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India's MFI transparency gap:
What causes it and what should be done about it?

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Contents

1. Introduction

"While a representative picture exists of MFI outreach and geographical coverage, little is known about the sector's overall financial performance."

- *Performance and Transparency: A Survey of Microfinance in South Asia*
Stephens and Tazi (2006)

A recent Microfinance Information Exchange (MIX) survey involving 78 countries revealed that India's microfinance sector saw the largest per-MFI percentage increase in active borrowers in 2005 than any other country.[1] In fact, the median Indian MFI surveyed more than doubled its client base during the year. Given these phenomenal growth rates, it should come as no surprise that Indian MFIs eagerly report their impressive outreach figures – rising numbers of borrowers, greater loan volumes, ever expanding geographic penetration. However, outside a small number of leading Indian MFIs, few institutions follow rigorous accounting and reporting procedures based on international standards. Consequently, financial data reported by the bulk of India's roughly 800 MFIs lacks credibility among sector stakeholders and is largely incomparable across institutions.[2]

How should microfinance regulators respond to this transparency deficit? This paper will argue that India's formal MFI accounting and reporting requirements are not fostering MFI transparency, and, if left unchanged, these lax requirements could pose real risks to the sector's health. However, CGAP[3] and others caution that overburdening MFIs with excessive regulatory requirements risks stunting sector growth and overburdening the microfinance regulator with undue supervisory requirements.[4] This suggests that effective MFI accounting and reporting policy must carefully identify which interventions could most narrow the transparency gap at least administrative cost to the MFIs *and* at least supervisory cost to the regulator.[5] This study is an attempt to strike this balance.

[1] *Transparency and Performance in Indian Microfinance 2005.* (October 2006) Microfinance Information Exchange.
[2] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation.
[3] The Consultative Group to Assist the Poor (CGAP) is a microfinance donor consortium, housed in the World Bank, consisting of 33 public and private development agencies.
[4] Robert Christen, Timothy Lyman, and Richard Rosenberg. CGAP (The Consultative Group to Assist the Poor). *Guiding Principles on Regulation and Supervision of Microfinance.* The World Bank Group. (2003).
[5] There is no single regulator for India's microfinance sector. MFIs registered as non-banking financial institutions (NBFCs) are regulated directly by the Reserve Bank of India (RBI). MFIs registered as NGOs are left almost entirely unregulated. They must submit audited annual financial statements to the RBI, though these statements aren't subject to standardized accounting or reporting requirements.

1.1. The Road Map

The study will proceed in two parts. In section II, comprising the bulk of the analysis, I will dissect the audited FY2005 financial statements for 19 Indian MFIs to determine how Indian MFIs account for and report on a number of crucial operational features such as portfolio quality reporting, loan loss provisioning, and accounting for donation revenues. I will then use this data to determine which components of Indian MFI accounting and reporting contribute most to India's MFI transparency gap. Having determined which areas of MFI accounting and reporting drive this transparency deficit, I will then propose targeted modifications to existing MFI accounting and reporting regulation which will improve MFI financial transparency at least administrative cost to the MFIs and at least supervisory cost to the regulator.

Section III of the analysis will discuss which MFIs should be covered by formal data transparency regulation. I will argue that, rather than blanketing all 800 of India's MFIs with formal transparency regulations, India's microfinance regulator can promote sector health and stability at minimal cost by tightening formal data transparency regulation for the 20 or so large-scale MFIs which comprise an estimated 95% of India's micro-loans outstanding[6] and whose failure could pose serious risks to India's goal of financial inclusion.

2. Decomposing the MFI Transparency Gap: Assessing Indian MFI Accounting and Reporting Practices

In this section, I will examine the 4 most commonly cited sources of weak MFI financial transparency: portfolio quality reporting, loan loss provisioning, donation accounting, and loan liability accounting. For each component, I will describe how India's formal MFI financial transparency regulation encourages weak financial transparency. I will then determine what (if any) policy changes could both narrow the transparency gap and benefit the overall sector.

I've disaggregated the 19 sample MFIs into two broad categories:

[6] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation. Data culled from Table 10.1 of Sa-Dhan 2006

a) *Non-banking financial companies (NBFCs)* [7]

NBFCs are for-profit companies supervised and regulated directly by the Reserve Bank of India (RBI). Because NBFC-MFIs are directly regulated by the RBI, this portion of the analysis will examine how the RBI's formal accounting and reporting requirements compares with international standards. This sample includes the financial statements of 7 NBFC-MFIs sourced from Mixmarket.org. These 7 NBFC-MFIs comprise all but one of the 8 institutions registered as NBFC-MFIs during FY2005.

b) *NGO-MFIs* [8]

NGO-MFIs are non-profit MFIs left almost entirely unregulated. They are required to submit audited annual financial statements to the RBI, though these statements aren't subject to any standardized accounting or reporting requirements. The NGO-MFI portion of the analysis will compare how Indian NGO-MFIs account and report financial data relative to international guidelines. This sample includes the financial statements of 12 "large-scale" NGO-MFIs sourced from Mixmarket.org.

A note on selection bias

MFIs voluntary supply their financial data to Mixmarket.org. Because the NGO-MFIs represented in the sample comprise the 12 "large-scale" NGO-MFIs[9] which voluntarily supplied their audited financials to Mixmarket, we can assume that the sample represents the most transparent segment of India's NGO-MFI accounting and reporting spectrum.

2.1. Portfolio quality accounting and reporting

Portfolio quality accounting and reporting is generally considered the most crucial determinant of MFI transparency.[10] Because loan receivables comprise the core of most MFIs' assets,

[7] The NBFC-MFI sample includes Asmitha Microfin, Basix Samruddhi Finance (Basix), Nanayasurabhi Development Financial Services (NDFS), Sarvodaya Nano Finance, Share Microfinance, SKS Microfinance, and Spandana Sphoorty Innovative Financial Services.

[8] The NGO-MFI sample includes All Backward Class Relief & Development Mission, Bandhan-Konnagar, Bharat Integrated Social Welfare Agency (BISWA), Cashpor Micro Credit, CReSA, Evangelical Social Action Forum (ESAF), Grameen Koota, Gram Vidiyal Trust, Indian Association for Savings and Credit (IASC), Mahasemam Trust, Star Microfin Service Society, and Village Welfare Society (VWS).

[9] CGAP recommends that only MFIs with total assets exceeding $200,000 be forced to comply with international MFI reporting guidelines. In keeping with this recommendation, I've defined "large-scale" NGO-MFIs as those having total assets above $200,000, and, consequently, have excluded from the sample MFIs below this threshold.

[10] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).

the quality of an MFI's loan portfolio largely determines the institution's financial health. Accounting for portfolio quality involves, among other things, defining and processing overdue loans, write-offs, and refinanced or rescheduled loans. Given the link between portfolio health and institutional health, it is crucial that stakeholders (including sector regulators and supervisors) have consistent access to standardized, detailed, and credible MFI portfolio quality reports.

2.1.1. International guidelines for portfolio quality reporting

CGAP[11] recommends that MFI financials include, at minimum, a portfolio quality report showing the extent of late payments on loans for the current reporting period.[12] CGAP also recommends that MFIs clearly disclose how they define "late payments," how they calculate portfolio at risk ratios, and how they treat delinquent or renegotiated loans. To ensure easy comparability across MFIs, CGAP also strongly recommends that MFIs follow international guidelines for portfolio reporting. These international guidelines advise that MFIs decompose their portfolios into multiple asset risk classes such as current, 1-30 days late, 31-60 days late, 61-90 days late, etc. Basix, Ltd., one of India's leading NBFC-MFIs, employs a portfolio quality report that is closely comparable to CGAP guidelines (Table 1). By dividing its portfolio into disaggregated asset classes, Basix's financials provide granularity beyond simple "current" and "late" categorizations to offer a much clearer picture of overall portfolio quality.

Table 1

	Portfolio at risk	Amount (Rs 000)	Portfolio at risk	Amount (Rs 000)
	As of March 31, 2006		As of March 31, 2005	
Current	97.8%	985,279	95.4%	546,250
1-30 days late	0.4%	3,775	0.5%	2,673
31-60 days late	0.2%	2,479	0.3%	1,589
61-90 days late	0.2%	2,363	0.2%	1,279
91-180 days late	0.2%	2,413	0.4%	2,441
> 180 days late	1.2%	10,687	3.2%	18,443
Total	**100%**	**1,006,996**	**100%**	**572,675**

Source: Basix, Ltd. Audited Financial Statements as of 3.31.06 (www.mixmarket.org)

[11] CGAP's *Disclosure Guidelines for Financial Reporting by Microfinance Institutions (2003)* is widely considered the international standard for MFI financial reporting guidelines.
[12] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).

2.1.2. Portfolio quality accounting and reporting requirements for NBFCs

The RBI mandates that NBFCs account for their portfolio quality subject to well-defined standards. As shown in Table 2 below, loans are categorized as "sub-standard" when interest has remained overdue for 6 months. When interest has been overdue for more than 24 months, it becomes a "doubtful loan." The moment a loan is rescheduled or restructured, it is defined as sub-standard until on-time payments have been made under the new terms for at least one year. Lastly, either the NBFC or the RBI (during an NBFC inspection) has discretion in determining when a loan is considered unrecoverable (i.e. a loss asset). The RBI then requires that all NBFC-MFIs meet the minimum portfolio quality reporting schedule shown in Table 2 below.

Table 2

Loan Category	Definition
Standard loans	Loans in which no default in payment of principal or interest has occurred.
Sub-Standard loans	i) Loans which have been non-performing for less than 18 months ***Loans become non-performing when interest payments are overdue for more than 6 months. Therefore, this category includes loans with interest past due for 6 to 24 months.*** ii) Rescheduled or refinanced loans which have not had on-time loan repayment under the new loan terms for more than 1 year
Doubtful loans	Loans which have been sub-standard more than 18 months ***Category includes interest payments past due for more than 24 months***
Loss assets	Loans written off as unrecoverable.

Source: RBI Master Circular: Prudential Norms for NBFCs, 1998 (www.rbi.org.in)

These guidelines are problematic for two main reasons. First, the threshold for categorizing a loan as "sub-standard" does not correspond with the typical structure of a microfinance loan. Under RBI guidelines, loans aren't considered "sub-standard" until interest has been overdue for 6 months. Thus, the RBI implicitly encourages NBFC-MFIs to make no distinction between on-time loans and loans which have been overdue for up to 6 months! This is especially problematic given the typical term and payment structure of an MFI loan. Because most MFI loans are short-term (generally 3-12 months), rely on weekly repayments, and lack collateral, a 6-month loan which has been overdue for just 30 days suggests that the borrower has missed 4 interest payments (comprising 1/6 of total payments) and has offered no collateral to protect the MFI in case of delinquency. Thus, a microfinance loan that is 30 days overdue generally contains more risk than, say, a conventional 2-year fully-collateralized loan which is also 30 days overdue. In short, the RBI's threshold for categorizing a loan as "sub-standard" or "doubtful" does not correspond with the term and payment structure of the typical microfinance loan. Consequently, Indian NBFC-MFIs can hide serious portfolio risks even when in full compliance with RBI accounting requirements.

In addition to having inadequate thresholds for categorizing loans as "sub-standard" and "doubtful," the RBI's portfolio quality categorizations lack the level of granularity needed to accurately assess the portfolio quality of an MFI. Take, for example, the RBI's "sub-standard" loan category for loans with unpaid interest between 6 to 24 months. Within the 6 to 24 month overdue range, there exist multiple sub-categories of loans with very different levels of corresponding risk – a loan which has been overdue for 23 months has a greater likelihood of going unpaid than one which has been overdue for 6 months. By lumping all loans overdue for 6 to 24 months into a single category, RBI minimum reporting standards fail to capture crucial portfolio quality data. Moreover, the RBI's requirements require no information concerning year-on-year changes in MFI portfolio quality. Such information is critical for assessing trends in an MFI's loan collection capabilities, delinquency rates, and overall performance.

2.1.3. NBFC-MFI portfolio quality reporting behaviour

How, then, do Indian NBFCs behave in response to the RBI's minimum portfolio quality accounting and reporting requirements? Of 7 sample NBFC-MFIs, only 2, Basix and Sarvodaya Nano Finance, have chosen to exceed the RBI's minimum asset classification requirements by unpacking their portfolios' sub-standard loan categories into smaller sub-categories.

As shown in Table 2 below, Basix Ltd. disaggregates its loan portfolio in keeping with international guidelines and provides readers with a clear picture of year-on-year changes in portfolio quality. Furthermore, by following a standardized, internationally recognized reporting format (rather than a *minimum* RBI reporting threshold), Basix, Ltd. ensures that its portfolio quality reports are not only sufficiently detailed, but are also readily comparable with other MFIs. That only 2 of 7 sample NBFC-MFIs chose to exceed the RBI's minimum asset classification requirements suggests that, in terms of portfolio quality reporting, most Indian NBFC-MFIs tend to revert to minimum RBI standards.

2.1.4. Policy recommendations

The RBI can significantly narrow India's overall portfolio quality transparency gap, either by raising its portfolio quality accounting and reporting requirements to meet international norms (which are currently met only by Basix and Sarvodaya), or by mandating that NBFCs account for and report portfolio quality in a standardized format such as the Basix format shown above. To ensure comparability across MFIs, the latter option is preferable. If NBFC-MFIs want to provide portfolio schedules with additional granularity beyond that required by international guidelines, they could do so at their discretion, but all NBFC-MFIs should be required to include one standardized asset classification schedule that is fully comparable with that of other NBFC-MFIs.

2.1.5. NGO-MFI portfolio quality accounting and reporting

Indian NGO-MFIs are not subject to any formal portfolio quality reporting requirements. As a result, these institutions report varying degrees of portfolio quality information. 9 of 12 sample NGO-MFIs offer no disaggregated representation of their loan portfolios, instead lumping their entire portfolios into a single line-item – "loans outstanding." Of the 3 NGO-MFIs who disaggregate their portfolios, none exceed the RBI's minimum "standard – sub-standard – rescheduled" classification requirement for NBFC-MFIs. Moreover, as shown in Table 3 below, among the 3 NGO-MFIs which follow the "standard - sub-standard – rescheduled" classification scheme, only 2, Cashpor and Mahasemam Trust, follow RBI standards when *defining* their sub-standard loans. Consequently, of 12 sample NGO-MFIs, an interested party can compare even basic portfolio quality across only 2 NGO-MFIs.

Table 3

	Standard	Sub-Standard	Doubtful
Cashpor Micro Credit	Past due < 4 weeks	Past due 5-50 weeks	Past due > 50 weeks
Mahasemam Trust	Past due < 4 weeks	Past due 5-50 weeks	Past due > 50 weeks
Star Microfin Service	Past due < 2 weeks	Past due > 2 weeks	Undefined

Source: Audited financial statements excerpted from www.mixmarket.org

2.1.6. Policy Recommendations

How, then, should the RBI approach NGO-MFI portfolio quality reporting? The RBI already requires NGO-MFIs to submit annual audited financials. Given this existing requirement, it's tempting to try to close the NGO-MFI portfolio quality transparency gap by simply requiring that these institutions account for and report portfolio quality information subject to a standardized format in line with international standards (see again Table 1 above). However, CGAP and other industry observers warn that placing overly costly portfolio quality reporting requirements on small-scale NGO-MFIs can, in some fledgling microfinance sectors, overburden these small institutions, and, consequently, limit poor people's access to financial services.[13] Therefore, any policy recommendation concerning NGO-MFI portfolio quality reporting must weigh the increased administrative costs to the MFI (and the effects of these increased costs on the poor's access to financial services), the increased supervisory costs for the RBI, and the benefits these increased requirements would yield for the overall health of the sector. As I will argue further in Part II of this study, promoting financial inclusion and ensuring sector health will likely flow from ensuring that NBFCs and only the largest NGO-MFIs that are financially sound, rather than ensuring that *all* MFIs, large or small, meet rigorous portfolio accounting and reporting guidelines. Therefore, on balance, only NBFCs and those large scale NGO-MFIs who are applying to become NBFCs should be subject to these increased accounting and reporting standards.

2.2. Provisioning for expected loan losses

It takes time for loans to become delinquent. Consequently, if a lending institution doesn't maintain a loan loss allowance for loans that are unlikely to be collected, its balance sheet will overstate the current value of its loan portfolio. Similarly, if a lending institution fails to include a provision expense for anticipated loan losses, its income statement will report revenues assuming *all* outstanding loans will be paid back, thereby over-estimating its profitability and misleading interested parties regarding its true financial condition. To correct for this, most lending institutions try to predict the portion of their current loan portfolios that will fall delinquent, and then make provisions in their financial statements to reflect these expected future losses.

2.2.1. International guidelines for loan loss provisioning

While there exists no international standard for MFI loan loss provisioning, CGAP recommends that, at minimum, an MFI should clearly explain its provisioning policy so a third party can easily determine what loss adjustments have been made to the MFI's financial statements.[14] Unfortunately, most Indian MFIs are young and lack sufficient historical loss-rate

[13] Robert Christen, Timothy Lyman, and Richard Rosenberg. CGAP (The Consultative Group to Assist the Poor). *Guiding Principles on Regulation and Supervision of Microfinance.* The World Bank Group. (2003).
[14] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).

data to make accurate loss provisions for various loan categories. However, this is no reason to avoid loan loss provisioning – all lending institutions will incur some loan losses. Both CGAP and The SEEP Network's 2005 report on MFI reporting, analysis, and monitoring suggest that when setting loan loss provisioning policies, MFIs should use predicted loss rates for *specific* loan categories and apply loan loss percentages to each category based on these estimates.[15] In addition, CGAP recommends that MFIs report their provisioning policies alongside their portfolio quality schedules (see Table 4 below). This format achieves two aims: 1) it encourages MFIs to apply more targeted provisioning percentages to specific asset classes to better reflect predicted losses, and, 2) it gives third parties a better idea of whether an MFI's particular provisioning policies are appropriate given the overall health of its portfolio.

Table 4

Asset Classification	Provision Percentage	Share of loan portfolio
Current	1%	95%
1-30 days late	25%	2%
31-90 days late	50%	1%
> 90 days late	100%	1%
Renegotiated loans (current and < 30 days late)	25%	0%
Renegotiated loans (> 30 days late)	100%	0%

Source: CGAP Disclosure Guidelines for Financial Reporting by Microfinance Institutions (2003)

2.2.2. RBI requirements for NBFC-MFI loan loss provisioning

The RBI mandates that NBFCs apply rules-based (non-discretionary) minimum provisioning levels to its "standard – sub-standard – rescheduled" classification scheme. Consequently, all 7 NBFC-MFIs in the sample either meet or exceed RBI loan provisioning requirements. In addition, all 7 NBFC-MFIs clearly define their provisioning policies. Therefore, at least in terms of mandating disclosure of loan loss provisioning policies, RBI guidelines are generally in line with international standards – they hold NBFC-MFIs to a minimum provisioning standard and mandate that NBFC-MFIs clearly define their provisioning policies.

[15] The SEEP Network and Alternative Credit Technologies. *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring.* (2005).

Table 5

Loan Category	RBI Provisioning Requirement
Standard loans	No provision necessary.
Sub-Standard loans	A general provision of 10% of total outstanding assets.
Doubtful loans	Either 100% provisioning for all non-collateralized loans or a full write-off of all outstanding assets.

Source: RBI Master Circular: Prudential Norms for NBFCs, 1998 (www.rbi.org.in)

2.2.3. Do RBI loan loss provisioning requirements accurately reflect expected MFI loan losses?

Though India's NBFC-MFIs define their provisioning policies, we must also consider whether the RBI's loan loss provisioning requirements accurately reflect the likelihood that an MFI will experience loan losses. An analysis presented in this paper found that the RBI's weak *portfolio quality* reporting requirements (outlined in Sections 1.1 – 1.4 above) feed into and limit the effectiveness of the RBI's loan loss provisioning requirements by encouraging extremely in-exact MFI loan loss provisioning policies. As shown in Table 5 above, the RBI requires only that NBFC-MFIs categorize and provision for bad loans based on two general categories: "standard" and "non-standard" loans. Just as an overly generalized portfolio quality report doesn't accurately reflect the actual risk within a portfolio, applying loan provision percentages to overly general asset classes ensures that provisioning percentages are not accurately linked with the likely loan defaults within a portfolio. For example, an Indian MFI can meet the RBI's provisioning requirements while still applying the same provisioning percentage to loans 5 *days* overdue as they apply to loans 5 *months* overdue. This is clearly a weak predictor of actual loan losses. In sum, the RBI's weak portfolio quality reporting requirements fuel imprecise loan loss provisioning policies, thereby widening the gap between actual MFI activity and the data NBFCs report to the public.

2.2.4. Attempts at NBFC-MFI *self*-regulation

Interestingly, 3 NBFC-MFIs in the sample – SKS, Share, and Asmitha – exceeded the RBI's provisioning requirements by disaggregating their sub-standard loans into multiple sub-categories and applying specific provisioning percentages to each of these sub-categories. To ensure comparability, all 3 MFIs settled on closely comparable asset classification categories for applying these percentages (Table 6 below). For example, using these (nearly) standardized asset categories, an interested party can quickly see that Share and Asmitha apply identical loan loss provisioning policies. It's also clear that both Share and Asmitha apply slightly more aggressive provisioning percentages than SKS – SKS provisions loans 5-24 weeks late at 10% while Share and Asmitha provisions this same loan category loans at 20%. By *self*-standardizing on asset classification categories, these MFIs ensure that their loan loss provisioning policies are not only more tailored to specific loan categories than RBI standards – thus better reflecting expected performance – but they also ensure that their provisioning policies can be easily compared across institutions.

Table 6

SKS Microfinance, Ltd.		Share Microfin, Ltd.		Asmitha Microfin, Ltd.	
Asset Classification	**Provision Requirement**	**Asset Classification**	**Provision Requirement**	**Asset Classification**	**Provision Requirement**
Standard	1%	Standard	1%	Standard	1%
< 25 weeks late	10%	< 5 weeks late	10%	< 5 weeks late	10%
		5-24 weeks late	20%	5-24 weeks late	20%
25-50 weeks late	50%	25-50 weeks late	100%	25-50 weeks late	100%
Doubtful	100%	Doubtful	100%	Doubtful	100%

Source: Audited financial statements pulled from www.mixmarket.org

2.2.5. NGO-MFI loan loss provisioning

Not beholden to any specific reporting requirements, Indian NGO-MFIs employ a heterogeneous set of loan loss provisioning policies. Indian NGO-MFIs fall into 3 broad categories in terms of provisioning policy: a) those who provision for loan losses and explicitly define their provisioning policy, b) those who provision for loan losses without defining their provisioning policy, and c) those who don't provision for loan losses at all. The 12 NGO-MFIs in the sample fall evenly into the 3 categories.

a) NGO-MFIs who provision for loan losses and define their provisioning policies[16]

4 of 12 sample NGO-MFIs meet international MFI provisioning norms by both provisioning for loan losses and clearly defining their provisioning policies. Among this sub-group, only Cashpor follows RBI guidelines for NBFC-MFI provisioning while the rest of the sample applies more aggressive provisioning percentages to the RBI's recommended loan categories (Table 7). Though these efforts to self-impose more aggressive provisioning standards are admirable, they don't support comparability across MFIs because each applies a unique provisioning policy. Moreover, applying more aggressive provisioning percentages to the RBI's overly-general loan categories still doesn't meet the aim of applying *tailored* provisioning per-

[16] Includes Grameen Koota, Bandhan-Konnagar, BISWA, IASC.

centages to specific loan categories. Consequently, an interested third party faces challenges on two fronts: 1) he/she cannot determine whether a particular MFI's provisioning policies are appropriate given the actual risk in the portfolio, and, 2) he/she is unable to compare actual financial performance across even those few NGO-MFIs which have clearly defined provisioning policies.

Table 7

RBI NBFC-Requirements		Mahasemam Trust	Cashpor	Village Welfare Society	Star Microfinance
Asset Classification	**Provision Requirement**	**Provision**	**Provision**	**Provision**	**Provision**
Standard	None	5%	1%	1.5%	1%
Sub-standard	10%	5%	10%	1.5%	1%
Doubtful	100%	100%	100%	100%	100%

Source: Audited financial statements pulled from www.mixmarket.org

b) NGO-MFIs who provision for loan losses without defining their provisioning policies[17]

Among the 8 sample NGO-MFIs who provision for loan losses, 4 don't define their provisioning policies. 2 MFIs in this sub-category clearly illustrate the problems with not explicitly defining one's provisioning policy:

i) Grameen Koota discloses the total amount it added to its provisioning balance during fiscal year 2004 and 2005 (provisioning flows), but doesn't disclose its year-end provisioning balances for either 2004 or 2005 (provisioning stocks). Therefore, a third party observer is unable to identify the provisioning balance these flows are trying to maintain – i.e. what provisioning balance is Grameen Koota aiming for when it incurs a particular provisioning expense in 2005. Consequently, a third party cannot compare provisioning balances to Grameen Koota's existing portfolio to determine whether it has adequately provisioned for expected future losses.

ii) In contrast to Grameen Koota, Bandhan-Konnagar reports both loan provisioning balances and additions in fiscal year 2005. However, because Bandhan doesn't provide a portfolio quality report, an outsider can assess its loan loss provisioning balances only as a percentage of total loans outstanding. Using the *loss provisioning/total loans outstanding ratio*, Bandhan's loan loss provisioning percentage rose from 0.15% of loans outstanding in 2004 to 2.00% in 2005. However, absent any formal explanation of Bandhan's provisioning policy, an external observer cannot determine whether 2.0% will be Bandhan's long-term

[17] Includes Grameen Koota, Bandhan-Konnagar, BISWA, IASC.

provisioning target, or if this target percentage will fluctuate based on Bandhan's periodic internal portfolio risk assessments.

c) NGO-MFIs who don't provision for loan losses[18]

4 of 12 sample NGO-MFIs make no loan loss provisions. Therefore, their financial statements (with $11.1 million in outstanding loans among them) assume that *all* their outstanding loans will be repaid – hardly a good indicator of a loan portfolio's true value. This omission would be less harmful to overall transparency if interested parties had access to detailed information on portfolio health. For example, if an institution's portfolio quality were clearly robust, with correspondingly low historical loss rates, not applying a loan loss provision might not lead to a gross understatement of that institution's current financial position. However, one cannot make this assessment without a portfolio quality report. Of the 4 NGO-MFIs which chose not to provision for loan losses, all simply lumped their performing and non-performing loans into one category – total loans outstanding. As such, interested parties have no information concerning delinquency risk, and, consequently, have no idea to what degree these MFIs are overstating their financial performance by not provisioning for future loan losses.

2.2.6. Policy recommendations

As with portfolio quality reporting, loan loss provisioning requirements should seek to achieve two aims: 1) ensure that the portfolio data MFIs report to the public is accurately adjusted for expected loan losses, and, 2) ensure that MFI portfolio data can be comparable across institutions. These two aims are not always compatible. For example, one MFI may have an especially good system for collecting delinquent loans. That MFI may then want to apply lower provisioning percentages to its delinquent loans than other MFIs in the sector. However, if all MFIs have discretion over the provisioning percentages they apply to various loan categories, one not only loses comparability across MFIs, but one also runs the risk that MFIs will systematically under-provision for expected loan losses, and, as a result, chronically over-estimate current profitability. On balance, closing India's transparency gap vis a vis loan loss provisioning should tend towards holding MFIs to a common provisioning standard. This would promote comparability across institutions and would close the loophole that allows MFIs to over-state their financial performance by applying excessively low provisioning percentages.

[18] Includes Grama Vidiyal, CreSA, ESAF, ABCR&DM.

To which institutions should these increased provisioning standards apply? In Section 1.6, I argued that the RBI had an interest in ensuring sector health and sustainability by closing the gap between a large-scale MFI's actual portfolio quality and the portfolio quality information it reports to the public. Once these large-scale MFIs – both NBFCs and those NGO-MFIs applying to become NBFCs – have disaggregated their portfolios into these smaller loan categories, it will be extremely straightforward for them to apply standardized provisioning percentages to each of these loan categories (Table 8). By using this reporting format, MFIs will be encouraged to apply *targeted* provisioning percentages to specific asset classes which, in turn, will more accurately reflect expected loan losses. This, thereby, provides third parties with a much better idea of how well an MFI's provisioning policies fit that institution's portfolio quality.

Table 8

Asset Classification	Provision Percentage	Share of loan portfolio
Current	1%	95%
1-30 days late	25%	2%
31-90 days late	50%	1%
> 90 days late	100%	1%
Renegotiated loans (current and < 30 days late)	25%	0%
Renegotiated loans (> 30 days late)	100%	0%

Source: CGAP Disclosure Guidelines for Financial Reporting by Microfinance Institutions (2003)

2.3. Accounting for donations

MFIs can drastically inflate their profitability by pooling donation revenues together with revenues from their normal operations. However, MFIs cannot guarantee that they will receive a steady stream of donation revenues over the long-term. Therefore, to assess an MFI's long-term sustainability, stakeholders must be able to gauge an institution's financial performance *excluding* donation inflows. To achieve this, international MFI accounting standards recommend that income statements clearly distinguish between operational revenues and non-operational revenues such as donations. They also recommend that lending institutions clearly explain their grant recognition policies. For example, one parameter they can look at is whether the MFI recognizes the entire grant upon receipt or it recognizes grant revenues only when the specific work for which the grant was made has been performed.[19]

2.3.1. RBI guidelines for NBFC-MFI treatment of donation revenues

Accounting for donations does not appear to be a significant contributor to the transparency gap for NBFC-MFIs. Because these institutions operate as for-profit companies, their grant inflows are generally small relative to gross revenues. In fact, only 2 of 7 sample NBFC-MFIs reported donation revenues in FY2005. Interestingly, both of these institutions treated donation revenues differently. Sarvodaya Nano Finance reported its $106,400 capacity building grant from the Small Industries Bank of India (SIDBI) as "other revenues and expenses," clearly distinguishing grant inflows from operational activities. This distinction is critical because this grant, if categorized under operational income, would have overstated Sarvodaya's operational revenues by 13.2%.

In contrast, Asmitha Microfinance reported its smaller $18,300 SIDBI grant as "other income" in its standard income statement. While this practice is clearly *not* in line with CGAP recommendations, the SIDBI grant comprised only 0.2% of Asmitha's total revenues. As such, by running the grant money through its normal income statement, Asmitha inflated its operational income by only 1.2%. Regardless of the grant's size, however, Asmitha should report grant monies as non-operational income to provide a clearer picture of its true financial performance.

2.3.2. Policy recommendations

Considering that only 2 of 7 sample NBFC-MFIs reported donation inflows in FY2005, NBFC treatment of donations is not a significant contributor to the transparency deficit in India's microfinance sector. Moreover, only 1 of the 7 NBFCs sampled (Asmitha) ran its grant inflows through its normal income statement. That being said, the RBI should raise its donation accounting requirements to meet international standards by requiring NBFCs be more explicit in distinguishing donation inflows from operational revenues.

[19] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).

Another area where the RBI (or MFIs themselves) could improve NBFC-MFI transparency is by improving how MFIs disclose cumulative donations. CGAP recommends that MFIs detail donation inflows for all previous periods to determine how much of an MFI's current net worth has been derived from past donations and how much has been derived from retained earnings.[20] Among the 19 Indian MFIs sampled, none reports past donations.

CGAP warns that if MFIs began to include such information in their financial statements, a caveat would be in order – when reporting cumulative donations, most MFI financials would show that large operational deficits have consistently been funded by donation inflows. This trend wouldn't necessarily reflect poorly on operational performance – many MFIs have evolved from non-profit, multi-service organizations into for-profit, commercial enterprises. Historical operational deficits would be the norm for such non-profit ventures.[21] Despite this possible concern over data interpretation, mandating that NBFC-MFIs report cumulative donation information would better inform interested parties on the degree to which past donation revenues have contributed to an NBFC's current financial position.

2.4. NGO-MFI accounting for donations

How Indian NGO-MFIs report donation inflows is a key source of India's MFI transparency gap. As mentioned above, to offer a clear picture of an institution's financial sustainability, it is crucial that an MFI reports its donation revenue *below* its net operating income/loss line.[22] However, only 1 of 12 sample NGO-MFIs, Bandhan-Konnagar, reported donation inflows below operational income. To illustrate the importance of this distinction, had Bandhan-Konnagar included its grant inflows within operational income, it would have overstated its operating income by 125%.

2.4.1. Distinguishing grant revenue from operational revenue

7 of 12 sample NGO-MFIs included donations as a line-item within their normal income statements, without first noting operational income or losses. For example, Grameen Koota included $329,000 in grant inflows within its normal income statement without separately reporting its operational profit/loss. In doing so, it boosted its reported net income from

[20] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).
[21] ibid.
[22] The SEEP Network and Alternative Credit Technologies. *Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring.* (2005).

roughly $9,000 to $338,000. Of course, using various line-items in the income statement, an interested party could perform some rough calculations to back-out an estimate for operational revenues. However, by requiring that third parties back-out operational income estimates, this format clearly complicates the task of assessing and comparing financial sustainability across MFIs.

Some NGO-MFIs failed to provide even a separate line item for grant monies, instead subsuming grant inflows within revenue categories that include operating income. The Evangelical Social Action Forum's (ESAF) financials fall into this category. After reporting financial services and marketing revenues, ESAF then reports "Other Income" as follows:

Table 9

ESAF Income Statement for Fiscal Year End 3.31.06 Annexure-XVI: Other Income		
	FYE 3.31.06	**FYE 3.31.05**
Admission Fees	856,320	188,477
Anniversary and Celebrations	14,130	0
Registration Fees	630	0
Recruitment and Training Fee	68	0
Members Training Fees	2,209	1,818
SIDBI REDP Grant	**15,000**	**0**
National Environmental Awareness Program	0	6,300
Duty and Legal Charges	16,092	0
Incentive from WWB for prompt repayment	67,280	0
SIDBI Grant	1,411,600	0
Grant for Micro finance Project	**3,000,000**	**0**
Grant from Kerala Institute of Entrep. Devt.	**133,000**	**0**
Grant from Kerala Bureau of Industries Promotion	**14,250**	**0**
Total	***5,530,579***	***196,596***

Source: ESAF Audited Financial Statements as of 3.31.06 (from www.mixmarket.org)

This schedule suggests that ESAF received roughly $70,000 (Rs. 3,162,250) in grant money in fiscal year 2005, comprising of about 9.1% of ESAF's total revenues for the year. This grant money is defined as "Other Income" alongside other revenue categories which clearly represent revenues derived from normal business operations, such as admissions revenues, registration fees, and training fees. By pooling revenue from operational activities together with non-operational activities, ESAF is providing an unclear picture of its financial sustainability, especially considering that ESAF received no grant money from these sources in the preceding year, thus suggesting that these revenue sources are temporary. Moreover, ESAF's financials provide no information explaining its grant recognition policy. It is not clear whether it recognizes the entire grant upon receipt or it recognizes grant revenues only when the specific work for which the grant was made has been performed. While an interested party could perform some rough calculations to estimate ESAF's financial sustainability excluding donations, even this estimate would have to assume a particular donation recognition policy.

ESAF's treatment of donations is, unfortunately, highly indicative of most Indian NGO-MFIs. As mentioned above, only 1 of 12 sample NGO-MFIs, Bandhan-Konnagar, reported donation revenues below operational income and only 3 sample NGO-MFIs clearly defined their grant recognition policies.

2.4.2. Omissions and unclear reporting

Unfortunately, the 7 sample NGO-MFIs which reported donation inflows above the net operating income/loss line were actually *more* transparent than many of their peers. 3 of 12 sample NGO-MFIs either make no mention of donations in their financials (e.g. Cashpor and CReSA), or they define their donation recognition policies but fail to disclose the size of those donations (e.g. Star Microfinance Service Society).

When an NGO-MFI makes no mention of donation inflows, it could elicit some suspicion. The vast majority of non-profit NGO-MFIs receive some level of grant funding to sustain their business. Given this assumption, if an NGO-MFI relies solely on loans, past grants, and income from operations, it should clearly note this in its financials, lest interested parties assume that grant money has been received and was then subsumed (hidden) in a larger revenue category. This uncertainty often leads interested third parties to conclude that net income has been inflated by an unknown amount.

In contrast to Cashpor's and CReSA's decision to completely omit donation information, Star Microfinance defined how it treated donation revenues during the year by noting that grants received in fiscal year 2005 were categorized either as capital or revenue grants and were placed in either the balance sheet or income statement accordingly.[23] Star's capital fund schedule then notes that no capital grants were received in fiscal year 2005. Revenue grants, however, are not mentioned anywhere in the financials. Consequently, interested parties can

[23] STAR Microfin Service Society Audited Financial Statements 2005-2006 Schedule 14, Part C *Grants and Donations*.

not determine whether STAR received grant revenues and subsumed them in "Other Income" or whether it received no grant money in fiscal year 2005.

2.4.3. Accounting for in-kind subsidies

Another key driver of India's transparency gap is MFI accounting and reporting for in-kind subsidies. By omitting in-kind subsidies from its balance sheet or income statement, an MFI can grossly overstate its financial sustainability. For example, if an MFI occupies offices rent-free, is given free access to vehicles, or receives free technical assistance, it can significantly reduce its operating expenses by keeping these transactions off- financials, thereby hiding the actual expenses it would have had to pay without the assistance.[24] To ensure transparency on this issue, CGAP advises that MFIs "estimate the additional expense they would incur in [the subsidy's] absence, even if the estimate is not based on a rigorous valuation."[25]

Of 12 sample NGO-MFIs, only 1, IASC, estimated the value of its in-kind subsidies – in this case, grant receivables from SIDBI. IASC included a schedule estimating the expected value of in-kind staff training, consulting, and equipment subsidies. Given the propensity for NGO-MFIs to accept in-kind subsidies from donor agencies, these findings suggest that many Indian MFIs are accepting in-kind assistance without disclosing it, thereby inflating their financial sustainability.

2.4.4. Policy recommendations

Weak and heterogeneous accounting for donations and in-kind subsidies clearly drives much of the discrepancy between actual Indian MFI activities and the data these institutions report to the public. By including grant money in net income/loss measures, the MFI's financial sustainability becomes extremely difficult to assess by interested parties. Moreover, because Indian MFIs treat donations and subsidies in such different ways, third parties are unable to compare non-subsidized financial performance across MFIs.

A useful policy intervention would be for the RBI to require all MFIs to report donation revenues below net income in a standardized format similar to one outlined in Table 10 below. This requirement should apply to all MFIs, regardless of size, because it would cost MFIs next

[24] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).
[25] ibid.

to nothing in reporting costs – they would merely have to move donation revenues below the operating income/loss line on their income statement.

All MFIs should also be required to explicitly define their grant recognition policies. Specifically, the financials should state whether the MFI recognizes the entire grant upon receipt, or only when the specific work for which the grant was made has been performed. Lastly, all in-kind subsidies should be clearly disclosed and MFIs should be required to estimate the cost they would have incurred had they not received the grant. These need not be sophisticated estimates. They could merely be back-of-the-envelope calculations to give interested parties a general idea concerning the level of in-kind assistance the MFI has received.

Table 10

Account Name	Definition
Net income (before taxes and donations)	All net earnings from the MFI's operations before the inclusion of taxes and donations.
Taxes	Taxes paid on net income.
Net income (after taxes and before donations)	All earnings on the MFI's operations recognized as revenue during the period, net of taxes and before the inclusion of donations.
Donations	**Value of all donations recognized as revenue during the period. This should include all donations used to fund the loan portfolio. Many MFIs tend to report donations for loan capital directly on the balance sheet. Under this recommendation, the MFI must first report these donations as non-operating revenue.**
Net income (after taxes and donations)	All net income from the MFI's operations, net of taxes and including donations.

Source: Adapted from The SEEP Network's, Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring" Table 2.2 p. 16 (2005).

2.5. Accounting for loan liabilities

NABARD[26], the Small Industries Bank of India (SIDBI), and some Indian commercial banks provide Indian MFIs soft loans at below-market interest rates. Because these MFIs cannot guarantee that they will be able to tap these soft money sources over the long-term, stakeholders must know the degree to which an MFI's operations are being subsidized in this manner. How explicitly do Indian MFIs disclose the terms of their loan liabilities, the guarantee mechanisms used to obtain the loans, and, crucially, the interest rates on each loan relative to market rates?

2.5.1. RBI guidelines for NBFC-MFI loan liability reporting

[26]National Bank for Agriculture and Rural Development.

According to RBI prudential norms for NBFCs, all NBFC-MFIs must disclose "loans and advances availed by the NBFCs inclusive of interest accrued thereon but not paid."[27] Consequently, NBFC-MFI loan liability reporting is generally transparent. Each sample NBFC-MFI included a schedule detailing the amount of interest incurred on all secured and unsecured loans, the guarantee used to obtain the loans, the amount availed during the financial year, the amount outstanding at year-end, and the expected amount due for payment by the end of the following fiscal year. One minor modification to give interested parties a better picture of an MFI's financial sustainability would be to require MFIs to explicitly detail the interest rates paid on each loan, rather than simply the interest incurred in each period. This modification would make it easier to determine how much more an MFI would have had to pay if the same loan were made on commercial terms.[28] Despite this minor shortcoming, RBI requirements for NBFC loan liability reporting are generally up to international standards, and, consequently, this area is not a key driver of India's MFI transparency gap.

2.5.2. NGO-MFI loan liability reporting

As in other key accounting areas, NGO-MFIs have far more heterogeneous loan liability reporting practices than their NBFC counterparts. Loan liability accounting and reporting is, therefore, another key driver of the NGO-MFI transparency gap. Only 2 of 12 sample NGO-MFIs, Star Microfinance and Cashpor, provided detailed loan liability schedules in line with international MFI disclosure norms. In other words, only 2 institutions clearly reported interest incurred during the period, balance outstanding at year-end, the interest rate on each loan, and details on all guarantees used to secure the loan. Surprisingly, these NGO-MFIs are the only MFIs in the study (including NBFCs) which disclosed both interest incurred during the period and the interest rates associated with each loan.

Another 3 sample NGO-MFIs – Village Welfare Society, IASC, and Bandhan-Konnagar – reported loan liability in a manner roughly in line with the RBI's loan liability reporting requirements, though Bandhan-Konnagar didn't disclose the guarantees used to secure each loan.

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[27] RBI Master Circular: Prudential Norms for NBFCs, 1998 (www.rbi.org.in).

[28] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).

The 7 remaining sample NGO-MFIs[29] disclosed only total loans outstanding to each institution. None in this grouping disclosed interest rates on the loans, interest incurred on each loan, or guarantees used to secure the loans. When assessing MFIs in this last grouping, interested parties are completely unable to determine the degree to which the institutions are being subsidized by soft money sources.

2.5.3. Policy recommendations

To offer a clearer picture of MFI sustainability, the RBI should require NBFCs and those NGO-MFIs applying to become NBFCs to report a complete schedule of all loan liabilities including the date each loan was received, interest accrued on each loan during the period, the interest rate on each loan compared with commercial lending rates, each loan's outstanding balance at the beginning and end of the fiscal year, total amount over-due, the expected total principal and interest due at the end of the following year, and a complete description of the guarantee used to secure each loan. This requirement would not be especially onerous for any larger institution – the MFI would only have to input its loan terms into a simple spreadsheet. However, by reporting this basic information, MFIs would better equip interested parties to compare the financial performance of a given MFI relative to industry comparables and determine whether a given MFI could operate sustainably without access to subsidized loans.

In the table below, I've summarized the proposed changes to the RBI's NBFC-MFI accounting and reporting requirements.

Table 11: Summary of policy recommendations

<table>
<tr><th colspan="2">MFIs Subjects to New Accounting and Reporting Requirements:</th></tr>
<tr><td colspan="2">These requirements should apply to NBFCs and large-scale NGO-MFIs who are applying to become NBFCs. Applicant NGO-MFIs should be required to meet these standards 1-year prior to the granting of an NBFC license. Donation guidelines should apply to all MFIs, regardless of their size.</td></tr>
<tr><th>Category</th><th>Recommendation</th></tr>
<tr><td>Portfolio quality reporting</td><td>• Rules-based (non-discretionary) accounting requirements for treating delinquent and restructured loans.
• Disaggregated MFI portfolio quality reporting (e.g. 0-30 days overdue, 31-60 days overdue, etc.) and year-on-year portfolio quality comparisons. (Table 1)</td></tr>
<tr><td>Loan loss provisioning</td><td>• Rules-based application of standardized provisioning percentages to each asset class in the disaggregated portfolio quality report. (Table 8)</td></tr>
</table>

[29] This group includes All Backward Class Relief & Development Mission, BISWA, CReSA, EASF, Grameen Koota, Gram Vidiyal Trust, and Mahasemam Trust.

Accounting for donations	• Donation revenues reported below operational revenues. (Table 10) • Disclosure of donation revenue recognition policy. • Disclosure of estimated value of in-kind subsidies. • Disclosure of cumulative donation revenues.
Accounting for loan liabilities	Provide schedule of all loan liabilities, including: • The date each loan was received. • Interest accrued on each loan during the period. • Interest rate on each loan compared with commercial lending rates. • Each loan's outstanding balance at the beginning and end of the fiscal year. • Total amount over-due. • Expected principal and interest due at the end of the following year. • Complete description of the guarantee used to secure each loan.

Note: The above recommendations have been adapted from international guidelines presented in CGAP's "Disclosure Guidelines for Financial Reporting by Microfinance Institutions" (2003) and The SEEP Network's, "Measuring Performance of Microfinance Institutions: A Framework for Reporting, Analysis, and Monitoring."(2005).

3. Which MFIs Should Be Included in Formal Accounting and Reporting Regulation?

Why should tighter MFI financial transparency regulation apply only to a small handful of MFIs? Wouldn't holding all Indian MFIs to more stringent financial transparency requirements attract more capital flows into the space, improve sector health, and promote financial inclusion?

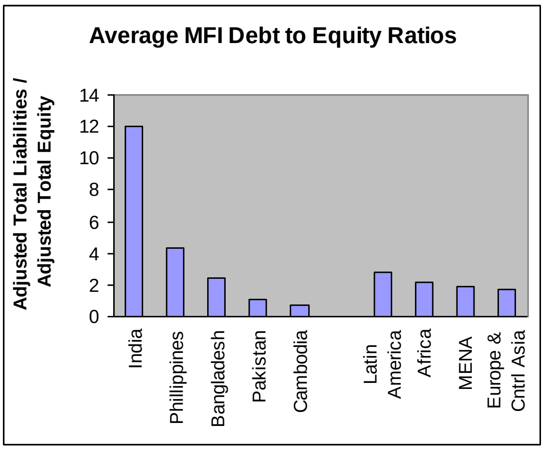
3.1. Financial transparency regulation and capital flows

An exhaustive study of India's microfinance sector, conducted by former Asian Development Bank economist Prabhu Ghate (Ghate 2006), estimated that commercial bank lending to MFIs doubled every year for the last three years.[30] Ghate noted that "MFI managers used to devote most of their energies to dealing with the uncertainty of where the next loan for on-lending funds would come from. Except for the smaller MFIs, this is no longer the case."[31] In fact, Indian MFIs are now the most leveraged micro-lending institutions in the world, with debt to equity ratios far exceeding global averages (Figure 1). The Ghate report concluded that the primary factor preventing more commercial debt from flowing into the sector wasn't

[30] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation.
[31] ibid.

MFI transparency concerns at all, but the capacity of Indian MFIs to absorb the additional funds.[32]

Figure 1



Source: Mixmarket.org.

Access to commercial debt for on-lending does not appear to be a major constraint in Indian microfinance. Even if it were a constraint, it's unclear if improved MFI transparency would stimulate greater debt flows. As noted in the Ghate report, only small-scale Indian MFIs lack access to funds for on-lending. Indian commercial banks tend to screen smaller MFIs by employing a step-lending strategy rather than through a rigorous due diligence process.[33] If a borrowing MFI repays its loan on time, the bank extends a larger loan, and so on. If a small-scale MFIs defaults on its borrowings from the bank, it typically constitutes a tiny portion of that bank's overall portfolio. Therefore, it appears that neither commercial banks nor small-scale MFIs have a strong incentive to improve the transparency norms for small-scale MFIs. Furthermore, if an NGO-MFI had insufficient access to commercial debt, it could voluntarily bolster its financial accounting and reporting practices to differentiate itself from its peers.

While some MFIs may have an incentive to *voluntarily* improve their financial transparency as a signalling mechanism, it appears that *mandated* transparency norms will have little affect on commercial banking flows into the sector. While weak financial transparency doesn't seem to be constraining commercial bank lending to the sector, could it be limiting MFIs' access to donor or equity capital?

In recent years, the Indian microfinance sector has seen the arrival of several MFI-specific equity funds. As of March 2006, these funds had raised a combined $34 million in capital and made five equity investments in some of India's largest NBFCs.[34] Ghate (2006) argues that

[32] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation.
[33] Daniel Radcliffe and Rati Tripathi. *Sharpening the Debate: Assessing the Key Constraints in Indian Micro Credit Regulation.* Centre for Micro Finance, Chennai, India. (2006).
[34] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation.

their arrival has "greatly eased the immediate equity constraint facing start-ups and emerging MFIs, and indeed have created temporarily almost a "buyer's market", with MFIs now being in a position to shop around for the best deals."[35] It appears that, at least for India's largest NBFC-MFIs, access to capital is not a major constraint.

As for small-scale MFIs, it's unclear if mandated transparency norms would spur greater donor or equity capital inflows. If an MFI seeks greater access to these funding sources, it can voluntarily bolster its financial and reporting practices as a signaling mechanism to differentiate itself from its peers and attract increased capital flows. Given an MFI's option to voluntarily improving its accounting and reporting requirements and the recent emergence of MFI-specific private equity funds in India, it does not appear that holding all Indian MFIs to more stringent financial transparency requirements would allow MFIs to access more donor or equity capital.

3.2. Would tighter MFI accounting and reporting regulations improve sector health and promote financial inclusion?

As India's financial regulator, the RBI's primary objective is to mitigate systemic risk by ensuring that deposit-taking institutions are engaging in prudential practices. Preventing systemic risk does not involve Indian MFIs because non-banking institutions are prohibited from accepting public savings deposits. However, a secondary RBI objective is to promote financial inclusion. This suggests that the RBI has some stake in ensuring that micro-lending institutions do not collapse, lest access to financial services to the poor be disrupted.

MFIs are especially exposed to default contagion. Because MFI loans typically lack collateral and rely heavily on the carrot of additional loans to induce repayment, borrowers who observe even a localized outbreak of loan delinquency will have reduced incentive to repay their loans if they perceive a reduction in an MFI's capacity to extend additional loans.[36] Local delinquency issues can, therefore, spread into regional or even national problems if corrective action is not taken swiftly.[37] To guard against the risks of sector-wide delinquency contagion,

[35] ibid.
[36] Richard Rosenberg, Patricia Mwangi, Robert Peck Christen, Mohamed Nasr, Consultative Group to Assist the Poorest (CGAP). *Disclosure Guidelines for Financial Reporting by Microfinance Institutions.* (2003).
[37] Philip Bond (University of Pennsylvania) and Ashok Rai (Williams College). *Borrower Runs in Microfinance.* (2006).

supervisory bodies need access to transparent portfolio quality information. For example, if the RBI (or some other supervisory body) observes that MFIs in a particular region are experiencing high delinquency rates, they could use this information to target the source of the repayment problems and try to contain the possible contagion effects from the delinquency outbreak. Thus, one could argue that the RBI has an incentive to ensure that all Indian MFIs provide detailed and credible financial data to mitigate this contagion risk.

However, as mentioned above, the RBI is rightly worried about the supervisory costs it would incur by bringing each of the roughly 800 Indian MFIs under its regulatory umbrella. CGAP articulates the trade-off faced by microfinance regulators: "serious consideration should be given to the cost of diverting too much of [a regulatory] agency management's attention away from their primary task, by requiring them to spend time on small MFIs that pose no threat to the country's financial systems."[38] Notably, the RBI's supervisory capacity is already stretched thin by its supervision of commercial banks, Urban Cooperative Banks, and the roughly 13,000 NBFCs (both MFI and non-MFI) under its purview.[39] If the RBI lacks the capacity to read the "improved" financial statements, would there be any benefit from improving MFI accounting and reporting requirements?

In sum, given its limited supervisory capacity, the RBI is right to worry about extending its supervisory duties beyond those MFIs large enough to pose threats to the overall microfinance sector. Given this concern, which Indian MFIs are large enough to pose sector-wide threats? India's microfinance sector is extremely top-heavy. Recent estimates suggest that as much as 95% of micro-loans outstanding are concentrated in India's 20 largest MFIs, with the bulk of this 95% coming from the 8 NBFC-MFIs already regulated by the RBI.[40] This suggests that attempts to promote sector health and financial inclusion by boosting MFI transparency should be focused on two segments of India's microfinance sector: existing NBFC-MFIs and those NGO-MFIs large enough to consider transforming into the NBFC legal form.

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[38] Robert Christen, Timothy Lyman, and Richard Rosenberg. CGAP (The Consultative Group to Assist the Poor). p. 27 *Guiding Principles on Regulation and Supervision of Microfinance.* The World Bank Group. (2003).
[39] At the end of June 2004, the RBI had received 38,050 applications from NBFCs for certificate of registration. Of these only 13,671 were approved, including 584 from companies authorized to receive public deposits. "The non-banking sector from a regulatory prism." The Hindu (December 20, 2004).
[40] Prabhu Ghate. *Microfinance in India: A State of the Sector Report.* (2006). A joint initiative of CARE and The Ford Foundation. Estimates are from Sa-Dhan.

3.3. What carrots/sticks can the RBI use to encourage compliance?

How can the RBI encourage MFIs to comply with increased accounting and reporting standards? Because the RBI directly regulates NBFCs, it can fine non-compliant MFIs or, in extreme cases, revoke an NBFC's license. Thus, the RBI's sanctioning powers over NBFC-MFIs are sufficient to encourage compliance.

The RBI's main leverage over NGO-MFIs is its licensing power over an NGO-MFI's transformation into an NBFC-MFI. Why would an NGO-MFI want to become an NBFC?

1) *signaling* – by becoming a formally regulated entity, the MFI signals to external investors greater professionalism and financial transparency relative to unregulated institutions
2) *legal advantages* – by becoming an NBFC, an MFI can take profits out of the business and disburse dividends. Consequently, NBFCs are able to attract for-profit equity investment which, in turn, makes it easier for NBFCs to attract greater commercial debt to fund expansion.

The RBI rations the number of NGO-MFIs registering as NBFCs by enforcing a minimum capital requirement for NBFC registration.[41] The RBI could incentivize large-scale NGOs to boost financial transparency by requiring that all NGO-MFIs wishing to become NBFCs must comply with (improved) RBI accounting and reporting requirements for NBFCs for at least one fiscal year prior to registration. In turn, the RBI could encourage NGO-MFIs to make this transition to an NBFC by lowering the minimum capital requirement for NBFC registration. This strategy would give large scale NGO-MFIs a positive incentive to elevate their financial transparency to the RBI's new standards.

4. Conclusion

Microfinance regulators must engage in a careful balancing act. On one hand, MFIs are relatively fragile institutions. Because they rely almost entirely on the carrot of additional loans to induce repayment, even localized delinquency problems can quickly become institution- or

[41] NBFCs commencing business before April 21, 1999 must have Rs. 25 lakh in net owned funds. For NBFCs commencing business after April 21 1999, this requirement increases to Rs. 200 lakh.

sector-wide problems if corrective action is not taken swiftly.[42] This might suggest that the financial transparency improvements outlined above (Table 11) should be mandated for all MFIs. However, placing reporting requirements of portfolio quality that are overly costly on small-scale MFIs would likely overburden these small institutions, thereby limiting their expansion capacity to reach more poor individuals and directly undermining the RBI's secondary aim of promoting financial inclusion.[43] Moreover, the increase in supervisory costs from bringing hundreds of small-scale MFIs under a formal regulatory umbrella would likely outweigh any increase in overall sector health. This suggests that the ideal way to narrow the Indian MFI transparency gap is to bolster accounting and reporting requirements only for those MFIs large enough to pose a risk to India's microfinance sector. In the Indian context, this means NBFC-MFIs and those NGO-MFIs large enough to consider transforming into NBFCs. Targeted regulatory intervention to improve MFI transparency in this market segment would cover roughly 20 of India's largest MFIs comprising up to 95% of total microfinance borrowers in India.[44]

This analysis showed that India's MFI financial transparency deficit can be narrowed and it needs not overburden either India's microfinance regulator or the MFIs themselves. But doing so requires carefully targeted interventions, aimed at the right deficiencies and the right institutions.

[42] Philip Bond (University of Pennsylvania) and Ashok Rai (Williams College). *Borrower Runs in Microfinance.* (2006).
[43] Timothy Lyman, and Richard Rosenberg. CGAP (The Consultative Group to Assist the Poor). *Guiding Principles on Regulation and Supervision of Microfinance.* The World Bank Group. (2003).
[44] Prabhu Ghate. *Microfinance in India: A State of the Sector Report*. (2006). A joint initiative of CARE and The Ford Foundation.

Appendix: Unanswered Questions – Topics for Further Research

1. Improving MFI transparency for the consumer

This piece has dealt only with MFI financial transparency. A possibly more pressing concern is MFI transparency vis-á-vis the consumer. To what degree do Indian MFIs hide effective interest charges through hidden fees, compulsory savings, or by calculating interest rates based on a non-declining balance? How can India's existing microfinance consumer protection regulation and enforcement be improved to correct these and other abuses?

2. Creating a microfinance-specific supervisory body

India lacks a unified microfinance regulatory authority. Therefore, MFIs under different regulatory umbrellas must follow different reporting guidelines. Most MFIs in India are registered as philanthropic societies and are left effectively unregulated, required only to conduct an annual audit of their financial statements. The remaining institutions are classified under various categories such as commercial banks, cooperative banks, and non-banking financial companies (NBFCs) among others. Depending on their classification, these entities are supervised by the RBI or state authorities.[45] Given the RBI's already extensive supervisory duties, should a microfinance-specific supervisory body be created? If so, should it be housed within the RBI or NABARD or outside these institutions? Can self-regulation credibly enforce reporting requirements on all Indian MFIs? Could Sa-Dhan[46] act as an effective self-regulatory organization? How would Sa-Dhan's rule enforcement capacity (e.g. membership suspension, aggressive fines, etc.) have to be modified for it to be a credible enforcer of financial transparency standards?

3. International experience with MFI accounting and reporting

How have microfinance sectors in other countries responded to increased accounting and reporting requirements? What have been the effects on sector growth and stability of introducing and enforcing stricter MFI financial reporting requirements? Have such reforms stimulated greater inflows of equity investment in MFIs? Have more or fewer MFIs formally regis-

[45] Blaine Stephens and Hind Tazi. *Performance and Transparency: A Survey of Microfinance in South Asia.* (53). MicroBanking Bulletin, April 2006.
[46] Sa-Dhan is a consortium of Indian microfinance organizations.

tered as NBFCs in response to these policy changes? How have other countries' microfinance sectors responded when regulators have left MFI financial reporting requirements to firm discretion, while targeting other areas of microfinance regulation such as rate policy, equity investment restrictions, prudential requirements, etc.?

4. Indian MFI MIS systems and internal control

With a standardized accounting system in place, MFIs use their MIS systems to "collect and process raw data into useful information and disseminate it to the user in the required format."[47] Are weak MIS systems a key source of flawed or delayed financial reporting in the Indian microfinance sector? How well and how quickly does MIS-processed data flow through most Indian MFIs? How well are Indian MFI MIS systems connected to other management systems like accounting or performance monitoring? How can NABARD, external donors, and commercial banks intervene to strengthen Indian MFI management information systems?

5. India's MFI external auditing system

Regardless of their legal form, all Indian MFIs must undergo external audits on an annual basis. However, external audits have limited value if the underlying accounting procedures used by an MFI to process its financial data are unreflective of the MFI's financial performance. Even if all Indian MFIs followed rigorous and transparent accounting procedures, are local auditors aware of international reporting norms for MFIs? Is there an adequate supply of local auditors who are familiar with Indian MFI operations and disclosure requirements? Is this a good area for Indian government agencies or external donors to intervene by subsidizing the training of microfinance-specific auditors?

6. India's third party MFI ratings market

Independent third party rating of MFIs is another important component within the MFI data processing and reporting system. Roughly 60 Indian MFI are rated annually, including nearly all of the 30 largest MFIs. Each year, SIDBI negotiates with M-CRIL and CRISIL[48] on the bulk purchase of most of these ratings, making SIDBI the main driver behind India's MFI ratings market. Interestingly, neither MFIs nor commercial banks have shown much interest

[47] Sa-Dhan. *Management Information System: Issues and Challenges. (2006).* www.sa-dhan.org.
[48] M-CRIL and CRISIL are the two leading international MFI ratings agencies.

in formally purchasing these reports. In fact, according to SIDBI, fewer than 5% of all MFI rating reports in India are formally purchased by MFIs or commercial banks.[49] This begs the question: "would India's MFI ratings market stand on its own without SIDBI support?" Are MFI ratings actually prodding MFIs towards better and more rigorous accounting practices? Are MFI ratings transmitting credible information concerning MFI financial performance to sector stakeholders? If not, is there scope for government or external donor intervention either to improve MFI ratings or to mandate third party ratings for all MFIs above a certain size?

By rigorously answering these challenging questions, researchers can facilitate the evolution of Indian microfinance into an efficient, sophisticated market, thereby advancing India's quest to extend financial services to its vast unbanked population.

[49] Daniel Radcliffe and Rati Tripathi. *Sharpening the Debate: Assessing the Key Constraints in Indian Micro Credit Regulation.* Centre for Micro Finance, Chennai, India. (2006).