinance is believed to have a positive developmental effect on the customers (Morduch, 1999), MFIs often receive subsidies in the form of grants, services or low-interest loans. This characteristic of the industry complicates the measurement of financial performance.

Moreover, the possibility that managers of MFIs are capable of influencing reported donations and loan-default levels has led donors and investors to question the financial reporting of MFIs (Manos and Yaron, 2009). The social performance dimension of MFIs is even more complicated to measure. In fact, because a large number of industry reports have supported the claims, e.g., of Morduch (1999), that access to microfinance has a positive effect on customers (Goldberg, 2005; Odell, 2010), it has been difficult to prove large positive effects when rigorous evaluation methodologies are applied (Duvendack et al., 2011).

2.1 The economic foundation

The optimal level of transparency in the microfinance industry, as with any other industry, can be found in the economics of information. On one hand, the demand for information indicates the significance that various stakeholders attach to transparency. On the other hand, the supply of information, the actual information disclosed by MFIs and their stakeholders, reflects their willingness to provide such information. Economically, there is an equilibrium

when the target transparency level (the demand for information and the corresponding willingness to pay) matches the disclosure of information (the supply of information at a certain price). The transparency debate often implicitly assumes that more disclosure is always ‘better’; however, throughout this chapter, it is important to keep in mind that information disclosure is costly and that infinite transparency is never optimal.¹

A number of market inefficiencies can result from a sub-optimal level of transparency in the microfinance industry. First, there might be free-riding problems given that the users of information (such as customers, donors and investors) are unlikely to equally share the cost of generating this information. Second, there might be externalities given that some of the main beneficiaries of microfinance activities may be stakeholders that do not directly interact with the industry, such as other local businesses (increased demand following increased supply of microfinance) and the local government (a wider tax base).

One solution to the free-riding problem could be some type of industry-based solution (e.g., the pooling of information on defaulting customers in establishments known in the microfinance industry as ‘credit bureaus’) that allows for the sharing of benefits and costs. To address externalities such as underinvestment due to a lack of transparency, national or multilateral organisations (such as the World Bank) can fund information collection and enforce disclosure standards among microfinance providers.

2.2 The key stakeholders of the industry

A distinctive feature of the microfinance industry is its unique combination of stakeholders. Mori (2010) highlights six stakeholder groups: customers, owners, donors, creditors, employees, and the government. In this chapter, we focus on what we consider the main stakeholder groups: the customers, owners, and donors. However, the discussion will also cover the requirements of creditors because the combined information demands of donors and owners are expected to be sufficient for the creditors.

Microfinance customers are characterised by a low socioeconomic status, which makes them vulnerable to economic exploitation. In fact, exploitation by money lenders has been part of

¹ This section has greatly benefited from insightful suggestions by Peter MacKay.

the motivation behind the origin of modern microfinance since the 1970s (Armendariz and Morduch, 2010). A large proportion of these customers are illiterate, and in general, many have a low level of knowledge concerning financial services. These aspects suggest that transparency is more important for MFI customers than for customers in other financial industries.

Although MFIs have different ownership forms, business practices are relatively similar across MFI types and legal contexts (Mersland and Strøm, 2008). Modern microfinance was first initiated by socially oriented development organisations. Non-governmental Organisations (NGOs), which are non-profit organisations, still represent the largest group of organisations in the microfinance industry. Other important organisations are member-based cooperatives and shareholder-owned MFIs; the latter MFIs are often considered the for-profit entities of the microfinance industry. However, the difference between for-profit and non-profit MFIs is not straightforward given that most MFIs consider social performance an important part of their mission and because shareholders in for-profit MFIs are often owned and controlled by NGOs (Armendariz and Morduch 2010). We argue that the variation in ownership types creates variation in the demand for transparency, which in turn affects MFIs' willingness to disclose information. For instance, one can expect that owners of for-profit MFIs would give more importance to financial performance information, and NGO boards would demand a stronger emphasis on social performance, in line with their stated mission.

The history of microfinance is closely intertwined with that of serving a social mission. According to Hudon and Nawaz, (2011) approximately 14 percent of the average MFI loan portfolio is financed by donations in the form of revenue grants, equity grants, or the difference between market rates and subsidised rates on concessionary loans. For example, the establishment of the Grameen Bank by Muhammad Yunus in 1983 provides an excellent case of the importance of a social mission and the associated donors. There are two major donor groups: private donors and public/institutional donors. The first group consists of individuals who typically donate small (often monthly) amounts and request information on how they are helping (i.e., "good stories") and/or other indications of social performance. The public or institutional donors can be individual governments, multilateral organisations (e.g., World Bank, UN), or donor organisations, such as the Bill & Melinda Gates Foundation. Such organisations have lately been much more specific in their demand for social impact

information and transparency on financial issues, which has forced the microfinance industry toward developing measures of social impact and financial sustainability.²

2.3 An overview of issues

Table 1 presents an overview of the key transparency and disclosure issues. For the first group of stakeholders, the customers, it can be seen that potential customers need to know that microfinance services are *available* before considering the *contents* of these services. Assuming that this information is provided, one can expect that knowing the true cost of a financial service is a key issue. In fact, the issue is most likely more relevant in developing countries than in developed ones. First, in the developing world, interest rates (and inflation) are usually higher and more volatile than in developed countries. Second, there is less competition among microfinance providers in less developed countries than in the financial markets of the developed world.

Unfortunately, informing customers about the actual costs of providing microfinance is a huge challenge. For example “the time value of money” is a rather demanding concept to the average microfinance customer. MFIs can respond to the need for transparency by disclosing comprehensible information about the financial services they offer and allowing third parties to assess their services. To bridge the gap between the customers’ need for information and information they can actually comprehend and apply, different types of financial literacy programs are gradually being promoted. Furthermore, having more competition in the industry would help to ease the proportional strong market power some MFIs possess in relation to their poor customers. In fact, competition is one of the most important means to guarantee that costs of financial services are kept at a reasonable level.³ Moreover, MFIs mobilising deposits need to be prudently regulated to protect customers’ savings. With respect to regulation, the challenge is assuring prudent regulation without substantially increasing the MFIs’ costs.

² Two of the co-authors are board members of MFIs and have experienced firsthand the tough demands that some professional donors require.

³ Although we recommend enabling more competition in the industry, we are fully aware of possible negative effects caused by micro-lending if customers become over-indebted as a consequence of MFIs competing for customers (McIntosh and Wydick, 2005).

Table 1: Transparency and disclosure in relation to key stakeholders

Key stakeholders:	Demand for information: Transparency	Supply of information: Disclosure	Current market failure?	Need for change in public policy?
Customers	True cost of service, market information	Transparent contracts, market information by third party	Financial illiteracy, few suppliers	Better customer education, facilitate more competition in industry, prudent regulation
Donors	Social impact	Indications of social impact: mostly the number of customers	Severe measurement challenges for social performance, important to include costs also as a social indicator, difficult to compare the social impact between suppliers	Microbanks should supply better social impact measures, need for industry-wide standards, need for lower costs in MFIs
Owners	Financial returns, sustainability	Financial statements, rating reports	No standard for performance measurement, some large investors cannot enter the industry	Yes, by means of more integration with local and global capital markets

We can assume that donors are motivated by the social impact of microfinance activities, such as a reduction in poverty and enhanced economic opportunities for MFIs' customers. Historically, this social mission has been "sold" to donors without rigorous facts other than the number of customers served and anecdotal evidence on the impact in poverty reduction. We argue that this lack of evidence on social impact has made it difficult to distinguish between successful and less successful MFIs in this regard. Lately, institutional donors have demanded more specific indicators of social impact. This gap between the disclosed information and the need for transparency has pushed the industry towards higher standards of social impact reporting⁴. We argue that the establishment of industry standards on social impact reporting is necessary if the industry wants to maintain its donor support. In addition we highlight the importance of reducing MFIs' costs which in relative terms are typically five to ten times higher than commercial banks operating in emerging markets. After all, as argued by Mersland and Strøm (2010), it is the high costs of MFIs that force them to drift away from the poorest customer segments and to charge high interest rates. Thus, the costs of the MFI not only influence its financial performance but also its social impact.

⁴ For example, most of the rating agencies discussed below now offer specific assessments of the social impact and social dimensions of MFIs.

Owners and boards of MFIs need to monitor their institutions. Without such monitoring, the top management or other stakeholder groups could potentially weaken the performance of an MFI and dilute its original mission. Owners also need to assess whether the institution is sufficiently capitalised with equity or in need of additional funding. In particular, the capitalisation of NGOs is a challenging issue given that they do not have any ownership to “sell”. However, in practice, several of the larger NGOs in the microfinance industry (e.g., Opportunity International and Accion International) operate through subsidiaries that are separate for-profit entities so that part ownership can be sold out to obtain outside funding if needed.

Financial monitoring by existing owners or boards as well as potential new owners (outside investors) requires information about financial returns and financial sustainability. To enable the continued flow of professionally managed capital into the industry, there is a need for industry-wide standards of performance. Rating agencies (see below) have been important providers of such industry-wide information, but it is still difficult to disentangle the financial and social performance of MFIs.

With an increasing number of private investors seeking to profit from participating in the microfinance industry, one might wonder if there really is an *investor* market failure in microfinance. However, given the long-term growth prospects of the industry (Mersland, forthcoming) and the resulting need for large amounts of external funding, the fact that some of the world’s larger capital providers, such as CALPERS of California and the Norwegian sovereign wealth fund, have restrictions on where and how to invest significantly reduces and limits the universe of potential investors. Moreover, the fact that most shareholders of MFIs are international and not national investors illustrates the importance of better integration also with the local capital markets. After all, if the industry is to reach its potential it can not continue being dependent on specialized international microfinance investment funds (Mersland and Urgeghe, 2013).

3. Regulation and rating

Public regulation and third-party ratings are measures commonly discussed in the debate on transparency in the microfinance industry. In this section, we present recent developments on these issues and discuss their relevance for transparency in the industry.

3.1 Regulation of the microfinance industry

Banks and financial institutions are regulated because failures generate negative externalities for their customers, particularly depositors (Freixas and Rochet, 1997; Inter-American Development Bank, 2004). Moreover, it is widely recognised that there is a public need to protect a country's payment system and, more generally, the financial system (Inter-American Development Bank, 2004). An additional objective for the regulation of the microfinance industry is increasing MFIs' outreach, sustainability and, as a result, contribution to poverty reduction (McGuire, 1999; Satta, 2004; Arun, 2005). Freixas and Rochet (1997) list six types of regulatory instruments used in the banking industry: lending rate ceilings; entry, branching, network, and merger restrictions; portfolio restrictions, including reserve requirements; deposit insurance; capital requirements; and regulatory monitoring (p. 259).

Several studies discuss how to optimise the regulation of MFIs given their special characteristics (see, Hardy, et al., 2003). Basically, there can be both too much and too little regulation. It should be noted that regulation, in both microfinance and traditional financial industries, is controversial essentially because it may prevent competition and increase the possibilities for creating and extracting rents (Stigler, 1971). However, traditional banking regulations do not typically cover microfinance activities (Hartarska and Nadolnyak, 2008); separate regulations are used for the microfinance industry. Appropriate MFI regulation depends on country-specific characteristics, such as the level of development and institutional capacities (Arun, 2005; Hardy et al., 2003), which complicate uniformly regulating MFIs across countries (McGuire, 1999).

Microfinance regulations can include rules governing MFI formation and operation, consumer protection, fraud prevention, the establishment of credit information services, secured transactions, interest rate limits, foreign ownership limits, and tax issues (Cull, et al., 2009). However, the majority of MFIs are not regulated at all. The level of regulation varies extensively by country. In many countries, some MFIs are regulated by a national authority,

whereas other are exempt even when they operate in the same national markets and follow similar business models (Mersland and Strøm, 2009). Typically, regulation is limited to MFIs that accept deposits, due to the vulnerability of these customers (Hartarska, 2009). Because banking regulations are not standard for MFIs, a ‘hot’ topic in the microfinance industry is whether mandatory regulation should be imposed. Unfortunately, research on the consequences of microfinance regulation is rather limited (Hartarska, 2009).

The existence of microfinance regulations may have a positive influence on the quality of governance and control in an MFI (Beisland, Mersland and Randøy, 2013). Thus, microfinance regulations may have an indirect effect on transparency and disclosure in the industry. Moreover, the regulation of MFIs may also have a more direct effect by including provisions for performance measurements and financial accounting (Cull et al., 2009; McGuire, 1999).

3.2 Global Risk Assessments - The MFI Ratings

Faced with a complex business model and the typical dual objectives of financial sustainability and social impact, the microfinance industry developed an interesting innovation: a special type of MFI rating assessment. Microfinance ratings should not be understood as traditional credit ratings because they are more extensive and claim to measure MFIs’ ability to reach multiple sets of objectives (Reille et al, 2002). In addition to creditworthiness, the microfinance rating assessments measure issues such as trustworthiness and excellence in microfinance (www.ratinginitiative.org). Reille et al. (2002) state that the rating grades seek to answer the question “Is this a good organisation?” rather than the traditional rating question “How likely am I to be repaid in full and on time?”

The purpose of rating reports is to present independent information that stakeholders (i.e., lenders, donors, owners, boards or managers) can use to make informed decisions. Thus, the main focus of an MFI rating is to offer a transparent third-party opinion about the rated MFI. Donors have welcomed the rating initiative and, since 2001, sponsored MFIs willing to be rated and publish the results. Large multilateral donors, such as the Consultative Group to Assist the Poor (CGAP) (a branch of the World Bank) and the Inter-American Development Bank (IDB), have been supportive of MFI ratings (see www.ratinginitiative.org and www.ratingfund2.org). According to Mitra et al., (2008), there are approximately 16 rating

agencies active in microfinance. The major rating agencies are the US-based Microrate, the Italian-based Microfinanza, the French-based Planet Rating and the Indian-based M-CRIL and Crisil.

Different rating agencies have different rating scales, in the same manner as credit raters such as Standard & Poor's and Moody's. However, the scales can be standardised. Beisland and Mersland (2012) identify the major factors influencing the rating grade assigned to an MFI. Their empirical study shows that the information embedded in microfinance rating grades is very similar to that of traditional credit ratings among listed firms in developed economies. Although the rating agencies claim that they assess the totality of the MFI and its regulatory and competitive environment, in reality, the major factors influencing the assigned grade are firm size, risk and profitability (Beisland and Mersland, 2012), which is very similar to traditional credit ratings (see Kaplan and Urwitz, 1979). However, Beisland and Mersland (2012) indicate that the grade itself is not necessarily the most important outcome of the rating process. Comprehensive reports about MFIs' operation, management, performance, markets, governance and regulatory environment provide stakeholders such as lenders and donors with valuable insights into the true state of MFIs.

Sinha (2002) maintains that many MFI operations are a "black box" to outsiders and that this creates questions about their true performance. Thus, from a transparency point of view, the creation of rating assessments has been of vital importance. Mixmarket is a web platform (www.mixmarket.org) where MFIs can present their profiles to international donors and investors and other industry actors. Mixmarket in itself is an important transparency initiative. It has established a diamond system, with a maximum score of five diamonds given to MFIs that present an external rating report that supports the information provided to Mixmarket. Consequently, external ratings have become a necessity for many MFIs, especially to those in need of international funding (Beisland and Mersland, 2012).

The rating assessments also have the potential to influence the strategy and behaviour of MFIs. So far, research on the impact of MFIs ratings is scarce. For instance, using an Eastern European sample, Hartaska (2005) reports that rating an MFI appears to have no influence on MFI performance. However, the possible impacts of ratings are difficult to measure empirically. Despite the limited research, it can be expected that MFIs with lower rating scores will find it relatively more challenging to fund their operations; potential capital

providers may demand higher returns (payment to investors and debt providers) or may not provide access to funds at all (donors withdraw).

4. Transparency and disclosure – the current situation, challenges and some suggestions for future development

In this section, we focus on the main transparency and disclosure issues identified in Table 1. We continue to focus on the customers, donors and owners, describing the current situation of the industry, the challenges it faces and the possibilities for policy improvements.

4.1 Market information and the true costs of services

As highlighted in Table 1, having access to information on the actual interest rates and, in general, the true cost of services is, or at least it should be, a major concern to microfinance customers. Donors and socially conscious investors also have an interest in knowing that the service conditions (level of interest rates, etc.) offered by MFIs can be considered acceptable.

Since the 1980s, the high interest rates charged by some MFIs have been a public concern. However, it was not until the highly profitable Mexican MFI Compartamos became a publically listed firm on the Mexican stock exchange in 2007 that high interest rates in microfinance became known to the general public (Rosenberg, 2007). Prior to this event, the argument for high interest rates was the high cost involved in micro lending. Many naïve stakeholders had never considered the possibility that some MFIs were in the business to make generous profits for their for-profit investors, as such investors had started to enter the industry (Rosenberg, 2007).

Some of the major microfinance innovations, such as lending small amounts to poorly educated women (and some men), requesting frequent instalments, organising borrowers in groups and not requesting collateral, are expensive. Mersland and Strøm (2013) report average and median operating costs of 33.1 percent and 23.8 percent, respectively (as a percent of the total loan portfolio); these levels are five to 10 times higher than those in commercial banks in developing countries and 20 times higher than those in efficient banks in Europe. In addition to high operating costs, many MFIs have high financial costs as well.

However because MFIs still receive considerable subsidies, Mersland and Strøm (2013) report average financial costs of only 7.6 percent of the total loan portfolio (with a median of 6.5 percent). Write-offs must also be added to the total cost. Adding together the operating costs, financial costs and write-offs, it is easy to see why microfinance lending rates are high. Indeed, Mersland and Strøm (2013) report that the average lending rate for microfinance customers is 40 percent (the median is slightly lower at 35.5 percent). Compared with interest rates in developed countries, microfinance rates are comparable to the interest rate levels of small consumer or credit card loans, which often range between 15 percent and 40 percent (although, in some extreme cases, effective interest rates of 9245 percent were reported on phone-based loans in Norway, cf. Dagens Næringsliv, May 31st, 2013). Nonetheless, there are large differences within the global microfinance industry. For example, larger MFIs can enjoy economies of scale (Hartarska, Shen et al. 2013), which when combined with ‘best practice’ operations, allow financially sustainable MFIs to lend at rates below 20 percent which is now common for instance in Bolivia.

Policy makers have asserted that the lack of “truth in pricing” in the microfinance industry is a major transparency problem, an argument strongly supported by Chuch Waterfield (the founder of Microfinance Transparency; see below). It can even be difficult for financial experts to understand microcredit contracts, which are often filled with conditions, obligations and commissions that substantially increase the real cost of borrowing. The following examples illustrate these issues. Interest rates are often not calculated on declining balances but on original loan amounts. Commissions are added for paper work instalments and monitoring. Mandatory insurance policies, such as life insurance, are often included. In a similar manner, mandatory savings are often part of the contract and, in some cases, at a ratio of 2:1 (need to save one \$ to obtain two \$ in loans). Thus, on a declining balance, in practice and on average, the customer is borrowing her/his own money and nothing else during the loan period.

The Microfinance Transparency initiative is interesting and could serve as an example for transparency initiatives, even outside the microfinance industry. The purpose of this initiative is to help microfinance customers and stakeholders understand the real cost of borrowing. First, it demonstrates the influence of different commissions and mandatory services being included in microfinance contracts on the effective interest rate. An easy-to-use calculator has been designed; users can see how an interest rate sold at, e.g., 25 percent easily results in an

effective rate of 75 percent or higher. Second and more importantly, Microfinance Transparency discloses real interest rates for most microfinance providers in 17 countries, including Bolivia, Kenya, India and Ecuador. For example, for the MFI FODEMI in Ecuador, although the institution claims to offer loans at 20 to 22 percent to its individual borrowers, the real interest rate is 27 to 30 percent. Other examples include ASA in Ghana, which claims to offer business loans at 3 percent per month, but after studying their loan contracts, Microfinance Transparency concluded that the effective annual interest rate is in the range of 64 to 82 percent. In a similar manner, the MFI Kwasha in Malawi offers business loans at 5 percent per month; however, according to Microfinance Transparency, the effective interest rate is between 109 percent and 133percent.

Surprisingly, even though participation by MFIs in Microfinance Transparency is voluntary, in practice, nearly all MFIs situated in countries covered by this initiative do participate. An explanation for the high participation rates is most likely that the MFIs themselves would like to offer more transparent contracts, especially if all MFIs in the same market reveal the same information. Another explanation is that donors may force MFIs to participate. If donors are pulling out of microfinance, there is a risk that MFIs will stop participating in this important initiative.

4.2 Social performance and customer impact

In Table 1, we identified the social impact as the major concern for donors. Therefore, transparency and disclosure on the social performance of an MFI is of vital importance for this group of stakeholders.

Microfinance providers are likely to claim that they pursue both financial and social objectives – the so-called “double bottom line” (Rhyne, 1998). In general, if financial performance can be difficult to measure (see below), social performance is even more difficult. In fact, it is even a challenge for researchers to agree on the meaning of the concept of social performance in the microfinance industry. Zeller et al. (2003:4) state that “*The social performance of an organization (whether a private-for-profit firm, cooperative or NGO) comprises the relations of the organization with its clients and with other stakeholder groups.*” In the microfinance industry, several initiatives have been launched to generate good social performance measurements for MFIs. Some of the indicators covered are the type of

customers served (gender, poverty levels, age, rural vs. urban, business type, etc.), consumer protection systems, the empowerment of customers, the amount of taxes paid, the degree to which the MFI's activities hinder child labour among borrowers, customers' influence on the environment, the working climate and the human resource policies of the MFI (Zeller et al., 2003; IFAD, 2006; Hashemi, 2007).

The first initiatives for a more accurate measurement of social performance came in the early 2000s. Until then, most had taken for granted that providing loans to poor people would improve their lives and that MFIs were more or less altruistic organisations primarily serving the needs of their customers. When critical voices started to surface “Truth in advertising” (Hashemi, 2007) became a buzzword in relation to the interaction with donors. In fact, it became evident that MFIs were not very different from other organisations with respect to the need for professional and appropriate staff incentives. Although workers, managers, board members and owners can be motivated by the good cause of microfinance (Besley and Ghatak, 2005), they are also “self-servers” protecting their own interests. In the same manner, stakeholders such as lenders and suppliers are not necessarily concerned about the general wellbeing of MFI customers. The SMART campaign (www.smartcampaign.org) is a recent initiative to assure that clients are kept first in microfinance. By certifying MFIs that fulfil some minimum standards the SMART campaign aims on regaining the prestige of the microfinance industry, though Hugh Sinclair, a well-known activist in microfinance, has little faith in the initiative (<http://blog.microfinancetransparency.com/author/hugh-sinclair/>).

Schreiner (2002) proposes a conceptual framework to be applied when discussing the social benefits of microfinance for its customers. Specifically, he suggests six aspects of (potential) social benefits from participating in microfinance: cost, depth, breadth, length, scope and worth. These six aspects can be considered performance dimensions of MFIs. Mersland and Strøm (2008) use the framework to analyse performance differences between non-governmental MFIs and shareholder MFIs. Surprisingly, they find that the MFIs' performance along the six dimensions is independent from the form of ownership. Mersland and Strøm (2008) summarise the dimensions as follows:

“Cost is [defined] as the sum of monetary costs and transaction costs to customers, Depth is defined as customers' poverty level or other social preferences like for instance the

percentage of women reached, Breadth is defined as the number of customers served, Length is defined as the time frame of the supply of services and Scope is defined as number of types of financial contracts supplied. Worth estimates to what degree the customers value the services.” (Mersland and Strøm, 2008, p.599).

‘Worth’ is subjective and, according to Schreiner (2002), difficult to define and measure, although customer retention rates should give some indication on whether the services are valued by the customers. The other performance dimensions are easily accessible in an MFI. Leaving out transaction costs, the real interest rate paid on loans represents the ‘Costs’. ‘Breadth’ is simply the number of customers served. ‘Scope’ can be proxied by the number of services offered. Standard financial performance and risk measures (e.g., profitability metrics and liquidity and solvency ratios) should give some indication of whether the MFI will stay in a business over time (‘Length’), although it is preferable to include governance measures as well. Measuring ‘Depth’ is most likely what practitioners and researchers debate the most. Typically, average loan size is the most used measure, but this measure is very crude, especially because an increasing number of MFIs have expanded their missions and now serve larger customers alongside many small customers. Thus, with less homogenous loan portfolios, it becomes difficult to proxy depth with the average loan balance. Moreover, poorer customers are not the only people who take small loans. Nevertheless, average loan size, which is sometimes coupled with the percentage of female customers and outreach to rural areas (Mersland and Strøm, 2010), is the most used depth proxy in microfinance research and, in fact, also the most used proxies by donors and funders when monitoring MFIs’ social performance. Indices with several depth dimensions have been used as well (Mersland, Randøy et al. 2011).

A challenge when measuring overall social performance is that there is a trade-off between the different performance dimensions. Schreiner’s (2002) underlying assumption is that “socially oriented MFIs can trade-off narrow breadth, short length and limited scope with greater depth, while less socially oriented MFIs compensate shallow depth with wide breadth, long length and ample scope” (Mersland and Strøm, 2008, p. 599). We find Schreiner’s framework helpful because it incorporates the fact that strong performances on all dimensions cannot be expected. Moreover, it illustrates that social and financial performances are interrelated. Empirical research (e.g., Hermes et al., 2011) has demonstrated that there is indeed a trade-off between overall social and financial performance in MFIs. Thus, the

microfinance transparency debate would most likely be more balanced if observers and stakeholders were better informed and more realistic.

Because social performance indicators are typically relatively crude measures of customer impact, Zeller et al. (2003) suggest that the terms social performance and customer impact should not be mixed. An MFI manager can influence the performance, but whether the services will benefit the customer depends to a great extent on several exogenous factors. Thus, even in cases where social performance indicators are actually transparent, robust inferences on customer impact cannot necessarily be drawn. MFIs often use anecdotal evidence on the impact of their activities, but more rigorous academic research is most likely a more efficient and necessary tool to improve transparency in this area.

Based on knowledge about entrepreneurship from other areas of business (Shane & Venkataraman, 2000), it has generally been accepted that by injecting capital into micro-enterprises, such businesses will grow and improve productivity on average. Thus, through greater economic output, the owners of microfinance-supported businesses can help provide improved nutrition levels for themselves and their families, as well as more schooling and better access to health services.

Indeed, using cross-country data, Levine (2005) finds a connection between access to finance and economic development. In the same manner, Imai et al. (2012) find an association between countries with high levels of microfinance loan portfolios per capita and lower levels of poverty indicators. However, the microcredit effect may be difficult to isolate for individual households and small enterprises. First, the loans from MFIs are often not used as agreed for enterprise purposes but are instead used for consumption smoothing (Collins et al., 2009). Second, the welfare impacts of such consumption smoothing are difficult to estimate empirically.

In the microfinance industry, the image given to donors, politicians and the public is that poverty can be eradicated with the help of small loans. Nobel Laureate Muhammad Yunus even claimed in his Nobel lecture that poverty can be relegated to a museum with the help of microfinance. Until recently, most studies concluded that access to microfinance, whether loans or savings, had a positive impact on poor people's economic activities and lives

(Goldberg, 2005; Odell, 2010). Recently, however, the evidence has been inconclusive, especially from studies based on social experiments with carefully designed randomised control trials (RCT), where some villagers (or villages) receive the treatment (a loan) and others serve as the control group (see Rosenberg (2010) for an overview). In general, access to savings appears to be beneficial, but whether access to credit has a positive effect depends on several personal and environmental factors. Access to credit alone is no longer a quick poverty fix, and donors such as the Norwegian government are gradually avoiding support to microfinance initiatives in developing countries. However, microfinance impact RCTs are typically performed over short periods of time, usually one year. It is often claimed that effects from access to capital should be measured over longer time spans and include indirect consequences, such as the increased economic activity of the local community. The use of such methodologies in social sciences is new, and we can expect considerable advances in the future.

Overall, many of the effects from microfinance are far beyond the level of the individual and appear at the country level, as suggested by Imai et al. (2012). A general increase in access to credit can “move” through society in apparently unpredictable ways. For example, a loan given to a woman in the city may easily end up in the hands of her father in a remote village. In any case, for the microfinance industry, who has portrayed the image of a woman buying a sewing machine as a means of escaping poverty, the complicated issues involved in measuring impact have become a major transparency problem. Given the measurement challenges, Mersland and Strøm (2010) suggest that MFIs looking for poverty impacts should mainly reduce their costs, which will allow them to reduce their lending rates. Lower lending rates will, in all cases, be beneficial to both micro entrepreneurs and individuals taking on loans for consumption smoothing.

4.3 Sustainability and financial performance

As highlighted in Table 1, from an owner’s perspective, the transparency debate should focus on the financial performance of the MFIs’ dual bottom line. Nonetheless, financial performance should be of interest to the donors as well, given that they are usually reluctant to become involved in entities that are not financially sustainable and require continued support to survive. In general, both investors and donors rely on financial reports in their due diligence before contracting with an MFI and later when monitoring their investments.

Financial sustainability is, in principle, also of interest to customers, at least when deposits are involved, but in practice, few customers will devote much attention to this issue. Trussel (2002) concludes that whether an organisation is susceptible to financial problems is a concern of all stakeholders of the organisation “because financial problems might not allow an organization to continue to meet its objectives and provide services” (Trussel 2002, p. 17)

As described by Beisland and Mersland (2013), prospective investors in exchange-listed companies typically have access to large amounts of financial performance information, which they can investigate before making a decision about whether to invest in a company. In contrast, the owners (or, more generally, the capital providers) of MFIs often have limited knowledge about the companies in which they want to invest. Decisions are often based on rather scarce and poorly standardised financial information (Gutierrez-Nieto and Serrano-Cinca 2007). Over the past decades, one of the main transparency issues in microfinance has been the trustworthiness of MFIs’ financial reports. In the accounting literature, there is an abundance of research suggesting that the accounting quality (which can be viewed as a collective term for the accounting information’s trustworthiness, usefulness and relevance) is of vital importance (for an overview see Dechow et al., 2010); high-quality accounting information decreases risk and is associated with increased fundraising possibilities and a lower cost of capital.

However, in the microfinance industry, some suggest that bottom-line earnings are almost useless for measuring the performance of an MFI (see Manos and Yaron, 2009; Bruett et al., 2005). Thus, some policy makers serving the microfinance industry have issued guidelines and tools on how to measure financial performance in the industry (such as the United Nations Capital Development Fund, USAID and CGAP). Because of the large proportion of donations and subsidies in the microfinance industry, the policy guidelines of such major organisations are closely monitored. These policy guidelines include methods of computing subsidy-adjusted earnings metrics, a much used alternative to bottom-line earnings.⁵ The

⁵ The following three types of adjustments to bottom-line earnings are typically conducted: adjustment for inflation, adjustment for subsidies and adjustment for loan provisions and write-offs (see www.ratingfund2.org for more details). Manos and Yaron (2009) describe these adjustments as follows: ‘The adjustment for inflation is to account for the fact that inflation decreases the value of net monetary assets. The adjustment for subsidies accounts for three types of subsidies: concessionary borrowings, cash donations and in-kind subsidies. The adjustment for loan loss provisions and write-offs is to account for variation in the recognition of delinquencies and the writing off of bad loans.’ (p. 5). Bruett et al. (2005) state that the adjustments are made

microfinance industry has also elaborated other financial performance measures, such as Operational Self Sufficiency (OSS), Financial Self Sufficiency (FSS) and Subsidy Dependency Index (SDI). Although all of these alternative measurements are interesting and add important information, they also make understanding the industry more difficult for outsiders. Our view is that transparency in microfinance would be improved by the industry merely presenting itself in a more comprehensible manner using indicators similar to those disclosed in other firms.

Many observers have focused on the potential challenges in measuring the financial performance of MFIs, but Beisland and Mersland (2013) have taken a different angle. Rooted in the accounting literature, they explain that there is a critical focus on the quality of accounting numbers in all industries, not just microfinance. Even for highly professional MFIs, various managerial incentives may reduce the trustworthiness of financial reporting. Moreover, possible outright manipulation aside, other aspects, such as conservative accounting procedures or volatile business conditions, may reduce the usefulness of the reported accounting numbers in any firm.

Beisland and Mersland (2013) apply standard methods used in the accounting literature to study the earnings quality of MFIs' official financial reports. They find that the quality of reported earnings in the microfinance industry seems to differ little from that of other industries. Although there is no established 'normal' level of earnings quality, the scores on earnings attributes, such as stability and predictability, are very similar to the values reported for listed companies in the US. Moreover, they find no evidence of more widespread earnings manipulation in microfinance than in other industries. They also check whether the adjusted earnings numbers are superior to reported earnings as far as earnings quality is concerned. Again, surprisingly, reported earnings generally achieve scores at least as high on earnings quality metrics as adjusted earnings. They conclude that the microfinance industry, at least in regard to accounting numbers, may not be as different from other industries as many observers seem to believe.

It should be noted that the findings in Beisland and Mersland's (2013) study do not necessarily mean that MFIs' reported earnings can always be trusted or that they provide the

to reflect the true performance of MFIs, to measure MFIs' ability to maintain their level of operations over the long term and to enable benchmarking across a wide range of institutions.

‘correct’ level of profitability for all entities in the industry. First, the finding that earnings quality scores, on average, appear to be similar to those of other industries is no guarantee that an MFI’s accounting numbers are exact representations of the underlying economics of the entities; accounting is not perfect in any industry. Second, the earnings quality literature focuses largely on the degree to which earnings numbers repeat themselves; if earnings numbers are stable and predictable, they are said to be high quality, even if subsidies and donations disturb the correct performance measurement. Therefore, it is most likely advantageous to supplement reported earnings numbers with alternative performance measures, such as adjusted earnings. Nonetheless, Beisland and Mersland’s (2013) study strongly indicates that important and relevant information is embedded in the reported accounting information, and it seems to be premature to characterise the financial reporting information of MFIs as useless or invalid.

In principle, microfinance regulations may contain provisions on financial reporting. However, so far, regulations have played a limited role in regard to improving the financial reporting of the industry. Still, Beisland et al. (2013) find that the accounting quality of regulated MFIs exceeds that of unregulated MFIs. This finding is attributed to regulations being an additional governance mechanism; consistent with prior research (Francis et al., 2006), improved governance is associated with increased financial reporting trustworthiness and usefulness. Moreover, empirical findings suggest that the transparency of smaller and less professional MFIs might be lower, at least when measured through accounting quality indicators (Beisland et al., 2013).

As for the rating agencies, it is our opinion that they serve an important role in increasing the transparency of MFIs’ financial performance. First, they publish a large amount of accounting information and supplementary financial performance measures. Second, they provide assessments and discussions of the reported figures. Third, they compute alternative earnings and financial performance measures, e.g., the adjusted earnings metric discussed above. It should also be noted that financial performance is one of the most influential determinants of an MFI’s rating score (Beisland and Mersland, 2013). Thus, from a transparency perspective, it is important to continue efforts to increase the proportion of MFIs being rated.

5. Conclusion

Over the last couple of decades, the microfinance industry has enjoyed considerable positive public attention; however, more recently, the industry has been criticised for not really “helping the poor” and practicing low standards of transparency (Pocantico 2008). The gap between microfinance expectations and microfinance realities today is one of the industry’s greatest challenges. Thus, in this chapter, we introduce the reader to the microfinance market and the transparency challenges related to the major stakeholder groups of customers, donors and owners.

Transparency can be regarded as particularly important in the microfinance industry. First, the customers are more vulnerable than in most traditional financial industries. Second, the capital providers are often less professional than in other industries. Third, the activities are often financed by means of donations and subsidies – from individuals, organisations, and governments – and the entities typically have explicit social objectives in addition to a financial sustainability objective. These characteristics separate the microfinance industry from other financial industries.

Over the last ten years, the need for transparency in the microfinance industry has become more evident. Due to public pressure and the self-interest of many MFIs, we argue that as of 2013, the level of transparency is substantially higher than it was only a few years ago. An important component in this recent development is the existence of specialised rating agencies, which provide objective third-party information to stakeholders, such as donors and owners. The fact that MFIs are under the scrutiny of rating agencies is one reason rating activity is most likely more important than the rating grade itself. Moreover, increased media attention has contributed to increasing the overall level of transparency in the industry, particularly for donors.

This study highlights several areas where there is a mismatch between the demand for transparency among the stakeholders and the supply of disclosure of information (e.g., market failure). For example, customer illiteracy could be alleviated through better customer education by MFIs and a better education system at large. Likewise, the lack of competition among microfinance suppliers makes it necessary to push for lower barriers to entry in the industry, for example, by promoting the entry of larger international operators. However, policy makers should be aware of the risk of customer over-indebtedness and loan default in highly competitive microfinance markets (McIntosh and Wydick,(2005). Thus, increased

competition should be followed by credit bureaus where MFIs can interchange information about defaulting customers.

The existence of donors sets the microfinance industry apart from other parts of the financial industry. Donors are concerned with MFIs' social impact; however, hard scientific evidence of such an impact is limited, which makes it difficult for donors to know the true impact of their donations and to compare social impact across MFIs. If the industry is to continue receiving donations, the level of transparency on this issue has to be improved, which can be accomplished by individual MFIs providing better measurements of impact and, most of all, by industry-wide agencies providing comparative numbers on the impact across a number of institutions.

The microfinance industry is characterised by a number of ownership forms, both for-profit and non-profit. For these to coexist, the playing field needs to be equal so that capital providers, small and large, national and international, are allowed into the industry. Better integrating the microfinance into the global financial market as well as the local capital markets will also help the industry grow, become more cost focused, and offer its poor customers cheaper financial products. Likewise, from a transparency view, we see a need for public regulators to treat microfinance similarly to other financial firms, with public scrutiny of solvency and the ability to absorb financial shocks. This could have the positive indirect effect of professionalising microfinance providers, which again can help to channel new investors into this high-growth industry and thus reduce the long-term cost of capital.

We conclude this analysis with a caveat. In our view, when discussing improved microfinance transparency, it is important to keep in mind that there are costs associated with increased levels of transparency. Thus, policy makers and others should seek economically optimal levels of transparency. For instance, when designing customer education programs and public regulations, policy makers should keep costs in mind. Thus, research is needed on the economics of microfinance transparency.

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