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e-MFP Action Group of Investors in Tier 2/3 MFIs Working towards a common consensus on the definition of Tiers in microfinance

Introduction

The microfinance sector has evolved considerably over the last years. In some areas though, the sector still lacks clarity of key concepts and definitions.

One of the important indicators in the microfinance sector is the so called “tier” a microfinance institution (“MFI”) belongs to. People within the industry commonly refer to tier 1, tier 2, tier 3 and sometimes even tier 4 MFI to describe which kind of microfinance institution they are talking about.

The first position paper of the European Microfinance Platform (“e-MFP”) Action Group of Investors in Tier 2 / 3 MFIs (the “Action Group”) highlighted that there is no consensus of what these tiers actually mean¹. Different organizations use a range of internal and external definitions when they talk about a tier 1, tier 2, tier 3 or tier 4 microfinance institution².

The current situation makes it difficult particularly for people outside the industry, to analyze the role and positioning of different microfinance institutions, donors, NGOs, technical assistance providers and investors.

This proposal is the result of the work of the Action Group to reach a common consensus on the definition of tiers. Numerous stakeholders outside the membership of the group have commented and provided inputs. The Action Group has also benefited extensively from work carried out by MicroRate³.

What do we want to define?

Considering only size is not enough to capture what we mean when we talk about tiers. What the tier really refers to is the relative maturity of a microfinance institution. This has been a key consideration in the elaboration of the proposed definition.

One of the difficulties in reaching a common consensus is getting the balance between qualitative factors which characterize mature microfinance institutions (governance, for example) and the need to find a simple, universally applicable definition based on indicators which can be easily measured and reported.

The tier definition outlined below is meant to bring transparency to the sector. The definition does not automatically imply that a tier 1 is a better microfinance institution compared to a tier 2 or tier 3 MFI. In order to advance financial inclusion, we will need many tier 3 MFIs developing into tier 2 and eventually becoming tier 1 institutions.

How many tiers?

How many tiers do we need? Is the diversity of microfinance institutions not best reflected in 4 or even 5 tiers? The proposed definition consists of a three-tiered system, giving preference to simplicity and aligning the definition to classifications used in other sectors and industries.

A definition around three dimensions

The definition of tiers has three dimensions: size, sustainability and transparency. All three dimensions are equally important. A MFI’s tier is determined by the lowest level of compliance with the criteria. For example if an institution qualifies as tier 1 MFI in terms of size and transparency, but only as tier 2 MFI in terms of sustainability, it is considered a tier 2 institution.

Size

Size is the easiest differentiator among different MFIs. Any MFI should normally evolve and become more sophisticated as it grows to serve an increasing number of clients and exceeds certain thresholds in terms of loan portfolio or total assets.

The indicator retained is total balance sheet size in USD since it relates closely to the number of clients and portfolio size.

Sustainability

Sustainability measures the strength of the institution to weather external and internal crisis. The criteria retained here is positive or improving return on assets. A positive Return on Assets (RoA) ensures the sustainability of a microfinance institution and is normally the result of a whole range of qualitative factors, independent of the legal form of an MFI.

¹ e-MFP Action Group of Investors in Tier 2/3 MFIs: Position Paper on supporting smaller MFIs to advance financial inclusion, July 2012, www.e-mfp.eu

² One of the more widely accepted definitions can be found in Meehan, J: Tapping Financial Markets for Microfinance, Grameen Foundation USA, February 2005, www.grameenfoundation.org

³ MicroRate has worked on a tier definition in the context of the Luminis service to analyse microfinance investment vehicles, www.luminismicrofinance.com

Transparency

A more mature microfinance institution is subject to increasing scrutiny from all kinds of stakeholders including clients, regulators, creditors, shareholders or other owners and the general public. The transparency factor should reflect

how the MFI has reacted to the demand for transparency and information from stakeholders.

The indicator chosen here is the regulation, or in the cases where no adequate regulation exists, the rating of an MFI and externally audited financial statements.

The proposed definition

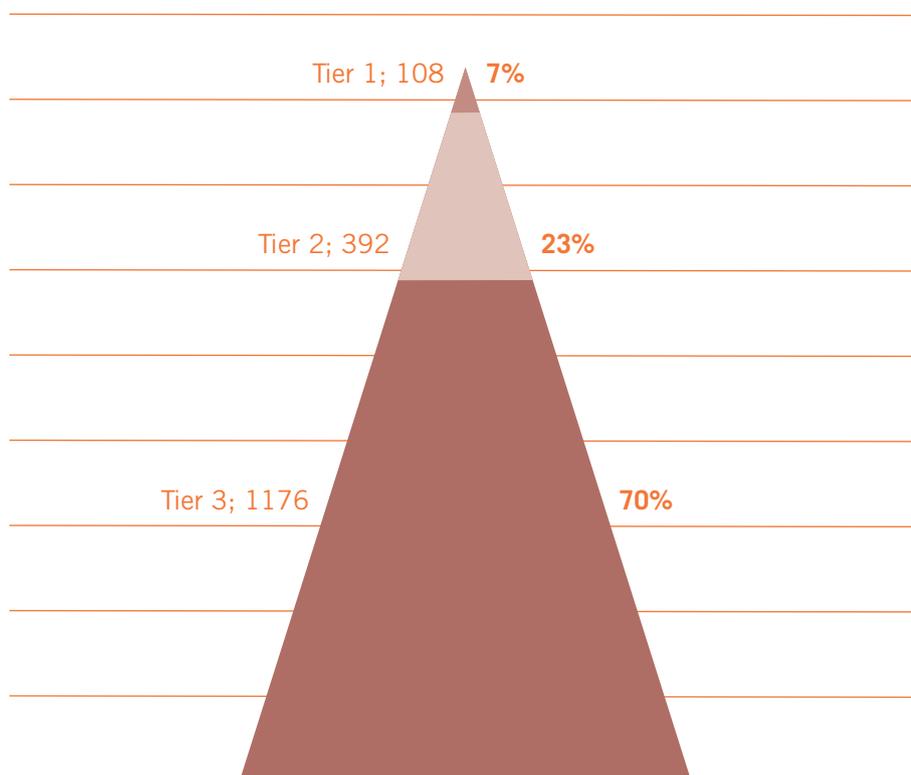
To be considered in the respective tier, a microfinance institution has to meet all of the following criteria:

	Tier 1	Tier 2	Tier 3
Size	> USD 50 million in assets	USD 5 – USD 50 million in assets	No requirement
Sustainability	RoA > 0 during 2 out of 3 last years AND all RoA > -5%	Positive RoA in 1 out of last three years and other >-5% OR positive trend in RoA and all >-5%	No requirement
Transparency	Regulated financial institution OR rated financial institution	Audited financial statements for at least 3 years	No requirement

The sustainability and transparency criteria require three year historical data on a rolling basis. In case a tier 1 MFI fails to meet all three criteria in any given year, it is a tier 2 or tier 3 MFI depending whether it complies with the tier 2 criteria.

Tiers 1, 2 and 3 MFIs end of 2011

Applying the definition criteria described above, the microfinance sector end of 2011⁴ consists of 7% Tier 1, 23% Tier 2 and 70% Tier 3 MFIs.



Source: MixMarket

⁴ Data from the MixMarket as at 31 December 2011, www.mixmarket.org, comprising 1676 MFIs.



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