The Microfinance Industry Needs an Infrastructure Fix:

Summary of Findings and Recommendations

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CENTER for FINANCIAL INCLUSION | ACCION

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Cover photo: VA Department of Conservation & Recreation.

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Introduction: Why this study?

> *"Nearly every industry requires infrastructure to thrive, and this goes for the microfinance industry too. But the infrastructure that the global microfinance industry has constructed over the past two decades is looking a bit shaky today. Infrastructure investments are urgently needed to keep the industry sound and prepare it for the future."*[1]

With that introduction, the Center for Financial Inclusion at Accion called for an investigation, to be followed by action, into the state of the information infrastructure that supports the microfinance sector. The Center subsequently conducted a study of three main microfinance information infrastructure elements. This study aimed to help microfinance stakeholders understand the business models of the information providers and allow the stakeholders to identify actions that might improve the sustainability of the information infrastructure. This report summarizes the findings of the study and puts forward action recommendations for consideration.

The role of the information infrastructure

The global microfinance industry has built a comprehensive information infrastructure in the absence, originally, of distinct infrastructures for each country. This report looks at three elements: the MixMarket (MIX), which provides financial and social performance information on individual microfinance institutions (MFIs), the four specialized microfinance rating agencies, which perform on-site ratings and certifications of financial and social performance, and Microfinance Transparency (MFT), which until recently provided information on product pricing by MFI.

This global information infrastructure underpins the success of the microfinance sector in a number of important ways. It serves to:

- Maintain transparency as a core value by both *setting* transparency standards and *providing* transparent information.
- Enable the construction of benchmarks on financial and social performance for MFIs.
- Provide independent analysis of MFI financial and social performance that is available publicly. Among other things, this enables new players to obtain the information needed to become involved in the sector.
- Maintain the identity and social character of microfinance as a distinct element within the larger financial sector.
- Provide a blueprint for national level players to construct domestic information initiatives in countries where these do not yet exist.

1 "The Microfinance Industry Needs an Infrastructure Fix," Center for Financial Inclusion blog, March 11, 2015. www.cfi-blog.org.

The study did not examine several elements of the infrastructure that are primarily social: the Smart Campaign, the Social Performance Task Force (SPTF), the Truelift initiative and the Progress out of Poverty Index. CFI limited the study partially on pragmatic grounds – to keep it within manageable bounds in terms of scale of investigation and breadth of issues to consider. It also recognized that these socially-oriented initiatives depend crucially on the core information providers – the MIX and the rating agencies. MFT was included as an information gathering and publishing operation, with some challenges similar to those facing the MIX.

Several issues arise repeatedly when discussing the microfinance industry infrastructure. In 2006, when CGAP was preparing guidelines for donors supporting the microfinance sector, it identified three questions about what it called the meso level:

- *"Should infrastructure and services be* ***microfinance-specific*** *or should microfinance skills be absorbed by existing mainstream providers that work more broadly with private sector clients?*
- *Which service providers are the most appropriate:* ***domestic or international ones****?*
- *Should meso-level support services be provided on a* ***purely market basis****, or should they be* ***subsidized*** *by donors or governments?"*[2]

These questions came up repeatedly during the study. The sector has changed significantly since MIX and the rating agencies began nearly two decades ago, causing answers to these questions to shift.

- Lines are increasingly blurred between microfinance and mainstream providers; MFIs have become banks, banks have taken on microfinance, and new players have shifted the sector towards financial inclusion. The social character of microfinance is not as salient as it was.
- Greater capacity for information gathering and analysis exists at the country level and within investing organizations, possibly reducing the need for global public resources.
- Sources of finance have changed. Sector growth means greater financial capacity to support information services, however, donor resources for microfinance have declined.

With these broad changes, the "public goods" nature of the information infrastructure may have evolved, and answers to the three questions CGAP posed may also have changed.

Study method

The study involved examination of the business models and sustainability of the MIX, the specialized rating agencies and MFT. We reviewed the services provided by these organizations, examined coverage and participation of MFIs, and asked who uses the information and for what purposes. Finally, we reviewed the finances of these organizations, both costs and revenues.

[2] CGAP, "Good Practice Guidelines for Funders of Microfinance: Microfinance Consensus Guidelines," October 2006, 2nd edition. (http://www. http://www.cgap.org/publications/good-practice-guidelines-funders-microfinance)

This information came from public data, interviews with a wide variety of stakeholders and confidential data supplied by the organizations themselves. Stakeholder interviews were mostly done with information providers themselves. The confidential data was used for analysis, but is not displayed here. In addition, several group consultations were held at the beginning, middle and end of the project with representatives of the different types of users of the information (researchers, donors, investors, etc.). Most notably, at two points along the way a small group of advisors met to review the findings in depth and provide guidance.

Throughout the study, emphasis was placed on identifying adjustments that could put these organizations on a stronger footing and on alternative ways to produce the information needed by the microfinance sector.

Main Findings

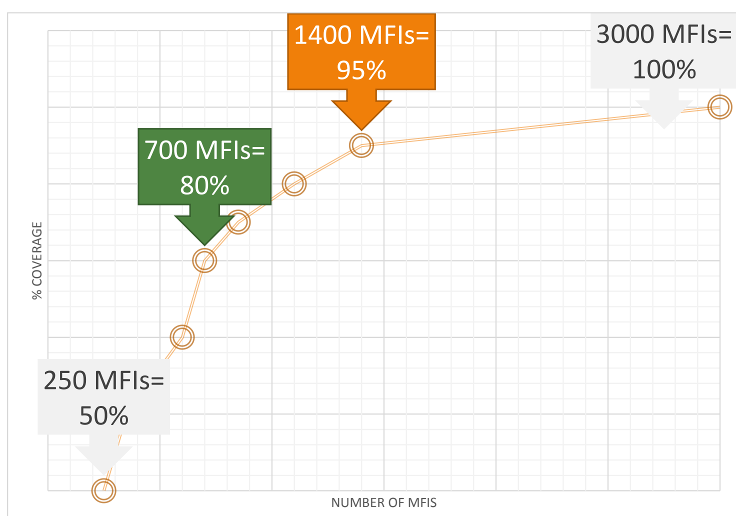
MixMarket

1. *Coverage.* A large number of MFIs are listed on MixMarket (2,600 in total) but relevance of coverage and speed of updates needs to be improved (See table). As of October 2014, only 642 MFIs have data as current as September 2013 or later. These MFIs represent just over 60 percent of the overall assets or borrowers of all MFIs listed on MixMarket, 60 percent also of the portfolios of microfinance investment vehicles (MIVs), and 40 percent of the funder portfolio (development finance organizations and public and private donors). Coverage is notably lower for financial institutions that provide microcredit as part of a wider range of services (e.g., downscaling banks), and for those that focus on small and medium enterprise (SME) financing.

Current Coverage	# MFIs	% Borrowers	% Assets	% MIV portfolio	% Funder Portfolio
MixMarket ID	**2,600**	**100%**	**100%**	**78%**	**52%**
MixMarket data >=Sept. 2013	**642**	**61%**	**63%**	**65%**	**39%**
MixMarket data >=Sept. 2013 & 4+ diamonds	**393**	**50%**	**40%**	**50%**	**21%**

Note: The number of borrowers and amount of assets of the MFIs is measured through the information provided by MixMarket.

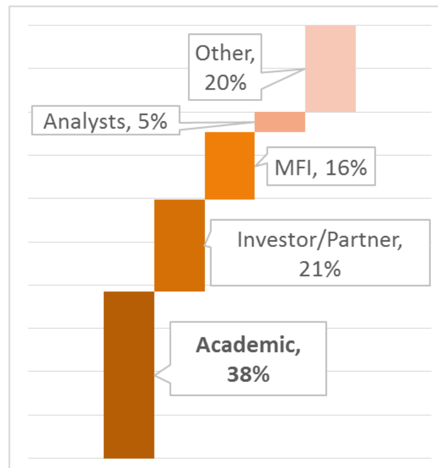
2. Optimized *coverage.* A targeted portfolio of 700 MFIs could represent 80 percent of the microfinance market, if selected to maximize the coverage of assets, borrowers, MIV portfolio and funder portfolio (see figure). A portfolio of 1,400 MFIs could cover 95 percent.



3. *Costs.* The overall cost of MixMarket is approximately $2.8 million, roughly divided in thirds between analyst costs ($0.9 million), technology and travel ($0.9 million), and overhead ($1.0 million). This includes both of the MixMarket's main business lines: the premium services (MIX Gold and Silver) available through subscription and the publicly available data, but does not include the other services developed by the Mix (Finclusion lab for instance).

4. *Revenues*. Fee-based reporting and premium data services (Mix Gold and Silver) are gradually gaining traction ($450k revenues in FY2014). They are trending toward covering direct costs of these services and generating some margin. The public side of MixMarket data (aggregation of MFI performance indicators and generation of benchmarks) is exclusively financed by private and public donations. Margins from fee-based services might in the long run cover the direct costs of public data collection, but are not likely to cover overheads or IT infrastructure. Public data provision will require long term donations or alternative revenue mechanisms.

5. *Users*. MixMarket, the portion of the MIX devoted to microfinance, is used by a wide range of actors (700,000 sessions per year), mostly for global or country level analysis, and by MFIs to gain visibility. (See figure)



6. *User response*. Feedback from users indicates an urgent need for improvement in ease of use (for the public site) and reliability of data (for both public and premium sites).

7. *Management trade-offs*. Co-existence of different use cases and a mandate to pursue sustainability through premium services create tensions in allocating management and staff attention to the public goods portion of the MixMarket.

8. *Public data at risk*. Factors affecting the public data on the MIX include: lack of direct funding from users of the public database, the precarious nature of public funding, the shift of MIX priorities toward premium services and other kinds of financial inclusion information, the uneven quality of the data and quality deficits in the user experience. All these factors put the public portion of the MixMarket at risk. This data serves the important purposes outlined in the introduction in a way that the premium services cannot, providing a public identity for microfinance as a sector, allowing benchmarks to be created, and the like. In the recommendations section, we propose a path to make the public data more cost effective for the MIX and at the same time more valuable for users.

Microfinance Transparency

1. *Coverage*. Microfinance Transparency has collected pricing data on a total of 535 MFIs over six years. Recent data (2013 or later) is available for 195 MFIs, representing 25 percent of microfinance borrowers.

Current Coverage	# MFIs	% Borrowers	% Assets	% MIV portfolio	% Funder Portfolio
Some data on MFT	535	36%	24%	30%	15%
Recent data on MFT (2013+)	195	26%	13%	15%	7%

2. *Costs*. The cost per MFI (for one pricing data set per product for one period) has been decreasing over the years. The overall average was $2,500. The bulk of the time required to obtain pricing data has been absorbed in convincing MFIs to report. The active time to gather and post data costs significantly less than $1,000 per institution.

3. *MFI incentives to report*. MFIs are concerned that they bear some risks if they publish pricing data on a public platform (mainly reputation risk and potential competitive disadvantage). On the other hand, in the absence of disclosure rules or pressure from investors or funders, there is little or no risk in not publishing it.

4. *Business model*. Microfinance Transparency tried working through a dedicated staff team and through third parties such as raters, associations, investors and networks. The first approach was costly and limited in coverage; the second approach involved inefficiencies and was found to be unworkable as a substitute for a dedicated staff.

5. Microfinance Transparency decided in March 2015 to stop data collection and cease active operations by the end of the year.

6. *MFT and MIX*. During several group discussions, we heard that publicly available pricing information is important, and also heard that it would make sense for it to be available in the same location as data on financial performance (i.e., MixMarket). MIX, however, has not been interested in taking up this function.

Microfinance Rating Agencies

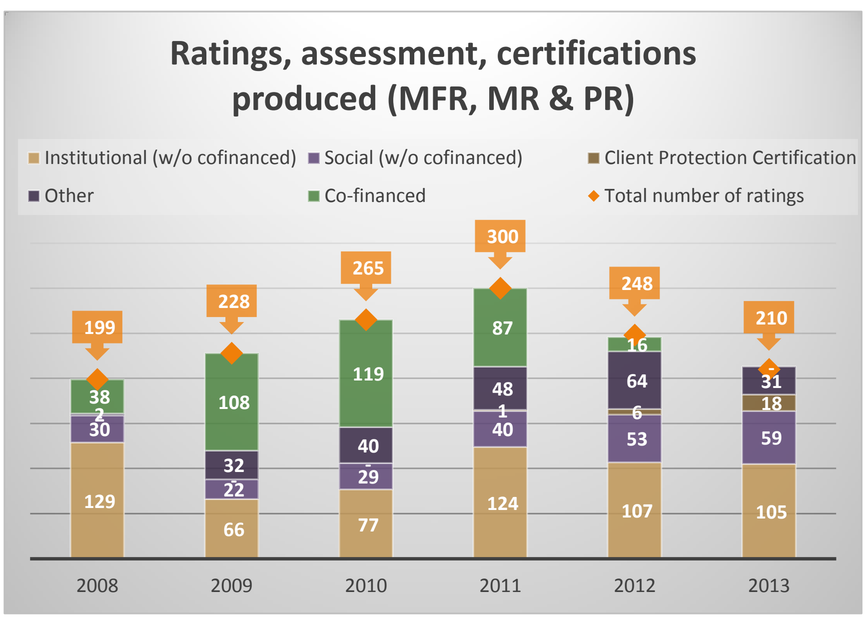
1. *Coverage.* Only 250 MFIs have a rating from 2013 or later. These cover 30 percent of the total borrowers and 16 percent of total assets. The current volume of about 200 ratings per year comes from a total pool of 650 MFIs that conduct ratings with a low frequency.

Current Coverage	# MFIs	% Borrowers	% Assets	% MIV portfolio	% Funder Portfolio
Recent rating (2013+)	250	30%	16%	30%	12%

2. *Drivers.* The main driver for ratings in microfinance is MFIs' interest in benchmarking and improving performance. Initially this aim focused on financial and institutional performance; increasingly it focuses on social performance and client protection. Unlike ratings in the mainstream financial sector, few requirements for ratings in the microfinance sector come from regulators or investors, resulting in this low coverage of recent ratings. Investors use the ratings more as an evaluation tool than as a way to monitor the risk of MFIs.

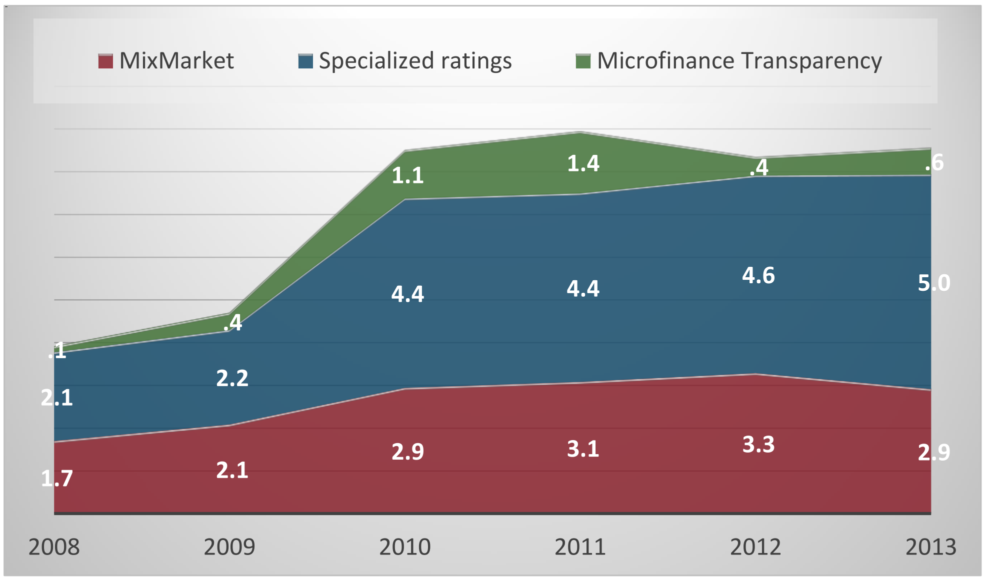
3. *Demand.* The ratings market is now primarily, though not fully, market-based. Without the subsidies that ended in 2011, demand is growing very slowly, with some increase in recent years in client protection certification (sometimes subsidized) and social ratings. Demand is likely to continue to slowly increase as more regulators and investors begin to require ratings. MFIs pay for about half of the ratings. Investors, mostly development finance institutions (DFIs) that commission ratings, pay for the other half.

4. *Costs.* Price per rating stands at $11,000-12,000. Prices have grown very slowly due to over-supply and limited demand. Margins are low, also due to the design of rating products, with intensive processes and long reports, and despite low daily staff costs.



Recommendations

The cost of the elements of the microfinance information infrastructure examined here, approximately $10 million per year (see figure), is minimal when compared to the $100 billion total size of the sector's assets. It should be feasible to maintain this infrastructure, if quality is provided and the sector as a whole contributes to revenues.



However, the realities of microfinance create challenging market conditions for information providers (data aggregators, auditors, analysts, raters):

- Small scale and wide geographic dispersion make it difficult to have sustainable actors at the country level and costly for international actors to cover the whole market: 1,400 MFIs worldwide constitute 95 percent of the market, spread across over 90 countries. Most countries have fewer than seven major MFIs.
- At this stage in the evolution of microfinance, we can expect MFIs to continue growing, but the number of MFIs will likely remain stable in most countries.
- Information disclosure and third party verification is required by regulators only in some countries or for some MFIs. While this is changing, changes are slow and inconsistent.
- Competition among funding partners of MFIs reduces incentives for transparency. Low transparency does not automatically lead to lower investor interest as investors can obtain the information they need directly without public transparency.
- Microfinance is "old news" or is "out of fashion" and cannot count on large/long-term donor support.

These factors do not create a stable public information flow from MFIs or a stable demand for third party verifications such as ratings, and they increase the cost of data collection. These market conditions need to be taken into account in the design of information services, as they are not likely to change in the short or medium term. In general, this calls for:

- Lean and simple services
- Collaboration, partnerships, mergers among actors in the information chain
- Collaboration with suppliers and users of the information, thanks to web-based collaborative tools that allow a wide range of stakeholders to provide data, comment on data, or check data reliability

More broadly, opportunities may exist to expand beyond microfinance (SME banks, digital finance, micro-insurance, agricultural financing, fair trade, impact investing, etc.).

However, we explored the possibility of using information providers from the mainstream financial sector (data aggregators, rating agencies, and research firms). This could in theory make sense because of the larger scale, the sustainability of these actors and their capacity to invest in new developments. But given current options, a complete shift to the existing private sector would not be feasible. It would likely cost more, cover fewer countries, leave out smaller institutions and exclude "social" data.

Finally, it would be helpful for studies to examine the value of an enhanced information infrastructure: how much staff cost can an MIV save if using the Mix Gold reporting service? What is the cost of the reputation risk created by the lack of information on the pricing of MFIs? What is the reduction of interest rates for end clients when more transparent information on pricing is available?

MixMarket

1. *Improve the public data platform while rationalizing costs*. As noted, we find that the public data of MixMarket is at risk. We suggest the following steps to increase the value *and* reduce the cost of the public platform:

    a. Focus on obtaining annual data from the top 765 MFIs that together account for 80 percent of the microfinance market. Ensure that all provide data annually and check their data for accuracy. (Interviews revealed that users of public data value industry coverage but do not require quarterly reporting.)

    b. Allow other MFIs to upload their own data with minimum or no review by MixMarket analysts, through a wiki-like platform. These data points would be public but might not be included in benchmarks.

    c. Upgrade the public website to become more user-friendly. This is necessary to build user confidence and interest. Include more information on sources and verifications of data.

2. *Introduce user fees*. If the above recommendations are taken, the value to users of the public platform will increase while data collection costs will decrease. This would set the stage for the introduction of user fees through a paywall. Fees could vary by intensity of use or type of user and would be set so as to ensure that the essentially public character of the data is preserved. While it is not likely that user charges will cover all costs of the public database, we estimate that a substantial fraction [perhaps up to 75%] of the direct costs could be covered. To avoid reducing the flow of data, MFIs should not be charged to make their data available. However, MFIs could be charged to get benchmarking reports or for additional visibility.

3. *Use of grant resources*. Under this scenario, initial grants would be needed to upgrade the user experience before introducing fees. In addition, ongoing grants would be needed to cover the remaining portion of the public data platform not covered through user fees.

4. *Partnerships, alliances or mergers* could be considered to reduce costs and/or enhance quality of service,

    a. With raters or researchers for data verification and analysis.

    b. With mainstream financial sector information providers for data platforms and online reporting services.

Microfinance Transparency

Several approaches to pricing transparency would be possible. In the case of the first three listed here, it would be necessary for one organization to take on the role of collecting and publishing the data and maintaining the website. Differences involve various approaches to collecting and publishing. In any of these scenarios, the pricing data collector should: have a good reputation, be independent, have entrepreneurial skills, be able to design and run a web platform, know the local microfinance markets and have good connections with MFIs worldwide.

1. *Voluntary reporting approach*. MFT's experience demonstrates that publication of detailed pricing data at the MFI or product level requires strong incentives. However, there are MFIs, investors and regulators who are dedicated to pricing transparency, opening the door to various approaches. We developed one suggested path, based on voluntary reporting to a central database, backed by various levels of verification.

    a. MFIs upload their own data, using standard templates for calculation, subject only to consistency checks by an analyst. Verification of data could be an additional user-paid service either to MFIs (as part of client protection certification) or to investors, donors and other partners.

    b. Provide a methodological guide for other pricing data collectors (raters, auditors, investment officers) so that more players collect data in a standard format and can potentially submit or share databases.

    c. Populate the database with any publicly available data (e.g. data published by regulators).

    d. Sell access to benchmarking reports per MFI for actors that have not contributed to the data collection. Benchmarking reports might use only data that has been verified. Provide free benchmarking reports and other information to MFIs and data aggregators (e.g., networks, associations) that report their data.

    e. Find a sustainable financing mechanism from the start. Costs could either be pre-financed (by a group of MFIs that want a benchmark of their position, a pool of donors/MIVs/DFIs interested in a given country, or an MFI network that wants to demonstrate the transparency of its affiliates); or cost could be partly "reimbursed" through the sale of data.

    To develop such a system, it would be necessary to organize a wide consultation on the new collection process and to ensure that the process and tools are easy to use and understand, reasonably quick, and widely accepted. Microfinance stakeholders, particularly initiatives such as SPTF and the Smart Campaign, should help define a consensus at the sector level on the type of pricing data that can be considered standard.

2. *Partial transparency approach*. One option is to publish aggregated data by country or market segment (average rate, best rate, etc.), eliminating reporting risk for MFIs. Although this would be less than full transparency, it would provide the pricing information needed to establish benchmarks.

3. *Original approach*. MFT's original strategy of direct information collection by a dedicated team operating on a county-by-country basis was quite successful for a time. There could be an attempt to re-instate this strategy in another institutional home. The strategy would only succeed with strong support from all stakeholders such that a high percentage of MFIs were willing to share their data. MFT's decision to end data collection was based on a determination that this condition does not now hold and is unlikely to change.

4. *Regulation*. An overwhelming message from our consultations is that stakeholders interested in pricing transparency in the sector should focus on advocating for better regulation as the best long-term solution. Data on pricing could also be obtained in other ways, such as mystery shopping, for specific uses. Regulatory improvements will proceed slowly and unevenly across countries.

5. *Note: Portfolio yield*, though readily available, is not a good proxy for price transparency.

    a. As an average weighted by portfolio amount, portfolio yield under-represents (high) interest rates charged on small loans.

    b. Portfolio yield only reveals average prices, while in reality, MFIs charge a wide range of prices. MFT data shows a median spread between maximum and minimum APRs charged by an MFI of 20 percentage points; more than a third of MFIs have a spread over 30 points.

    c. Portfolio yield is not a good proxy for APR when an MFI uses forced savings or compensating balances ("cash collateral"), or bundles loans with services provided by third parties whose revenues are not reflected in MFI financial statements (such as insurance).

Microfinance Rating Agencies

1. To be sustainable with current market pricing, raters should attempt to reduce the time it takes to produce a rating report to 15-25 days. This most likely would require a scorecard approach rather than a detailed written report, if on-site time is to be maintained.

2. The current market demand (about 200-250 ratings or evaluations per year) suggests a need for consolidation of the microfinance specialized rating agencies to enable each rating company to reach adequate scale.

Donors

1. Donors will need to remain involved in information infrastructure as a public good on an ongoing basis, at least at some level. For the MixMarket, margins from premium subscription-based services might in the long run allow MIX to cover the direct costs of public data collection, but are not likely to cover overheads or IT infrastructure. Donors should also be prepared to support transparent pricing data collection at some level.

2. Donors should consider themselves the "shareholders" of this public good, and as such should have:

   a. Clear targets for "return on subsidy";

   b. Regular monitoring of whether these targets are being achieved: this will likely require specific research or evaluations;

   c. An active supervisory role: providing a free service creates a de facto monopoly on this "market" making it almost impossible for other offerors to compete. This situation entails risks to quality and cost. Therefore, quality needs to be carefully monitored by an active board, supported by independent evaluations.

   d. A strategy to move as many costs to other users as possible. The externalities created by publication of data might never justify complete exit of donors. However, efforts should continue to identify means of reducing dependency on donor funding, such as cost reduction, quality improvement, and – most importantly – user fees. User fees would ensure that only data that is really valued is collected. Nevertheless, some portion of the costs will likely remain uncovered under any user-fee model.

Investors and other stakeholders

1. Microfinance stakeholders of all types need to raise incentives for MFIs to report their data.

2. Microfinance stakeholders should raise demand for ratings and evaluations by asking or requiring MFIs to get evaluated and enhancing the value to MFIs of being rated, rather than by direct subsidies that distort market dynamics and only temporarily boost demand.

3. Although the microfinance industry currently has a full set of standards, the implementation of these standards is for the most part left up to the MFI. It is strongly recommended that the leadership of the microfinance industry (CEO Working Group members, MIVs, DFIs, Associations, the Principles for Investors in Inclusive Finance signatories, the Financial Inclusion Equity Council, etc.) support standards by requiring that MFIs obtain a social and financial rating every 2-3 years and requiring regular certifications or assessments of client protection, and publish pricing data on a public platform (once it is reinstated).

4. Stakeholders interested in fostering pricing transparency should ensure that they use appropriate pricing data such as APR in making investment, partnership, rating or certification decisions.