

Appraisal Guide for Microfinance Institutions

Revision of 1999 Appraisal Handbook
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Consultative Group to Assist the Poor

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Jennifer Isern (CGAP) led the development of the revised appraisal guide, resource manual, and accompanying Excel spreadsheet. The principal authors of this appraisal guide are Jennifer Isern and Julie Abrams (Microfinance Analytics). Matthew Brown contributed extensively to an earlier draft while he was research assistant at CGAP in 2004–05. Kim Craig developed *appraise.xls*, the accompanying Excel spreadsheet to generate summary tables for the appraisal report, and provided useful comments on the appraisal guide.

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The Consultative Group to Assist the Poor (CGAP) produced its first guide to appraising microfinance institutions (MFIs) in 1996, for internal use in evaluating MFIs being considered for grants. Before long, colleagues from other organizations were asking for copies and adapting the document for other purposes. CGAP published a version for general use in 1999.

The present updated version is intended primarily for two types of users: funders that are considering support for, or investment in, MFIs and MFIs that are conducting self-evaluations.

This revised MFI Appraisal Guide includes new sections on analyzing savings, social performance, information systems, and risk management. In addition, this Guide includes new indicators and financial statement formats agreed within the microfinance industry from 2003 to 2005.

Users should note some important cautions:

- *The Guide is not a one-size-fits-all tool.* It calls for a lot of detail and analysis because it was designed for use with relatively mature MFIs (generally, MFIs with more than 3,000 clients and three years' experience) being considered for large investments (often several million dollars). For smaller or newer MFIs, or for smaller investments, a less intense review may be appropriate. Indiscriminate use of the format may result in MFIs being burdened with requirements to produce information that is either unnecessary or unlikely to be used by the donor or investor requesting it. Sample terms of reference for a lighter analysis and a more thorough analysis are included in the Resource Manual that accompanies this Appraisal Guide.
- *The Guide assumes the involvement of a highly knowledgeable analyst.* It is essentially a checklist of information to be gathered, and the analyst's judgment is critical in deciding which information is worth pursuing and in evaluating the information collected. If the person conducting the appraisal lacks substantial experience with MFIs and good financial analysis skills, the results will not be reliable.

- *This revised Guide gives more attention to assessing poverty levels and social performance impact of the MFI's clients.* However, a serious poverty analysis may require more resources than are budgeted during a typical appraisal. The Resource Manual references several guides for determining client poverty, including CGAP's Poverty Assessment Tool.

Please send questions or comments by email to Jennifer Isern (jisern@worldbank.org) or contact us at the CGAP Operational Team offices (mailing address: CGAP, 1818 H Street NW, Washington, DC 20433, USA; fax 202-522-3744).

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Microfinance Appraisals—Why and How?

This appraisal guide (and its companion resource manual and electronic spreadsheet, *appraise.xls*) incorporates the latest microfinance knowledge and best practices¹ to form a comprehensive guide analysts can use to evaluate microfinance institutions (MFIs). For the purposes of this guide, MFIs are defined as licensed and unlicensed financial institutions that include nongovernmental organizations (NGOs), commercial banks, credit unions and cooperatives, and agricultural, development, and postal savings banks. They range from specialized microfinance providers to programs within larger, multipurpose development organizations.

Purpose of an appraisal

Funders use appraisals to help them make informed funding decisions. Funders can be foreign or domestic donors, foundations, development agencies, or NGOs. Funding can take the form of loans, grants, equity investments, or financing for technical assistance. Reports generated through the process described in this appraisal guide enable existing and potential funders of MFIs to assess the following:

- How well does the MFI match the funder's strategic priorities?²
- Is the MFI efficient, well managed, and profitable (or en route to being so)?
- What is the quality of the MFI's products? Do they meet client needs?
- Would funding add value to the MFI?

This guide is primarily for funders and their qualified consultants who analyze the MFI. But others, such as MFIs conducting self-assessments or diagnostics or commercial banks or investors considering issuances of debt or equity, will find it useful. Commercial and quasi-commercial investors and raters are not the primary target of this guide because they typically have their own assessment and due diligence processes.

¹ For a comprehensive look at best practices for donors, see CGAP 2006.

² For example, a donor may want to have an impact on certain regions, target MFIs at a certain point in their institutional life cycle, target certain types of clients, fulfill certain types of MFI funding requirements, or focus on social performance. Ideally, the donor should be clear on what its objectives and focus are, and if this investment would further those objectives.

Before initiating an appraisal, a funder should find out whether an MFI has received a rating from a rating agency³ or analysis by another reputable organization.⁴ If high quality and recent, information in an MFI's rating report is sometimes sufficient for making a funding decision.⁵ In other cases, rating information may need to be supplemented by an appraisal. If no rating exists, a funder may want to consider commissioning one, or hiring a rating agency to conduct a confidential, less formal evaluation in place of an appraisal.

This guide is organized in the form of an outline of a complete appraisal report. The report should begin with a funding recommendation that is one to two pages long. The recommendation should include a summary of key factors and any mitigating circumstances. The body of the report should be brief—about 10 pages—but it should provide sufficient supporting information for the funder to make an informed funding decision. A complete report covers seven areas:

1. *Overview*—summarizes the MFI's vision and mission, organizational strengths and weaknesses, and macroeconomic, political, and other external factors.
2. *Institution*—describes the MFI's ownership and governance, organizational structure, regulation and supervision, management, external relationships, human resource management, information and communications technology, information availability and quality, internal controls, and external auditing.
3. *Products*—analyzes the MFI's voluntary savings, lending, and financial and nonfinancial products.
4. *Social performance*—assesses how well the MFI translates its social goals into practice, looking at systems, outreach, and potential for achieving impact.
5. *Loan portfolio quality*—reviews how the MFI measures, monitors, and manages its loan portfolio, including delinquency and write-offs.
6. *Financial performance and risk management*—analyzes the MFI's financial performance, risk management, and financial ratios.
7. *Business planning*—evaluates the MFI's strategic and business planning processes and financial projections.

³ Ratings and other information about the risk and performance of MFIs are available from the Microfinance Rating and Assessment Fund (www.ratingfund.org), an initiative sponsored by CGAP, the Inter-American Development Bank, and the European Union.

⁴For example, Symbiotics sells credit risk reports on more than 80 MFIs. (http://www.symbiotics.ch/en/mfi_data/microfinance-credit-risk-reports.asp) The Calvert Foundation has more than 30 MFI due diligence reports available for purchase. (<http://www.calvertfoundation.org/>)

⁵ See the Microfinance Rating and Assessment Fund (www.ratingfund.org) for more information.

Each area has a corresponding section below, with key questions and issues for funding decisions identified using the following format:

- **Essential information is starred (★) and appears in boldface.**
- Crucial information is starred (★).
- Topics of material concern are indicated with this symbol: ⚠

The accompanying resource manual provides supplemental information, analysis, and references, though it is too comprehensive to be used as the basis for terms of reference for an MFI appraisal. Finally, a companion spreadsheet—appraise.xls (for use with Microsoft Excel)—provided on the CD-ROM included with this publication and on the CGAP Web site (www.cgap.org) can be used to generate summary tables for appraisal reports. Selected summary tables are included below; the resource manual contains additional tables and instructions for using the spreadsheet.

This guide intentionally avoids weighting or rating the importance of the seven key areas above or subtopics. The funder's priorities and the MFI's specific circumstances will determine the importance of each topic during an appraisal mission.

Conducting an appraisal

The amount of time required to conduct an appraisal depends on the funder's desired outputs and deliverables. A qualified, experienced analyst would need at least two to three weeks to complete a comprehensive appraisal—including a site visit of 5–7 days or more—depending on how much information is readily available from the MFI. A complete appraisal would be appropriate only for significant funding decisions, and even then, the topics for analysis should be carefully selected. It rarely makes sense to apply the full appraisal guide.

A shorter appraisal may involve 2–3 days in the field and lighter reporting. Funders should consider a full or shortened appraisal only if preliminary discussions indicate that funding is reasonably likely, because gathering and analyzing information needed for the appraisal requires the MFI to collect substantial preparatory data.

An appraisal must answer two overarching questions:

1. Does the MFI's mission align with the funder's?
2. Is the MFI a viable and profitable institution (or does it have realistic and timely plans to become one)?

Answering the second question requires thoroughly analyzing an MFI's operations to determine whether it is a fundamentally sound institution with a clearly identified and implemented mission and strong management and processes that support its goals. The analyst also should assess the potential impact of extreme or unexpected situations, such as drought, national or local civil unrest, severe inflation or exchange rate devaluation, or sudden loss of a key manager or technical staff, on the MFI and its portfolio.

Although a lot of information is available about most MFIs, funders generally prefer brief decision documents. The analyst should focus on topics relevant to the funding decision, and not simply apply an exhaustive checklist of information. Appraisals should proceed in carefully conceived stages—from deciding its design, to planning and conducting the site visit, to preparing the appraisal report.

Step 1: Structuring the appraisal

Before commissioning an appraisal, the funder should identify its main goals for doing so and establish clear terms of reference for the analyst. For an investment to succeed, the funder should be familiar with the type of MFI it is considering funding and the environment in which it operates.⁶

Terms of reference should draw on various sections of this guide, based on the appraisal's purpose, the type of funding proposed, and features of the MFI gleaned from a rating or other informed sources. Only in rare cases involving major funding proposals should the *entire* appraisal guide be used as the terms of reference for analysts. Sample terms of reference, including a short appraisal of 2–3 days and a more complete appraisal with 5–7 days for a site visit, are provided in Annex 1 of the resource manual.

Step 2: Identifying and selecting the analyst

Successful appraisals require experienced analysts with excellent judgment. This guide assumes that the appraisal will be conducted by at least one external analyst who has direct experience with microfinance appraisals or ratings. The analyst also should be fluent in speaking and reading the working language of the MFI. Given the brief timeframe and many topics to be covered, the analyst must prioritize which information to collect and synthesize relevant findings for the funding decision.

⁶ For donor guidance on selecting the most appropriate funding initiatives visit CGAP's Donor Information Resource Centre (www.cgap.org/direct).

Analysts should be chosen carefully. Recommendations may not be reliable unless their source is knowledgeable about microfinance (or at least financial services). Although the Microfinance Gateway maintains a registry of consultants (www.microfinancegateway.org/content/member/), keep in mind that this list is subject to only minimal quality control. After preliminary selection, the quality of an analyst's work should be assessed by asking for references from relevant completed projects or by requesting copies of previous appraisal reports, then having a microfinance specialist review them.

Step 3: Mapping out the appraisal

The analyst should first devise a plan for conducting the appraisal. The first step is to clarify expectations and processes with the funder, the MFI's board and management, and other major stakeholders. Involving the MFI's leadership from the outset can help them better understand their organization's operations and improve its performance.

The analyst should identify the best ways of collecting and compiling information from the board, staff, and clients at the MFI's head office and selected branch offices. The analyst—not the MFI—should make the final decisions about which branches to visit and whom to interview, ensuring that these represent the MFI's diverse operations.

Step 4: Gathering documents before the site visit

Before the visit, the analyst should ask the MFI to provide the following information:

- External reports about the MFI from the past two years, such as ratings, assessments, evaluations, and impact studies
- Audited financial statements for the past two years
- Unaudited financial statements for the year to date⁷
- Complete chart of accounts for the year to date
- Complete set of summary reports from the loan tracking system
- Documentation of funding liabilities
- Organizational chart
- List of board of directors, including curriculum vitae, if possible
- List of committee memberships of board of directors (if board has committees)
- Minutes from past three meetings of board of directors⁸

⁷ When possible, internal financial data should be sent as Excel files.

⁸ The minutes can help determine if there is continuity and follow-up between board meetings.

- Description of financial and nonfinancial services
- Operations manual
- Personnel manual
- Credit manual
- Loan loss provisioning, write-off, and recovery policies (if not in credit manual)
- Savings manual
- Internal controls manual
- Internal audit policies and manual
- Risk management policies
- Relevant microfinance regulations from national regulator
- Relevant regulatory interest rate ceiling policies
- Internal reports monitoring clients at entry, dropouts, market assessments, and other research

The MFI should provide this information only if it already exists and is readily available; it should not calculate new data, draft policies, or make any other significant efforts in response to the appraisal. If an item is unavailable before the site visit, the analyst can try to obtain it during the visit.

After receiving the financial statements and other documents, the analyst should determine whether *appraise.xls* (the accompanying spreadsheet) is the best format for compiling the MFI's data, based on the amount and quality of data. (If little information is available, the analyst should consider using a simpler spreadsheet.) If *appraise.xls* is used and information is provided in advance, input the data before the visit and verify on-site with key MFI personnel.

Appraise.xls is designed to help the analyst collect and calculate key data and financial ratios, such as return on assets, using methods consistent with standards proposed by CGAP and the Small Enterprise Education and Promotion (SEEP) Network's Financial Services Working Group.⁹ If a proposed method cannot be used, the analyst should thoroughly explain the reason and the alternative method used. Data can be entered into the spreadsheet in local currency or U.S. dollars and can be converted to different currencies automatically and displayed in both constant and nominal amounts. Templates of the basic data to be entered in *appraise.xls* are provided in Annex 4 in the Resource Manual. Numerous tables for the appraisal report are generated from the data.

⁹ All financial variables and indicators are consistent with the MicroBanking Bulletin.

Before the site visit, the analyst should schedule interviews with internal and external MFI officials, experts, and stakeholders, such as members of the MFI's board, the national banking or financial services regulator, local providers of technical assistance, and possibly domestic donors or foreign donors with offices in the country (if relevant). The questions for each interview should be developed in advance.

To support various calculations, the analyst may want to obtain information on the country's per capita gross national income (GNI); historical inflation, interest, and exchange rates; and peer group benchmark rates. Income, monetary, and exchange rate data compiled by the International Monetary Fund (IMF) are available at www.mixmarket.org/en/environment/environment.search.asp. International benchmarks for peer groups based on age, target market, size, region, and the like are available from *MicroBanking Bulletin* (MBB) (www.mixmbb.org). The analyst also may want to review national microfinance regulation to be familiar with regulatory issues facing the MFI. Such information is being compiled by CGAP through the University of Maryland's IRIS Center and is available for selected countries at http://microfinancegateway.com/resource_centers/reg_sup.

Step 5: Conducting the visit

The funder should decide on the scope of the appraisal (shorter or more complete) depending on the potential funding amount, the MFI's level of development, and the funder's key areas of interest. When visiting the MFI, the analyst should meet with the board, chief executive officer (CEO), and management team. Depending on the scope of the analysis and size of the institution, the analyst should visit a representative sample of the MFI's branches (e.g., urban/rural, recent/mature) and interview a wide range of clients (old, new, and delinquent), staff, and other stakeholders. At the end of the visit, the analyst should organize a debriefing meeting with the board, CEO, and management team. Additional activities may be needed, based on the goals of the appraisal. For example, an analyst hired to assess an MFI's social performance should budget extra time for more extensive client interviews.

Step 6: Preparing and sharing the draft report

Depending on the amount of data collected, the appraisal report could easily become unwieldy. Thus the analyst should focus on information and analysis most relevant to the funding decision.

The draft report should be shared with the MFI's board and management to confirm the accuracy of its information and to draw on their understanding of the institution and its clients. The analyst should discuss initial findings with the board and management and request written feedback on the draft report. The final report should contain a statement from the MFI's board or management about any matter where it disagrees with the analyst.

Step 7: Distributing the final report

The final report should provide the funder with useful insights on whether to provide funding. A quality appraisal report would also help the MFI better understand its capacity and improve its performance. The commissioning funder, in consultation with the MFI, should decide on the distribution of the final report.

Funding Recommendation

The funding recommendation should succinctly state whether funding is recommended based on a summary of key factors and any mitigating circumstances. The recommendation also should answer key questions about the MFI relevant to the appraisal's focus:

- If funding is recommended, what is the suggested amount and type, and over what period?
- What are the MFI's main strengths and weaknesses? How would the funding strengthen the MFI?
- Especially with large amounts of funding, are there any risks of overwhelming the institution or shifting incentives or operations?
- Is the MFI profitable? If not, is it expected to be profitable within a reasonable time-frame? What are the drivers of its (current or anticipated) profitability?
- Are there any concerns, contingencies, requirements, or improvements the MFI should address or achieve before funding is approved or disbursed? What areas should the funder monitor over time?
- What are the main internal and external risks facing the MFI? What are the mitigating factors?

The analyst also should discuss any other essential findings in the funding recommendation.

Most funders want to finance MFIs with reasonable portfolio quality, as indicated by measures, such as a portfolio at risk greater than 30 days (PAR30) below 10 percent combined with a write-off ratio below 5 percent. If the MFI's performance does not meet this threshold, or if it is operating in an extreme environment (such as an area recently emerging from conflict), the funder may want to consider providing technical assistance grants instead of direct financing.

Overview

2.1 Summary institutional data

- ★ **Are the MFI's performance, management, and governance reasonable, given its length of time in operation?**
 - Briefly describe the MFI's history and evolution, to provide context for its current operations. Essential information includes the MFI's legal name, year of incorporation, year operations commenced, and current and planned legal structure. If the MFI is part of a larger organization, describe the structure, strengths, and weaknesses of this arrangement (including the relationship between the organization's microfinance and other activities, and whether the organization keeps separate accounts for microfinance activities).
 - Does the MFI's legal structure meet its current and long-term needs? If not, will transformation be possible? If the MFI plans to adopt a new legal structure, explain how and why the proposed structure was selected, and identify related risks.

Table 2.1 Summary of Key Data

		Currency:					
		Actual				Projected	
		Prior Year 1	Prior Year 2	Current, as of (date)	MBB Peer Group	Projected Year 1	Projected Year 2
<i>Clients and Products</i>							
1	Number of borrowers						
2	Number of active loans						

Currency:						
Table 2.1 Summary of Key Data (continued)	Actual				Projected	
	Prior Year 1	Prior Year 2	Current, as of (date)	MBB Peer Group	Projected Year 1	Projected Year 2
<i>Clients and Products</i>						
3	Total gross loan portfolio					
4	Number of voluntary savings clients					
5	Total balance of voluntary savings accounts					
<i>Portfolio Quality</i>						
6	Adjusted PAR30					
7	Adjusted write-off ratio					
8	Adjusted risk coverage ratio					
<i>Efficiency and Productivity</i>						
9	Average loan balance					
10	Average savings balance					
11	Adjusted operating expense ratio					
12	Adjusted cost per active client					
13	Adjusted average outstanding loan size					
14	Client turnover					

							Currency:
Table 2.1 Summary of Key Data (continued)		Actual				Projected	
		Prior Year 1	Prior Year 2	Current, as of (date)	MBB Peer Group	Projected Year 1	Projected Year 2
<i>Profitability</i>							
15	Adjusted return on assets (AROA)						
16	Adjusted return on equity (AROE)						
<i>Asset/Liability Management</i>							
17	Yield on gross portfolio						
<i>Macroeconomic Data</i>							
18	Year-end free market exchange rate (local currency/ other currency)						
19	GNI per capita						
<i>Note: MFI can use GNI per capita or GDP per capita, depending on which figure is more readily available.</i>							

2.2 Vision and mission

- ★ Do the MFI's management and board have the vision, ability, leadership, and experience to lead it, now and in the future?
- ★ Does the MFI have a clear mission that is embraced and implemented by its board and staff?
Are the MFI's mission and vision consistent with the goals of the commissioning funder?
- ★ Include the MFI's mission statement (verbatim), and discuss whether it is embodied in the MFI's daily work.

- ★ What are the main strengths and weaknesses of the MFI's mission?
- ★ Does the MFI have a clear target market it is trying to reach? Does it have a coherent strategy for reaching that market? How successful has it been in reaching it?
- ⚠ Does the MFI have an unclear or vague mission? Does it have a well-defined mission that it is not fulfilling?

2.3 Organizational strengths, weaknesses, and competition

- ★ What are the MFI's key strengths and weaknesses?
- ★ What opportunities and threats does it face?
- ★ What are the MFI's greatest comparative and competitive advantages and disadvantages?
- ★ Who are the MFI's main competitors –and potential new entrants–and how are they positioned in the local market as compared with this MFI?
 - How does the MFI's competitive environment affect its outreach, growth, operations, effectiveness, and profitability? Briefly describe management's view of the MFI's competitive situation.¹⁰
 - How does the MFI differentiate itself from competitors (e.g., products, service, pricing, a combination, or other factors)?
 - To what extent does the MFI take competitors into account when making key decisions regarding operations, products, and interest rate policy?
 - How has the MFI handled its growth thus far? Is it prepared to manage (often rapid) growth, in terms of staffing, products, and funding?
 - Does the MFI operate in nontransparent ways? For example, are loan files available as needed, can portfolio quality be easily monitored, are there any unusually high inter-branch balances, etc.? Did the appraisal unearth any concerns about transparency in terms of reporting, operations, or behavior?

2.4 Macroeconomic and political environment

- ★ How does the domestic macroeconomic and political environment affect (positively and negatively) the MFI's operations, including its ability to execute its stated strategy?

¹⁰ If the MFI is large or faces serious competition, a more comprehensive competitive analysis may be appropriate. This could include analysis of the number, scale, and market focus of MFIs in the local market (regionally or nationally, depending on the MFI's context). If data are available, provide the market share and competitive advantages of each competitor, including commercial banks and their subsidiaries, consumer lenders, NGOs, cooperatives and credit unions, postal savings banks, and other financial service providers. Based on the potential market, evaluate overall microfinance market penetration and saturation and the implications of the competitive environment for the MFI's current and future market share and profitability. This information should be as quantitative as possible and accompanied by qualitative insights.

- If the economic, political, or social environment has undergone significant changes that affect microfinance, discuss any positive or negative impacts on the MFI.

2.5 Other external environmental factors

★ What other external environmental factors bear significantly on the MFI?

- Identify the impact of any influential local conditions, such as a high incidence of HIV/AIDS, a post-conflict environment, seasonal loan cycles (because of agriculture, for example), or market disruptions because of natural disasters. Indicate how the environment could or does adversely affect the quality of infrastructure (roads, electricity, water), availability of qualified staff, and so on. Specify the potential disruptions and risks they pose to the MFI's operations.

The Institution

3.1 Ownership and governance

- ★ Does the MFI's board have the experience and commitment needed to provide fiduciary and strategic oversight of the MFI? Is the board capable of enabling the MFI to achieve its mission, guiding its strategic direction, managing and mitigating risks, and ensuring accountability throughout the institution?
- ★ Is the board appropriately qualified, active, and experienced in fields such as banking, law, accounting, and social development?

3.1.1 Ownership

- What is the MFI's legal structure? (Most MFIs are NGOs, cooperatives, credit unions, nonbank financial institutions, or commercial banks.)
- If the MFI is a bank or nonbank financial institution, complete Table 3.1, providing the names and types of owners and their ownership amounts and shares. (Ownership in Table 3.1 should sum to 100 percent and to the MFI's stated equity book value. If market value is used instead, that should be specified.)
- Indicate any relevant recent change in ownership or significant impact the composition of ownership has on the MFI's mission, strategic direction, and operations. Also note any significant contingencies in ownership, or puts, calls, or buyout options pertaining to the owners. Finally, note if not all allowable capital is subscribed, or if there is a significant upcoming increase in the number of shares.

3.1.2 Governance¹¹

- ★ Evaluate if and how the MFI's board practices sound governance in terms of defining and upholding the MFI's mission (and changing it as needed), guiding major strategic decisions, managing risks and maintaining the MFI's health, and ensuring accountability throughout the institution.¹²

¹¹ See also Natilson and Bruett 2001.

¹² Adapted from Council of Microfinance Equity Funds 2005.

Table 3.1 MFI Ownership Summary

As of (Date):					
	Owner Name	Type (individual, company, bank, NGO, other)	Domestic or International	Amount of Ownership (in local currency)	Percentage Ownership
1					
2					
3					
Etc...					

- ★ Does the board have the skills and ability to lead the MFI strategically?
 - ★ Do board members' roles extend beyond governance and into management of the MFI?
 - ★ Do all board members agree on the MFI's mission and strategic direction?
- Indicate the criteria for board membership, including professional experience and education level. Note the number of board members and their expertise. How many board members are "independent directors" with no other ties to the MFI? If there are outside investors in the MFI, how many seats do they hold on the board?¹³
 - How often does the board meet? (Base your determination on minutes of meetings and discussions with board members). Are the board's committees appropriate, given the MFI's stage of development?¹⁴
 - Does the board have policies stipulating term limits and rotation for its members?
 - Does it follow those guidelines?
 - If board is not fulfilling its oversight and strategic role, explain how that evolved, and what practices should be established to provide adequate board oversight.
 - Confirm that the MFI has guidelines preventing conflicts of interest among board members. Specifically, do the guidelines prohibit related-party (insider) lending, require full disclosure of all conflicts of interest, and require arm's length business transactions?¹⁵

¹³ Equity investors with a 15% or higher ownership position typically seek a seat on the board as a condition of their investment.

¹⁴ A young or small MFI may not have or need a lot of committees. Typical committees in mature MFIs include an audit and finance committee, executive committee, compensation and personnel committee, risk management and investment committee, committees related to social performance management (client monitoring, market research), and temporary committees for specific, time-limited issues. If an MFI accepts deposits or has reached a scale where asset-liability management is a challenge, it will likely want to form an asset-liability committee as well.

¹⁵ See guideline 5.3 on "Related-party (insider loans)" in CGAP 2003.

- If loans to board members are allowed, are the criteria for eligibility and loan size the same as for all borrowers? Are all board members current on their loan repayment? Are loans to board members subject to periodic review? If a board member is delinquent on a loan or receives preferential loan terms, what are the consequences or sanctions, such as removal from board, etc.?
- For credit unions and other deposit-taking institutions, do board members receive the same deposit rate as other members?
- Does the MFI have any of its invested funds in a financial institution or other company in which a board member has significant ownership?

⚠ Have any events damaged the MFI's reputation and operations?

3.2 Management

- ★ **Does management have the experience, ability, vision, and leadership to lead the MFI to achieve its mission?**
- ★ Describe the backgrounds and positions (CEO, chief financial officer, and so on) of the management team. Provide an evaluation of top management, based on fact and opinion.
- ★ Has management handled any particularly challenging internal or external circumstances?
- ★ Has management been candid with the analyst (and others) about past or current challenges facing the MFI?
- ★ If the MFI is new, does management include anyone with a track record of achieving sustainable microfinance in another institution or setting? If not, does management have access to intensive support (more than a few weeks a year) from someone with such a track record?
- ★ How effective is management in representing the MFI externally, responding to crises (cite examples if possible), and advancing the MFI's vision and mission?

⚠ Would the MFI be able to operate if, for any reason, certain members of the management team were suddenly unable to fulfill their obligations?

3.3 Organizational structure

- ★ **Does the MFI's organizational structure ensure staff accountability?**
- ★ **Is the organizational structure designed to optimize the MFI's branch network (if it has one)?**
- ★ **Does the organizational structure enhance the MFI's efficiency and productivity? Does it lower costs for the MFI and its clients? Do staffing levels meet client demands?**

- ★ Does the organizational structure support effective management oversight?
- ★ How do branch structure and management influence the MFI's ability to effectively and efficiently meet clients' needs?
- ★ For cooperatives, is it a member of a network or federation? If so, in what ways does the cooperative's membership in the network affect its operations? What revenues, funding, costs, expenses, or services does the network or federation incur or provide to the cooperative? What decisions are made at the network or federation level that affect the institution? Is its membership in the network or federation a clear benefit to the cooperative?
- ★ Include the MFI's organizational chart as an appendix to the appraisal report. Are key functions represented in the structure?

Evaluate how the organizational structure supports management:

- How are departments or units organized (e.g., cost centers and profit centers)? Does the organizational structure contribute to efficient processes and decision-making? Is it appropriate for the MFI's mission, scale, target client base, geographic dispersion, and local environment?
- Do the number and type of staff in the MFI's headquarters and branches match their levels of responsibility and delegated authority? (The headquarters may be an administrative head office but is often a key branch as well.)
- Are branches treated as cost or profit centers? How effective is this approach? Are head office costs fully and appropriately allocated among the branches?
- How is the branch reporting system organized? What inputs do branch managers have in the annual planning and budgeting process?
- Are staff functions assigned appropriately? (For example, are too many functions given to one person, or is a single function spread inefficiently across too many people?)

3.4 Human resource management

- ★ Does the MFI have enough motivated, trained, capable staff to implement its mission?

Table 3.2 can be used to summarize key human resource information and compare with the MFI's peer group.

Table 3.2 Staffing Summary Data

		Prior Year 1	Prior Year 2	MBB Peer Group	Variance (between MFI and MBB Peer group)
1	Total # staff				
2	Total # client officers				
3	Staff turnover				
Staffing Efficiency					
4	Personnel expense/Loan portfolio				
5	Average Salary/GNI per capita				
Staffing Productivity					
6	Borrowers per client officer				
7	Borrowers per staff member				
8	Clients per staff Member				
9	Personnel allocation ratio (client officers/# of personnel)				
<p><i>Notes:</i></p> <ul style="list-style-type: none"> • The analyst can select which (if any) of these indicators is relevant to the analysis of human resources management. • Data on MBB peer groups are available at www.mixmbb.org. • Loan officers are defined as staff that interact with clients regularly specifically for loan administration. • Savings officers are client officers who mobilize or handle savings. • Administrative staff includes management, finance, bookkeeping, internal control, and management information system staff; it does not include loan or savings officers, cashiers, and others who spend most of their time dealing with clients. • Line staff includes loan and savings officers, cashiers, and other staff with direct and continual client contact. • The term <i>client officers</i> refers broadly to all staff that interact with clients for loan administration, deposits, repayment collections, and the like. This broader staff officer definition can be useful for productivity metrics looking at a full range of financial services, including savings and money transfers. 					

- ★ Evaluate the MFI's human resource management in terms of recruiting, training, compensation (including salary and performance-based incentives), sanctions and promotions, retention and turnover, and termination of staff members. To what extent are these policies and procedures institutionalized? How big a priority are they for managers?
- ★ If the MFI has recently experienced a significant expansion in staff because of rapid growth, provide information on the increase.

3.5 Information and communications technology¹⁶

- ★ Does information and communications technology provide relevant information for the right people at different levels of the MFI?
- ★ Is the information reliable and available in a timely manner?
- ★ How many days does it take for a loan officer, branch manager, and headquarters manager to become aware of a missed payment?
- ★ Does the MFI use the information it produces?

Functionality and expandability

- ★ Can the MIS handle the MFI's growth? Or is it a bottleneck to growth? (See Annex 2 in the Resource Manual for more information.)
- ★ Can the MIS easily incorporate new MFI products or expand to accommodate new reporting needs?
 - If there are plans for technology upgrades or MIS staff additions, how realistic are those plans? Identify any MIS shortcomings and their impacts on data quality and control, as well as the MFI's proposed solutions.¹⁷

Usability

- How do staff members feel about the MIS—particularly its ease of use?
- Does the MIS interact with any applied delivery technologies, such as handheld computers, point-of-service (POS) terminals, and automated teller machines (ATMs)?¹⁸

Reporting

- ★ How many days does it take for a loan officer, branch manager, and headquarters manager to become aware of a missed loan payment?

¹⁶ See also Ivatury 2006.

¹⁷ More information about MISs and other technology issues can be found at CGAP's Technology Resource Center (www.microfinance-gateway.org/resource_centers/technology), including a helpful checklist from Mainhart 1999. See also Waterfield and Ramsing 1998.

¹⁸ This question helps to assess the MFI's technological savvy and to determine whether the MFI has used good planning processes, measured results against expectations, effectively managed any donor funds for such initiatives, and been innovative in, or willing to experiment with, new technologies.

- ★ How timely are financial performance data received by managers at various levels?
- ★ Identify which of the following the MIS provides: supervisor reports (operations, staffing), monitoring reports (compliance, liquidity), management accounts (statistical summaries, cash flow projections, branch office and loan officer performance data), analytical systems (costing, etc.), client interface data, market intelligence, back office data processing, and accounting ledgers?

▲ Client loan and savings files and resulting data in loan tracking and accounting systems ideally should be identical; if not, it should vary by less than 5 percent.

Standards and compliance

Using a small sample, verify that paper or electronic loan files correspond to loan data in the MIS. Confirm that general ledger or accounting records flow correctly into the financial statements. Is the loan portfolio system fully integrated with the accounting system? If not, comment on any quality-control measures used to ensure adequate data transfer.

Administration and support

- Analyze data security, and determine whether adequate safeguards are in place for data retrieval, fraud protection, and physical security. Also ensure that data backup and physical security are timely and appropriate for the local environment (based on weather conditions, electricity supplies, and the like).

Technical specifications and correctness

- Does management have the capacity to implement technology and make technology decisions that benefit the MFI?

Cost

- What are the costs of purchasing, installing, and operating the MIS? Include hardware, software, training, project management, consulting, staff time, and operating costs. Software costs should include base prices, maintenance agreements, installations, training, and upgrades. (Note: This could be a time-consuming cost analysis and may be useful only if the funder is considering support for the institution's MIS.)

3.5.1 Information quality, availability, and transparency

- ★ Is the MFI's information—including internal, MIS, internal and external audit, product, and portfolio data—reliable and readily available to management and staff? Is the MFI able and willing to be transparent with its information?
- ★ Does the MIS support the client and transaction information required for AML/CFT compliance?
- ★ Is there a willingness to provide information and a consistency of answers across the MFI?

⚠ Describe any significant data quality or availability issues encountered during the appraisal and their implications for the report and funding decision.

3.6 Internal controls

- ★ Does the MFI have adequate policies and procedures to manage its operational risks?
- ★ Does the MFI have an operations manual? Are its contents appropriate and widely accessible to MFI staff? Does the MFI have and adhere to written policies and procedures to manage operational risks in the following areas:
 - *Financial operations*: credit (applications and approvals, disbursements and collections, refinancing and repeat loans¹⁹), savings (approvals for opening and closing accounts, deposits and withdrawals), portfolio quality review, and provisioning
 - *Procurement*: purchases (requisitions through payments), payroll (hiring, remuneration, personnel file documentation), and fixed assets (budget requests and approvals, purchases, uses, security, depreciation policy, disposition)
 - *Treasury*: cash handling, banking (accounting, account opening and closing, deposits, transfers, withdrawals), investments, funding (donations, capital stock, debt), and liquidity management

¹⁹ Fictitious loans are the most common form of fraud in MFIs.

- *Financial management*: budget controls, asset safeguarding, production of accurate financial statements, and fulfillment of statutory requirements
 - *Other applicable areas*
- ★ How effective is the MFI at detecting fraud or other significant operational risks? Does the MFI have adequate safeguards in its procedures, policies, and practices to prioritize risks, detect fraud, and maintain fair and transparent human resource management?
 - ★ How are interbranch balances monitored and cleared? What are procedures for uncleared interbranch balances?
 - ★ Does the MFI have appropriate and sufficient AML/CFT internal controls in place?²⁰

⚠ Ask if there have been any instances of fraud or embezzlement by clients or staff. If so, provide detailed descriptions, along with related changes in procedures and safeguards. Has the MFI made the changes needed to avoid future occurrences of fraud or embezzlement? Was it sufficiently transparent about the issue?

3.7 Internal audit

Internal audit is an important tool for internal control. Although it is a function of the internal control system, internal audit warrants special attention.

- ★ Do the MFI's internal audit functions ensure effective use of resources, accurate financial reporting, and ample random spot checks of MFI branches, clients, and staff?
- ★ Assess the effectiveness of internal audit functions, staffing, and responsibilities. Does the internal audit manager report to the head of the MFI or to a committee of the board of directors? Is the reporting structure appropriate and effective?

⚠ Include any material irregularities found by internal auditors, recommendations made, the extent and success of their implementation, and any remaining issues to be resolved.

3.8 External audit²¹

- ★ Does the MFI have an external auditor? If not, is there a valid reason? What are the MFI's future audit plans and requirements?

²⁰AML: Anti-money laundering and CFT: combating the financing of terrorism. Based on international guidelines by the Financial Action Task Force, four main activities are required for AML/CFT compliance: (1) internal controls; (2) customer due diligence, including "know your customer" requirements; (3) surveillance and record-keeping; and (4) reporting of suspicious activities. Further information on AML/CTF implications for microfinance can be found in Isern, Porteous, Hernandez-Coss, and Egwuagu 2005 and Isern 2006.

²¹ Further information on MFI audits is available at the Microfinance Audit Information Center (www.microfinancegateway.org/audit/index.htm). See also CGAP's "Disclosure Guidelines for Financial Reporting by Microfinance Institutions" (2003), to be used in addition to an MFI's compliance with International Financial Reporting Standards or national accounting standards.

- ★ **Does the external audit accurately reflect the MFI’s financial picture? Can the board and management adequately monitor and manage the audit process?**
- ★ Does the MFI generate an annual audited set of financial statements? Has the auditor issued an unqualified letter supporting the financial statements? If not, summarize the key reasons.
- ★ Are the financial statements reliable and publicly available?
- ★ Attach all audit reports from the past two years.
- ★ Does the MFI adhere to generally accepted accounting standards, such as national standards or International Financial Reporting Standards, or the microfinance-specific CGAP “Disclosure Guidelines for Financial Reporting”?
- ★ Are auditors familiar with the specific risks related to and monitoring required for microfinance and for voluntary savings mobilization?
- ★ Evaluate the quality of audited financial statements, the composition and qualifications of the external auditors, and the frequency and track record of the MFI’s audits. Is the audit opinion clean? How consequential are the reservations, if any? Did the auditors produce a meaningful, useful management letter, with specific recommendations emerging from the audit? Did the MFI follow up any findings in the management letter? Did the MFI and its board address and resolve any outstanding issues? Did the MFI implement all material recommendations made by the auditors?

3.9 Regulation and supervision²²

- ★ **If the MFI is regulated, how does the prudential and nonprudential regulatory and supervisory environment affect its ability to charge appropriate interest rates or access commercial funding? Do regulation and supervision affect its operations in other ways?**
- ★ Do local laws (such as interest rate ceilings) affect the MFI’s operations and profitability?
- ★ If the MFI is a licensed intermediary, is it out of compliance with any regulations? Review and include any reports issued to the MFI by the supervisory authority in the past two years. Note any corrective actions required by supervisors and whether the MFI has implemented them.
- ★ What are the AML/CFT regulations in the country that affect the MFI?²³ Is it compliant with all relevant regulations?

²² More information on regulation and supervision can be found at the Microfinance Regulation and Supervision Resource Center, created by CGAP and the University of Maryland’s IRIS Center (http://microfinancegateway.com/resource_centers/reg_sup). The site contains profiles for selected countries and a comparative database.

²³ This will vary, depending both on the extent and type of AML/CFT regulation in place in the country. For more information on AML/CFT, see Isern, Porteous, Hernandez-Coss, and Egwuagu 2005.

- ★ Do any of the MFI's operations clearly function outside the precepts of the law? For example, is the MFI collecting deposits illegally?
- Is the MFI regulated? If so, by whom. If the institution is a credit union, does the formal financial sector supervisor regulate it? If not, who does?
- Does the regulatory environment provide an appropriate framework for the MFI's current and potential operations and legal status? Does the supervisory agency provide adequate supervision of the MFI?

3.10 Ratings²⁴

- ★ Attach all the MFI's rating reports for the past two to three years. If it is a credit union, has it undergone a PEARLS or other similar rating?
- ★ Summarize the conclusions and scores of all ratings and any key areas of strength or concern.
- ★ If there are concerns about the quality of a rating report and such information is available, evaluate the composition and qualifications of the rating team.

3.11 External relationships

- ★ **What are the MFI's most significant external relationships? What impact have they had?**
- ★ What are the MFI's most significant relationships or alliances with donors, domestic or foreign networks (such as microfinance or banking networks), technical assistance providers, and domestic political or commercial institutions?
- How have any of these relationships affected the MFI's ability to manage or improve its operations? Does the MFI depend on any of these relationships? If so, what would happen to the MFI if the relationship ended?
- If the MFI is a member of a national, regional, or international federation or network, what is the extent of the network's influence on the MFI's strategy and/or operations? What is the role of the network on prudential oversight, financial support or costs, liquidity and cash management, internal controls, training, product mix, branding, and marketing?²⁵

²⁴ More information on ratings and rating agencies is available at the Microfinance Rating and Assessment Fund (www.ratingfund.org).

²⁵ For further questions to consider on the role of an MFI's network, see Isern and Brown 2007.

Products

The extent of possible analysis of an MFI's products heavily depends on its stage of development. If an MFI is young and small, the analyst does not need to spend much time analyzing its products and should mainly assess whether management is focused on making the institution's initial products stable and profitable. In such cases, most of the detailed questions below can be skipped.

- ★ **For larger and more advanced MFIs: Does the mix of products adequately meet current and anticipated client demand?²⁶ Does the MFI have the capacity to meet the evolving demands of its clients and expand its client base? Does the MFI offer a suitable variety of financial products—voluntary savings, loans, transaction accounts (such as checking), insurance, money transfers, leasing, and so on—that reflect client demand and are aligned with its capacity? Does the MFI have effective strategies for product design, marketing, delivery, maintenance, and evaluation?**

- ★ Summarize the MFI's products in Table 4.1, including a brief description and the period covered for each. Provide any useful breakdowns of these products, such as individual relative to group loans or microcredit relative to consumer loans.

Table 4.1 Product Summary

		As of (Date):			
		Number of Products	Number of Active Clients	Total Balance or Value	Average Account Balance (Means or Median)
1	Savings Products				
2	Loan Products				
3	Other Financial Products				
4	Other Nonfinancial Products				
<i>Notes:</i> <ul style="list-style-type: none"> • Analyst can use average or median figures in this table, noting any significant outliers and their implications. • Analyst can select number of active clients or number of active accounts, depending on what data are available from MFI. 					

²⁶ Information about clients and product choices appears in the next section, on social performance.

- ★ Does the MFI have a formal or informal code of conduct or ethics? Does it have a pro-consumer statement or policy? If so, are these enforced? To what extent is a product's full cost disclosed to clients?²⁷
 - To what extent does the MFI's mix of financial products reflect its mission and strategy?
 - How are products marketed? Comment on the strategy, mix, and appropriateness of lending, voluntary savings, money transfers, insurance, and other financial and nonfinancial products offered.
 - Are any products designed specifically for poorer clients?
 - Do the MFI's products seem appropriate given its current and anticipated growth?
- ⚠ Have there been any material crises related to the MFI's products—involving, for example, mismanagement, repayment, default, or liquidity? If so, what was the impact? What is the current status?
- ⚠ Are there any significant concerns about the design, marketing, pricing, or delivery of any of the products?

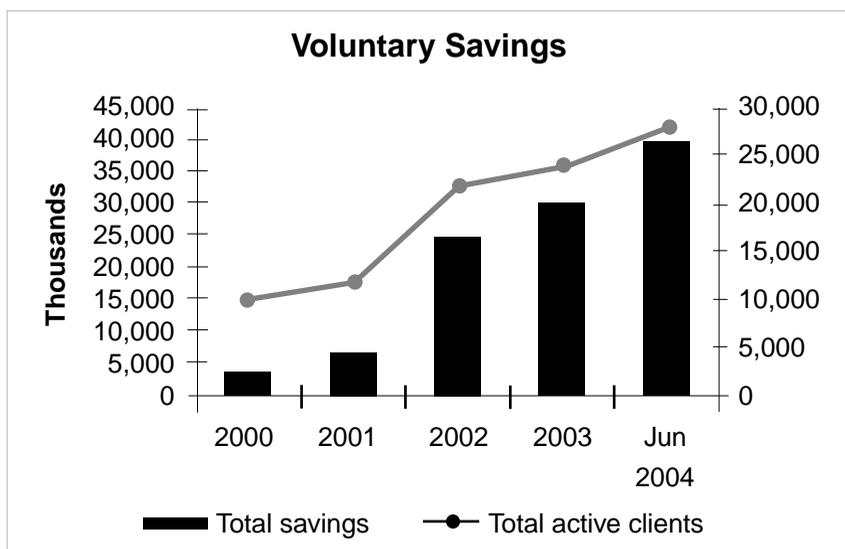
4.1 Voluntary savings²⁸

This section addresses voluntary savings only. If an MFI requires clients to save as a condition of receiving loans (forced savings), see the next section on loans. If the MFI does not offer voluntary savings, eliminate this section from the appraisal report. If it plans to establish voluntary savings, comment on whether the plan is credible and realistic.

- ★ **Does the MFI offer, or plan to establish, voluntary savings products? If it offers them, what have been the main outcomes and challenges? How have these products affected the MFI's cost of funds, client satisfaction, and market demand?**
- ★ Is the MFI legally allowed to collect voluntary savings?
- ★ Is savings a requirement for borrowing? (If so, these are forced or compulsory savings.)
- ★ To what extent do the MFI's savings products reflect its mission and strategy?
- ★ Are voluntary savings used to fund loans? If so, what percentage of the loan portfolio does savings fund?

²⁷ For more information on product transparency and consumer protection, see McAllister 2000, Porteous and Helms 2005, Rhyne 2003, and ACCIÓN Network 2004.

²⁸ See also CGAP's *Developing Deposit Services for the Poor: Preliminary Guidelines for Donors* (2002) and Savings Information Resource Center (http://www.microfinancegateway.org/resource_centers/savings).



- ★ Do the lower financing costs of using savings to fund portfolio growth exceed the costs of administering a savings program?²⁹
 - ★ How does the MFI manage the operational risks (fraud) and the financial risks (liquidity) associated with mobilizing deposits?
 - ★ To what extent is the MFI exposed to repricing risk on its deposits?
- How well does the MFI deliver its savings products?
 - Has the MFI determined the fully loaded cost of its voluntary savings program? If so, what contribution does it make to overall profitability?
 - Can the MFI give a breakdown of savings deposits by size? Is it achieving its desired average deposit size? Is it trying to increase deposits by attracting new clients, increasing balances of existing clients, or a combination?
 - If deeper analysis of the MFI's savings products would offer useful insights, assess the products using any of the following features (as needed and if available): individual relative to institutional clients, short-term products relative to long-term products (such as passbook versus time deposits), and client characteristics (such as socioeconomic levels and types of savings products).

²⁹ Many MFIs would not be able to answer this question easily, because many have not done a complete cost allocation for their savings programs. Even if the MFI cannot answer this question, it should be posed to consider the effectiveness of savings as a funding mechanism.

Table 4.2 Voluntary Savings Product Summary

		Currency:				
		Prior Year 1	Prior Year 2	Current, as of (date)	Projected Year 1	Projected Year 2
<i>Savings Product 1</i>						
1	Interest rate (%) and calculation					
2	method Minimum deposit to open account					
3	Fees to open account					
4	Minimum deposit per transaction					
5	Fees per transaction					
6	Penalty for early withdrawal					
7	Minimum account balance					
8	Withdrawal frequency (average per period)					
9	Deposit frequency (average per period)					
10	Number of active individual savings accounts					
11	Number of inactive individual accounts					

Table 4.2 Voluntary Savings Product Summary (continued)

		Currency:				
		Prior Year 1	Prior Year 2	Current, as of (date)	Projected Year 1	Projected Year 2
<i>Savings Product 1</i>						
12	total individual balance, end of period					
13	Individual account balance as percentage of total savings balance					
14	Average individual account balance (mean or median)					
15	Number of active institutional savings accounts					
16	Number of inactive institutional accounts					
17	Total institutional account balance, end of period					
18	Institutional account balance, as percentage of total savings balance					
19	Average insti- tutional account balance (mean or median)					

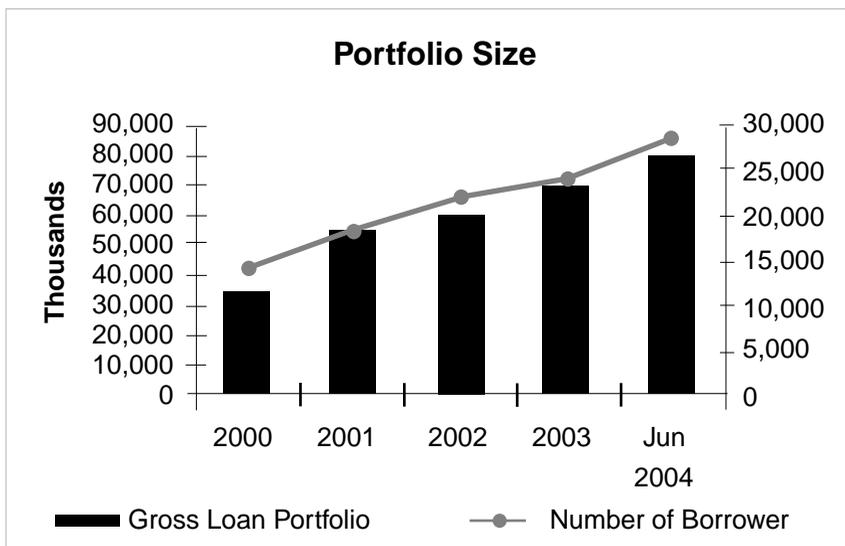
Table 4.2 Voluntary Savings Product Summary (continued)

		Currency:				
		Prior Year 1	Prior Year 2	Current, as of (date)	Projected Year 1	Projected Year 2
Savings Product 2						
1	Interest rate (%) and calculation method					
2	Minimum deposit to open account					
Etc.	Fees to open account					
<p><i>Notes:</i></p> <ul style="list-style-type: none"> Analyst has option of using institutional or individual breakdowns or both. Analyst can select number of active clients or number of active accounts, depending on what data are available from the MFI. The analyst may want to compare savings fees and rates to local financial institutions or benchmarks deposit rates against MBB. 						

4.2 Loans³⁰

Note: Loan portfolio quality is addressed in Section 6.

- ★ What are the main features of the MFI’s loan products? What have been the key results and challenges of each? Which products are most important to the MFI and its clients?



³⁰ For more information on microfinance loans, see the MicroSave toolkit (www.microsave.org/toolkits.asp?ID=14)

- ★ How well does the MFI deliver its loan products? What contribution do they make to the MFI's profitability and strategic goals?
- ★ Do the types of loans offered (size, individual versus group, tenor, seasonality) seem to address client needs in that market?
- ★ What percentage of outstanding loans is accounted for by forced savings? (If it is a high percentage, this is a serious drawback from a client's perspective.)
- ★ Complete Table 4.3, summarizing loan products for the past two years and the year to date. Where useful and feasible, distinguish between loan types, such as microcredit, consumer, and mortgage.

Table 4.3 Loan Products Summary

		Prior Year 1	Prior Year 2	Current, as of (date)
<i>Loan Product 1</i>				
1	Initial amount			
2	Increment /maximum			
3	Term			
4	Repayment frequency			
5	Interest rate			
6	Commissions and fees			
7	Guarantees and collateral			
8	Theoretical interest yield (APR)			
9	Savings requirement (if any)			
10	Number of active loans (clients), end of period			
11	Average principal balance per client			
12	Median principal balance per client			
13	Average principal balance outstanding, over period			
14	Total principal balance outstanding, end of period			
15	Percentage of total loan balance			
16	Total outstanding balance associated with loans that are: On time (and never renegotiated)			

Table 4.3 Loan Product Summary (continued)		Prior Year 1	Prior Year 2	Current, as of (date)
Loan Product 1				
	Overdue 1 to 30 days (and never renegotiated)			
	Overdue 31 to 90 days (and never renegotiated)			
	Overdue 91 to 180 days (and never renegotiated)			
	Overdue 181 to 365 days (and never renegotiated)			
	Overdue over 365 days (and never renegotiated)			
	Renegotiated loans—On time			
	Renegotiated loans—Overdue 1 to 30 days			
	Renegotiated loans—Overdue 31 to 90 days			
	Renegotiated loans—Overdue 91 to 180 days			
	Renegotiated loans—Overdue 181 to 365 days			
	Renegotiated loans—Overdue over 365 days			
Loan Product 2 ...				
1	Initial amount			
2	Increment/maximum			
Etc.	Term			
<p><i>Note:</i> Regarding Average Principal Balance per Client, if possible, calculate monthly averages by summing the opening balance and end-month balances, then dividing by the number of months plus one. Or calculate quarterly or annual balances. If the income statement and balance sheet include an inflation adjustment according to generally accepted practice in the MFI's country, leave this section blank. The use of average balances here and in the accompanying spreadsheet is a simplified deviation from standard inflation accounting. If desired, opening balances can be used instead. In this case, a separate adjustment should be calculated if there has been a major change in the balance sheet during the year (such as a large grant), using the inflation accumulated between the time of the grant and the end of the year.</p>				

- ★ Does the MFI have a forced savings program?³¹ If so, what are its terms? Do clients have to save in order to receive loans? Under what circumstances can clients access their savings? Is the MFI's real reason for taking members' savings to cover defaults by other members of their lending groups? Does the MFI intermediate (use) the savings, or does it deposit them in a bank? If the MFI deposits the savings in a bank, do clients earn interest?

4.3 Other financial products

- ★ Does the MFI offer other financial products, such as checking, insurance,³² money transfers, remittances, or leasing?³³
 - ★ How useful are these products to the MFI and its clients?
 - ★ What is the institution's capacity to manage other financial products?
- Many MFIs are beginning to offer services, such as money transfers, remittances, and insurance, while fewer currently offer checking or leasing.
 - How do other financial products offered by the MFI contribute to client satisfaction and retention? Is each of the other financial products offered appropriate for the market, well designed, and well managed? Do each of these products add value to the institution? What are the key components of each of the financial products in terms of specific product management, branding, and pricing?
 - Has each product shown consistent growth in usage and revenues?

4.4 Nonfinancial products

- ★ What nonfinancial products—such as marketing services or financial management training—does the MFI offer?
 - ★ How do these contribute to the MFI's overall services and respond to client demand?
- Summarize all the MFI's nonfinancial products, indicating whether they are tied to financial products (for example, if business training is a loan condition). Note whether they are managed separately from financial products and whether the accounting system separates income and expenses for financial and nonfinancial products.
 - What is the measurable impact of nonfinancial products on clients and the MFI's profitability?

³¹ Forced (compulsory) savings are savings payments required by loan terms or for membership, usually in a credit union, cooperative, MFI, village bank, or savings group. Compulsory savings are often required in place of collateral. The amount and timing of these deposits, as well as the level of access to them, are determined by the institution, not the client. Compulsory savings policies vary: deposits may be required weekly or monthly, before the loan is disbursed, when the loan is disbursed, or whenever a loan installment is paid. Clients may be allowed to withdraw deposits at the end of the loan term, after a set number of weeks, months, or years, or when they end their memberships.

³² See Churchill et al. 2003.

³³ Checking and payment accounts are uncommon in many MFIs. For information on money transfers and MFIs, see Isern, Deshpande, and van Doorn 2005 and Isern, Donges, and Smith, 2006. For information on insurance, see Microinsurance Focus (sponsored by the CGAP Working Group on Microinsurance) at www.microfinancegateway.org/section/resourcecenters/microinsurance. For information on leasing, see www.itcltd.com/microleasing/ and "Leasing in Development: Lessons from Emerging Economies" (www.ifc.org). See also Westley 2003.

*Social Performance*³⁴

- ★ Does the MFI have clearly defined social goals—and a strategy for achieving them?

5.1 Intent and design

- ★ Does the MFI have systems that are aligned with its social goals?
- ★ To what extent has the MFI adapted its product designs, loan policies, and staff hiring, training, and incentives to ensure it reaches its target clients?

5.2 Depth and breadth of outreach

Note: Rather than compiling data for funders, this section is designed to gather information for MFIs to show how they are serving their clients and examine their social performance. (See Annex 3 in the Resource Manual.)

- ★ Is the MFI achieving its desired depth and breadth of outreach, or does it have credible plans to do so?
- Depending on available information, summarize the MFI's outreach in Table 5.1. Include historical data if readily available, and identify the poverty tool used. Use absolute poverty assessment tools, such as the Progress out of Poverty Index (PPI) or USAID Poverty Assessment Tool (PAT), if they are available.³⁵ If these tools are not available, a relative poverty tool can be used. The analyst should cite the tool used when presenting data.³⁶

Table 5.1 Outreach Summary

		Prior Year 1	Prior Year 2	% Change
1	Population of region(s) covered			
2	Market size (if available)			
<i>Breadth of Outreach</i>				
3	Total number of active clients			
	(end of period)			

³⁴ For further information, see Microfinance Gateway Social Performance Resource Center: http://www.microfinancegateway.org/resource_centers/socialperformance/.

³⁵ For a list of countries in which these tools are available, go to http://www.povertytools.org/USAID_Tools/USAID_Tools.htm and http://www.microfinance.com/#Poverty_Scoring. More information on poverty tools maybe found at http://www.microfinancegateway.org/resource_centers/socialperformance/.

³⁶ In the absence of credible data, M-CRIL uses a quick sample survey of recent clients for social rating purposes. For a list of relative poverty tools, go to http://www.microfinancegateway.org/resource_centers/socialperformance/targeting.

Table 5.1 Outreach Summary (continued)		Prior Year 1	Prior Year 2	% Change
4	Total number of loan clients			
5	Total number of savings clients (voluntary)			
6	Percentage of clients who are women			
7	Percentage of clients located in rural areas			
<i>Depth of Outreach*</i>				
8a**	Percentage of recent clients living below the national poverty line			
8b	Percentage of clients living on less than PPP adjusted US\$1 per day			
9	Average or median loan balance as % of national poverty line or GNI			
10	Average or median voluntary savings balance as % of national poverty line or GNI			
<p>* If relative poverty is being measured, specify the assessment tool being used.</p> <p>** The MFI should define what it means by the term <i>recent</i> clients. For example, M-CRIL rating agency defines <i>recent</i> as less than two completed years.</p>				

Provide any variations on the data in Table 5.1 that the MFI tracks, such as average first loan size. If the MFI targets a group other than women or rural clients, adapt Table 5.1 to reflect the institution's focus.

5.3 Changes in the social and economic lives of clients and their households

This section applies only if the MFI is explicitly trying to improve the social and economic lives of its clients.

★ **Have the social and economic lives of the MFI's clients improved since they became clients?**

- If needed, open-ended questions can be posed to clients (and savings and loan officers) about their perceptions of the MFI, such as what they like and do not like about its products.
- If further information is required, the analyst can consider incorporating additional market research, adding time to the appraisal to do so.

Loan Portfolio Quality ³⁷

- ★ Is the MFI effectively measuring, monitoring, and managing portfolio risk to maintain its viability?

Prepare an aging of the loan portfolio in Table 6.1, including a breakdown based on whether loans have been renegotiated.

Table 6.1 Loan Portfolio Report

		Currency:				
		Prior Year 1 (Amount)	Prior Year 2 (Amount)	% of Average Gross Loan Portfolio	Current, as of (Date) (Amount)	% of Average Gross Loan Portfolio
1	Number of overdue loans					
2	Loans at risk					
3	Loan loss amount					
4	Loan losses written off over the period amount					
5	Increase in impairment all- owance over the period					
6	Principal loan balance for loans that have never been renegotiated: Current					

³⁷ For more on how to test a loan portfolio, see Christen 2005 and MicroSave's *Loan Portfolio Audit Toolkit* (www.microsave.org/relateddownloads.asp?id=14&cat_id=313&title=Loan+Portfolio+Audit+Toolkit).

		Currency:				
Table 6.1 Loan Portfolio Report (Continued)		Prior Year 1 (Amount)	Prior Year 2 (Amount)	% of Average Gross Loan Portfolio	Current, as of (Date) (Amount)	% of Average Gross Loan Portfolio
	1–30 days overdue					
	31–90 days overdue					
	91–180 days overdue					
	181–365 days overdue					
	> 365 days overdue					
7	Principal Loan Balance for Renegotiated Loans					
	Current					
	1–30 days overdue					
	31–90 days overdue					
	91–180 days overdue					
	181–365 days overdue					
	> 365 days overdue					
8	Total gross loan portfolio					
<p><i>Note:</i> If the MFI does not have systems in place to calculate portfolio at risk, it can calculate loans at risk manually instead. In addition, the analyst can calculate the current recovery rate, even from a sample of loans. (See also Rosenberg 1999.)</p>						

- ★ What method does the MFI use to determine portfolio quality? Does this method hide risk?
- ★ What is the trend in portfolio quality? How is portfolio quality affected by seasonal factors?
- ★ Provide a two-year summary of the portfolio, including allowance for impairments (formerly called loan loss allowances), loan loss rates, and write-offs, noting trends in the combined story

of these variables. (This can possibly integrate findings from Table 4.3 and Table 6.1.) Is the MFI's loan loss provisioning policy adequate and in compliance with legal requirements?³⁸ Is the MFI's allowance for impairments adequate, given its historical portfolio quality and write-offs?

- ★ What is the write-off policy? Is it prudent, given the MFI's history and operations?
- ★ What is the MFI's policy and practice for restructuring loans?
- ★ What percentage of the portfolio of renegotiated loans is more than 30 days past due?³⁹
- ★ Does the MIS provide a clear idea of the MFI's PAR, by product, branch, or loan officer? If so, is risk concentrated in a certain product, branch, loan officer, or other identifiable area?
- ★ How easy is it to track loans from disbursement to final payment? Are in-kind, delinquent, and refinanced loans tracked separately in the MIS?
- ★ What do the MFI's board and management consider acceptable levels of delinquency?
- ★ Has the MFI experienced any delinquency crises in the past five years? (How does the MFI define crisis?) If so, what did it do about them, and with what result?
- ★ Is the MFI's collections policy sufficiently aggressive and effective?
- ★ What is the extent of loans to the MFI board and staff? Does the MFI board or staff receive preferential interest rates on loans or preferential treatment for loan disbursement or collection?
- ★ Has the MFI had any independent testing of its portfolio, such as special audit procedures arranged for that purpose?⁴⁰ If not, the analyst may want to consider evaluating the procedures auditors used to test the MFI's portfolio information, especially for delinquency and default. (The risk of inadequate control and reporting of portfolio quality is among the most significant in an appraisal.)
- ★ The analyst should conduct a spot check on 20–50 of the MFI's largest loans. (This can include detailed scrutiny of loan files, payment vouchers, and electronic data in the local accounting system as well as spot checks on a random sample of customers.)

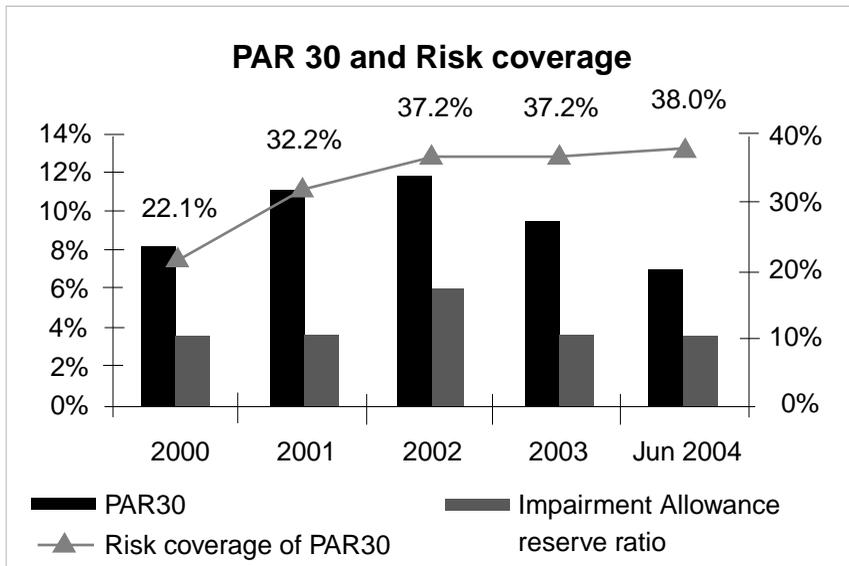
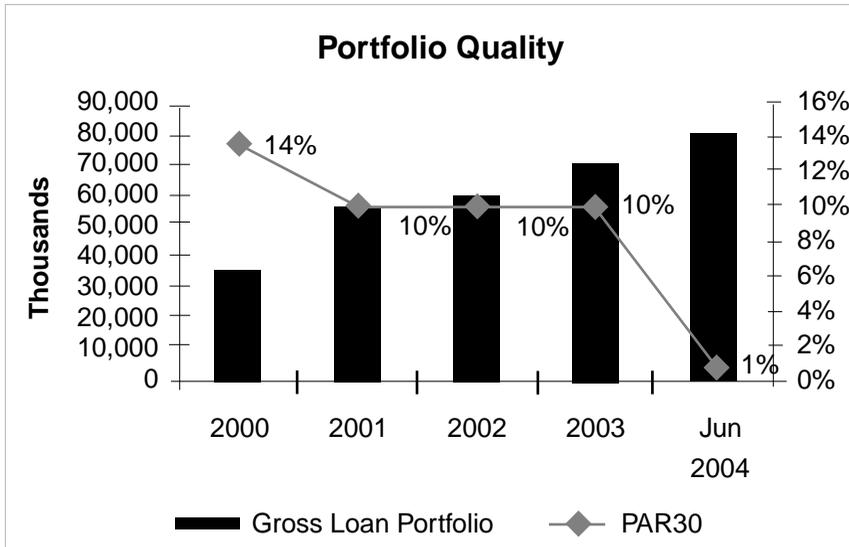
⚠ When reviewing trends in loan portfolio quality, the analyst should pay close attention to both absolute amounts of the past due portfolio and indicators of the past due portfolio relative to the total portfolio, because rapid growth in the portfolio can mask increases in delinquency and so dilute measures of portfolio at risk.

⚠ Does the MFI have a PAR30 of more than 10 percent, a write-off ratio of more than 5 percent, or a large number or percentage of renegotiated loans? If so, is management aware of such concerns—and taking realistic, sufficient steps to strengthen the portfolio?

³⁸ Legal requirements are often less stringent than needed for MFIs because they are based on collateral-based lending.

³⁹ If the MFI has significant overdue loans in the renegotiated loan portfolio, it may be on the verge of collapse and should be examined carefully.

⁴⁰ Normal audits and ratings seldom include procedures sufficient to provide reliable assurance that an MFI's portfolio quality reporting is accurate.



Financial Performance and Risk Management

- ★ Is the MFI efficient and profitable? If not, does it have a credible plan to become profitable in a reasonable timeframe? What is management's attitude toward profitability?
 - ★ Do the MFI's financial statements and performance reflect a sound financial institution, as shown by strong portfolio quality, profitability and sustainability, asset-liability management, and efficiency and productivity ratios—relative to other MFIs in the country and relevant international benchmarks?
 - ★ Does the MFI use sound financial risk management to protect against losses, attract capital, and instill confidence in the institution? Does the MFI adequately monitor, manage, and mitigate its main financial risks?
 - ★ Can the MFI manage the financial implications of its growth—for example, by attracting new funding, increasing savings, improving cash and liquidity management, and strengthening its portfolio?
-
- Financial performance is best evaluated in light of the institution's context and stage of development. Note where the MFI's key strategic moves may have adverse short-term financial consequences but positive long-term effects.
 - Before completing this section, the analyst may first want to input and adjust the MFI's income, balance sheet, and cash flow data in *appraise.xls*. Annex 5 in the Resource Manual describes each of the line items needed for the income statement, balance sheet, and cash flow statement. *Appraise.xls* then requires inputs to make analytical adjustments to the financial statements and calculate information that can be benchmarked against the MFI's peer group, as defined in the MBB (see www.mixmbb.org and Annex 8 in the Resource Manual). Annex 6 of the Resource Manual describes these adjustments. Table 7.6 summarizes the macroeconomic data inputs; Table 7.9 shows the analytical adjustments (found in the Resource Manual). The analyst should provide explanatory notes for all appropriate items—especially for adjustments derived using methods that differ from the instructions.

7.1 Financial statement analysis

★ Do the MFI's financial statements and performance reflect a sound financial institution?

Include the MFI's income statement and balance sheet in the final appraisal report. If a cash flow statement is available and/or required by the funder, it should be included in the appraisal.⁴¹

Table 7.1 Income Statement

		Currency:		
		Prior Year 1	Prior Year 2	Current, as of (date)
1	Financial revenue			
2	Financial revenue from loan portfolio			
3	Interest on loan portfolio			
4	Fees and commissions on loan portfolio			
5	Financial revenue from investments			
6	Other operating revenue			
7	Financial expense			
8	Financial expense on funding liabilities			
9	Interest and fee expense on deposits			
10	Interest and fee expense on borrowings			
11	Other financial expense			
12	Net financial income			
13	impairment loan			
14	Provision for loan impairment			
15	Value of loans recovered			
16	Operating expense			
17	Personnel expense			

⁴¹If needed, the cash flow statement can be created in Appraise.xls. It does not need to be created unless specifically requested by the funder. A growing number of funders require a current cash flow statement and one to two years of historical cash flow statements.

Currency:				
Table 7.1 Income statement (continued)		Prior Year 1	Prior Year 2	Current, as of (date)
18	Administrative expense			
19	Depreciation expense			
20	Other administrative expense			
21	Net operating income			
22	Net nonoperating income/(expense)			
23	Nonoperating revenue			
24	Nonoperating expense			
25	Net income (before taxes and donations)			
26	Taxes			
27	Net income (after taxes and before donations)			
28	Donations			
29	Donations for loan capital			
30	Donations for operating expense			
31	Net income (after taxes and donations)			

Table 7.2 Balance Sheet

Currency:				
		Prior Year 1	Prior Year 2	Current, as of (date)
Assets				
1	Cash and due from banks			
2	Trade investments			
3	Net loan portfolio			
4	Gross loan portfolio			

		Currency:		
Table 7.2 Balance Sheet (continued)		Prior Year 1	Prior Year 2	Current, as of (date)
Assets				
5	Allowance for impairment			
6	Interest receivable on loan portfolio			
7	Accounts receivable and other assets			
8	Other investments			
9	Net fixed assets			
10	Fixed assets			
11	Accumulated depreciation and amortization			
12	Total assets			
Liabilities				
13	Demand deposits: voluntary savings			
14	Demand deposits: forced savings			
15	Short-term time deposits			
16	Short-term borrowings			
17	Interest payable on funding liabilities			
18	Accounts payable and other short-term liabilities			
19	Long-term time deposits			
20	Long-term borrowings			
21	Other long-term liabilities			
22	Total liabilities			

Currency:				
Table 7.2 Balance Sheet (continued)		Prior Year 1	Prior Year 2	Current, as of (date)
Equity				
23	Paid-in capital			
24	Donated equity			
25	Prior years			
26	Current year			
27	Retained earnings			
28	Prior years			
29	Current year			
30	Reserves			
31	Other equity accounts			
32	Adjustments to equity			
33	Total equity			
<i>Note: Demand deposits are broken out between voluntary and forced savings (rows 13–14), which differs from the SEEP FRAME tool.</i>				

Table 7.3 Cash Flow Statement

Currency:				
		Prior Year 1	Prior Year 2	Current, as of (date)
Cash Flows from Operating Activities				
1	Cash received from interest, fees, and commissions on loan portfolio			
2	Cash received from interest on investments			
3	Cash received as other operating revenue			
4	Value of loans repaid			
5	(Cash paid for financial expenses on funding liabilities)			

Table 7.3 Cash Flow Statement (continued)		Currency:		
		Prior Year 1	Prior Year 2	Current, as of (date)
Cash Flows from Operating Activities				
6	(Cash paid for other financial expenses)			
7	(Cash paid for operating expenses)			
8	(Cash paid for taxes)			
9	(Value of loans disbursed)			
10	Net (purchase)/sale of trade investments			
11	Deposits/(withdrawals) from clients			
12	Cash received/(paid) for other operating assets and liabilities			
13	Net cash from operating activities			
Cash flows from investing activities				
14	Net (purchase)/sale of other investments			
15	Net (purchase)/sale of fixed assets			
16	Net cash from investing activities			
Cash flows from financing activities				
17	Net cash received /(repaid) for short- and long-term borrowings			
18	Issuance/(repurchase) of paid-in capital			

Currency:				
Table 7.3 Cash Flow Statement (continued)		Prior Year 1	Prior Year 2	Current, as of (date)
Cash Flows from financing activities				
19	(Dividends paid)			
20	Donated equity			
21	Net cash from financing activities			
22	Net cash received/(paid) for nonoperating activities			
23	Net change in cash and due from banks			
24	Cash and due from banks at the beginning of the period			
25	Exchange rate gains/(losses) on cash and cash equivalents			
26	Cash and due from banks at the end of period			

- ★ Analyze the main components of the financial statements, adapting the guidelines below as needed.⁴²

What are the MFI's key accounting policies? Does it use cash or accrual accounting? How does it account for interest on delinquent loans? Does it unduly capitalize expenditures, such as for group formation? Does it have a policy on accounting for foreign exchange gains (or losses)?

⁴² See section 3.8 External Audit for further questions regarding the MFI's audited financial statements.

*Income statement analysis**INCOME*

- ★ Evaluate income growth over the past two to three years.
- ★ Has income growth kept pace with portfolio growth?
- ★ Have there been any significant changes in the composition of income (interest versus fees)?
- ★ How have changes in product composition affected income?
- ★ How has asset allocation affected income?

EXPENSES

- ★ Have expenses grown faster or slower than income?
- ★ What are the largest components of expenses? How have these evolved?
- ★ What (if any) measures is the MFI taking to contain expenses?
- ★ How do the MFI's expense ratios compare with peer benchmarks?
- ★ Are there any unusual one-time expenses, such as large foreign exchange rates or inflation adjustment loss?

NET INCOME

- ★ How have profit margins evolved (net operating income as a share of total operating revenue)?
- ★ Have absolute profit levels increased proportionate to growth in portfolio, number of clients, or other drivers?

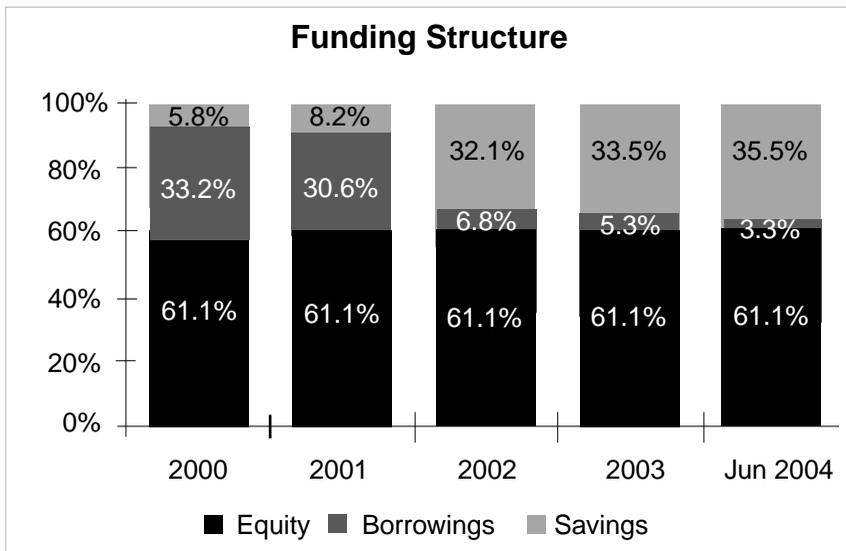
*Balance sheet analysis**ASSETS*

- Describe the MFI's main assets and calculate the loan portfolio as a percentage of total assets.
- To what extent does the MFI maximize asset returns through appropriate asset allocation?
- Have assets grown significantly over the past three years? Has portfolio growth kept pace? Does the MFI maintain sufficient liquid assets for its liquidity needs? If the MFI's assets are highly liquid, is there a prudent financial reason? Are any assets restricted, such as mandatory reserves placed in a central bank? Are there any significant issues with large fixed assets (such as if the MFI buys a building)?
- Are assets primarily funded by debt or equity?
- Are assets used productively, with a majority funding the portfolio?

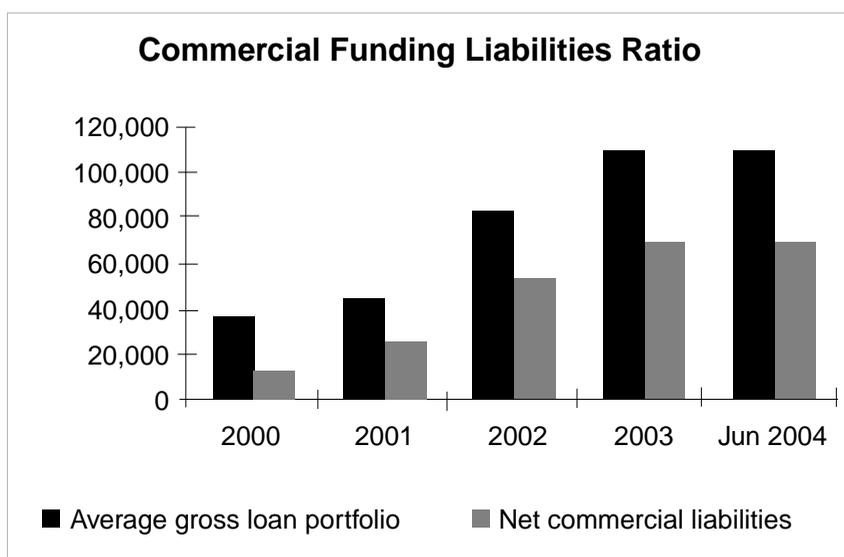
- How well does the MFI manage its funds?

LIABILITIES

- Are the MFI’s funding liabilities by source, product, and pricing competitive (in pricing and terms), given its age and size? How stable and assured are the MFI’s sources of funding liabilities now and in the short term?
- What percentage of the loan portfolio do voluntary savings fund? How has this affected the MFI’s cost of funds?
- What percentage of the portfolio do funding liabilities finance? Has the MFI accessed commercial funds? If so, what has been its experience? Describe the sources, terms, and track record (credit history, repayment experience, and so on).
- If known, what have been the historical trends in the MFI’s funding liabilities, in terms of commercial versus noncommercial, domestic versus international, and short term versus medium and long term?
- Are the MFI’s assets and liabilities in different currencies? If so, is there a significant mismatch? Does it expose the MFI to foreign exchange risk?
- Using data from Table 7.4, summarize trends in funding liabilities based on their type, range, and average tenor and cost. What is the MFI’s weighted average cost of funds?
- If the institution is a cooperative or credit union, does it classify member shares as liabilities or as equity?⁴³ What are the implications of how member shares are classified on its balance sheet?



⁴³ See IASB 32 *Financial Instruments: Disclosure and Presentation* and IFRIC Interpretation 2: *Member Shares in Co-operative Entities and Similar Instruments*. The World Council of Credit Unions advocates classifying member shares as liabilities because they can be withdrawn.



CONCENTRATION RISK

⚠ Are the MFI's assets, liabilities, or both are heavily concentrated in one or two financial institutions? How strong are those institutions? What are implications of their potential failure?

⚠ In the case of a deposit-taking MFI, are liabilities concentrated among a few individuals or nonfinancial institutions with large deposits? How would the MFI be affected by a run on deposits or sudden significant withdrawal of funds?

Table 7.4 Composition of Funding Liabilities

		As of (Date):
		Currency:
Liability 1		
1	Creditor (specify if domestic or international)	
2	Commercial or noncommercial liability (note method of calculation if needed)	
3	Tenor (Term)	
4	Original principal balance	
5	Balance outstanding	

Table 7.4 Composition of Funding Liabilities (continued)

6	Currency in which repayment is due	
7	Interest rate	
8	Amortization schedule	
9	Details of external guarantee backing the credit extended to the MFI, if any	
10	Other relevant information	
Liability 2 ...		
<i>Note:</i> The risk-free interest rate is the basis to determine whether liabilities are priced at commercial or noncommercial rates (and so track the degree of subsidy). This table excludes deposits, accounts payable, and other nonfunding obligations.		

Table 7.5 External Grants and Subsidies

As of (Date):			
Source, Date, Terms	Amount	Currency	Funding Status
Grants			
1			
2			
3			
Etc...			
Significant In-kind Subsidies			
1			
2			
3			
Etc...			
<i>Note:</i> Include in-kind subsidies and an estimate of their value.			

EQUITY

- ★ What are the MFI's main sources of equity?
- ★ How much of the MFI's equity is donated or subsidized, as opposed to derived from retained earnings? If a lot of its equity and funding is donated, does the MFI have a realistic plan for mobilizing commercial funds and/or raising net income to increase retained earnings?

- ★ Does the MFI have any current or anticipated funding shortfalls?
- ★ Do sources of equity capital (current or original investors, donors, or shareholders) exercise ownership of the MFI? Is the MFI appropriately leveraged?
- Analyze cumulative gains and losses from operations.
- For cooperatives or credit unions and, if relevant, for other share-capital companies, analyze the MFI's net capital⁴⁴ position. What are the trends in net capital over time? If it has declined, was it because of losses in loans, failure to provision, operating losses, or deposits growing faster than capital reserves? If there was a large drop in net capital, what shock caused the drop, and how is the institution rebuilding its net capital base? More broadly, what does current net capital reveal about the institution's history of retained earnings, business and social philosophy (based on extent of reinvested retained earnings), asset quality, provisioning, pricing, and cost management?

▲ Using data from Table 7.5, calculate the MFI's accumulated losses—including a break-out between grants plus subsidies and operating results—since its inception.⁴⁵

Cash flow statement analysis

Include this only if the MFI calculates a cash flow or the analyst feels that such analysis is needed.

- ★ Has the MFI had a positive cash flow for the past two years?
- ★ What are the significant trends in cash flow?

Asset–liability management

- ★ **Is the mix of the MFI's assets and liabilities appropriate for the scale and maturity of its operations?**
- ★ Is the MFI matching the rates and tenors of its assets and liabilities?
- ★ How leveraged is the MFI when compared to peers with similar legal structures?⁴⁶
- ★ How does the MFI's cost of funds affect its profitability?
- ★ Does the MFI have a credible strategy for lowering its cost of funds?

⁴⁴ Net capital in a credit union is defined as tier one capital less any losses.

⁴⁵ Refers to historical and current grants for equity and concessional liabilities. There are several accounting methods for booking donor grants to an MFI. The important point is that all grants for current and previous years should appear separately from retained earnings and other items in the equity section of the balance sheet. Material in-kind subsidies should be included as well.

⁴⁶ The MBB (www.mixmbb.org) can be used to benchmark the MFI's leverage against peer institutions.

- ★ Does the MFI have any significant asset–liability risks that should be further investigated? (For example, to what degree is it exposed to repricing risk on its deposits or other liabilities?)
- If the MFI is mature and has sophisticated systems, the analyst can review the effectiveness of the stated asset–liability management policies, the functioning of any risk management committee(s) the MFI convenes, and the abilities of staff or board involved in asset–liability management.
- Have there been any significant changes in asset and liability risk levels or risk tolerance?
- If the analyst has cause for concern that asset–liability mismatches—such as those driven by interest rates, the tenor of assets versus liabilities, concentration of savings deposits, or large foreign exchange risks—may cause significant damage to the MFI’s financial position, further analysis is available in Annex 7 of the Resource Manual. The typical MFI being appraised will not need this more in-depth analysis; it should be used only if there is a serious concern.

7.2 Analytical adjustments

Key financial rates are required to calculate the analytical adjustments to the MFI’s financial statements.⁴⁷ Shadow prices from a standard source, such as the International Monetary Fund (IMF),⁴⁸ are recommended to create a data set comparable with those in the MBB. Several different rates can be used as shadow prices, including the following:

- Inflation rate or GDP deflator
- Rate commercial banks charge conventional, medium-grade customers or, if the MFI already borrows commercial funds, the marginal rate charged to the MFI for any additional loan
- 90-day deposit rate (if using a deposit rate lower than the rate for 90-day certificates of deposit, an appropriate amount should be added to reflect the MFI’s likely cost of managing such deposits)
- Overdraft lending rate from the central bank⁴⁹

The selected shadow prices and exchange rates should be shown in Table 7.6.⁵⁰ In all cases, indicate what kind of rate has been selected and the source for determining it. Note the adjustment amounts for the past two years and current period, and use them to calculate the adjusted line items for the income statement and balance sheet in Table 7.9,

⁴⁷ More details on analytical adjustments are available in SEEP Network 2005, pp. 39–64.

⁴⁸ Regularly updated IMF statistics are available on a country-by-country basis at www.mixmarket.org/en/environment/environment.search.asp.

⁴⁹ The overdraft lending rate is the minimum interest rate at which banks can access funding.

⁵⁰ For interest rates, use annual percentage rates (APRs) when available. To calculate APRs starting with the effective rate for one period, annualize the rate by multiplying it by the number of periods in a year. Indicate when rates are not APRs. Average inflation and exchange rates over a period should be used to adjust flows (income statement items); end-of-period figures should be used to adjust stocks (balance sheet items).

Analytical Adjustments (found in the Resource Manual).⁵¹ These adjustments are used to calculate adjusted financial ratios.

These adjustments can be calculated easily using *appraise.xls*. The results will flow into Table 7.7, on performance ratios. If explanatory details are required, Table 7.9 on Analytical Adjustments (found in the Resource Manual), can be included as an annex to the appraisal report.

Table 7.6 Macroeconomic Data

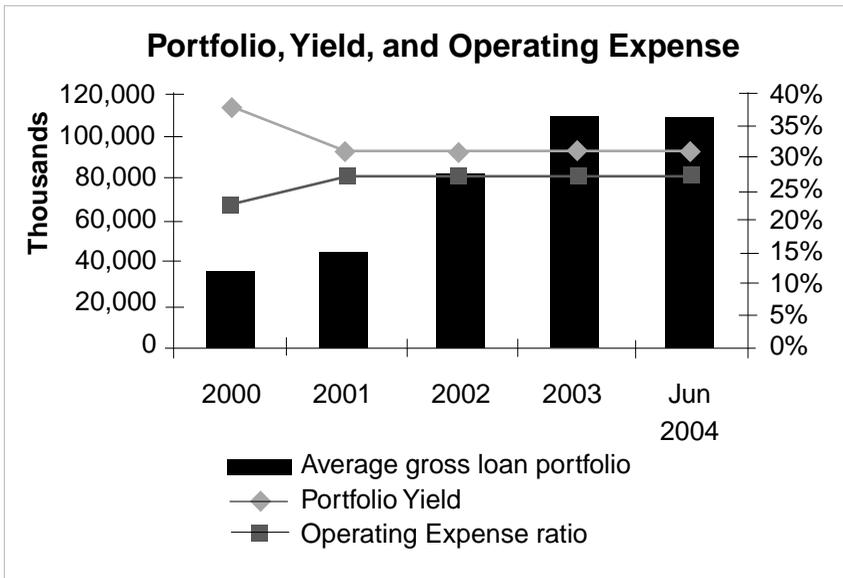
		Prior Year 1	Prior Year 2	Current, as of (date)
1	Inflation rate			
2	GDP deflator			
3	Market rate for borrowings (IMF statistics)			
4	90-day certificate of deposit rate			
5	Prime rate paid by commercial bank borrowers			
6	Marginal commercial rate available to the MFI			
7	Per capita GDP			
8	Per capita GNI			
9	Exchange rate (local currency/ other currency)			
10	National poverty line			
<i>Note:</i> Analyst should pick either GDP or GNI as basis for calculations, depending on which figure is more readily available.				

7.3 Financial performance ratios analysis

- ★ Does the MFI's financial performance reflect a sound financial institution as demonstrated by strong portfolio quality, profitability and sustainability, asset–liability management, and efficiency and productivity ratios, relative to other MFIs in the country and relevant international benchmarks?

Multiple indicators, when evaluated and together, tell a story about the MFI's performance. This Appraisal Guide (and its accompanying Resource Manual) examines 18 key financial ratios recommended by SEEP (R1–R18 in Table 7.7) that address four areas of financial performance: portfolio quality, profitability and sustainability, asset–liability

⁵¹ Analysts may use opening balances instead. In this case, a separate adjustment should be calculated if there has been a major change in the balance sheet during the year (for example, a large grant), using the accumulated inflation between the time of the grant and the end of the year.



management, and efficiency and productivity (SEEP Network 2005). Table 7.7 presents these ratios and other selected performance indicators. Analyze the MFI's financial performance over time, noting trends and possible explanations.

Benchmarking helps MFI management and board members understand their performance relative to other MFIs that are similar in terms of age, legal structure (NGO, nonbank financial institution, etc.), lending methodology (individual versus group lending), outreach (number of borrowers), region, and scale (size of loan portfolio). The indicators used in *appraise.xls* can be used to benchmark against MBB data. Details on MBB peer groups are provided in Annex 8 of the Resource Manual. Benchmark the most recent available full-year results for the MFI to appropriate peer institutions using the MBB benchmark definitions and data.⁵² If information is available and the analysis is useful, consider benchmarking the MFI's most mature branch to the appropriate MBB peer group.⁵³

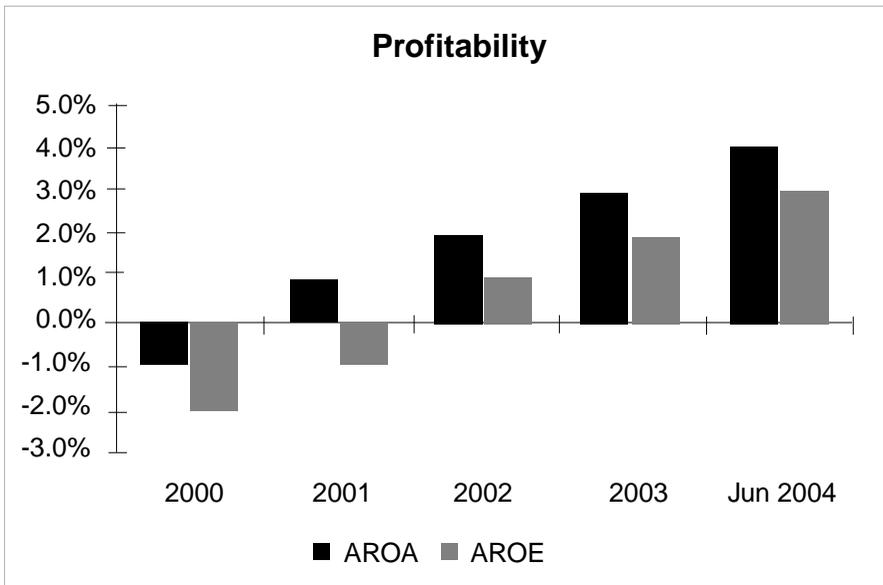
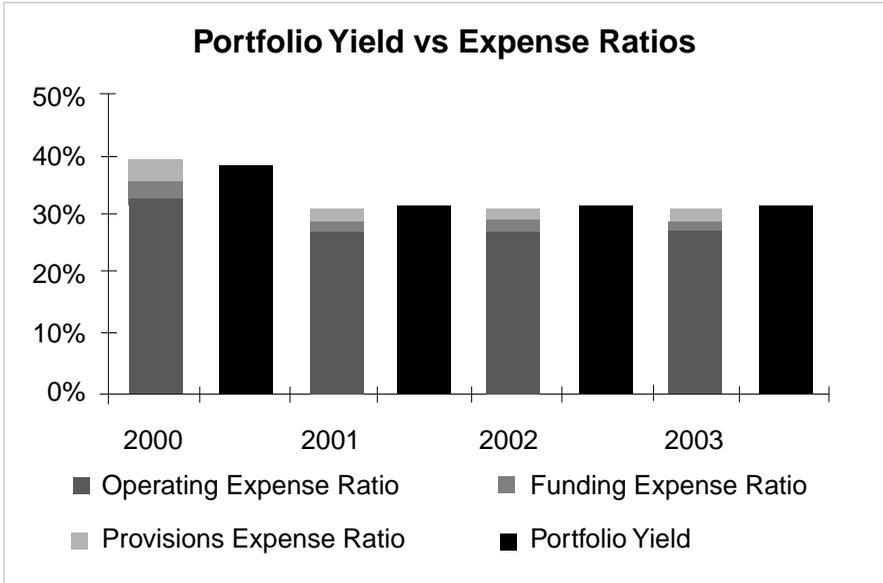
Credit union financial performance can be evaluated using *appraise.xls* and the PEARLS⁵⁴ or a similar rating system, and benchmarked against both MicroBanking Bulletin data and International Credit Union Safety and Soundness Principles⁵⁵ developed by the World Council of Credit Unions.

⁵² Details on MBB peer groups can be found in Annex 8 and at <http://www.mixmbb.org/Templates/Methodology.aspx>

⁵³ In a rapidly growing MFI, most clients, staff, and branches are new, so today's performance may not indicate the performance likely in the future as growth slows and clients, staff, and branches mature. Benchmarking against mature branches and institutional peers helps explain the MFI's performance and trends.

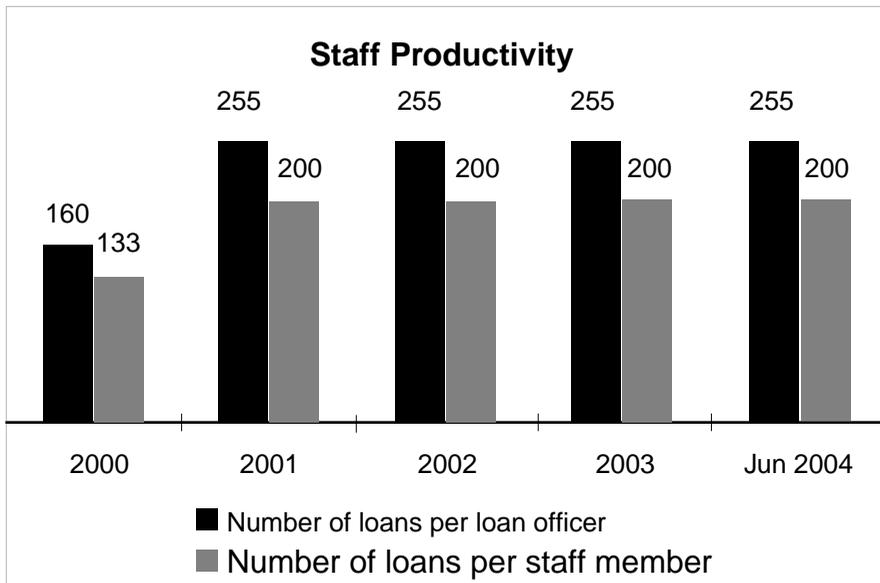
⁵⁴ Further information on PEARLS can be found at <http://live.woccu.org/dev/pearls/aboutpearls>

⁵⁵ http://woccu.org/functions/view_document.php?id=SafetyOperGovPrinciples



Profitability and sustainability

- ★ What are the MFI board and management’s attitudes toward profitability? Is it considered a desirable and attainable goal? A pipe dream? Or is it viewed with suspicion?
 - ★ Is management aware of the factors impeding profitability? If so, how is it addressing them (for example, by repricing products, managing expenses more stringently, lowering the cost of funds)?
- How do trends in portfolio quality, pricing, and efficiency affect the MFI’s profitability?
 - How do the MFI’s leverage and cost of funds affect its return on equity?
 - How does the MFI set interest rates?
 - Does the MFI have control over its product pricing, to assure profitability?
 - Do competitive pressures, usury limits, or other factors affect pricing?
 - Does the MFI rely on a single financial product to drive profitability?
 - How do trends in the distribution of the MFI’s assets, liabilities, and equity affect profitability?



Efficiency and productivity

- ★ **Is the MFI efficient and productive relative to peer institutions and good practices?**⁵⁶
- ★ What are the key drivers of trends in efficiency?
- ★ Is the MFI operating at optimal efficiency and productivity levels? To answer this question, compare its performance to similar MFIs using MBB data and evaluate management's plans to increase efficiency—including the measures and timeframe.

7.4 Risk management⁵⁷

This section is relevant only to large or mature MFIs. Further information on financial-risk management is available in section 7.4 and Annex 7 of the Resource Manual.

Table 7.7 Performance Ratios and Peer Group Benchmarking

		Prior Year 2	Current, as of (date)	MBB Peer Group [1]	Mature Branch
<i>Profitability & Sustainability</i>					
R1	Operational Self-sufficiency (OSS)				
R1	Financial Self-sufficiency (FSS)				
R2	Return on Assets (ROA)				
R2	Adjusted Return on Assets (AROA)				
R3	Return on Equity (ROE)				
R3	Adjusted Return on Equity (AROE)				
<i>Asset/Liability Management</i>					
R4	Yield on Gross Portfolio				
R5	Portfolio to Assets				
R6	Cost of Funds Ratio				
R6	Adjusted Cost of Funds				
R7	Debt to Equity				
R7	Adjusted Debt to Equity				
R8	Liquid Ratio				
<i>Portfolio Quality</i>					
R9	Portfolio-at-risk (PAR) Ratio 30				

⁵⁶ Benchmarks can be found at <http://www.mixmbb.org/Templates/BenchmarksTrendLines.aspx>. An explanation of the benchmarking process is found in Annex 8 of the Resource Manual.

⁵⁷ More information on risk management in microfinance can be found at www.microsave.org/relateddownloads.asp?id=14&cat_id=59&title=Institutional+and+Product+Risk+%20Management.

Table 7.7 Performance Ratios and Peer Group Benchmarking (continued)		Prior Year 2	Current, as of (date)	MBB Peer Group [1]	Mature Branch
R9	Adjusted PAR Ratio				
R10	Write-off Ratio				
R10	Adjusted Write-off Ratio				
R11	Risk Coverage Ratio				
R11	Adjusted Risk Coverage Ratio				
<i>Efficiency & Productivity</i>					
R12	Operating Expense Ratio				
R12	Adjusted Operating Expense Ratio				
R13	Cost per Active Client				
R13	Adjusted Cost per Active Client				
R14	Borrowers per Loan Officer				
R15	Active Clients Per Staff Member				
R16	Client Turnover				
R17	Average Outstanding Loan Size				
R17	Adjusted Average Outstanding Loan Size				
R18	Average Loan Disbursed				
<i>Note:</i> appraise.xls includes additional performance indicators that may be useful for deeper analysis.					

- ★ Does the MFI understand the concept of risk management?
- ★ Is the MFI adequately measuring, monitoring, and managing its financial and operational risks?
 - Evaluate any financial risk management policies and practices. If the MFI is not familiar with financial risk management, discuss any training and steps being taken to better understand and address this topic.
 - Does the MFI perform scenario or sensitivity analyses? If so, discuss the findings and how this information has been used.
 - How complex is the MFI's balance sheet? Do the tenors of its liabilities and portfolio require active financial management? Mature MFIs usually form an asset-liability committee that meets regularly (weekly, monthly, or less desirably, quarterly).

7.5 Liquidity risk management⁵⁸

- ★ **Does the MFI adequately monitor and manage its liquidity?**
- ★ Has the MFI set guidelines for how many months of operating cash it wants to maintain? If so, is it a realistic goal? Is it being achieved?
- ★ What liquidity management measures does the MFI have in place?
- ★ What plans does the MFI have to address liquidity shocks? How efficient are these plans?
- ★ Does the MFI have cash flow projections? If so, have earlier projections been close to actual results?
- ★ Does the MFI adequately match assets and liabilities to reduce liquidity risk?
- ★ Does the MFI have an overdraft line of credit with a local bank? If the MFI takes deposits, does it adequately balance savings and liquidity requirements?
- ★ Does MFI management actively monitor liquidity management? If so, note accountability, liquidity trends, ratios used, etc.
- ▲ Has the MFI experienced any liquidity crises? If so, how were they handled? Did they affect loan disbursement or repayment of loans to the MFI or its ability to honor savings withdrawal requests from clients?

7.6 Interest rate analysis

- ★ **Given the local market, has the MFI set appropriate interest rates that will allow it to be profitable?**
- ★ How big is the gap between the weighted theoretical interest yield and the actual yield on portfolio? If it is more than 10 percent, explain possible reasons.
- How does the MFI establish and update loan (and deposit) interest rates?
- Are the MFI's interest rates appropriate and responsive both to its financial requirements and to external factors, such as inflation?
- Do external factors affecting interest rates—such as price competition and legal constraints—limit the interest rates the MFI can charge on loans?

⁵⁸ For more information on liquidity and cash management policies, see Women's World Banking 2005.

Table 7.8 Comparison of Actual and Theoretical Yield

		Prior Year 1	Prior Year 2	Current as of (date)
Loan Product 1				
1	Theoretical interest yield (APR)			
2	Monthly average of outstanding balance on this loan product for the year (opening balance plus 12 month-end balance divided by 13).			
3	Line 1 times line 2			
Loan Product 2				
1	Theoretical interest yield (APR)			
2	Monthly average of outstanding balance on this loan product for the year (opening balance plus 12 month-end balance divided by 13).			
3	Line 1 times line 2			
Loan Product 3 ...				
4	Weighted theoretical interest yield (sum of line 3 for all loan products)			
5	Actual yield on portfolio			
6	Yield gap ratio (line 5 as a percentage of line 4)			

Business Planning

- ★ Does the MFI have a credible three- to five-year business plan and realistic financial projections to achieve or maintain profitability given its current institutional capacity?

- ★ How have the MFI's vision and mission changed over time?
- ★ Where does the MFI want to strategically position itself in the local market?
- ★ Does the MFI's business planning process support its direction and goals?
- ★ If the MFI is not yet profitable, describe its plan and timeframe for becoming profitable and assess the plan's credibility. Identify any potential threats to achieving the plan, including institutional risks (such as changes in target clients, limits in institutional capacity, labor disputes, and continued donor dependency) and external risks (such as regulatory, competitive, demographic, macroeconomic, political, etc.).

- Does the MFI use short-term planning tools, such as budgeting and variance analysis?
- Does its management or board check variance analyses regularly during the year? If so, what are the findings? How is the information used?
- Does the MFI conduct a strategic or business planning process? If so, describe it: What and whom does it involve? Do staff members have an opportunity to provide input? Do the method and results appear sound? If the MFI has plans for any proactive or reactive shifts in strategy, comment on their feasibility.

8.1 Financial projections

- ★ Has the MFI developed realistic financial projections?

- How does the MFI create its projections? What planning software, if any, does it use?
- Are the underlying assumptions and growth expectations plausible given the MFI's local environment and past performance (including costs, productivity, loan demand, and growth trajectory of mature branches and loan officers), as well as industry benchmarks (such as those produced by the MBB) for similar MFIs?

- Include two years of projections for the indicators in Table 8.1, if available. Are the projections technically coherent? If the MFI does not have projections for the indicators in the table, provide any prospective financial planning data it has available.

Do not prepare financial projections for the MFI. Such projections should be prepared by the MFI, in a process that usually takes several months. Business plans prepared by consultants in response to external requirements, with input from the client organization, typically are not useful.

Table 8.1 Projected Performance

		Currency:	
		Projected Year 1	Projected Year 2
1	Total number of clients		
2	Total gross loan portfolio		
3	Number of active loans		
4	Total balance of voluntary savings accounts		
5	Number of voluntary savings clients		
6	Number of staff		
7	Number of branch offices		
8	Return on assets (ROA)		
9	Return on equity (ROE)		
<i>Note: Use clients rather than accounts whenever possible. Add projections for other financial products as relevant.</i>			

8.2 Funding strategy

★ Does the MFI have a well-designed strategy to finance its anticipated growth?

- Is the MFI's funding plan credible given current funding relationships, amounts, and interest rates?
- Is funding the MFI's primary constraint to growth? Or are there more significant factors (such as institutional capacity or local competition)?
- Evaluate trends in the MFI's cost of funds and sources of liabilities and equity relative to its projections for future growth. How does the MFI plan to diversify funding risk?

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