Sa-Dhan
The Association of
Community Development
Finance Institutions

Side-by-Side

A Slice of Micro Finance Programs

2006

IN INDIA

July 2006

Published by :

Sa-Dhan Microfinance Resource Centre

12 & 13, 2nd Floor, MPTCD Building, Special Institutional Area
Shaheed Jeet Singh Marg, New Delhi – 110067
E-mail : info@sa-dhan.org
Website: www.sa-dhan.org

Printed in India by :
Sahara Renewal

Typeset & Design
Digitatemedia

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TABLES

GLOSSARY OF TERMS

Active Clients	Clients regularly availing service(s) provided by MFI
ADB	Asian Development Bank
APMAS	Andhra Pradesh Mahila Abhiruddhi Samity
Avg.	Average
CDFI	Community Development Financial Institution
Co-Op	Co-operative Society
CordAid	Catholic Organization for Relief and Development AID
CRISIL	Credit Rating Information Services of India Limited
CRR	Current Repayment Rate
DFID	Department for International Development
EDP	Entrepreneurship Development Program
FCRA	Foreign Contribution and Regulation Act
FPS	Financial Performance Standards
FWWB	Friends of World Women Banking
FY	Financial Year
GB	Grameen Bank (refers to one of the microfinance operating methodologies)
GLP	Gross Loan Portfolio
HIVOS	Humanist Institute for Cooperation with Developing Countries
JLG	Joint Liability Group
I	Individual (refers to a microfinance operating methodology)
ICAI	The Institute of Chartered Accountants of India
INR/Rs	Indian Rupees
LAB	Local Area Bank
MF	Microfinance
MFI	Microfinance Institution (In the report MFI refers to both MFIs as well as NGOs involved in MF)

NBFC	Non Banking Finance Company
OCR	Operating Cost Ratio
OSS	Operating Self Sufficiency
PAR	Portfolio at Risk
RGVN	Rashtriya Gramin Vikas Nidhi
RMK	Rashtriya Mahila Kosh
Sec.25 Comp.	Companies registered as 'not-for-profit' under Section 25 of Indian Companies Act
S. No.	Serial Number
SDC	Swiss Agency for Development & Co-operation
SHG	Self- Help Group
SIDBI	Small Industries Development Bank of India
TCR	Total Cost Ratio
USD	United States Dollars
W/w	Within which

Unless specifically mentioned otherwise, the years 2003, 2004 and 2005 refer to respective financial years (April to March of next calendar year). Therefore, FY 2003 denotes 2002-2003, FY 2004 denotes 2003-04 and FY 2005 denotes 2004-05.

Indian Rupees is counted in LAKH and CRORE. Lakh stands for tenth of a million; Crore is equal to ten million Indian Rupees.

Rupee to USD conversion rate is taken at Rs.45.

CLASSIFICATION OF MFIS

MFIs have been classified into specific categories for analysis. The classifications are made on three parameters viz. (1) Gross Loan Portfolio; (2) Client Outreach and (3) Age of the MFI in terms of their years of experience in providing microfinance services. The classifications are made solely for the purpose of this report.

The categories, used in this report are as under.

GLP	Large	MFIs with GLP of over Rs.20.00 crores (4.44 m USD) as on March 31, 2005
	Medium	MFIs with GLP between Rs.5.00 crores and Rs.20.00 crores (1.11 m to 4.44 USD) as on March 31, 2005
	Small	MFIs with GLP of less than Rs.5.00 crores (1.11 m USD) as on March 31, 2005
Client Outreach	Large	MFIs with client outreach of over 50,000 as on March 31, 2005
	Medium	MFIs with client outreach between 10,000 and 50,000 as on March 31, 2005
	Small	MFIs with client outreach of less than 10,000 as on March 31, 2005
Age	Organisational experience in microfinance	MFIs with experience of 1 to 5 years (Calendar Year 2000 and later)
		MFIs with experience of 5 years to 10 years (Calendar Year 1994 to 1999) MFIs with experience of above 10 years (Calendar Year 1993 or earlier)

Set of Financial Performance Standards[1] Recommended by Sa-Dhan

S.No.	Indicator	Benchmark	Formula
1. SUSTAINABILITY PERFORMANCE STANDARDS			
1	Operational Self-Sufficiency	At least 100%	Operating Income [2]
			Operating Costs + Loan Loss Provisions + Financing Costs
2. ASSET QUALITY PERFORMANCE STANDARD			
2	Portfolio at Risk > 60 Days Past Due	Less than 10%	Unpaid Principal Balance of Past Due Loans (with Overdue > 60 days of age)
		`	Total Gross Outstanding Portfolio
3	Current Repayment Rate	Greater than 90%	Total Amount (Principal) Collected for the Period – Prepayments
			Total Amount (Principal) Due (to be collected during period)
3. EFFICIENCY PERFORMANCE STANDARDS			
4	Operating Cost Ratio [3]	Less than 20%	Total Operating Costs Average Outstanding Portfolio
5	Total Cost Ratio	Less than 30%	Total Costs [4] Average Outstanding Portfolio
6	Active Borrowers Per Credit Officers [5]	Between 250-350	Average Number of Active Borrowers
			Average Number of Credit Officers

[1] The Sa-Dhan Sub-Group on Standards finalized the indicators proposed here.

[2] Operating Income is income from Loans and Investments

[3] Sometimes called as Administrative Efficiency Ratio

[4] Total Costs = Operational Costs + Loan Loss Provision + Cost of Funds

[5] Sometimes, also called as client to staff ratio with staff being loan officers/ Field officer primarily

FOREWORD

In continuing with our endeavor to compile and present performance and progress of microfinance institutions in form of a report, the 'Side-by-Side A Slice of Microfinance Programs in India 2005' report is now before us.

The report is contributed by 83 MFIs, a quantum leap from 53 MFIs in the previous report (Side-by-Side A Slice of Microfinance Programs in India: 2004). It is encouraging to us that MFIs are sharing their financial and non-financial data with incremental depth. The report is enriched in depth with incremental data from MFIs now covering two to three financial years. It is also encouraging to note that MFIs that are not members of Sa-Dhan, are contributing to the report. We thank them all.

The responses we received from bankers, development agencies and members on our earlier reports have been very useful. We believe that this report will provide increased understanding of performance trends and issues among MFIs, across size, operating model, age and location.

This report has been further broad-based by incorporating the developments that have promises to contribute to working environment and sustainability of MFIs. Reference to other significant work / studies undertaken by us has been drawn wherever found relevant.

Indian microfinance is largely based on SHG methodology. The quality of SHGs is therefore a significant determinant to programmatic effectiveness of MFIs. We have initiated a process of collecting and analyzing data on SHGs. Though the work is in nascent stage, we are sharing the preliminary findings on quality of SHGs. This is given as annexure-1 to the report.

We thank members including members of the Standards Sub-Group for their comments and suggestions on the draft report.

Congratulations to the Standards team comprising of Mr. R.K. Mukherjee, Mr. Sarat Das, Mr. Pravin Kumar and Ms. Reshu Khattar in bringing out the report.

The work would not have been possible without support from The Ford Foundation and USAID. We gratefully acknowledge their support.

We look forward to hearing from you all on refining the work in days to come!

Mathew Titus

Executive Director

March 31, 2006

1 Genesis of the Sa-Dhan *Side-by-Side* Report

From the days of '70s, when SEWA initiated provision of microfinance services to the unorganized sector in India, microfinance is characterized by diversity in terms of operating models, legal forms, local contexts, regional imbalances etc. The sector has made significant progress in terms of expansion across regions and outreach and now is significantly, attracting attention of the policy makers.

While these are the existing realities of the sector today, the huge demand for microfinance services remains the challenge. The collective picture of the sector therefore requires to be put together to appreciate the character and complexities of expanding this service across the country. More importantly, performance of MFIs has not been captured enough. Consequently, in absence of a broader picture of the sector, important stakeholders' viz. policy makers, investors, bankers etc. have not been able to capture the scenario in adequate details.

Sa-Dhan, as Association of Community Development Finance Institutions, took up the work of facilitating the setting of standards for financial performance of MFIs. This followed finalization of a set of six financial standards with extensive engagement of members through regional workshops and field tests. The set of six financial standards, recommended by Sa-Dhan cover three core elements of financial performance viz. Sustainability, Asset quality and Efficiency. This work has evolved into a composite set of financial performance benchmarks among MFIs across operating models, size of operations, legal forms and variety of services. In taking the practice of financial standards to the next level, Sa-Dhan found the significance of public reporting by MFIs to build transparency and in turn increase flow of funds to the sector.

Sa-Dhan believes that reporting is an effective instrument to ensure transparency and performance. Transparency and disclosures would hold the key for the microfinance sector and would enhance the flow of funds to these MFIs.

1.1 Positioning the Report

In order to showcase a broader picture of the sector, Sa-Dhan in its first attempt, (Side-by-Side – A Slice of Microfinance Operations in India) in September 2004, captured financial performance of MFIs for FY 2004, by consolidating features among MFIs across the country. The report covered 53 MFIs.

Firstly, the work started with the assumption that it would significantly help other stakeholders to assimilate the broader picture of MFIs in India.

Secondly, that it would facilitate deeper understanding of their strategies and strengths by stakeholders like banks, who in turn could make necessary investments in MFIs.

Thirdly, the report was thought to be most cost-effective mechanism of consolidating information on MFIs all across the country, for dissemination among stakeholders' viz. public policy makers, commercial banks, Regional Rural Banks (RRB), donors and investors- Indian and international.

The respondents to the report covered small to large MFIs in all regions and legal forms, working on SHG, Grameen, or JLG models.

Primarily, the tasks of data compilation and analysis were achieved in a period of eight weeks. This indicates the transparency and readiness among MFIs to share their operational and financial details.

The principal findings from the analysis were as under.

- MFIs also provide other services like livelihood support, health, education and support for rights of the poor. Many of these services are integrated in the financial services of the MFIs.

- Credit has emerged as the main service that MFIs are providing to their clients. The exact design and nature of credit services varies widely from model to model and MFI to MFI. As of March 2004, the sample of retail-MFIs that are providing credit services to the clients directly (49 MFIs) had credit portfolio outstanding at Rs.374, 26 lakhs (77.97 million USD).

- MFIs, whether on direct service mode or in facilitating mode, are engaged in providing alternate channels of savings to the poor. As of March 2004, the sample of 51 retail-MFIs shows that the amount of savings mobilized within their clients was to the tune of Rs.99, 02 lakhs (21.53 million USD1

- The number of MFIs providing insurance services is significantly different from one model to another. Most MFIs working on GB and JLG models are also providing insurance services. The MFIs working on SHG model have a long way to go in bringing insurance services to their clients.

1.2 The First Report

Financial Performance of MFIs: Summary of the First Report

The financial analysis grouped the 42 MFIs into peer groups based on Lending Model, Operational Region and Legal form.

Summarily, the report showed that

- Regional features were significant across operating models.
- MFIs are graduating towards self sustainability while grappling with the twin issues of outreach and loan asset quality
- Reporting by MFIs on their performance was good but broadly, appreciation of the Sa-Dhan recommended financial performance standards were limited.

1.3 The Second Report

The second report (Side-by-Side – A Slice of Microfinance Programs in India – March 2005) focused on programmatic features of MFIs as logical extension of the first report on financial performance. This report attempted to cover some of core programmatic features of MFIs. The report captured data from 62 MFIs across regions.

The analysis in this report was around issues such as products, services, outreach, staff productivity, accounting policies, MIS, cost control etc. The report provided interesting insights on the impact of credit or credit plus approach on growth rate, outreach, range of services etc.

Summarily, the report showed that

- MFIs are innovating on appropriate products for various segments of clients, based on livelihood and life cycle needs of the clients
- MFIs are undertaking cost control measures by optimizing their outreach penetration and internal management systems.

1.4 The Third Report

The third report (Side-by-Side – A Slice of Microfinance Operations in India – September 2005) focused on financial operations of MFIs. While the first report on financial performance (Side by Side – A Slice of Microfinance Operations in India – September 2004) was a snapshot based on financial operations data for the financial year 2003-04 of 42 MFIs, this report covered financial data of 74 MFIs for three years viz. 2002-03, 2003-04 and 2004-05. This report therefore not only covered a more diverse set of MFIs but also analyzed their financial performance over a period of three consecutive years.

As the report seeks to increase its presence and impact, we felt it is important that the exercise bring together learning and insights that the earlier reports had offered to us. It was evident that members were facing key challenges in operations, in terms of growth speed in both client base and operational self-sufficiency.

We therefore examined performance of MFIs by categorizing them by four peer groups. The peer groups are (a) age of the organisation by years of working in microfinance services, (b) variety of services (credit, insurance and savings), (c) size of loan portfolio and (d) region.

Summarily, the report showed that

- Size matters in financial sustainability of MFIs.
- Providing range of financial services is not constraint to growth. However the challenge is if all costs can be met without affecting operational sustainability.
- Strategically, MFIs are not being constrained by operating models. They are responding to demands of clients by adapting to the most appropriate operating models in the localized context.
- There are systemic issues among small and medium size MFIs. The balance between expansion in client outreach on one hand and cost recovery and portfolio quality should attract greater clarity and action.

In the process of incentivising MFIs that contribute to this Sa-Dhan initiative, we have now introduced an individualized report to each of the contributing MFIs. This report provides the MFI with comparative insight of its performance vis a vis MFIs in variants of peer groups such as outreach, age, size, operating model and regions.

2 Methodology : How we put the 4th Side-by-Side Report together?

The programmatic issues of MFIs clearly need closer attention. While the report on financial operations of MFIs provides a set of performance based insight, the programmatic issues are broader, diverse and actually determine the overall effectiveness of MFIs. There are constraints of availability of data on programmatic aspects. The operational data of MFIs are useful inputs. We are gradually building the database needed to draw relevant findings.

The earlier report on programs (Side-by-Side – A Slice of Microfinance Programs in India – March 2005) was based on data of 62 MFIs for one year (Financial Year 2004). This report has contributions from 83 MFIs and data for three financial years (2003, 2004 and 2005) are available. The report therefore throws up the distinct trends among MFIs by outreach, age, services and size.

The report analyses performance of MFIs on a set of programmatic issues like expansion, costs, funding and sustainability.

2.1 Process of Preparation of Report

The report is based on data voluntarily provided by MFIs.

The report preparation process has been in the following stages.

1. Sa-Dhan prepared a data acquisition sheet. The Data Acquisition Sheet (DAS) covered outreach, operating model, services and financial aspects of a MFI.

2. Data of MFIs that had contributed to the first round of reports were inputted in DAS of such MFIs before it was sent to such MFIs.

3. The DAS was sent to 157 MFIs engaged in providing microfinance services. This number comprised of both Sa-Dhan MFI-members and MFIs that are not members. The list of MFIs was complied from various sources like Sa-Dhan membership, other MFIs that have participated in Sa-Dhan events and partners of NABARD and SIDBI.

4. On receipt of DAS from MFIs, data was verified for completeness and on co-relation among data-variables within a MFI. During the data verification process, Sa-Dhan referred back to MFIs for necessary clarifications and corrections, wherever necessary.

5. Reference to policy developments like ECB and Banking correspondent model and studies undertaken by us were incorporated.

6. The report, in draft form, was circulated among Sa-Dhan members and MFIs that contributed to the report.

7. The report was finalized after necessary changes considering feedback on the draft report.

2.2 Sample

The sample is contribution from 83 MFIs. The outreach analysis covers 83 MFIs. The financial analysis covers 74 of the 83 MFIs. These represent client base of 2.33 million and Gross Loan Portfolio (GLP) of Rs.722.19 crores (160.49 m USD) as of March 2005. In terms of regional distribution, 47 MFIs are from South, 20 from East, 7 from West and 9 are from the North.

3 Executive Summary

- The annual credit demand by the poor in India is huge. The supply of microfinance services is growing but needs exponential growth to come anywhere closer to the demand..

- The growth of MFIs is regionally skewed but growth is happening across the country.

- The SHG movement leads to growth of microfinance. There are quality issues in sustaining the growing number of SHGs.

- Some interesting policy initiatives like the MFDEF, access to ECB and unified regulation for MFIs are expected to provide substantive support to growth of microfinance

- The transitory emergence of microfinance is fuelling growth of service-based MFIs while a sizeable number of NGO-MFIs combine microfinance with other development initiatives.

- MFIs are significantly innovative organizations. This is evident in their outreach expansion, product design, operating methodologies and costs control measures.

- The MFIs that are operating in form of a company (NBFC / Section 25) are leading the growth. The MFIs that are in form of Society / Trust are more in numbers but are much slower in their growth.

- MFIs are increasingly re-organizing their operations by means of professionalizing staff, internal controls, MIS and technological backbone. In the public space, MFIs undergo audits and ratings.

- Building transparency in the sector is the way forward.

- Across size of operations and age, MFIs would need to emphasize on further innovations and cost reduction to remain competitive. Competition on effectiveness and outreach is expected to intensify both among MFIs and between MFIs and other financial institutions.

4 The Current Challenges For Microfinance In India

The demand for microfinance services in India is huge. The Census of India 2001 estimated the Indian population at 1028.6 million. The 55th Round Survey (July 1999 –June 2000) by National Sample Survey Organisation (NSSO) estimated national poverty ratio at 26.10 %. There are therefore estimated 270 million people living below the poverty line. This translates into an estimate of 53.60 million households in need for mF services (based on mean household size of 5 as per Census of India 2001).

The annual credit demand by the poor in India is estimated at Rs.1,35,000 crores1. (USD 300,00 m). Though the poor households also have high demand for thrift and insurance services, quantified estimates are not available.

The Indian formal financial sector has an impressive network of branches yet significant portion of the population do not have access to the services of the formal financial sector.

Post 1969, with the nationalization of banks, India entered into a phase of social banking, where the expansion of branches to rural areas was guided and encouraged by the government. The government not only regulated branch expansion, but also put in place a system of compulsory lending to the priority and weaker sections of the society. So the financial services sector in this phase (i.e. the period prior to 1991) was highly regulated by the state, as a result of which the role played by market incentives was severely circumscribed.

The financial sector reform policies initiated after 1991 are fuelling a comeback of market incentives in guiding the business strategy for banks. Now branch expansion is guided by market signals. Government now achieves its social goals (toward reducing poverty) by use of stipulated priority sector lending and various schemes run by government with the help of banks, like Integrated Rural Development Programme (now SGSY), differential interest rate schemes, credits to agriculture, kisan credit cards, etc.

The formal banking sector in India has one of the largest branch networks in the World with close to 50,000 commercial bank outlets, 14420 Regional Rural Bank outlets and 90,000 primary agricultural cooperative societies. Yet, the All India Debt and Investment Survey 1992 of the Reserve Bank of India (RBI) shows that though the overall share of

[1] Vijay Mahajan: Presentation in Microfinance India Conference April 2005

institutional credit to rural households have gone up steadily, households in the lower asset groups were more dependant on non-institutional credit.

The Task Force on Revival of Cooperative Credit Institutions [2](Vaidyanathan Committee) noted that "The traditional banking system, the systems and procedures of which are actually designed for the urban industrial and business financing, has limitations in reaching out to the last mile. The exposures of the banks for this segment have risen, but, the rates for defaults in repayment have also gone up. Most often, this happened because banks have not applied appropriate methods for banking with the poor, by keeping in touch with the customers and applying social collaterals. Banks have traditionally worked on documentation related appraisals, rather than on trust and production related appraisals. The client group, however, needs much more support than what the banks currently provide"

The supply of microfinance services is growing but needs exponential growth to come anywhere closer to the demand.

RBI data shows that the number of small borrower accounts (of up to Rs.25,000) in the banking system has fallen from 5.6 million in March 1994 to about 5.0 million in March 1997.

The National Advisory Council note[3] on agriculture and irrigation states that about 60% of credit requirements of farmers are now met by the institutional sources and the remaining 40% by informal sources like moneylenders. However small and marginal farmers (with land holding of less that 2 ha.) including tenants, who account for nearly 80% of holdings and one-third of area operated, depend far more heavily on informal sources.

A World Bank-NCAER study (2003) revealed that 87% of rural households are denied credit from formal sector and 71% do not have access to formal savings services. Penetration of insurance services is less than 10% in rural areas.[4]

The microcredit portfolio outreach as of March 2005 is estimated at Rs.2,900 crores (USD 644 m) under SHG-Bank linkage program and Rs. 1,095 crores (USD 243 m) through MFIs (Sa-Dhan member database).

[2]The Task Force on Revival of Cooperative Credit Institutions: Dec.2004
[3] Note prepared by Mr. C. Hanumanthaiya. For details refer to nac.nic.in/concept papers
[4] NCAER/World Bank Study :Rural Finance Access Survey 2003

5 Microfinance Initiatives

The Self Help Group methodology is the most predominant means of bringing microfinance services to the reach of the needy and poor, both by banks and MFIs.

In 1992, the SHG-bank linkage programme was formally launched by NABARD which circulated guidelines to banks for financing SHGs under a pilot project aimed at financing SHGs across the country through the formal banking system. The good repayment rate among SHGs gave the banks the confidence to continue financing SHGs in the coming years. This encouraged the Reserve Bank of India (RBI) to include financing to SHGs as a mainstream activity of banks under their priority sector lending in 1996. The Government of India bestowed national priority to the programme through its recognition of mF, and mentioned it in the Annual Union Budget of 1999.

Since then, the Bank-SHG linkage programme has become an innovative strategy for mainstreaming rural banking. By end of March 2005, the Bank-SHG linkage programme has covered over 24.3 million families who have cumulatively availed bank loans of Rs.689,85 million (USD 1,533 m).

MFIs in India predominantly operate through group methodologies. 60% of the 6.7 million clients[5] have been covered by MFIs through SHGs, with the rest being covered under Grameen and JLG models.

Microfinance received greater recognition in 1998 when Small Industries Development Bank of India (SIDBI) set up the ‘SIDBI Foundation for Microcredit’ with an initial capital of Rs 100 crores (USD 22 m). The foundation aims at supporting MFIs as alternate financial institutions.

In addition to the SHG-bank linkage programme, alternative mF initiatives following Grameen Group and/or SHG methodology or at times individual lending models have also been successful, though on a smaller scale.

Microfinance institutions have emerged over the last two decades as effective ‘last mile’ institutions. The SEWA Cooperative Bank, operating in Gujarat since 1974, is arguably the first mF programme in India. The bank has been viable right from its inception and is an ideal example of a community-owned sustainable financial service delivery vehicle.

[5] Sa-Dhan database on its members 31st. March 2005

The early Nineties witnessed the rise of several microfinance institution (MFI) initiatives. There is paucity of authentic data on the number and size of institutions that provide microfinance services in India though several studies estimate of about 800 institutions providing microfinance services across the country.

The Sa-Dhan data base as of March 2005 on its membership of 139 institutions that comprise of most of the larger MFIs shows that their combined client outreach was 6.7 million and their total credit portfolio size was to the tune of Rs.1,095 crores (USD 243 m). The cumulative annual growth rate among Sa-Dhan members in terms of their credit portfolio has been 76% over five year period of 2001 to 2005.

6 Policy Thrust

The sector is now receiving attention from the government. The government is actively working on creating a separate regulatory regime for microfinance institutions. The establishment of Microfinance Development and Equity Fund (MFDEF) and proposal to bring a separate law for MFIs are the two significant pronouncements made in the Annual Union Budget 2005.

6.1 Microfinance Development and Equity Fund[6]

During 2005-06, Government of India has redesignated the existing mFDF as microFinance Development and Equity Fund (mFDEF). It has also decided to enhance the fund size from the existing Rs100 crores (USD 22 m) to Rs 200 crores (USD 45 m). The additional amount of Rs 100 crores will be contributed by Reserve Bank of India, NABARD and the commercial banks in the same proportion as earlier (40:40:20).

Objectives

The objective of the redesignated Fund is to facilitate and support the orderly growth of the microfinance sector through diverse modalities for enlarging the flow of financial services to the poor particularly for women and vulnerable sections of society consistent with sustainability.

Activities to be supported from out of the mFDEF

The Fund will be utilized to support interventions to eligible institutions and stakeholders. The components of assistance will include, inter alia, the following purposes:

Capacity Building

(i) Training of SHGs and other groups for livelihood, skill upgradation and micro enterprise development.

[6] For further details, refer to www.nabard.org

(ii) Capacity building of staff of institutions involved in microfinance promotion such as Banks, NGOs, government departments, NABARD, etc.

(iii) Capacity building of MFIs.

Funding Support

(iv) Contributing equity/other forms of capital support to mFIs, service providers, etc.

(v) Providing financial support for start-up and on-lending for microFinance activities;

(vi) Supporting Self Help Promotion initiatives of banks and other SHPIs.

(vii) Meeting on a selective basis the operational deficit of financial intermediary NGOs/ mFIs at the start up stage;

(viii) Rating of mFIs and self regulation

Mode of Assistance

Mode of assistance from the Fund will include the following:

- Promotional support for training and other promotional measures
- Loans and advances including soft loans
- Revolving Fund Assistance (RFA) to NGOs/ mFIs
- Equity and quasi equity support to mFIs
- Administrative subsidies and grants
- Administering Charges

Advisory Body to mFDEF

The Advisory Board shall guide and render advice on the various aspects relating to the micro finance sector. The Board may determine its own procedures for day-to-day working including constitution of committees, task forces etc, for examination of various issues. The advisory board will meet at such intervals as deemed necessary but in any case once in a quarter to review the status and progress of outflow and to render policy advice in respect of orderly growth and development of the sector.

The Advisory Body comprises of representatives from NABARD, commercial banks, Sa-Dhan and MFIs.

6.2 External Commercial Borrowing (ECB)

External Commercial Borrowing (ECB) Rules–an important funding avenue specifically opened for NGO-MFIs

The Reserve Bank of India declared ECB guidelines in April 2005[7]. The notification enable NGOs engaged in micro finance activities to raise ECB of up to USD 5 million during financial year.
To apply through ECB route, an NGO in the microfinance activity should comply with the following conditions.

- Satisfactory borrowing relationship for at least three years with a scheduled commercial bank and it should be routed through normal banking channel.

- Require a certificate of due diligence on 'fit and proper' status of the board/ committee of management of the borrowing entity from the designated Authorized Dealer (AD)[8].

- ECB fund should only be utilized for lending to SHGs or for micro-credit or for bonafide microfinance activity including capacity building.

- Documents like audited statement of account and income tax return of the overseas lender should be certified. Individual lenders from countries wherein banks are not required to adhere to Know Your Customer (KYC) guidelines are not permitted to extend ECB.

6.3 Banking Correspondents

Another important development is adoption of banking facilitators and correspondents to extend banking services. The Union Finance Minister, in the Union Budget announcement for FY 2005-06 proposed that "Commercial banks may appoint MFIs as 'banking correspondents' to provide transaction services...". The RBI set up an internal group to examine the issues.

Subsequently, RBI[9] has suggested banks to use the services of Non-Governmental Organizations / Self Help Groups (NGOs/ SHGs), Micro Finance Institutions (MFIs) and other Civil Society Organizations (CSOs) as intermediaries in providing financial and banking services through the use of Business Facilitator and Correspondent models.

[7] RBI notification no. 2004-05/434 AP (DIR Series) Circular no. 40 dated April 25, 2005
[8] For details on ADs, refer to www.fedai.org
[9] RBI Circular to SCBs: DBOD No.BL.BC.58/22/01.001/2005-2006 dated January 25, 2006. Also refer to report of RBI Internal Group to Examine Issues Related to Rural Credit and Microfinance (Khan Committee) June 2005.(www.rbi.org.in)

"Under the "Business Facilitator" model, banks may use intermediaries, such as, NGOs/ Farmers' Clubs, cooperatives, community based organizations, IT enabled rural outlets of corporate entities, Post Offices, insurance agents, well functioning Panchayats, Village Knowledge Centres, Agri Clinics/ Agri Business Centers, Krishi Vigyan Kendras and KVIC/ KVIB units, depending on the comfort level of the bank, for providing facilitation services. Such services may include (i) identification of borrowers and fitment of activities; (ii) collection and preliminary processing of loan applications including verification of primary information/data; (iii) creating awareness about savings and other products and education and advice on managing money and debt counseling; (iv) processing and submission of applications to banks; (v) promotion and nurturing Self Help Groups/ Joint Liability Groups; (vi) post-sanction monitoring; (vii) monitoring and handholding of Self Help Groups/ Joint Liability Groups/ Credit Groups/ others; and (viii) follow-up for recovery.

Under the "Business Correspondent" Model, NGOs/MFIs set up under Societies/ Trust Acts, Societies registered under Mutually Aided Cooperative Societies Acts or the Cooperative Societies Acts of States, section 25 companies, registered NBFCs not accepting public deposits and Post Offices may act as Business Correspondents.

In addition to activities listed under the Business Facilitator Model, the scope of activities to be undertaken by the Business Correspondents will include (i) disbursal of small value credit (ii) recovery of principal / collection of interest (iii) collection of small value deposits (iv) sale of micro insurance/ mutual fund products/ pension products/ other third party products and (v) receipt and delivery of small value remittances/ other payment instruments"

7 Features of MFIs

MFIs are demand-driven and therefore innovate in various ways.

MFIs are significantly innovative organizations. This is evident in their outreach expansion, product design, operating methodologies and costs control measures. MFIs provide credit for various purposes ranging from consumption needs, life cycle needs, emergencies, medical needs, education, housing to farm based and non-farm micro enterprises.

MFIs expand their outreach in contagious geographic locations. This is facilitated by their incremental understanding of the local dynamics and demand in their existing locations. The expansion of the sample MFIs has been in / around their earlier areas of operations.

MFIs help build financial discipline as a core value among clients.

MFIs invest significantly and continuously in building and maintaining financial discipline among its clients. This is done at three levels, group, group leaders and individual members (clients). The process of acquiring clients by MFIs is rigorous and time consuming. Through area surveys and local contact programs, MFIs identify their future clients. Forming group require developing common goals, nurturing and group management processes. Existing clients need incremental assistance in coping with their financial needs.

MFIs predominantly target women. The sample data of 83 MFIs shows the share of women clients at 95% of total clients (2.20 million women clients among total clients of 2.33 million).

Client dropout rate among MFIs is minimal. As a strong indicator of client satisfaction, the sample of 83 MFIs reveal that none of the MFIs had client dropout rate of more that 0.5% during the FY 2005. The prevalent range of annual client dropout rate is between 0.2 to 0.03%.

MFIs have emerged in various legal forms

Indian microfinance has emerged from NGO movement. As a self-propelled sector, various legal forms characterize MFIs.

The various legal forms of MFIs today are:

- Not for Profit MFIs such as societies registered under the Societies Registration Act, 1860 or similar State Acts, the Public Trusts registered under the Public Trusts Act, 1882, or the Section 25 companies of the Companies Act, 1956.

- Mutual Benefit MFIs are registered as co-operative societies registered under the Co-operative Societies Act of the respective State or the Central Multi-State Co-operative Act, 1984 or as Mutual Benefit Trusts. This is the case of MFIs such as SEWA Bank.

- For profit MFIs are registered either as Non-Banking Finance Company (NBFC) or as Local Area Bank (LAB) and are registered under the Companies Act 1956. BASIX, Cashpor and SHARE Microfin Ltd. are some of them. The minimum capital requirements for a deposit taking NBFC is Rs.2.00 crores (USD 0.44 m) and Rs.5.00 crores (USD 1.11 m) for a Local Area Bank (LAB).

The transitory emergence of microfinance is fuelling growth of service-based MFIs while a sizeable number of NGO-MFIs continue to combine microfinance with other developmental initiatives.

As extension of the NGO movement, MFIs started as divisions within their parent organisation. As the microfinance portfolios of such parent organisation grow to commercial scale, the organizations are moving towards creating separate institutions that specialize in providing microfinance services. This also presupposes adaptation to newer legal forms, from Society / Trust in case of the parent organisation to Section 25 Company or NBFC for the MFI.

In terms of numbers, Sa-Dhan member database as of March 2005 showed that 111 are in form of Society/Trust and 16 are in form of Section 25 Company / NBFC. Most of these MFIs in company form are less than 5 years of age.

Observations from interactions with microfinance clients

The Standards team of Sa-Dhan undertook a field trip in March 2006 to understand the ground conditions through interactions with microfinance clients in Andhra Pradesh. The visit covered about 42 women clients in five locations. The views of the team are contextual but also throw up some important elements for wider debate for microfinance practitioners. The observations and issues raised by the team on institutional, programmatic and *client perspectives are given below.*

A. Organisational issues

There is increase in credit disbursement by all players in microfinance.

The microfinance institutions are moving toward higher operational costs in certain geographical areas that are witnessing intense competition among financial institutions to expand their client base. The clients access credit simultaneously from multiple institutions and hence a client cost for each of the institutions is high.

There is possibility that competitive credit interventions from various institutions are allowing multiple members from same family into microcredit programs. The credit exposure of families, as the result, is a matter of concern.

B. Program issues

Microfinance programs do not seem to adequately assess the credit absorption capacity of clients.

In absence of systemic monitoring of groups, the clients find improvised means to control and access their group-based access to various providers of microcredit (including private money lenders) to suit their individual needs.

SHG leaders bear the onus of repayment among SHG members. This is a burden to the leader. In most cases the leader graduates to role of a monopolistic agent.

On the issue of SHG members also accessing loans from other institutions, the SHG leaders do not consider this detrimental or in any way affecting operations of their own SHGs. Rather they feel that MFIs are topping up the facilities from banks.

Within SHGs, it is a common practice that defaulting members make in-kind repayments to other member(s) who had earlier provided them with cash for prompt repayment of loan.

There is clearly evidence of clients moving beyond their groups in accessing credit. This would need an in-depth analysis to (i) develop means to make SHGs more responsive to needs of their members and (ii) systemic facilitation to clients to individually access higher amounts of credit.

C. Issues around clients

Clients perceive every microfinance institution, irrespective of their stated institutional objectives, as providers of only credit.

Clients themselves do not consider their own responsibilities in increasingly exposing themselves to credit.

Wilful defaulter clients complain. Their ire is against both their co-members, leaders and the credit providers (banks, MFIs, individual money lenders).

While clients do weather bad periods in ensuring prompt repayment, they remain clients of the credit provider in future periods. Client loyalty was not found to be a general issue

8 Growth Patterns among MFIs

MFIs are growing across regions. Among the sample MFIs[10], the annual growth rate is highest in the South followed by MFIs in the East. The rate of growth on a year-to-year basis has regional features due to presence of some high-growth MFIs in each region. During FY 2005, the annual growth rate is highest in the South (67%) followed by MFIs in the East (61%). MFIs in West and North are expanding but their annual growth rate, on a year-to-year basis between FY 2004 and 2005 is lower. The South also leads the growth in absolute numbers (client outreach of 1710323) followed by the MFIs in East (client outreach of 332476).

Cumulative credit disbursement by MFIs reveals their pattern of growth.

A sample data available on 44 MFIs show the trend.

Table 1 : Cumulative Disbursement of Loans by MFIs since their inception to FY 2005

Amount in Rs. lakhs

MFIs by regional distribution	Number of MFIs	Number of Loans	Cumulative Disbursement (Amount)	Average of cum. disbursement per MFI
East	13	368,892	1,06,03	816
West	2	3,942	1,24	62
North	4	237,117	2,16,22	5405
South	25	3,008,942	18,78,96	7516
Total	44	3,618,893	22,02,45	5006

Sample of 44 MFIs

The MFIs since their respective inception, have cumulatively disbursed 3.62 million loans amounting to Rs. 22,02.46 Crores (489.44 m USD).The average size of loans over the years among these MFIs is therefore Rs 5006 (112 USD).

The sector is clearly moving at a fast pace in providing the poor with access to credit.

However the following table throws some more interesting insights on the relative growth among MFIs classified by their legal forms.

[10] For more details, refer to the Sa-Dhan publication '*Side by Side* –A Slice of Microfinance Operations in India 2005'.

Table 2 : Credit Outreach and Disbursement by MFIs

Amount in Rs. Lakhs

MFIs by Legal Forms	Number of MFIs	Number of Loans		Cumulative Disbursement (amount)	
		Cumulative number	Average per MFI	Cumulative amount	Average per MFI
Non-Banking Finance Company (NBFC)	5	24,33,031	4,86,606	16,26,25	32525
Not For Profit Company (Sec.25 Co.)	4	2,33,041	58,260	1,43,63	3591
Local Area Bank (LAB)	1	13,411	13,411	14,28	14,28
Co-operative	3	65,883	21961	48,54	1618
Society & Trust	27	6,95,112	25745	3,69,75	1369
Total	44	3,618,893	82247	22,02,45	5006

Sample of 44 MFIs

The MFIs that are operating in form of a company (NBFC / Section 25) are leading the growth. The MFIs that are in form of Society / Trust are more in numbers but are much slower in their growth. This trend can be possibly explained in terms of MFIs transforming from NGO-MF to separate MFI entity.

The Table below depicts the details of credit portfolio of sample of 57 MFIs as of March, 2005.

Table 3 : Segmented Credit Portfolio of MFIs

Amount in Rs. Lakhs

	Credit Provided by Purposes			
	Agriculture	Animal Husbandry	Other Income Generation	Other Purposes
No. of MFIs	48	37	57	45
Loans disbursed in FY 2005 (Amount)	5079.67	8102.05	24370.33	7983.28
Active clients (nos)	77416	142640	318033	88096
Average loan size (Rs.)	6562	5680	7663	9062
Percentage of total disbursement	11.16	17.79	53.52	17.53

No. of MFIs denote the MFIs that are providing credit for each of the indicated purposes

MFIs are therefore providing credit for diverse needs ranging from non-farm to non-income generation purposes. All MFIs are involved in providing income generation (IG) loans. They provide credit for non-farm income generation, agriculture, animal husbandry and general purposes. The average loan size is highest for 'other purposes' followed by 'other income generation purposes'.

More than fifty percent of the total credit goes to 'other IG' activities that broadly cover non-farm activities like small trading, retail vending, tailoring, local transport, home based manufacturing. Apart for income generating activities clients borrow for 'other' purposes like marriage, children's education, medical needs, repayment of previous debt and other emergency needs. This segment of client-needs is evidently of high significance because there are very few avenues, other than microfinance, for clients to obtain credit for these purposes.

The tenures of such credit are short term (six months) to longer term (eighteen months) with a repayment mode of weekly or monthly frequencies. The time lag between sanction and disbursement of credit is minimal (less than a week). Some MFIs are building insurance as a risk mitigation measure for their clients.

MFIs are not constrained by the operating methodology. There is a significant trend evident from the sample MFIs that suggest that they are adapting to different operating methodologies based on local needs. Eighteen out of 83 MFIs, in the sample, operate on multiple models. Some MFIs also provide individual lending. This facility is provided to clients who have long (3 to 5 credit cycles) and satisfactory credit history with the MFI under its group based lending methodology.

MFIs provide small loans. The sample of 74 MFIs shows their average loan size of Rs. 4,250 (94 USD) for FY 2005.[11] MFIs provide larger size loans to their clients as they acquire credit history of clients through successive loans.

MFIs having positive OSS (100% or more in FY 2005) have average loan size in the range of Rs.1,000 (22.22 USD) to Rs.11, 479 (255 USD). Most of such MFIs have average loan size of about Rs.4,000 (89 USD). Similar features exist among MFIs that have OSS of 90 to 99% in FY 2005. MFIs with OSS of 80 to 89% (FY 2005) have a lower average loan size of around Rs.2,000 (44.44 USD).

MFIs of less than 5 years of age (Calendar Year 2000 and later) have average loan size of Rs.3,526 (78.35 USD). MFIs of age between 5 and 10 years (Calendar Year 1994 to 1999) have average loan size of Rs. 5,291 (117.57 USD). MFIs of 10 years or more (Calendar Year 1993 or earlier) have average of Rs.7,114 (158 USD).

[11] For further details, refer to Sa-Dhan publication '*Side by Side* – A Slice of Microfinance Operations in India 2005'.

9 Cost Control Measure

MFIs adopt various measures to keep costs under control. The sample of 83 MFIs reveal the prevalent measures being adopted for bringing down the costs.

The most common measures of cost controls are:

A1. Expansion of outreach around existing areas of operation

MFIs expand their geographical outreach in contagious areas. MFIs that operate through branches bifurcate their existing branches to create new branches in adjoining areas. The costs of expansion and time lag of a new branch to attain sustainable volume of business is therefore low.

A2. Increasing staff efficiency

MFIs keep exploring avenues to increase efficiency of staff. This is achieved through various measures like continuous training on operational systems and client relations, performance incentives and use of technology.

A3. Developing internal control system that reduces leakages

MFI are working on systemic internal controls that optimize their use of funds and manpower.

A4. Raising cheaper funds from commercial sources

MFIs principally expand through borrowings. Better negotiations with banks and ECB route are becoming effective means to reduce the financial costs of MFIs.

The second set of cost control measures are:

B1. Reducing cash based transactions

MFIs are exploring means to reduce cash based transactions with clients as well as internally, between their different locations. Besides reducing costs and time, this also reduces the cash based risks.

B2. Developing MIS to avoid repetitive work

MIS is being increasingly used to improve methodological duplications.

B3. Expanding operations in geographical areas with larger concentration of possible clients

Besides expansion in contagious geographical areas, MFIs are also identifying new locations that have large concentration of needy and poor clients.

The MFIs are therefore using a mix of measures to expand at lower costs and reduce their existing costs through better systems and controls.

10 Portfolio Quality and Financial Performance

MFI manage their portfolio well

The range of Portfolio at Risk (PAR) > 60 days in the sample of 74 MFIs for FY 2005 is between 5% and 0.2%. The larger MFIs have PAR > 60 days between 3% and 0.1%.

14 MFIs have OSS of 100% or above; 11 MFIs have OSS between 90 and 99%; 7 MFIs have OSS between 80 and 89%. Most of the remaining 42 MFIs have OSS of 70 to 79%.

It can therefore be deduced that MFIs are fairly close to overall efficiency.

Table 4 : Performance of MFIs (FY 2005) based on Sa-Dhan recommended Financial Performance Standards: MFIs classified by size of their Loan Portfolio

MFIs categorised by Loan Portfolio	Number of MFIs	Financial Performance Parameters					
		Sustain ability		Asset Quality	Efficiency		
		OSS	PAR > 60	CRR	OCR	TCR	Active Borrowers per Credit Officer
Small	53	66.6	3.6	93.3	12.4	21.2	561
Medium	14	90.0	4.9	94.3	25.9	36.2	298
Large	7	125.8	1.3	99.2	13.0	22.3	389
Aggregate	74	110.3	2.2	97.7	15.4	25.0	405
Sa-Dhan recommended Standards		100%	<10%	> 90%	< 20%	< 30%	Between 250 and 350

Small MFIs have a high client load on credit officers (561). Despite operating on a low cost band (OCR at 12.4% and TCR at 21.2%), small MFIs have high level of risky assets (PAR > 60 days at 3.6) and low OSS (66.6).

Medium size MFIs has a low client load on credit officers (298). Operating on a high cost band (OCR at 25.9% and TCR at 36.2%), these MFIs have very high level of risky assets (PAR > 60 days at 4.9) while their OSS is reasonably high at 90%.

Large size MFIs has a client load on credit officers at 389.Their operating cost bands are low (OCR at 13% and TCR at 22.3%). These MFIs have very low level of risky assets (PAR > 60 days at 1.3) and their OSS is high at 125.8%.

It can be fairly deduced that high level of 'Active Borrowers to Credit Officer Ratio' may keep immediate costs low but this has implication on asset quality. The MFIs need better measures comprising of cost-return spread, client targeting and optimal utilization of staff and delinquency management as a package for managing credit risk.

MFIs are increasingly accessing commercial funds

MFIs are growing based on borrowed funds. Such funds are available from DFIs like SIDBI and RMK, wholesale providers like FWWB and RGVN and from commercial banks.

In the sample of 74 MFIs, Small MFIs (Loan portfolio of less than Rs.5.00 crores; 1.11 m USD) have borrowed funds at 78% of their loan portfolio. Medium MFIs (Loan portfolio of Rs.5.00 crores to 20.00 crores; 1.11 m to 4.44 USD) have borrowed funds at 86% of their loan portfolio; among large MFIs ((Loan portfolio of more than Rs.20.00 crores; 4.44 m USD) the ratio is at 82%.

Banks are innovating new means to provide funds to MFIs. For example, partnership model of ICICI Bank facilitate MFIs to manage credit operations while the credit portfolio is owned by the Bank. The banks directly own the client-loans. The MFI is an operating partner with the Bank on a cost-sharing basis. Client-loans by MFIs under the bank-partnership model therefore do not appear on the Balance Sheet of such MFIs.

MFIs need funds for three purposes. While loan funds for on-lending are increasingly available, funds for capitalization and for operational growth are not available.

Larger MFIs are more efficient in use of funds. The loan asset to total assets co-relation among large MFIs is high at 81%; small and medium MFIs with the co-relation at around 75% have larger proportion of their assets (21%) as investments and current assets.

However, MFIs are typically saddled with high costs. As financial institutions with developmental agenda, MFIs are engaged in building communities around financial services coupled with add-on inputs like business development services. Some DFIs like SIDBI provide initial support to partially offset the operational losses and building infrastructure. However such avenues are limited. The only source of recovery of costs is through the interest charged on credit provided to clients.

11 Operating cost of MFIs[12]

There are three types of costs: transaction costs, risk costs and cost of funds. As cost of fund is driven by market and not within institution's control, it is the transaction and risk costs that are affected by operational policies of an MFI. Reduction of risk cost is possible by adding to transaction costs through close monitoring of loan portfolio. As an element of operating costs variable costs is directly affected by scale of operation and therefore it is the fixed cost, which needs to be kept minimum by MFIs and converting fixed cost to variable costs as much as possible.

In an environment where there are limitations on the interest chargeable, MFIs must focus on maximizing yield through ensuring portfolio quality, minimizing idle funds and operating in the most efficient and effective manner to limit operational costs in order to achieve sustainability.

Standardization is another way to reduction of costs. An organic expansion strategy also leads to lower operational costs. The scattered growth model has high costs initially and requires aggressive client mobilization to reduce the costs.

The interest rate charged should cover at least the cost of funds, operating expenses, loan losses and the effect of inflation on any owned funds. But to remain prudentially correct, products should be designed to minimize total effective interest rate to the borrowers.

Just how challenging the cost of small financial operations can be, is represented by the money order services operated by the Indian Post Office. The money order service is a one-way financial transaction. The Indian Post Office (IPO) receives the money deposited by the remitter in one of its post offices and undertakes to deliver the money to the addressee as specified by the remitter. The Indian Post Office has standard charge of Rs.5 per Rs.100 of money to be remitted. This translates into a 5% charge for a one-way transaction that takes approximately 7 to 10 days. At this rate, the money order business of Indian Post Office should look profitable. However the annual report of the Indian Post Office for the year 2005 speaks of the losses it incurs on the money order business.[13] The report reveals that while the IPO earns an average of Rs.27.37 per money order, it incurs an average cost of Rs. 57.61 per money order.

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[12] For more details, refer to Sa-Dhan publications 'Operating Cost of Microfinance' December 2004 and 'Side by Side – A Slice of Microfinance Operations in India 2005' September 2005.
[13] Annual Report 2005 of Indian Post Office. www.indiapost.gov.in/Part-I.doc Table 11.

Operating costs of MFIs reduce with the age of mF operations. The proportion of personnel cost to total cost of operation of a MFI to steep. This is primarily contributed by the operating methodology, remote operations and small size of credit that are operational characteristics of an MFI.

The issue of high costs among MFIs has several dimensions

A. The investment needed to acquire new clients is disproportionate to the returns expected from interest on credit to be provided to such clients. This is particularly significant in the initial 2-3 years of a MFI operation with new clients.

B. Cost of funds for MFIs remain higher than market level. Though there are growing instances of MFIs obtaining bulk funds from banks at competitive rates, the sample of 74 MFIs show that their average cost of funds from commercial sources are around 14%.

C. Most MFIs are efficient in overall application of bulk funds as on-lending to clients. However the on-lending operations are largely cash based. The operational costs of handling cash and high level of float funds add to the overall cost of MFI operations.

D. MFIs are not able to generate surplus from their operations. Most MFIs, especially the small and medium size MFIs have not achieved 100% OSS. Funding for growth of smaller MFIs to enable them reach operational sustainability is a matter of concern.

E. A contentious issue is the issue of trade-off between the operational costs of financial services and the achievement of social development objectives. The social development goals of an MFI would require that it serve poor clients with small loans and in dispersed areas that lead to high transaction costs. A focus on limiting operating costs could result in MFIs working exclusively with semi-urban and urban clients and with larger loans to the relatively better off clients.

12 Audit and Ratings

MFIs work through systems. MFIs are increasingly re-organizing their operations by means of professionalizing staff, internal controls, MIS and technological backbone. In the public space, MFIs undergo audit and ratings.

Audits

MFIs are incorporated institutions. As a condition of incorporation under any of the statutes viz. for society, trust, cooperative, NBFC or company, all MFIs undergo statutory audit of their annual accounts by qualified accountants. The annual accounting reporting system is framed by the provisions contained in Schedule VI of The Companies Act. These provisions are practised by the qualified accountants (practising Chartered Accountants certified by the ICAI).

ICAI brings out incremental guidelines to Chartered Accountants (CA) for disclosures by financial institutions. The CAs, as statutory auditors of MFIs is required to follow all the norms and guidelines of the ICAI. MFIs therefore get necessarily their annual accounts statutorily audited and certified by CAs.

The practice of statutory audit covers verification of financial transactions of the organisation, in conjunction with its stated objectives.

- Auditors use sampling methods to verify assets and financial transactions in the branches of organisations and obtain balance confirmation from debtors and creditors of the organisation.
- The income and expenses of the organisation are verified against the policies of the organisation.
- If case of inadequate information on transactions, systems or procedures, the statutory auditor ‘qualifies’ his report with such remarks and may abstain from certifying the accounts as ‘true and fair’ in their opinion.

Besides the statutory annual audit, not-for-profit MFIs such as societies or trusts are also audited for specific purposes of tax exemption and under FCRA in case they have received funds from foreign sources. The tax and FCRA authorities engage CAs to carry out special audits.

Co-operatives undergo annual audits specified by the Registrar of Co-operatives.

The Reserve Bank of India (RBI) specifies separate accounting reporting norms for banking institutions. The RBI has a dedicated department that audit Banks and NBFCs. It also engages CAs in carrying out special audits.

Donors and DFIs selectively specify separate set of external audits based on their respective institutional requirements. These audits are carried out by CAs.

The audit reports provide an institutional insight into financial assets and operations of an organisation. In case of organisations that are engaged in various other activities, over and above microfinance services, the operational details are annexed to audited financial statements.

Rating

Microfinance institutions are increasingly accessing commercial financial markets. To succeed in their efforts for mobilizing source of funds MFIs need to be assessed and evaluated by independent agencies. The advantage of rating for the MFIs are many viz. to raise funds from donors and lending agencies, to raise grant for capacity building from donor agencies, raise commercial funds from markets etc.

CRISIL

CRISIL adopts the MICROS© methodology for undertaking the grading of microfinance institutions (MFIs) and non-government organisations which have microfinance programmes as among their key activities (NGO-MFIs). This is a comprehensive framework to assess the ability of MFIs to scale up and sustain their operations. The acronym MICROS stands for Management, Institutional arrangement, Capital adequacy and asset quality, Resources and asset-liability management, Operational effectiveness and Scalability and sustainability. The MICROS framework includes a traditional creditworthiness analysis using the CRAMEL approach, modified as applicable to the microfinance sector. The acronym CRAMEL stands for Capital adequacy, Resource raising ability, Asset quality, Management and systems evaluation, Earnings potential and Liquidity/Asset liability management, the focus being on credit worthiness, scalability and sustainability.

MCRIL

M-CRIL is the most widely experienced agency having undertaken over 270 microfinance ratings across Asia. MFIs using a wide range of organizational forms, from NGOs to cooperatives, non-bank companies and banks have been covered.

Ratings have been undertaken for leading investors including ADB, DFID, SDC, HIVOS, CordAid and SIDBI. It maintains a comprehensive database of all its rating actions, which is used for developing benchmarks required for assessing MFIs. As the leading microfinance rater, M-CRIL makes a substantial contribution to this process.

APMAS

APMAS, a capacity building organisation, based in Hyderabad (AP), is working towards a common acceptance and wide use of quality as well as organisational capacity assessment processes for SHG Federations and MACS. APMAS has developed a Quality Assessment (QA) system called GRADES (Governance & Strategy, Resources, Asset Quality, Development & Impact, Efficiency & Profitability, Systems & Operating Processes, and SHG Performance) in collaboration with Micro Credit Ratings International Limited (M-CRIL), New Delhi. To further internal quality consciousness, APMAS is developing a self-assessment tool for SHG Federations. APMAS was involved in the development of NABARD Critical Rating Index, which is being used to rate SHGs. APMAS has assessed MACS in several districts of Andhra Pradesh.

PLANET FINANCE

'Planet Rating' an initiative of ' Planet Finance' carries out independent evaluation and rating missions of Microfinance Institutions (MFIs), disseminates the results of these missions, provides customized evaluation and training sessions. These services are based on the GIRAFE methodology: a comprehensive evaluation and rating methodology designed to meet MFIs' characteristics. The focus of rating is on parameters like governance and decision making process, information and management tools, risk analysis and control, assets including loan portfolio, funding, efficiency and profitability.

MFIs seek rating predominantly as fulfilment of conditions to access funds from DFIs. The SIDBI initiative to obtain ratings as an annual input for their credit support to MFIs has pioneered the practice of rating of MFIs in India. MFIs that access funds from SIDBI have been undergoing ratings periodically.

NABARD has instituted rating by CRISIL for MFIs as a condition to access funds from NABARD. The Micro Finance Equity and Development Fund (MFEDF), constituted by the Government in 2005 propose to support rating of MFIs. A couple of MFIs have themselves rated at one point of time or other on a voluntary basis. During FY 2005, it is estimated that about 75 MFIs were rated.

13 Building transparency in the sector

Building transparency in the sector is the important way forward

As the sector is growing in diversity of operations and outreach, transparency is becoming more important. Sa-Dhan initiative on MFI specific financial performance standards and reporting is accelerating the scope of transparency. The Sa-Dhan recommended set of financial standards[14] is an important initiative in building standards specific to MFIs. This is facilitating MFIs to benchmark their financial performance on industry standards and inter-MFI comparisons. The Sa-Dhan manual on financial standards is being widely used in the microfinance sector as a set of best practices.

The MFIs are also encouraged by DFIs and commercial banks to increase the depth of disclosures as instruments to their partnership. SIDBI, a DFI took an initiative to reach out to CAs with accounting disclosure issues. Banks are providing impetus to MFIs in their partnership, to enhance the depth of transparency.

Excerpts from the Speech by Mr. Y.V. Reddy, Governor of the Reserve Bank of India , at the International Conference on 'Role of Accountancy Profession in Fostering Economic Growth' organized by Institute of Chartered Accountants of India, Mumbai on January 19, 2006

Accounting standards constitutes one of the core elements of financial infrastructure. It encompasses mechanisms for providing information about the financial condition and performance and importantly, the risk profile of firms to all potential users. Once these information are received, it would help in utilizing the scarce resources more efficiently and productively thereby ensuring financial discipline be it in any kind of institutions.

Market forces had been believed to bring about efficiency but even that necessitated the assumption of having perfect knowledge. This knowledge can be gained once true information is generated. It is in this respect that one cannot ignore the information cost associated in achieving efficiency. The benefits accrued from the information gathered would be a public domain whereas the costs are borne by a single party only. It was basically this undersupply of information that led to the Asian crisis.

Since then, the importance of institutional aspects as well as the micro and macro concepts of economic growth have been recognized and given attention too.

[14] Sa-Dhan publication 'Technical Tool Series-I: Tracking Financial Performance Standards of Microfinance Institutions' August 2003

In this context, the importance of intermediaries, issuers, investors, regulators and professionals cannot be shirked aside as they are the ones who are the key providers and verifiers of information. More so, with the globalization and inflow of foreign capital more transparency in the working of institutions are demanded and hence the need for adopting the best practices in accounting standards. In response to this, a working group was constituted by the RBI with the former president of ICAI as the chairperson. The group looked over the issue of bank's following the Indian accounting standards and recommended steps to reduce deviations from them.

Indian accounting standards have been making efforts to be at par with the international ones and it is worth pointing out that a review of the recommendations of the advisory group by the Reserve bank, 2004 showed a narrowing gap between the two. The successful implementation of any reform process lies with these professionals so as to ensure, the highest level of integrity of any statements they make. By providing the foundation for compilation of credible financial statements, these professionals facilitate market discipline, engender confidence among various stakeholders and reduce the possibility of misleading information that can disrupt stability of the system.

Sa-Dhan is currently working jointly with the ICAI to develop 'Guidelines for Accounting Standards and Disclosure Norms for MFIs'. The ICAI has set up a Study Group comprising of representatives from ICAI and Sa-Dhan. The guidelines will be made mandatory by the ICAI for their CAs auditing and certifying MFIs. The guidelines therefore will create a uniform reporting and disclosure environment for all institutions involved in providing microfinance in India.

Sa-Dhan is equally focussed on developing non-prudential norms for MFIs. A set of ethical norms has been discussed among members of Sa-Dhan. A dedicated committee has now been formed to suggest a comprehensive set of norms for ethical standards.

14 Conclusions

In the current trajectory of exponential growth backed by demonstrated efficiency, the sector faces some important flag posts.

A. The small and nascent MFIs need to induct professional expertise and systems in order to grow. These MFIs face comparative disadvantages of lack of credit history and field presence. The systems and staffing therefore need utmost care and priority.

B. Medium size MFIs needs a long-term growth strategy to remain focussed on poorer communities and organizational sustainability. These MFIs are in the transition phase of moving from concessionary conditions to commercial sustainability. These institutions have reasonable market goodwill and experience to move quickly to become commercially viable and remain socially effective.

C. The large MFIs face issues of succession planning and management of large operations in a distributed network of branches. Adaptation to changing demands of clients and maintaining staff efficiency are the twin challenges for the large MFIs.

D. Across size of operations and age, MFIs will need to emphasize on further innovations and cost reduction to remain competitive on their product offerings to poor clients. Competition on effectiveness and outreach is expected to intensify both among MFIs and between MFIs and other financial institutions.

E. In view to increasingly competitive environment, all financial institutions need to develop a systemic process of sharing client-level information. This would reduce the operational risks of each financial institution by enhancing their credit assessment process and reduced incidence of multiple financing.

F. MFIs operate closely with community groups. The regularity in meeting clients is an important operational strength of MFIs. MFIs are actively supporting larger community collectives like SHG Federations.

G. There are issues around maintaining quality the groups and SHG Federations that need concurrent attention. The quality issues cover sustainable leadership within community, self-management of the collectives by members and ability to deal with demand of services from members.

H. MFIs need to grow at a steady pace. Internal systems and focus on client perspectives will provide impetus to sustainable growth of MFIs.

I. Transparency and public reporting assumes priority. The other important stakeholders like government and banks are eager to comprehend working and efficiency of the sector in detail.

J. Banks would need to build longer term and competitive relationship with MFIs. This will strengthen the effectiveness of both banks and MFIs in reaching the poor.

K. Social goals of MFIs to assist the poor will remain critical. MFIs need to keep their microfinance operations integrated to their social objectives. This also makes it imperative upon MFIs to find level playing role with the social objectives of the government.

Annexure-1

Preliminary findings on SHG data analysis based on Sa-Dhan SHG performance Measurement Tool

The Context

SHGs today have become a vehicle to pursue diverse developmental agendas of the government, banks and civil society organizations. In microfinance, rapid growth has been observed in the SHG-Bank Linkage programme during the last decade. This has resulted in a cumulative linkage of 16.18 lakh SHGs to banks by March 2005 resulting in an estimated 24.3 million poor households gaining access to microfinance from the formal banking system. MFIs in India predominantly operate through group methodologies. Within the variants of group methodologies, 60% of the 6.7 million clients[15] have been covered by MFIs through SHGs, with the rest being covered under Grameen and JLG models.

The exponential success of SHGs as community collective has attracted considerable attention of development practitioners, policy makers, funders, academicians, researchers and even corporate bodies. Findings of some micro-studies on SHGs however do not reflect a very encouraging picture in the of quality of SHGs. Such revelations are quite alarming as quality of SHGs has a direct bearing on the future prospects of the SHG movement. The situation seems to be deteriorating day by day, as quality aspects have not been given proper attention in the rush to promote SHGs (to reach targets by numbers). The perception of leading SHG promoters is that very few promoters have clarity about the objectives and the long-term trajectory of the SHGs. For example, very few SHGs have been groomed as autonomous institutions that can intermediate on behalf of members with banks and public agencies. Study conducted by APMAS[16] has shown that over times the quality of SHGs in terms of different quality parameters tend to fail to score enough and the same practically lead to lower financial disciplines and thereby affecting the viability of SHGs in long term.

To avert such a situation , quality has become the paramount agenda today among different stakeholders, as there is an overarching concern about sustainability of the SHG movement in India.[17]

It is therefore important that the qualities of SHGs are maintained. It entails the necessity

[15] Sa-Dhan database on its members 31st. March 2005
[16] Visit APMAS website at http://www.apmas.org for details of the study
[17] Sa-Dhan Discussion Paper on Quality Parameters of Self-Help Groups August 2003

of quality measurement and find out the key weaknesses so that proper capacity inputs could be provided to the SHGs by the promoting institutions.

The Sa-Dhan tool for performance measurement of SHGs[18] has been prepared with two objectives. The tool is specifically focused on assessment of SHGs as financial collectives. The tool is therefore aimed at SHPIs and branch-bankers as users.

Sa-Dhan is engaged with eleven MFIs across the country to help them in assessment of SHGs associated with them. Sa-Dhan is also engaged with a couple of banks to discuss the ways and means of institutionalizing the application of the tool in improving the SHG financing by the banks.

The preliminary data available to Sa-Dhan comprises of 203 SHGs across nine organizations operating in the States of Maharashtra, West Bengal and Orissa. The organizations are Chaitanya in the state of Maharashtra; BIRDS in Andhra Pradesh; NBJK in Jharkhand; Sanghamitra, Janodaya and Outreach in Karnataka; Adarsha in Orissa; Kotalipara in West Bengal and IASC in Tamil Nadu.

The SHG performance measurement tool analyses SHG on a range of 17 parameters that cover social goals, operational aspects like meetings and decision making and financial issues like record keeping, funds management and credit usage and repayment. Assessment is based on age-wise classification of SHGs, the three categories viz. (a) 6-12 months; (b) 13-24 months and (c) 25 to 36 months. The tool provides a numeric score to SHGs that signifies the overall quality of the SHG

Though the database is small yet the varied and distributed location of the sample SHGs provide some interesting quality issues and concerns for SHGs.

- Articulation of SHG objectives by members is varied (26% to 91%) across SHGs.
- The quality of group meetings improves substantially after an initial period of about 12 months from formation of the SHG.
- 75% of SHG members participate in group decisions
- Annual election of leaders happens only in 29% cases
- 70% of groups manage their transactions independently
- 87% SHGs maintain books of accounts on time; 20% SHGs have updated but partially incorrect records.
- Even for relatively mature SHGs, linkage with banks for credit is low at 28%
- Repayment performance of members to their SHGs is 90% on time

[18] Sa-Dhan publication ‘SHG Performance Measurement Tool: Technical Tool Series –2:October 2005

- Overall PAR (Portfolio at Risk) of loan portfolio within SHGs is alarmingly over 10% in 82% cases.

Out of the total sample of 203 SHGs, 90 SHGs scored grade A (overall score of 75% or above), 84 SHGs scored grade B (overall score of 60% to 74%), 13 SHGs scored grade C (overall score between 50 and 59%) and 1 SHG scored grade D (overall score of less that 50%).

Annexure-2

List of 83 MFIs in the Sample : Classified by Peer Groups

S. No.	Name / Acronym of MFI	GLP	Client Outreach	Age
		(Large/ Medium/ Small)	(Large/ Medium/ Small)	A = 1- 5 Yrs B = 5 - 10 Yrs C = > 10 Yrs
1	ADARSA	S	S	B
2	Adarsha MACS	S	S	A
3	Agradut Polly Unnayan Samity	S	S	B
4	Amber Ashrayee Mahilla	S	S	A
5	AMMACTS	M	M	B
6	Asmita Institute for development	S	S	A
7	ASSIST	S	M	C
8	BANDHAN	M	M	A
9	BASIX	L	L	B
10	Bhagyalaxmi MACS	S	S	A
11	Bharatmata MACS	S	S	A
12	BIRDS	S	M	B
13	BISWA	S	M	B
14	BODHANA	S	M	A
15	BWDA	M	S	B
16	BWDA FINANCE	M	M	A
17	CASHPOR Microcredit	L	L	A
18	DARABAR SAHITYA SANSAD	S	S	B

S. No.	Name / Acronym of MFI	GLP	Client Outreach	Age
		(Large/ Medium/ Small)	(Large/ Medium/ Small)	A = 1- 5 Yrs B = 5 - 10 Yrs C = > 10 Yrs
19	Deepalaya	S	S	A
20	DISHA	S	M	A
21	Gram Swaraj Seva Trust	S	S	A
22	Grameen Koota	M	M	B
23	GUIDE	S	S	A
24	Halo Medical Foundation	S	S	B
25	Himalayan Action Research Centre	S	S	A
26	Holy Cross Social Service Centre	S	M	C
27	IASC	M	M	B
28	Janodaya Public Trust	S	S	A
29	Jhanase MACS	S	S	A
30	Jyothi MACS	S	S	A
31	KBS LAB	M	M	A
32	Kotalipara dev Society	S	S	B
33	Krushi	S	S	B
34	Krushi MACS	S	S	A
35	LEAD	S	M	B
36	Mahasemam	M	M	B
37	Mahila Pragothi MACS	S	S	A
38	Mothere Teresa Mahila MACS	S	S	B
39	NBJK	S	M	C
40	NEEDS Ajiwika	S	S	A
41	New Life	S	M	C

S. No.	Name / Acronym of MFI	GLP	Client Outreach	Age
		(Large/ Medium/ Small)	(Large/ Medium/ Small)	A = 1- 5 Yrs B = 5 - 10 Yrs C = > 10 Yrs
42	NIDAN	S	S	B
43	Organisation for Rural Survival	S	S	A
44	OUTREACH	M	M	C
45	PANI	S	S	A
46	Pavithra MACS	S	S	A
47	Pragathi Seva Samity	S	S	B
48	Prochesta	S	S	B
49	Professional Assistance for Development Action	S	L	C
50	Pustikar LVPBSSS Ltd	L	S	B
51	RAIDS	S	S	B
52	Rajapur Seva Niketan	S	S	A
53	RASS	S	S	C
54	RGVN	S	M	B
55	Rural Education and Action for Change	S	S	A
56	Sanghamitra Rural microfin	M	L	A
57	Sargaman Women's MPTC CO.	S	M	A
58	Sarva Jana Seva Kosh	S	M	C
59	Sarvodaya Nano Finance	L	L	A
60	Satin Credit Care	M	S	C
61	SEARCH-KOPSA	S	S	B
62	SEVA	S	S	A
63	Sharda Women's Association	S	M	B

S. No.	Name / Acronym of MFI	GLP	Client Outreach	Age
		(Large/ Medium/ Small)	(Large/ Medium/ Small)	A = 1- 5 Yrs B = 5 - 10 Yrs C = > 10 Yrs
64	SHARE MICROFIN	L	L	B
65	SHEPHERD	S	M	B
66	Shramik Bharti	S	S	C
67	SKS	L	L	B
68	SPANDANA	L	L	C
69	Sree Chayathyana MACS	S	S	A
70	Sri Dhanalaxmi MACS	S	S	A
71	Star Youth Association	S	M	B
72	Stree Shakthi MACS	S	S	A
73	Subhashini MACS	S	S	A
74	SUPPORT	S	S	B
75	SWATI	S	S	A
76	Swayam Krushi MACS	S	S	A
77	Swayamshree Microcredit services	S	S	A
78	PWMACTS	S	S	B
79	Thirumalai Charity Trust	S	M	B
80	Vikas Center for Development	S	S	B
81	Vivekananda Seva Kendra - O- SU	S	S	B
82	VMCS	S	S	A
83	VWS	M	M	B

Appendix-3

List of Sa-Dhan Publications

Title of publications	Year of publication
Microfinance Regulation in India	2001
Tracking Financial Performance Standards of Microfinance Institutions - An Operational ManualTechnical Tool Series -1	August-03
Onthe Road to Effective Governance of Microfinance Organizations	August-03
Quality Parameters of Self help Groups	August-03
SHG Federations in India: Emerging Structures and Practices	July-2004
Side By Side - A Slice of Microfinance Operations in India -2004	September-2004
Operating Costs of Microfinance Services and its Impact on Interest Rate Setting	December-2004
Indian Experience of Microfinance: A Sustainable Banking Solution for the Poor	December-2004
Microfinance & Poverty	March-2005
Microfinance Development in India	March-2005
An introduction to Microfinance Delivery Models in India	March-2005
Sustainability of Microfinance Intervention	March-2005
Sustainable Livelihoods & Microfinance	March-2005
Side By Side - A Slice of Microfinance Programs in India - 2004	March-2005
Side By Side - A Slice of Microfinance Operations in India – 2005	September-2005
SHG Performance Measurement ToolTechnical Tool Series -2	October-2005
Existing Legal & Regulatory Framework for the Microfinance Organizations in India- Challenges and Implications	January- 2006

Sa-Dhan publishes ‘Patrika’ twice a year. Each such publication is dedicated to one issue of importance to the microfinance sector. The next issue (11th.) of ‘Patrika’ will be dedicated to ‘Scope and application of technology in microfinance’.

All publications of Sa-Dhan are for private circulation only.

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