

*Forum Series on the Role of Institutions in Promoting Economic Growth*

ALTERNATIVE MEASURES OF THE EFFECTIVENESS OF MICRO FINANCE  
ORGANIZATIONS

**A Field Guide for USAID  
Prepared by the  
Mercatus Center at George Mason University**

**Forum 8**

*New Institutional Economics and Development: Case Studies and Applications*

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*Forum Series on the Role of Institutions in Promoting Economic Growth*  
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## **About the Series**

The objectives of the Forum Series are to help USAID make its donor assistance more effective and sustainable by incorporating insights from the New Institutional Economics into USAID's programming and delivery of development assistance. Services for Forums 6,7, and 8 are provided by the Mercatus Center at George Mason University and its consultants and the Center for Institutional Reform and the Informal Sector (IRIS). Editor for Forums 6, 7, and 8 is Peter Boettke, the project director for this portion of the Series with support from the overall project director, Clifford Zinnes, and the Forums Steering Committee (Ed Connerley, Jim Elliott, Jonathan Sleeper, and Mark Gellerson), chaired by the activity's COTR, Fred Witthans. Funding for the Series is provided by USAID's Bureau for Economic Growth, Agriculture, and Trade, Office of Economic Growth through SEGIR/LIR contract PCE-00-97-00042-00, Task Order 07. Copyright 2003 by the Mercatus Center.

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*New Institutional Economics and Development:  
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**Introduction**

The current microfinance industry measurement standards rely on three benchmarks for assessing the effectiveness of microfinance organizations. While the limits of these benchmarks are acknowledged in the micro finance literature, there has been no consensus regarding alternative approaches. They are generally accepted in practice both by donors to, and operators of, microfinance organizations. They are:

1. Repayment Rate
2. Outreach
3. Loan Portfolio

The following tool offers an improved set of measures to more effectively assess the effectiveness of these organizations. It should be applied before decisions regarding intervention in the micro finance sector are undertaken. Without meaningful information about the effectiveness of current organizations it will be impossible to determine where, if at all, intervention would be useful.

Encouraging the use of meaningful measures will also have implications for the behavior of micro finance organizations. The current standards arrange incentives such that micro finance organizations direct their behavior to satisfy the goals set out therein. By improving the standards by which micro finance organizations are evaluated, one would expect to improve the behavior and therefore the effectiveness of micro finance organizations as they adjust to meet these new goals.

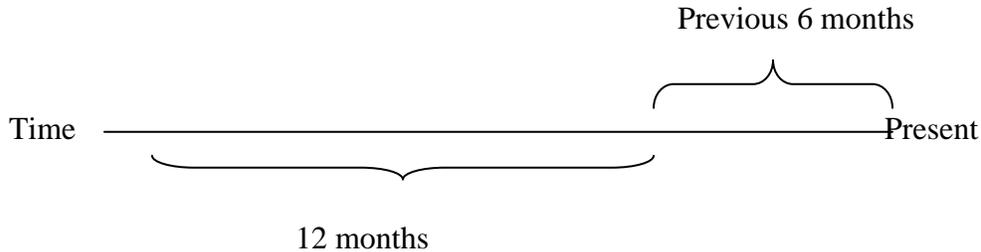
<p style="text-align: center;"><b>Current Measure</b></p> <p style="text-align: center;"><b>REPAYMENT RATE</b></p>	<p style="text-align: center;"><b>Alternative</b></p> <p style="text-align: center;"><b>REAL RECEIPTS</b></p>
<p><b>Explanation:</b> The current standard involves reporting the repayment rate of ‘current loans’. When a client defaults their loan is in practice invariably taken off the books so that, in effect, the loan no longer counts against the MFI’s repayment rate for the purpose of reporting.</p> <p><b>Criticism:</b> While the practice of removing inactive or unpaid loans from the books is a necessary process for an organization, the health of the MFIs capital base cannot sufficiently be understood with reference to a repayment rate unless these unpaid loans are considered therein.</p>	<p><b>Explanation:</b> Measure the real receipts of the organization: payments received versus loans paid out. (See Note A for a detailed procedure.)</p> <p><b>Benefits:</b> This standard provides a ‘real’ repayment rate over time. That is payment received compared to loan amount paid out. It will also be much more useful in comparing the performance of different organizations, having removed the ambiguity caused by the variance of accounting practices across microfinance organizations.</p>
<p style="text-align: center;"><b>OUTREACH</b></p>	<p style="text-align: center;"><b>CLIENT LONGEVITY</b></p>
<p><b>Explanation:</b> Outreach represents the number of active participants in a given program and is reported as a single figure.</p> <p><b>Criticism:</b> While useful in an aggregative sense, this fails to provide any information regarding the variance in turnover within the client base.</p> <p>This is important in the following sense: Consider one organization that gains 110 new clients in a month, while at the same time 100 clients drop out. Another organization of roughly the same size has 40 new clients join while losing only 30. The outreach figure for both organizations will have changed by the same amount (10). Both organizations however have achieved this growth in importantly different ways and their success will depend on the goal of their operation (retention of clients, or maximal distribution of minimal loans).</p>	<p><b>Explanation:</b> Report lost clients as a percentage of total clients and conduct exit interviews. (See Note B for a detailed procedure.)</p> <p><b>Benefit:</b> The aggregate outreach number and the number of new clients should still be captured and reported. These two figures combined will allow a much more detailed analysis of the activity and success or failure of an organization with respect to different goals.</p> <p>The exit interviews, while missing much of the subtlety of the conditions that may have caused a client to leave, provide a deeper understanding of the success of the organization – whether they are having a sustained impact on the individuals with which they work.</p>

LOAN PORTFOLIO	GRADUATION SCHEDULE
<p><b>Explanation:</b> The total amount of active loans is reported with the usual implicit economic assumption; more is preferred to less.</p> <p><b>Criticism:</b> The aggregate number tells us nothing about the activity within the loan portfolio and this can make a difference concerning whether an organization is actually meeting its goals, or simply posting impressive numbers. For instance, an organization that grew every period but had no clients graduating to larger loan amounts is not really contributing to the growth of businesses in the way that an organization that retains clients that are consistently borrowing and repaying increasingly larger amounts.</p> <p>The aggregation of these figures has created a false sense of security in that, while the loan portfolio has been growing, it cannot be said with any confidence that this is because any significant number of clients are staying in the program and are therefore able to access amount of capital that will grow their business.</p>	<p><b>Explanation:</b> A graduation schedule that tracks: (1) the number of clients receiving different size loans (2) how many of those clients are first time vs. repeat recipients, and (3) the number of loans at each level as a total percentage of the overall portfolio. (See Note C for a detailed procedure.)</p> <p><b>Benefit:</b> If an organization's loan portfolio is growing as an aggregate, this analysis shows from where the growth is coming. Is the growth the consequence of many new clients entering the system or is it a combination of moderate growth and many clients progressing to the higher loan amounts. This level of detail allows an organization to be judged against significantly more specific goals and provides information about the impact the organization is having on the growth of business.</p>

### Note A: Real Receipts

The *Real Receipts* standard requires one to measure the received versus loans paid out. This can be accomplished in the following way:

The term of most microfinance loans do not exceed six months. As such it is possible to look at real repayment rates through collecting data on recent, but completed loan cycles in order to capture the actual repayment rate in terms of cash flow within the organization.



By looking at the total amount an organization has lent in the last complete 12 month period, which can be obtained by examining records going back 18 months, and comparing this to the actual amounts repaid (taking into account the interest rate charged), it is possible to determine the actual repayment rate while avoiding the problem of missed defaults that have been taken off the books. Having taken into account the interest, the difference between loans paid out and money taken in should be zero. Negative deviation from zero represents default amounts.

In order to get a sense of whether or not an organization is improving or deteriorating by this standard over time, one might repeat the process described above to compare the 12 month performance with the 24 month performance.

### Note B: Client Longevity

The *Client Longevity* standard requires that lost clients as a percentage of the total number of clients should be reported. This information should be gathered, as with real receipts, for completed loan periods and the method employed in Note A will also be useful here. As noted in the table, the aggregate figures do contain some information with respect to magnitude of the operation and should also be recorded.

Exit interviews will shed light on why clients have left the program. While an interview cannot be done with every exiting or past client, even a small sample will provide more information than is currently captured. (Ultimately, this information is useful to the microfinance organization and one way to ensure this information is captured is to request that the loan officers begin to keep these records as well. Some organizations already conduct exit interviews, however this is not a systematic effort.)

After locating a number of previous clients using the microfinance organization's records, the clients should be asked why they left the program. A simple report of percentage of exiting clients leaving as a result of default vs. percentage of clients leaving in good standing will be extremely helpful in determining the impact of an organization, at least with respect to its client base.

**Note C: Graduation Schedule**

The *Graduation Schedule* tracks: (1) the number of clients receiving different-sized loans (2) how many of those clients are first time vs. repeat recipients, and (3) the number of loans at each level as a total percentage of the overall portfolio.

Create a table with loan amounts (grouped according to the levels by which an organization categorizes them, or into logical groups according to amount) as shown below in the case of a micro finance organization in the Philippines. Collect the requisite information: number of clients and number of those that are first time clients. Calculate the number of loans at each level as a percentage of the overall amount loaned by the organization.

Current Loan Amount	Number of clients (Total)	First time clients	Total loans (% of total)
< 10,000 Php			
10,000 – 25,000 Php			
25,000- 40,000 Php			
> 40,000 Php			

This information, in conjunction with the client longevity measure, provides an insight into the long term impact the microfinance organization is having at an individual level.

**Summation**

The problems with the standard measures were identified through field work alongside USAID mission in the Philippines. The solutions, to a large extent, were derived from standard accounting practices, but have been greatly simplified so they may be applied by non-accountants and specifically USAID field mission representatives tasked with making a recommendation regarding intervention in the micro finance sector.

This simple set of measures should greatly improve the assessment phase of such an assignment. While it may not always be appropriate to apply all generally accepted accounting practices to micro finance organizations, the above represent some standard tools of accounting that, once applied, provide much needed information about the health of a micro finance organization in order to make judgments about interventions that touch the sector.