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IFAD

INTERNATIONAL FUND FOR AGRICULTURAL DEVELOPMENT

Executive Board – Sixty-Ninth Session

Rome, 3-4 May 2000

REPORT AND RECOMMENDATION OF THE PRESIDENT

TO THE EXECUTIVE BOARD ON A PROPOSED LOAN TO THE

SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI)

GUARANTEED BY THE

REPUBLIC OF INDIA

FOR THE

NATIONAL MICROFINANCE SUPPORT PROGRAMME

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CURRENCY EQUIVALENTS

Currency Unit	=	Indian rupee (INR)
USD 1.00	=	INR 43.5
INR 1.00	=	USD 0.02

WEIGHTS AND MEASURES

1 kilogram (kg)	=	2.204 pounds (lb)
1 000 kg	=	1 metric tonne (t)
1 kilometre (km)	=	0.62 miles (mi)
1 metre (m)	=	1.09 yards (yd)
1 square metre (m^2)	=	10.76 square feet (ft^2)
1 acre (ac)	=	0.405 ha
1 hectare (ha)	=	2.47 acres

ABBREVIATIONS AND ACRONYMS

DFID	Department for International Development (United Kingdom)
FFIs	Formal financial institutions
MFIs	Microfinance institutions
NABARD	National Bank for Agriculture and Rural Development
SCs	Scheduled castes
SFMC	SIDBI Foundation for Microcredit
SHGs	Self-help groups
SIDBI	Small Industries Development Bank of India
STs	Scheduled tribes
UNOPS	United Nations Office for Project Services

GOVERNMENT OF THE REPUBLIC OF INDIA

Fiscal Year

1 April - 31 March

MAP OF IFAD PROJECTS IN INDIA

Source: IFAD

The designations employed and the presentation of the material in this map do not imply the expression of any opinion whatsoever on the part of IFAD concerning the delimitation of the frontiers or boundaries, or the authorities thereof.

REPUBLIC OF INDIA

NATIONAL MICROFINANCE SUPPORT PROGRAMME

LOAN SUMMARY

INITIATING INSTITUTION:	IFAD
BORROWER:	Small Industries Development Bank of India (SIDBI)
GUARRANTOR:	Republic of India
EXECUTING AGENCY:	SIDBI and the SIDBI Foundation for Microcredit (SFMC)
TOTAL PROJECT COST:	USD 134.0 million
AMOUNT OF IFAD LOAN:	SDR 16.35 million (equivalent to approximately USD 22.0 million)
TERMS OF IFAD LOAN:	40 years, including a grace period of ten years, with a service charge of three fourths of one per cent (0.75%) per annum
COFINANCIERS:	- SIDBI - Department for International Development, (DFID) (United Kingdom)
AMOUNT OF COFINANCING:	SIDBI: USD 88.5 million DFID: USD 23.5 million
TERMS OF COFINANCING:	SIDBI: Equity and Loans DFID: Grant
APPRAISING INSTITUTION:	IFAD
COOPERATING INSTITUTION:	United Nations Office for Project Services (UNOPS)

PROGRAMME BRIEF

The target group and poverty situation. In the last three decades, the Government of India has made concerted efforts to provide financial services to the poor through formal financial institutions (FFIs). The most important interventions include: (i) the nationalization of all major commercial banks in 1969 and subsequent expansion of banking facilities in rural areas: and (ii) introduction of a number of credit-linked, subsidy-driven poverty alleviation programmes since early 1980s. Despite these efforts, microfinance has yet to grow to any significant scale in India. As a result, there is a huge, unmet demand for microfinance services, especially among those who are the poorest and most vulnerable. For example, of the annualized credit usage of all poor families of INR 450 billion (USD 10.5 billion), only about a quarter is met by formal sources. The access to appropriate savings services is even worse. The programme proposes a two-pronged strategy to meet this gap: first, it will strengthen the microfinance institutions (MFIs) and link them with the FFIs; and second, it will strengthen the microfinance programmes of the FFIs.

The programme's target group will embrace all strata of the poor in rural and urban areas who are in need of microfinance services. IFAD funds will, however, be restricted to rural and semi-rural areas only. As poverty is a dynamic process, the programme will also partially include those households that are sometimes marginally above the poverty line, but are highly vulnerable and in danger of falling back into poverty. Emphasis, however, will be placed on ensuring that the poor are at the centre of the programme. Based on the experience gained in microfinance projects supported by IFAD, self-selection procedures, ceiling on loan size, joint liability groupings, requirement for regular meetings and other disciplines will be applied to control an undue influx of the not so poor.

Programme activities to benefit the poor. The design focuses on two key themes: (i) capacity-building to create adequate institutional capacity among the various actors within the microfinance sector; and (ii) providing adequate funds for on-lending to MFIs/FFIs. Within this framework, the programme will support the strengthening of the Small Industries Development Bank of India (SIDBI) Foundation for Microcredit (SFMC) and the MFIs by providing technical assistance, training, operating costs and mentoring support in order to expand capacity in the microfinance sector to serve the poor. It will also provide equity capital support to selected MFIs and a line of credit to the SFMC for on-lending to MFIs and FFIs so as to provide credit to these households. With the aim of influencing the policy and regulatory environment, the programme will also promote an annual, high-level forum to discuss key issues in microfinance, examine new innovations, support policy research studies, action-research studies and the pilot-testing of new products and services that benefit the poor.

Beneficiaries and participation. The programme is expected to benefit around 1.26 million women and men. Of these, 70% are women and 80% poor. Over 540 000 households are expected to borrow under the programme. In addition, self-help groups (SHGs) will recycle the savings among themselves as loans. Over the life of the programme, the borrowers will have access to an average of INR 14 500 in loan funds, a significant contribution to ensuring that the majority of them move out of poverty. The programme will have an active clientele of 50 large MFIs, 40 medium MFIs and 10 FFIs by the end of the programme period. MFI financial performance is expected to improve and by the tenth year the rate of return on equity will reach about 23%. The projections for SFMC indicate the return on equity at 2.6% in the second year and 18% in the seventh year.

At the national programme management level, the current SFMC governing body comprises representatives from reputable MFIs from the private and non-governmental sector. This allows for the participation of MFIs in programme operation. The ownership of the programme is expected to be very high at the SFMC level, as it will contribute almost two-thirds of the total programme cost. At the grass-roots level, participation is inherently built in the microfinance methodology itself, as microfinance operation can only be demand-driven. Furthermore, the self-help and the solidarity models of small group management will ensure that the participation of the beneficiaries in all decisions takes place at that level.

REPORT AND RECOMMENDATION OF THE PRESIDENT OF IFAD TO THE EXECUTIVE BOARD ON A PROPOSED LOAN TO THE SMALL INDUSTRIES DEVELOPMENT BANK OF INDIA (SIDBI) GUARANTEED BY THE REPUBLIC OF INDIA FOR THE NATIONAL MICROFINANCE SUPPORT PROGRAMME

I submit the following Report and Recommendation on a proposed loan to the Small Industries Development Bank of India (SIDBI) for SDR 16.35 million (equivalent to approximately USD 22.0 million) on highly concessional terms to help finance the National Microfinance Support Programme. The loan, guaranteed by the Republic of India, will have a term of 40 years, including a grace period of ten years, with a service charge of three fourths of one per cent (0.75%) per annum. It will be administered by the United Nations Office for Project Services (UNOPS) as IFAD's cooperating institution.

PART I - THE ECONOMY, SECTORAL CONTEXT AND IFAD STRATEGY[1]

A. The Economy and Agricultural Sector

1. India is the seventh largest and the second most populous country in the world. Around 73% of its people live in rural areas, eking out a livelihood mainly from agriculture. While substantial progress has been made in recent decades in terms of increasing national income, its impact has been diluted by the increase in population. As a result, a large segment of the population continues to be illiterate, uneducated, undernourished and without adequate access to productive assets and employment.

2. Agriculture remains a key economic activity and is the single largest contributor to the well-being of the poor, providing a livelihood to over 75% of the rural labour force. Past growth in the agricultural sector has been below average at 3.4%. It is above the population growth rate, permitting India to accumulate sizeable food reserves. Yet inequity in income distribution continues to constrain access to adequate supplies of food to the most disadvantaged groups.

3. The proportion of the poor in India has declined in the last two decades, albeit very slowly. About 40% of the population presently live below the officially defined poverty line. Among social groups, scheduled tribes (STs) have the highest incidence of poverty (54%), followed by the scheduled castes (SCs) at 50%. Three eastern states of West Bengal, Bihar and Orissa account for over 42% of the rural poor. Women in India remain one of the most disadvantaged groups; women-headed households suffer a disproportionate burden of poverty. At the same time, the delivery structures of credit, technical advice, etc. do not reach them, as institutions are slow to recognize women as heads of households.

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1 See Appendix I for additional information.

4. The Government of India nationalized all major commercial banks in 1969, which led to a very rapid expansion of the rural branch network. Later efforts were made to improve financial service delivery in the rural areas through priority licensing to open rural branches, lending targets for the priority sector advances and the establishment of regional rural banks. The second-generation microfinance initiatives mainly involved the promotion of self-help groups (SHGs).

5. The outreach of the microfinance institutions (MFIs) and programmes is still quite small. Overall, the transaction cost for both the small client and the institution continue to remain high. Women in general and resource-poor women in particular have even lower access to financial services, mainly due to restricted mobility and a lack of asset ownership. The All India Debt and Investment Survey of 1992 showed that the share of the non-institutional agencies in the outstanding cash dues of the rural households was 36%. The share of debt from the non-institutional credit agencies among the poor, however, is much higher at 58%. As a result, the poor continue to remain overwhelmingly dependent on the informal sector for their credit needs. Informal credit providers do not generally cater to longer-term productive credit needs and the interest rates are very high. In addition, most moneylenders have developed exploitative linkages between credit delivery, output marketing and input supply.

B. Lessons Learned from Previous IFAD Experience

6. IFAD has financed fourteen projects in India since 1979, with funding amounting to some USD 386 million. Of these, the Tamil Nadu Women's Development Project supported early initiatives to form SHGs, and provided preliminary linkage with the banking system. The Andhra Pradesh Tribal Development Projects tried to transplant the SHG concept into a more difficult cultural environment with mixed results. The Maharashtra Rural Credit Project built on the earlier experiences of SHG development and blended it with the SHG-bank linkage programme with considerable success. These projects have demonstrated the latent capabilities of the SHG concept to increase the income levels of poor rural women while providing banks with a cost-effective and profitable additional portfolio of loans with high repayment rates.

7. The impact of these projects on SHGs and their members were numerous. Women were transformed into small-scale entrepreneurs, developing the habit of systematic savings and a loan repayment culture. More importantly, women began acting as agents of change, playing a transformational role rather than being passive recipients. Lessons from IFAD's wider experience of microfinance projects indicate that the institutional financial sustainability of the MFIs depends upon their ability to set an appropriate interest rate that covers all operating costs, the cost of funds and loan loss and yield a reasonable return. In addition, the MFIs will have to minimize operating costs, achieve economies of scale, minimize financial costs through greater savings mobilization and maintain near perfect repayment rate.

C. IFAD's Strategy for Collaboration with India

8. **The country's policy for poverty alleviation.** In recent decades India has spent large amounts on anti-poverty programmes. Of the total central plan budgetary expenditure, the Government spent 5.5% on anti-poverty programmes in 1990-91, which increased to 8% in 1993-94, more or less stabilizing at that level. A large part of the total central allocation is for food subsidies (40% of the anti-poverty programmes); not including two states (Andhra Pradesh and Kerala), the impact of food subsidies upon the poor is limited. Rural employment programmes have grown quickly in recent years and, in terms of central government allocation, equal the food subsidy programme.

9. Attempts to bring microfinance services to the poor began in the early 1980s with government-directed and subsidized poverty alleviation programmes. These were integrated rural development programmes that aimed at creating self-employment through credit from banks and a one-time capital grant from the Government. The programme targeted exclusively households below the poverty line

and assigned priority to the SCs, STs and women. Recovery of loans under this programme was low and the subsidy-induced leakage to the "better-off" and "well-connected" households was high. The programme was recently renamed Sworna Jayanti Rozgar Yojana, with the added feature of group-based social collateral as the basis for lending. Improvement in the overall performance of the programme has yet to be seen.

10. **The poverty-eradication activities of other major donors.** Most donor agencies have a strong anti-poverty focus in their development cooperation with India. Many actively support microenterprise, microfinance, primary health and education, and the management of rainfed areas. Overall, official development assistance contributes only about 18% of India's development budget. However, its emphasis on social-sector investments and innovative inputs has enabled official development assistance to perform a catalytic function. The World Bank's assistance to India in recent years shows a clear tilt towards the social sector, especially towards education and health. Among major bilateral agencies, the Overseas Economic Co-operation Fund (Japan) concentrates chiefly on the power and transportation sectors. German development cooperation is shifting from the large, high-tech projects to the social sector and more specifically to poverty alleviation. The Department for International Development (DFID) (United Kingdom) aid programme concentrates mainly on supporting the Government's efforts to alleviate poverty.

11. In the arena of microfinance, the Swiss Development Cooperation (SDC) has provided funds to retail MFIs, such as BASIX, and has created a rural financial services fund with the National Bank for Agriculture and Rural Development (NABARD) to support capacity-building for the SHG-bank linkage programme. Similarly, the German Credit Institution for Reconstruction's (KfW) credit lines to Small Industries Development Bank of India (SIDBI) were to finance small and medium size enterprises. The German Agency for Technical Cooperation (GTZ) recently commenced its first collaboration with NABARD to support the SHG-bank linkage programme, focusing on working with select regional rural banks to develop appropriate systems for dealing with SHGs. The DFID has supported microfinance activities through its urban poverty-alleviation programmes and also under the Credit and Savings for Household Enterprises Project. The programme will also provide start-up capital for the Andhra Pradesh Women's Fund.

12. **IFAD's strategy for collaboration with India.** IFAD's strategy in India focuses on searching for solutions to constraints on the poor, building on and deepening the experience gained in past programmes and developing innovative approaches that, if proven successful, can serve as replicable models. To this end the main areas for programme intervention continue to be microfinance initiatives and women's empowerment, and the development of tribal areas and non-farm enterprise. Within this overall structure, the major strategic thrusts are on: (i) increasing popular participation in implementing anti-poverty initiatives; (ii) strengthening grass-roots institutions; (iii) increasing the access of the poor to resources, including land and common property resources; (iv) improving access of the poor to financial services; (v) generating sustainable incomes for the poor from non-farm enterprises; and (vi) targeting the rural population belonging to STs and SCs and women, in view of the higher incidence of poverty, vulnerability and the usually lower social status of these groups.

D. Programme Rationale

13. Microfinance is an important instrument for empowerment, sustainable social and economic progress and a key strategy in poverty alleviation. It has evolved slowly but steadily over the years. Several past projects of IFAD contributed to its development. Despite these efforts, microfinance has yet to grow to any significant scale. As a result, there is a huge unmet demand for microfinance services. For example, the annualized credit usage of all poor families (rural and urban) is estimated at over INR 450 000 million. Of this only about 20% is met by formal sources. The demand for savings services is ever higher than for credit in rural households. To meet the unmet demand, a two-pronged strategy – strengthening of the MFIs and formal financial institutions (FFIs), and mainstreaming the

microfinance sector – will be required. This is based on the fact that several retail MFIs have emerged in the recent past and their efforts are promising.

14. The SIDBI has been one of the major actors in microfinance development with a strong commercial orientation capable of providing initial assistance and guidance of the MFIs. The partnership with the SIDBI will enable it to expand its involvement in microfinance and also increase the probability of deeper integration of microfinance into the mainstream financial system. This will ensure sustainability of programme interventions. The availability of grant funds from DFID provides the resources to support the essential task of capacity-building. IFAD's long-term loan funds are able to underpin the long-term debt capitalization of the SIDBI Foundation for Microcredit (SFMC), making it easy to mobilize funds in the financial market to on-lend to MFIs.

PART II - THE PROGRAMME

A. Programme Area and Target Group

15. The coverage of the programme will be national. The SFMC will service the MFIs located in different parts of the country through its head office based in Lucknow and the network of regional offices and branch offices. The coverage will depend on the demand for assistance from the MFIs. The target group under the programme will embrace all strata of the poor in rural and urban areas who are in need of microfinance services, both savings and credit. IFAD funds will, however, be restricted to rural and semi-rural areas only. The assistance from the programme to MFIs will flow to poor borrowers who otherwise might not have easy access to credit from formal sources.

16. Poverty is a dynamic two-way process: while some of the poor climb out of poverty, others of the not-so-poor fall back. The latter can be classified as tomorrow's poor. These groups are generally excluded from programmes targeted at the poor, although they may be equally vulnerable to sharp fluctuations in income and expenditure, leading them to the poverty trap once again. The programme will include this group among its clientele, the justification being that the poverty level income has been defined in India rather conservatively. Hence, a much higher proportion of people will fall under poverty if a more reasonable consumption level is defined. This inclusive approach may paradoxically best serve the interests of the poor as mixed clientele financial institutions tend to be more sustainable.

17. Emphasis, however, will be placed on ensuring that the poor are at the centre of the programme. Self-selection procedures through such techniques as a ceiling on loan size, joint liability groupings, together with the discipline imposed by most microfinance programmes have generally proven effective in controlling an undue influx of the not so poor. Still close monitoring will be built into the programme to ensure that the poor are not sidelined. The proposed initiative will include both men and women as its target group.

B. Objectives and Scope

18. The overall goal of the programme is to expand the horizontal and vertical outreach of MFIs and programmes, and to mainstream them in terms of their access to resources available in the financial sector so as to enhance the access of the poor to microfinance services. The purpose of the programme is: (i) to contribute to the development of a more formal, extensive and effective microfinance sector on a national scale that serves poor women and men; and (ii) to assist in the evolution of an appropriate enabling environment for the development of sustainable MFIs.

C. Components

19. The programme will adopt a flexible and demand driven approach whereby the MFIs and FFIs determine their priorities, and with some external assistance, acquire the resources needed for their effective implementation. Within this framework, the programme will: (i) assist in institutional strengthening of SFMC and partner MFIs/FFIs by providing resources for capacity-building and mentoring support; (ii) finance expansion of lending; and (iii) support activities that assist in the evolution of an appropriate enabling environment for the development of sustainable MFIs through policy studies, action-research and networking[2].

Capacity-Building of the Microfinance Sector

20. The programme will support the strengthening of the SFMC, particularly through staff and management development. It will provide expertise in impact assessment, new financial products for the SFMC and MFIs, and management information system (MIS) development. It will also link SFMC with MFI best practices elsewhere in the world. Capacity-building of MFIs will include three sub-components: (i) technical assistance and training; (ii) operating cost support; and (iii) mentoring support. Both large and medium MFIs will be eligible for technical assistance and training and operational support. The mentoring support will be exclusively directed towards medium MFIs.

21. The capacity-building component will also address the issue of high debt-to-equity ratio, a major weakness of the MFIs, by providing equity capital support. The programme will also assist the SFMC in identifying FFIs, with management willing to explore microfinance as a viable new service area. A technical assistance package for these institutions will be provided to help them mount or expand microfinance programmes. The programme will support capacity-building of a range of specialized, in-country resource agencies in order to develop professional, long-term, back-stopping capability for the sector along with a sound rating system.

Credit Funds for Microfinance Programmes

22. The programme will provide credit funds to the SFMC to relend funds to eligible MFIs for on-lending to SHGs and other retail level partner institutions or through direct lending. The SFMC will also provide credit funds to FFIs such as urban cooperative banks, regional rural banks, non-banking finance companies, commercial banks, credit unions etc., for on-lending to MFIs/SHGs and other partner institutions or for direct lending. It is expected that this segment of the market, which cannot be addressed directly by the SFMC, will be served through these FFIs. Moreover the cumulative demand on incremental basis (disbursements net of repayments) over the seven-year programme period is expected to be INR 4 806 million (USD 110 million). Of this, the programme will provide a line of credit amounting to INR 4 300 million (USD 99 million) to SFMC for on-lending. It is envisaged that at the end of the seven-year programme period, around 50 large MFIs and 40 medium MFIs will be active clients of the SFMC.

Policy, Advocacy and Action-Research

23. The programme will promote an annual, high-level forum to discuss key issues in microfinance, to examine new innovations and to compare Indian achievements to state-of-the-art practices elsewhere. The programme will also support policy research studies, international exposure visits, action-research studies and pilot testing of new products and services developed by action-research. The action-research will also focus on gender issues, which neglected in most microfinance programmes. Similarly, MFI networks will be supported by emphasizing the development of a self-regulatory mechanism in the absence of any central bank regulation for the MFI sector. Support will

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[2] See Appendix III.

be provided to contract top-quality, socio-economic research institutions to undertake ongoing impact assessment.

Programme Management

24. The SIDBI will be the borrower as well as the principal executing agency for the programme. The SFMC has prepared a business plan that was revised during appraisal, and will have a separate balance sheet within the SIDBI overall accounting system from the financial year 1999-2000. The SFMC has an exclusive advisory board consisting of experts, MFI practitioners and senior management officials of SIDBI whose main task is to advise on policy issues for the SFMC. A wide array of service providers will assist the SFMC in programme management.

D. Costs and Financing

25. The total programme cost over seven years inclusive of contingencies is estimated at INR 6 606 million (USD 134.0 million). As per the World Bank projection, price contingencies for local costs are estimated at 6% per year; the same is estimated for foreign costs, which are minimal at 1% of total base cost. This is based on the projected G-5 Manufacturing Unit Value Index. In converting local costs in Indian rupees to USD, a constant purchasing parity approach has been used. The programme cost is comprised entirely of investment costs since the recurrent costs of the SFMC are financed from the interest rate spread on the lending. Investment credit is calculated as incremental credit after the recycling of loan repayments. The overall programme cost is summarized in Table 1.

TABLE 1: SUMMARY OF PROGRAMME COSTS[a]
(USD million)

Components	Local	Foreign	Total	% of Foreign Exchange	% of Base Costs
Capacity-building of microfinance sector	20.7	0.7	21.4	3	17
Credit funds for microfinance programmes	99.3	-	99.3	-	80
Policy, advocacy and action-research	2.8	0.3	3.1	8	2
Total base costs	**122.8**	**0.9**	**123.7**	**1**	**100**
Physical contingencies	-	-	-	-	-
Price contingencies	10.3	0.0	10.3	-	8
Total programme costs	**133.1**	**1.0**	**134.0**	**1**	**108**

[a] Discrepancies in totals are due to rounding.

26. As can be seen, credit funds for microfinance programme account for 80% of base costs. About 17% is for capacity-building. The policy, advocacy and action-research cost is estimated at a level of 2%. When examining expenditure by category, credit (80%) is followed by operational grants (9%), technical assistance (5%) and equity contribution (4%). Training, consultancies and studies each cost about 2% of the base cost.

27. The programme will be funded by the SIDBI, DFID and IFAD. While IFAD and the SIDBI will jointly finance the on-lending funds, DFID will fund the entire capacity-building component. The proposed IFAD loan of USD 22.0 million will finance 16.5% of the total programme cost, including contingencies and 20.4% of the incremental credit funds. The remainder of the credit funds (USD 88.5 million) and part of the equity financing will be provided by the SIDBI. The programme will also maintain the flexibility to use IFAD funds for capacity-building and equity support as the

need arises. The DFID has already approved about GBP 16.6 million (equivalent to approximately USD 23.5 million) of grant funds to finance all capacity-building activities.

28. In addition to the cost presented above, the programme will generate approximately INR 926 million (USD 21.3 million) – or about 22% of the net disbursements from SFMC – as savings from the clients at the end of seventh year.

29. The programme will fall under the Flexible Lending Mechanism, allowing for thorough testing and reviewing of the programme activities during the first three years of the programme before entering the second phase. The programme aims to climb the steps of the development ladder in phases; it plans to closely evaluate the ability of MFIs to evolve an appropriate legal form, become financially viable and move towards self sufficiency before major funding is committed. Performance triggers are stipulated for SDBI/SFMC for the continuation of the programme beyond year 3[3].

TABLE 2: FINANCING PLAN[a]
(USD million)

Components	IFAD Amount	%	Government Amount	%	DFID Amount	%	SIDBI Amount	%	Total Amount	%	Foreign Exch.	Local (Excl. Taxes)	Duties And Taxes
Capacity-building of microfinance sector	-	-	-	-	20.3	89.8	2.3	10.2	22.6	16.9	0.7	21.9	-
Credit funds for microfinance programmes	22.0	20.3	-	-	-	-	86.2	79.7	108.2	80.7	-	108.2	-
Policy, advocacy and action-research	-	-	-	-	3.2	100.0	-	-	3.2	2.4	0.3	3.0	-
Total Disbursement	**22.0**	**16.4**	-	-	**23.5**	**17.6**	**88.5**	**66.0**	**134.0**	**100.0**	**1.0**	**133.1**	-

[a] Discrepancies in totals are due to rounding.

30. The total duration of the programme will be seven years. Eligible expenditures incurred for on-lending to MFIs beginning 1 January 2000 not exceeding USD 2.0 million will be reimbursable from the IFAD loan under a retroactive financing arrangement.

E. Procurement, Disbursement, Accounts and Audit

31. **Procurement**. Since the IFAD loan will be used for provision of credit funds to MFIs and FFIs, it will not be used for any direct procurement of either good or services. MFI procedures, stringent repayment requirements and borrower's self-interest will all ensure that the procurement is economic and efficient. Through its own supervision and strengthening of field-level financial accountability arrangements, the SFMC will ensure that the MFIs use the on-lending funds for the designated purpose.

32. DFID and IFAD procedures will be followed for procuring services of the national and international consultants. In the event that IFAD funds are used for the procurement, IFAD's prior approval will be obtained before signing any contract with an estimated value of USD 100 000 or more. Local bidding procedures will apply for procurement of goods and services whose value is the equivalent of USD 25 000 and less than USD 100 000. Local shopping procedures, after obtaining three bids from local suppliers/service providers, will apply to procurements valued at the equivalent of USD 10 000 or more and less than USD 25 000. Direct procurement can be made for goods and services costing less than equivalent of USD 10 000.

[3] See Appendix VII.

33. **Disbursement**. The proceeds of the IFAD loan will be disbursed over seven years after effectiveness. In this regard, a reimbursement ceiling of USD 8.0 million will be stipulated during the first three years. In order to maximize the contribution of IFAD funding to the viability of SFMC, IFAD will seek to facilitate early the draw-down of its loan funds, while recognizing the need to move cautiously with the expansion of the programme. During programme years 1-3, the reimbursement will be restricted to 70% of the incremental disbursement of SFMC to MFIs/FFIs. Thereafter, the disbursement percentage will be 30% of the incremental credit. All reimbursement applications will be prepared by SIDBI based on the statement of expenditure submitted by SFMC. Eligible expenditures will be drawn from a special account that will be opened in a bank of SIDBI's choice. While the authorized allocation in the Special Account will be up to USD 2.0 million, it will be limited to USD 1.0 million until the aggregate amount of withdrawals from the loan account *plus* the aggregate amount of all outstanding special commitments entered into by IFAD equals or exceeds USD 2.5 million.

34. **Accounts and audit**. A full set of accounts will be maintained by the SIDBI, in accordance with internationally accepted accounting standards. Financial records will be prepared by the SIDBI on a semi-annual basis and submitted to IFAD for review. SFMC accounts will be audited annually by SIDBI's appointed independent auditor. SIDBI will provide, as a part of its annual report, a separate statement from the auditor with respect to the statement of expenditure under the programme and the status of compliance to the loan agreement as well SFMC's overall financial situation.

F. Organization and Management

35. At the national level, the SFMC will be responsible for the planning, coordinating and monitoring programme activities. Initially, the SFMC management structure will comprise three divisions – financial services, capacity-building, and policy and action-research[4]. In programme year (PY)6, a new products division and resources management division will be added. The SFMC will have an initial staff complement of 13, which is expected to grow to 44 by PY7. The majority of the staff will initially be based at the SIDBI head office at Lucknow. Relationship managers will be posted at certain strategic locations depending on the regional concentration of the business. Over time more activities will be decentralized and moved to the regional offices. The MFIs and FFIs will serve the beneficiaries at the grass-roots level with their network of branches/centres/units. The SFMC has a separate credit committee, with authority to sanction credit applications up to INR 100 million (USD 2.4 million). The credit and operational guidelines will be prepared and approved by SIDBI/SFMC after receiving comments from DFID and IFAD. This will be a condition for the first disbursement. The SFMC will have a full time chief executive officer in the category of chief general manager.

36. As this programme is national in scale, monitoring is crucial for its success. Hence, the programme will be monitored and evaluated from the perspective of input, output and impact. MFIs/FFIs will monitor their programmes at the field level. An MIS system will be established to enable SFMC to track and monitor the performance of its lending portfolio. Capacity-building funds available to SFMC will be used to contract specialist assistance for the development of the system.

37. The SFMC will prepare a comprehensive report before the first phase review and a completion report will be submitted within six months of the closing date of the programme. An ongoing impact assessment study will be commissioned and will include: (i) impact assessment on the poor households in general and women in particular; (ii) impact on institutional transformation; and (iii) assessment of institutional and financial performance of MFIs.

38. This programme will be supervised by UNOPS, which will undertake the exercise jointly with DFID and on a selective basis with IFAD. A common approach for implementing the programme and

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[4] See Appendix VIII.

for monitoring and reviewing its performance and sharing information will be designed and letters of intent will be exchanged between all stakeholders prior to the first disbursement.

G. Economic Justification and Programme Impact

39. The programme is expected to benefit around 1.26 million women and men[5]. Of these, 70% (0.88 million) are women and 80% poor. Over 540 000 are expected to borrow under the programme. In addition, the SHGs will recycle the savings among themselves as loans. Over the life of the programme, the borrowers will have access to an average of INR 14 500 in loan funds, which will make a significant contribution to ensuring that the majority of them move out of poverty.

40. The financial performance of client MFIs will improve substantially during the programme period. The MFIs are projected to start earning a return on equity from year 4. By year 10, the rate-of-return on equity will reach about 23%. The operating expense as a percentage of average outstanding will decline from 37% in the first year for SHG model to 5.1% in the tenth year.

41. By the end of seven years, the SFMC is expected to emerge as a professionally managed and profitable apex development institution for the microfinance sector in India. In addition, the SFMC will have facilitated the development of a network of 50 large MFIs, 40 medium MFIs and 10 FFIs. It is also expected to develop capacity and a network of technical assistance and consultancy service providers, and 10-15 national-level technical and management institutions for delivering training programmes in microfinance.

42. The projections of the SFMC indicate both a comfortable debt-equity ratio and a capital-adequacy ratio. The effective spread will be about 1% in the second year and 2.3% in the seventh year; the SFMC is expected earn operating profit from the very first year of the programme. The return-on-average assets is projected to grow from 4% in the second year to about 10% in the seventh year. The return on equity is projected at 2.6% in the second year and 18% in the seventh year.

43. Essentially, the SFMC will be able to achieve operational, financial and economic viability in the second year. While being sensitive to fluctuations in some parameters, SFMC's financial performance is not overly exposed to unacceptable level of risks. For example, if the outstanding loan portfolio of SFMC declines by 15% and loan loss provision increases to 4%, the SFMC will be able to achieve financial viability from the third year; economic viability remains a possibility only in the fifth year. Similarly, if one assumes a 10% increase in the administrative expenses along with these two conditions, the achievement of financial viability will be postponed to the fourth year and economic viability marginally from the fifth year. Increasing the lending rates to 12% for the first four years and 12.5% thereafter, however, can offset this decline in financial performance.

44. The major impact of the programme on women will be a significant increase in their economic and social empowerment. The qualitative benefits accruing to women from access to financial services will include: (i) access to alternative livelihood opportunities; (ii) increased autonomy and control over household income; (iii) improved status in society and in the household; and (iv) ability to take collective action to address social and gender oppressions. In addition, the improved financial standing of women will directly result in improved nutrition and schooling of children.

[5] See Appendix IX.

H. Risks

45. First, the credit risk could be unacceptably high given the history of rural finance in India. Rigorous appraisal and monitoring of loans hold the key to its reduction. The intensive capacity-building package proposed under the programme will also enable SFMC to reduce this risk. Second, a sound legal regulatory framework may not be put in place. The task force set up by the Reserve Bank of India and the report it already submitted should contribute to improving the legal and regulatory framework. Moreover, the risk will be reduced through regular interaction between policy-makers and microfinance practitioners along with internal and external exposure visits to the policy-makers. Third, as SFMC's lending rates may be higher, it may be unable to attract the requisite number of clients. This risk is also considered manageable with the SFMC driving towards professional service delivery to the MFIs. Giving freedom to MFIs to decide the ultimate lending rates will also reduce the risk. Fourth, the SFMC may not be able to become fully acquainted with, and sensitive to, the needs of the microfinance sector and to develop the necessary management capacity to implement an innovative and pioneering microfinance programme. This risk is mitigated by building adequate support for strengthening the capacity of the SFMC staff. Fifth, the failure of the MFIs to perform adequately due to the lack of financial management, institutional weakness or inadequate commitment to commercial principals is a risk. This is reduced by: (i) adopting rigorous selection, appraisal and monitoring processes; (ii) focusing capacity-building inputs on developing managerial capacity to develop sustainable microfinance services; and (iii) liberalizing the interest rates the MFIs can charge the ultimate beneficiaries. Sixth, FFIs may not be interested in developing microfinance programmes. SIDBI's strong links with the FFIs, together with the greater exposure to the sector through the capacity-building inputs, will reduce it.

I. Environmental Impact

46. The programme will benefit the environment by providing alternate employment sources and reducing pressure on agricultural activity. The programme will indirectly promote activities such as sanitation, health and family planning which will have major impact on the environment. The programme will also institutionalize environmental concerns by helping the SIDBI to develop a formal environment policy statement and establish a separate environment department.

J. Innovative Features

47. While building on the successes of past IFAD-assisted projects in India, the programme also introduces a number of innovative features. With an input of USD 22 million, this programme has been able to leverage a total grant fund of USD 23.5 million and total loan and equity fund of USD 89.0 million. Additionally, the programme has been built on the clear vision of moving towards commercial principles in a sector that is historically subsidy-oriented. Charging a near commercial rate on loans to MFIs, allowing MFIs to charge market rates for their on-lending, and above all passing on exchange rate risk and guarantee charges in respect of IFAD lending directly to SIDBI are important steps in commercializing the microfinance sector.

48. A two-tier institutional transformation is incorporated into the programme: first, at the SIDBI level the capacity in a mainstream financial institution to focus on microfinance will be developed. Second, at the level of the intermediary institutions, socially oriented, non-governmental organizations will be converted into specialized, professional financial intermediaries operating on commercial principles. Similarly, strong support for policy and advocacy will go a long way to providing a more conducive and enabling environment for the microfinance sector. The programme has built in a client panel system of simple impact monitoring at the household level to measure both quantitatively and qualitatively the impact of microfinance on the poor households in general and women in particular.

PART III - LEGAL INSTRUMENTS AND AUTHORITY

49. A guarantee agreement between the Republic of India and IFAD and a loan agreement between the Small Industries Development Bank of India (SIDBI) and IFAD constitute the legal instruments for extending the proposed loan to the borrower. A summary of the important supplementary assurances included in the negotiated loan agreement is attached as an annex.

50. The Small Industries Development Bank of India (SIDBI) is empowered under the laws of the Republic of India to borrow from IFAD.

51. I am satisfied that the proposed loan will comply with the Agreement Establishing IFAD.

PART IV - RECOMMENDATION

52. I recommend that the Executive Board approve the proposed loan in terms of the following resolution:

> RESOLVED: that the Fund, on the guarantee of the Republic of India, shall make a loan to the Small Industries Development Bank of India (SIDBI) in various currencies in an amount equivalent to sixteen million three hundred and fifty thousand Special Drawing Rights (SDR 16 350 000) to mature on and prior to 1 May 2040 and to bear a service charge of three fourths of one per cent (0.75%) per annum, and to be upon such terms and conditions as shall be substantially in accordance with the terms and conditions presented to the Executive Board in this Report and Recommendation of the President.

Fawzi H. Al-Sultan
President

SUMMARY OF IMPORTANT SUPPLEMENTARY ASSURANCES INCLUDED IN THE NEGOTIATED LOAN AGREEMENT

(Loan negotiations concluded on 20 April 2000)

1. SFMC will prepare draft annual work plans and budgets (AWPBs) for each programme year (PY). The draft AWPBs will include, among other things, a detailed description of planned programme activities during the coming programme year, and the sources and uses of funds therefor, based on the respective work plans and budgets prepared by each of the programme parties. SFMC will submit each draft AWPB to IFAD, for comments and approval, no later than 30 days before the beginning of the relevant programme year. If IFAD does not comment on the draft AWPB within 30 days after receipt, the AWPB will be deemed approved.

2. SIDBI will make available to SFMC during the programme implementation period funds from its own resources in an aggregate amount of one thousand million Indian rupees (INR 1 000 000 000). SIDBI has provided an initial amount of five hundred million Indian rupees (INR 500 000 000) to SFMC. SIDBI will provide an amount of three hundred million Indian rupees (INR 300 000 000) to SFMC during PY 4 and an amount of two hundred million Indian Rupees (INR 200 000 000) thereto during PY 6.

3. (a) SIDBI, SFMC, IFAD and DFID, will jointly carry out a review of programme implementation no later than the latter half of the third programme year (the "first phase review") based on terms of reference prepared jointly by SIDBI, DFID and IFAD. Among other things, the first phase review will consider the achievement of programme objectives and the constraints thereon, and recommend such reorientation of activities and/or reallocation of programme resources as may be required to achieve such objectives and remove such constraints.

(b) The results of the first phase review and recommendations thereon will be communicated to IFAD, and will be the basis upon which IFAD will determine whether its funding for the programme will continue during the second phase. SIDBI acknowledges that unsatisfactory performance during the first phase, as evaluated according to and based on a review of the trigger indicators, may result in a decision by IFAD to delay the commencement of, or cease funding for, the second phase.

(c) Should IFAD decide to:

(i) cease funding for the programme, any unused loan proceeds will be cancelled;

(ii) delay the commencement of phase II of the programme, SIDBI will make any necessary corrections/adjustments as recommended and communicated by IFAD. Such delay will be for a maximum of one year from the date of IFAD's decision. In the latter half of such year, a second review will be conducted in accordance with the procedures set out in paragraph (a) above. The results of such review will be communicated to IFAD which will then make a final determination of whether to continue to phase II or to cease funding under the programme. In no event will SIDBI be entitled to receive funding from the loan relating to the delay period; and

(iii) proceed with phase II of the programme, a mutually acceptable action plan and design for the second phase, based on the findings of the first phase review, will be prepared. Such action plan and design will result in reallocations of loan proceeds and modifications to the loan documents.

(d) SIDBI will ensure that, should IFAD decide that the programme will continue to the second phase, the recommendations resulting from the first phase review are implemented within the time specified therefor and to the satisfaction of IFAD. It is agreed and understood that such recommendations may result in modifications to the loan documents or cancellation of the loan. It is further agreed and understood that failure to implement the recommendations resulting from the first phase review within the time limits specified may result in cancellation of the loan.

4. IFAD may suspend, in whole or in part, the right of SIDBI to request withdrawals from the loan account upon the occurrence of any of the following events:

(a) On or after the effective date, the DFID agreement has failed to enter into full force and effect by the date or dates specified therein or a later date or dates established by DFID for that purpose and substitute funds are not available to SIDBI on terms and conditions acceptable to IFAD.

(b) The right of SIDBI to withdraw the proceeds of the DFID grant has been suspended, cancelled or terminated, or any event has occurred which, with notice or the passage of time, could result in any of the foregoing.

(c) The Credit By-laws, or any provision thereof, has been waived, suspended, terminated, amended or otherwise modified without the prior consent of IFAD, and IFAD has determined that such waiver, suspension, termination, amendment or modification has had, or is likely to have, a material adverse effect on the credit component.

(d) Any competent authority has taken any action for the dissolution of SIDBI or the suspension of its operations, or any action or proceeding has been commenced for the distribution of any assets of SIDBI among its creditors.

(e) The recommendations and action plan and design resulting from the first phase review have not been implemented within the time specified therefor.

5. SIDBI and SFMC will, upon SFMC attaining independent legal status, enter into an agreement (the lead subsidiary agreement), no later than the end of PY 4, which will provide, among other things, that:

(a) SIDBI will transfer the proceeds of the loan and other resources to SFMC as a loan at a variable interest rate not exceeding nine per cent (9%) per annum, a repayment period of 40 years, including a grace period of 10 years. SFMC will on-lend the proceeds of the loan it receives from SIDBI to the financial institutions (FIs).

(b) SFMC will declare its commitment to the goal and purposes of the programme and, in furtherance of such goals and purposes, SFMC will undertake to carry out the programme in accordance with the loan agreement.

6. SIDBI will submit a draft of the lead subsidiary agreement to IFAD for its comments and approval before signature.

7. The credit component will be carried out by the MFIs and FFIs selected by SFMC, in accordance with selection criteria approved by IFAD, and located in the programme area.

8. SFMC will select each of the FIs on the basis of their track record, professional expertise, sound management practices, organizational capabilities and growth potential. SFMC will also use the proceeds of the loan for on-lending to MFIs in accordance with eligibility criteria acceptable to IFAD.

The following eligibility criteria are acceptable to IFAD and may be amended by agreement between IFAD and SFMC:

(a) the MFI will use the on-lending funds to finance microcredits to its target group of beneficiaries which, *inter alia*, will include the most vulnerable groups of poor households (such as of scheduled castes, scheduled tribes and female-headed households). Women will receive priority;

(b) the MFI will establish and maintain satisfactory procedures and operational policies for the supervision of microcredits so as to ensure the achievement of the objectives of the programme; and

(c) the MFI will ensure that the client beneficiaries provide all relevant records, documents and information in respect of microcredits and eligible activities as SFMC will reasonably request.

9. In making such selection, SFMC will also apply the following criteria while providing credit from the proceeds of the loan:

(a) For the large MFIs (total outstanding debt exceeding INR 5 million):

(i) the MFI or its promoter(s) has experience of operating a successful microcredit programme for at least four years;

(ii) the MFI has established, or agrees to establish within a period of one year after the loan is sanctioned, a separate system of accounts and monitoring for its microfinance operations;

(iii) the MFI has a sufficiently large number of existing borrowers and has strong potential for expansion;

(iv) the MFI has an adequate financial base in terms of its own equity/member's savings and has sufficient systems and procedures in place for increasing its members' savings as well as the equity of the MFI;

(v) the MFI's microfinance programme is generally oriented towards poverty reduction and has appropriate mechanisms to monitor the level of participation of the poor in the microfinance programme;

(vi) the non-performing assets of the MFI do not exceed 7%;

(vii) the MFI maintains strong and transparent accounting, management information and internal audit systems; and

(viii) the MFI has its accounts audited by a reputable external auditor on a timely basis.

(b) For the medium MFIs (total outstanding debt not exceeding INR 5 million):

(i) the MFI has a demonstrated track record of running a successful microfinance programme or demonstrates the potential to become successful after undertaking capacity-building activities;

(ii) the MFI is prepared to hive-off microfinance activity as a separate business no later than three years after the approval of the capacity-building grant under the programme;

(iii) its microcredit programme has a poverty focus with the necessary monitoring system to assess their level of participation;

(iv) the non-performing assets of the MFI do not exceed 15% and the MFI has a plan to improve its portfolio performance to reduce the level of non-performing assets to 7% within three years;

(v) the MFI possesses adequate staff for intensive supervision and has good management; and

(vi) the MFI has transparent accounting, management information and internal audit systems or is willing to adopt such practices with the assistance of SFMC.

10. SIDBI, or SFMC upon its attaining independent status, will enter into an agreement with each FI, which will provide, among other things, that:

(a) SFMC, generally guided by the AWPBs, will transfer available funds in accordance with the provisions of paragraphs 8 and 9, and on terms and conditions acceptable to IFAD.

(b) The FI will declare its commitment to the goals and purposes of the programme and, in furtherance of such goals and purposes, it will undertake to carry out the credit component in accordance with the loan agreement and the Credit By-laws, which will be annexed to the relevant sub-loan agreement.

SIDBI will submit a model FI sub-loan agreement to IFAD for comments and approval.

11. SFMC will prepare draft by-laws for the credit component, acceptable to IFAD, as soon as practicable, but in no event later than the effective date. SFMC will submit the draft Credit By-laws to SIDBI's Advisory Board for approval. When approved by the Advisory Board, SFMC will submit the draft Credit By-laws to IFAD and DFID for comments and approval. The Advisory Board will adopt the Credit By-laws, substantially in the form approved by IFAD, for application to all credits extended to programme beneficiaries which are financed (directly or indirectly) by the loan. SFMC will provide copies thereof to IFAD promptly after adoption.

12. SFMC will establish and maintain a revolving fund into which all net revenues from credits extended to programme beneficiaries financed (directly or indirectly) by the loan will be deposited. SFMC will use the revolving fund to fund further credits to programme beneficiaries in accordance with the loan agreement at least until such date as will be specified in the relevant FI sub-loan agreement or, if no date is so specified, until all loan service payments have been made in full.

13. The first phase review will analyse the following specific indicators that will be used as triggers for the confirmation, by IFAD, of funding and subsequent detailed design of the second phase of the programme:

- SFMC will have adequate, capable staff in place (in line with the time-frame of the business plan) and has developed efficient and effective management systems, including a rigorous management information system and demonstrates adequate managerial capacity;

- SFMC will have achieved financial sustainability covering all operating costs, cost of capital, depreciation, etc., from interest on its loan portfolio;

- the portfolio of SFMC at the time of the first phase review will comprise at least ten established MFIs and 25 emergent MFIs;

- there are clear indications that the MFIs supported are on course to achieving financial sustainability in line with their business plan programmes and that such MFIs have made substantial progress in establishing separate legal entities for their microfinance activities;

- SFMC will have developed a strategy for involving FFIs more effectively in microfinance and will have entered into negotiations with at least two FFIs to participate in the programme;

- SFMC will have developed adequate mechanisms for providing mentoring and other services to emergent MFIs;

- substantial progress will have been achieved in developing a core of specialized microfinance resource agencies, including promotion of at least two agencies providing long-term courses and four agencies providing specialized short courses in microfinance;

- SFMC will have launched a number of policy studies to address some of the major issues identified in the development of the microfinance sector and will have promoted action-research activities and converted some of these into pilot-scale experiments; and

- the procedures for impact assessments will have been fully established and functional, with client panels set up and operational.

14. Based on the findings and recommendations of the first phase review, a mutually acceptable action plan and design for the second phase of the programme will be prepared and an overall evaluation of the programme will be concluded.

15. SFMC will include the following key areas of coverage in its monitoring of the programme:

(a) ability to quickly identify any MFIs/FFIs facing unsatisfactory repayment on credits extended under the programme;

(b) tracking repayment performance of the entire credit operations of the FFIs and MFIs; and

(c) evaluating financial performance, on a regular basis, of all MFIs and monitor their evolution.

16. SFMC will ensure that gender issues are addressed and dealt with under the programme through the following:

- the appraisal process for selecting NGOs/MFIs as programme partners;

- ensuring that gender sensitization is effectively addressed in the capacity building packages provided to the MFIs;

- research studies on the inter-relationship between issues of women's empowerment and microfinance;

- dissemination of best practices of treatment of gender issues by MFIs so that other NGOs/MFIs can modify their approaches accordingly; and

- effective monitoring of the MFIs' programmes and ensuring that gender impact indicators are included in the overall framework for the impact assessment studies.

17. As part of its requirements to maintain records and provide financial statements and an annual audit report, SIDBI will provide a detailed summary of the activities of SFMC.

18. SIDBI will draft the charter of SFMC, at the time of its incorporation as a separate legal entity, in such a way that it will allow SFMC to test and develop a range of microfinance products and use the funds received under the programme to finance economically and socially productive activities for households and microenterprises engaged in the non-farm, agro-allied, processing and service sectors. Such a charter will be finalized after receiving, and in accordance with, the comments of IFAD and DFID, as well as the approval of the Republic of India.

19. SIDBI will treat SFMC as a cost and profit centre and separate its accounts from those of SIDBI notionally until such time as SFMC will have assumed separate legal status and the accounting system will have been formally separated. To this end, SIDBI will assign separate and distinct account codes for all financial transactions, assets and liabilities of SFMC and ensure that such funds and net income as are received thereon will form the capital of SFMC upon attaining separate legal status.

20. SIDBI will give SFMC adequate operational autonomy and authority to take business decisions, manage its finances and obtain staff until such time as it will obtain separate legal status.

21. The Central Credit Committee of SFMC will have the authority to approve loans and also expenditure under capacity-building assistance. Until SFMC has been established as a separate legal entity, SIDBI will continue to delegate to this committee the authority to approve credit applications up to INR 100 million and capacity-building grants up to INR 5 million.

22. Over time SFMC will bring its interest rates gradually closer to market rates. Until then, SFMC will introduce an interest rate band to provide flexibility in the rates of interest charged to different categories of MFIs/FFIs. Initially, this band will be between 11% to 12% but, in the event of interest rates going down further, loans may be priced within a band of 10-12%. Subsequently, with the development of the sector and growth in business, SFMC may adopt differential pricing depending on loan requirement and lending methodology. The on-lending rates will be reviewed periodically jointly by SIDBI, IFAD, DFID and SFMC, and adjusted to reflect the market conditions and ensure the financial viability and sustainability of SFMC's operations. In addition, from a date acceptable to IFAD, SFMC will ensure that further sanctions, which enhance the borrowing FIs' loans outstanding to over INR 30 million, will be made only to a borrowing FI which has a legal structure appropriate to it acting as a financial intermediary. The loans to MFI/FFI clients will be repayable in accordance with the Credit By-laws.

23. SIDBI and SFMC will take all reasonable measures to ensure that their non-performing assets under SFMC operations (including, but not limited to, those loans made from the proceeds of the loan) will be limited to 7%. The portfolio created in the past under the microcredit scheme will be excluded while making such assessment and the definition of non-performing assets will be as per the Reserve Bank of India guidelines effective at the time of assessment.

24. SIDBI will promptly inform IFAD in the event that the DFID grant or any part thereof becomes unavailable for the capacity building and policy, advocacy and action-research components of the programme. SIDBI, in consultation with IFAD, will immediately attempt to arrange alternate financing

for such components. No withdrawals will be made in respect of eligible expenditures from the loan Account until such alternate financing will have been obtained. IFAD may consider financing capacity building and equity investment in MFIs from the proceeds of the loan: (a) in the event of the unavailability of all or part of the DFID grant; and/or (b) IFAD, SIDBI and DFID jointly identify a gap in funding available for the said activities.

25. SIDBI will establish, no later than the end of PY 4, SFMC as a separate entity with independent legal status and will ensure that the latter is duly registered with the appropriate governmental authorities.

26. No withdrawals will be made in respect of expenditures under the credit component until:

(a) the Credit By-laws will have been approved by IFAD in draft; a copy of the Credit By-laws as adopted by the Advisory Board, substantially in the form so approved and certified as true and complete by a competent officer of SFMC, will have been delivered to IFAD;

(b) with respect to any FI, an FI sub-loan agreement will have been approved by IFAD; IFAD will have received certification from a competent officer of SFMC that the FI sub-loan agreement has been signed by the parties thereto substantially in the form so approved; the signature and performance thereof by SFMC and such FI have been duly authorized or ratified by all necessary corporate, administrative and governmental action; and all conditions precedent to the effectiveness thereof will have been fulfilled; and

(c) IFAD, SIDBI and DFID will have agreed a common approach for implementing the programme, for sharing information on the programme and for monitoring and reviewing the performance of the programme and will have signed a memorandum of understanding to that effect.

27. The following are the conditions precedent to the effectiveness of the loan agreement:

(a) SIDBI will have duly opened the Special Account;

(b) the Credit By-laws will have been approved by SFMC;

(c) the loan agreement will have been duly signed, and the signature and performance thereof by SIDBI will have been duly authorized and ratified by all necessary corporate, administrative and governmental action;

(d) a favourable legal opinion, issued by a competent legal officer of SIDBI authorized to issue such opinions, in form and substance acceptable to IFAD, will have been delivered by SIDBI to IFAD; and

(e) SIDBI, through its Board of Directors, will have approved SFMC's business plan, acceptable to IFAD.

COUNTRY DATA
INDIA

Land area (km^2 thousand) 1996 1/	**2 973**	**GNP per capita (USD) 1997 2/**	**370**
Total population (million) 1997 1/	**962.4**	**Average annual real rate of growth of GNP per capita, 1990-97 2/**	**4.3**
Population density (people per km^2) 1996 1/	**318**	**Average annual rate of inflation, 1990-97 2/**	**8.8**
Local currency	**Indian Rupee (INR)**	**Exchange rate: USD 1 =**	**INR 43.5**

Social Indicators		**Economic Indicators**	
Population (average annual population growth rate) 1980-97 1/	2.0	GDP (USD million) 1997 1/	381 566
Crude birth rate (per thousand people) 1997 1/	27	Average annual rate of growth of GDP 1/	
Crude death rate (per thousand people) 1997 1/	9	1980-90	5.8
Infant mortality rate (per thousand live births) 1997 1/	71	1990-97	6.0
Life expectancy at birth (years) 1997 1/	63		
		Sectoral distribution of GDP, 1997 1/	
Number of rural poor (million) (approximate) 1/	256.3	% agriculture	25
Poor as % of total rural population 1/	36.7	% industry	30
Total labour force (million) 1997 1/	423	% manufacturing	19
Female labour force as % of total, 1997 1/	32	% services	45
Education		Consumption, 1997 1/	
Primary school gross enrolment (% of relevant age group) 1996 1/	100	General government consumption (as % of GDP)	10
Adult literacy rate (% of total population) 1995 3/	52	Private consumption (as % of GDP)	70
		Gross domestic savings (as % of GDP)	20
Nutrition			
Daily calorie supply per capita, 1995 3/	2 382	**Balance of Payments (USD million)**	
Index of daily calorie supply per capita (industrial countries=100) 1995 3/	75	Merchandise exports, 1997 1/	32 201
Prevalence of child malnutrition (height for age % of children under 5) 1992-97 1/	52	Merchandise imports, 1997 1/	36 293
Prevalence of child malnutrition (weight for age % of children under 5) 1992-97 1/	53	Balance of merchandise trade	-4 093
Health		Current account balances (USD million)	
Health expenditure, total (as % of GDP) 1990-97 1/	5.6	before official transfers, 1997 1/	-17 641
Physicians (per thousand people) 1990-97 1/	0.4	after official transfers, 1997 1/	-5 811
Percentage population without access to safe water 1990-96 3/	19	Foreign direct investment, 1997 1/	3 351
Percentage population without access to health services 1990-95 3/	15		
Percentage population without access to sanitation 1990-96 3/	71	**Government Finance**	
		Overall budget surplus/deficit (including grants) (as % of GDP) 1996 1/	-5.2
Agriculture and Food		Total expenditure (% of GDP) 1996 1/	15.8
Food imports as percentage of total merchandise imports 1997 1/	*5*	Total external debt (USD million) 1997 1/	94 404
Fertilizer consumption (hundreds of grams per ha of arable land) 1995-97 1/	856	Present value of debt (as % of GNP) 1997 1/	20
Food production index (1989-91=100) 1995-97 1/	117.1	Total debt service (% of exports of goods and services) 1997 1/	19.6
Land Use		Nominal lending rate of banks, 1997 1/	13.8
Arable land as % of land area, 1996 1/	54.7	Nominal deposit rate of banks, 1997 1/	n.a.
Forest area (km^2 thousand) 1995 1/	650		
Forest area as % of total land area, 1995 1/	21.9		
Irrigated land as % of cropland, 1994-96 1/	32.0		

n.a. not available.
Figures in italics indicate data that are for years or periods other than those specified.

1/ World Bank, *World Development Report*, 1999,
2/ World Bank, *Atlas*, 1999,
3/ UNDP, *Human Development Report*, 1998.

PREVIOUS IFAD LOANS TO INDIA

Project Name	Initiating Institution	Cooperating Institution	Lending Terms	Board Approval	Loan Effectiveness	Current Closing Date	Loan Acronym	Currency	Approved Loan Amount	Disbursement (as % of approved amount)
Bhima Command Area Development Project	IFAD	World Bank: IDA	HC	18 Sep 79	14 Dec 79	31 Dec 85	L - I - 23 - IN	SDR	38 500 000	100%
Rajasthan Command Area Development and Settlement Project	IFAD	World Bank: IBRD	HC	19 Dec 79	03 Mar 80	31 Dec 88	L - I - 32 - IN	SDR	42 700 000	100%
Sundarban Development Project	IFAD	World Bank: IDA	HC	03 Dec 80	04 Feb 81	30 Jun 89	L - I - 49 - IN	SDR	13 350 000	100%
Madhya Pradesh Medium Irrigation Project	World Bank: IDA	World Bank: IDA	HC	17 Dec 81	17 Sep 82	31 Mar 88	L - I - 81 - IN	SDR	21 900 000	100%
Second Uttar Pradesh Public Tubewells Project	World Bank: IDA	World Bank: IDA	HC	21 Apr 83	06 Oct 83	31 Mar 91	L - I - 124 - IN	SDR	32 000 000	85%
Orissa Tribal Development Project	IFAD	UNOPS	HC	03 Dec 87	27 May 88	31 Dec 97	L - I - 214 - IN	SDR	9 250 000	100%
Tamil Nadu Women's Development Project	IFAD	UNOPS	HC	26 Apr 89	26 Jan 90	31 Dec 98	L - I - 240 - IN	SDR	13 150 000	98%
Andhra Pradesh Tribal Development Project	IFAD	UNOPS	HC	04 Apr 91	27 Aug 91	31 Mar 99	L - I - 282 - IN	SDR	14 050 000	92%
Maharashtra Rural Credit Project	IFAD	UNOPS	HC	06 Apr 93	06 Jan 94	30 Sep 00	L - I - 325 - IN	SDR	21 250 000	45%
Andhra Pradesh Participatory Tribal Development Project	IFAD	UNOPS	HC	19 Apr 94	18 Aug 94	31 Mar 02	L - I - 349 - IN	SDR	18 950 000	40%
Mewat Area Development Project	IFAD	UNOPS	HC	12 Apr 95	07 Jul 95	31 Dec 03	L - I - 379 - IN	SDR	9 650 000	34%
Rural Women's Development and Empowerment Project	IFAD	World Bank: IDA	HC	05 Dec 96	19 May 99	30 Jun 02	L - I - 439 - IN	SDR	13 300 000	
North Eastern Region Community Resource Management Project for Upland Areas	IFAD	UNOPS	HC	29 Apr 97	23 Feb 99	31 Dec 04	L - I - 444 - IN	SDR	16 550 000	5%
Bihar-Madhya Pradesh Tribal Development Programme	IFAD	IFAD	HC	29 Apr 99			L - I - 506 - IN	SDR	16 950 000	

SUMMARY OF DESCRIPTION OF THE PROGRAMME

A. Capacity-Building of the Microfinance Sector
(Base cost USD 21.4)

1. **Capacity-building of the SFMC.** The programme will support the strengthening of the SFMC particularly through staff development to build a high-quality portfolio to ensure its viability. Programme inputs will include the following: the design and conduct of custom-made courses for staff; exposure visits to successful microfinance institutions and apex lending institutions within India and overseas; on-the-job training through internships with specialized MFIs within India; participation in training courses; and attendance at key Indian and international workshops/seminars.

2. The programme will provide 12 person-months of international and 52 person-months of national consultancy to assist the SFMC in key programme areas. Some will come in the form of repetitive, short inputs by consultant(s) over an extended period. International consultancy will include, *inter alia*, expertise in impact assessment and new financial products for the SFMC and MFIs and will link SFMC with MFI best practices elsewhere in the world; it will act as a mentor for SFMC's development. National consultancy will cover counterpart support to international consultants, human resources development, MIS development and other support required by the SFMC. Consultants will also provide on-the-job training for SFMC staff through joint visits and initial support in recommending technical assistance for specific MFI partners.

3. **Capacity-building of the MFIs.** The capacity-building of MFIs will include three sub-components: (i) technical assistance and training; (ii) operating support; and (iii) mentoring support. Both large and medium MFIs will be eligible for technical assistance and training and operational support. The mentoring support will be exclusively directed towards medium MFIs.

4. The technical assistance support will be directed towards helping MFIs to move up the development ladder towards increasing the outreach and becoming self-sufficient. The support will be demand-driven and, within the overall limit, cover the costs of: (i) attending training programmes conducted by the short-listed service providers; (ii) participating in exposure visits; (iii) conducting studies for identifying MFI specific-service delivery, targeting and viability issues; (iv) engaging service providers for conducting in-house training of staff; (v) engaging service providers for training of beneficiaries; (vi) engaging service providers for shifting towards a legal format that allows savings mobilization from non-members and allows operation on a commercial basis; (vii) developing MIS and accounting system; and (viii) establishing new branches and computerization.

5. In addition, the mentoring support to medium MFIs will include assistance by short-listed service providers or capable MFIs to help them in emerging as a separate commercial entity with microfinance as their core strength. It will do so by providing necessary inputs for planning human resource development, incorporating microfinance best practices into the work culture, preparing business plans and monitoring achievements vis-à-vis the plan and resource mobilization. It will also incorporate best practices for professionalizing management.

6. **Equity investment in the MFIs.** High debt-to-equity ratio is one the major weaknesses of the MFIs. This results chiefly from two factors: social entrepreneurs who pilot MFIs have limited financial capital; and India does not recognize the concept of sweat equity. In order to address the issue, the SFMC will consider equity investments in the MFIs whose legal structure can accommodate equity. Initially, this will be in the form of redeemable preference shares carrying dividend at 11%.

7. Equity investments by the SFMC will initially be funded 100% from DFID assistance, declining to 50% during years 4 and 5, and to 25% during year 6 and 7, with SIDBI funding the balance. Depending upon the developments in the sector, the SFMC will also consider the use of IFAD loan funds for equity investment. The exit route will be through redemption of preference shares, which may be bought by other MFIs or primary stakeholders, such as the local community members,

employee stock options, buy-back, etc. The dividend and exit proceeds from the equity investments will be used to support new MFIs during the post-programme period.

8. **Capacity-building of the FFIs.** The programme will assist the SFMC in undertaking market research in year 1 to explore the specific interest and opportunities for microfinance within the FFI sector. Capacity-building support for FFIs will be specific and focused. It will cover costs of workshops and training on microfinance for commercial bankers and central bankers, national and international exposure visits and support for conducting marketing research. No operational grant support will be provided.

9. **Capacity-building of capacity-builders/service providers.** The programme will provide support for course development, cotraining, exposure/exchange visits and equipment/materials for long-course (SIMAP model) and short-course providers (STUP model). It will also provide a subsidy of 50% of the participation fees of the initial 10 courses run by each provider.

10. The programme will promote development of the rating system by organizing capacity-building workshops that involve national and international experts. In order to promote the use and appreciation of the value of ratings of the MFIs, the programme will provide 100% of the cost of ratings in PY1 and 2 and 80% of these costs in PY3 and 4. Thereafter, the SFMC and its clients will bear these costs.

B. Credit Funds for Microfinance Programmes

(Base cost USD 99.3 million)

11. **The MFIs.** An assessment of the demand for credit funds from the SFMC has been made on the basis of the following: the demand projections for the Solidarity and SHG model MFIs, the requirements of existing clients for further funding; and the demand from MFIs that have approached SFMC for funds and the information obtained through the case studies to project rate of growth in the lending programmes. It is expected that the cumulative demand for SFMC funds over the seven-year programme period is estimated to reach INR 4 806 million (USD 110 million).

12. **The FFIs.** The SFMC will provide credit funds to FFIs like urban cooperative banks, rural regional banks, non-banking finance companies (NBFCs), commercial banks (CBs), credit unions, etc. for on-lending to MFIs/SHGs and other partner institutions or for direct lending. It is expected that the segments of the market that cannot be addressed directly by the SFMC (e.g., small and new MFIs servicing remote rural and urban poor) will be served through these FFIs. The SFMC will seek out a niche in the FFI sector, especially in the subsectors of urban cooperative banks and NBFCs The SIDBI will produce a strategy document for developing an FFI client base by the end of PY1.

13. **Allocation.** The programme will provide a line of credit amounting to INR 4.3 billion (USD 99.3 million) to the SFMC for on-lending to MFIs and FFIs taking up microfinance programmes to provide credit to over 540 000 borrowers. Over the programme period, it is expected that the SFMC will provide credit to about 65 medium MFIs, of which it is expected that 12 will develop into large MFIs, 13 will drop out and the remainder will stabilize as medium MFIs. The total credit disbursements to MFIs is expected to be about INR 4 806 million (USD 111.0 million), while those to FFIs is projected at INR 1 355 million (USD 31.2 million).

C. Policy, Advocacy and Action-Research

(Base cost USD 3.1 million)

14. **Policy and advocacy.** The SIDBI is well placed to play an important role in policy development. It has a broader financial sector involvement and its commercial orientation is much greater than other microfinance advocates in India. In this background, the SFMC will promote the development of at least one annual high-level forum to discuss key issues in microfinance to examine new innovations and to compare Indian achievements to the state-of-the-art practices elsewhere. This

workshop will also provide an opportunity to the SFMC to synthesize the issues emanating from the regional level workshops and present it to the policy-makers.

15. The programme will support one regional level policy workshop per year from PY1, focusing more specifically on policy issues in the Indian context. The programme will support costs of dissemination of the workshop proceedings and costs of formation of committees, as a follow-up of policy workshop, to formulate policy guidelines for speedy development of the microfinance sector. The programme will support five person-months of international microfinance policy assistance during PY 2-3 to stimulate Indian debate on key issues and to support the policy research effort. It will support nine policy research studies three international exposure visits (one each in PY2-4) for senior policy-makers.

16. **Action-research.** The programme will support 48 action-research studies, dissemination of the results and six pilot tests of new products and services developed by action-research. Action-research will focus on: (i) the impact of widening the client base while ensuring that the poor receive due attention; (ii) progression to larger loan sizes for the poor in a manner which is sustainable, manageable and beneficial to the beneficiaries; (iii) the level and types of support required by the poor to facilitate the absorption of higher loans, including the importance of credit-plus services; (iv) impact of differential loan sizes on group cohesion and joint liability; (v) targeting SCs/STs and other vulnerable groups; (vi) innovative ways of reducing credit delivery costs, e.g., through transferring responsibility for promotion, capacity-building, supervision and support functions at the grass-roots level to community-based organizations, such as federations of savings and credit groups or by exploring the use of other possible credit delivery agents such as trade intermediaries, insurance agents, etc.; and (vii) development of new financial products and services.

17. The action-research will also focus on gender issues, which are mostly neglected in most microfinance programmes. It will include: (i) the effects on the health of women due to the increase in the workload; (ii) reduction in time devoted to childcare; and (iii) the possibility of women becoming the front for their menfolk to obtain loans and in the process lose control over loan utilization and income from the activity (while being responsible for repayment).

18. **Network support.** SIDBI's support for advocacy will include the formation of MFI networks. The programme supports about 19 networks at an estimated cost of USD 0.5 million. The network's main emphasis shall be on developing a self-regulatory mechanism in the absence of any central bank regulation for the MFI sector. This will ensure the sustainability of the sector and prepare MFIs for future regulation by the Reserve Bank of India. Support will be provided on a tapering basis after PY4, as the network becomes stronger and more capable of supporting itself through members' contributions and other means.

19. **Impact assessment.** A significant contribution to the policy debate will come from support for ongoing analysis of the impact of microfinance services on the poor (to be performed nation-wide). To this end, the SFMC will contract top quality socio-economic research institutions on long-term contract who will, among others, use a panel approach of collecting observations from a small and carefully selected sample of MFI clients on a regular basis. Primary data collected through these impact assessments will contribute to making policy dialogue better informed and more focused on changes of the greatest priority for improving financial services for the poor.

LOGICAL FRAMEWORK

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
GOAL • Expand access to microfinances for the poor	• Numbers of enterprises • Value added/enterprise increases • Employment/sector increases • Poor remain focus of microfinance services	• Sector analysis by the Government of India and external funding agencies	• Microenterprise development contributes to wage and self-employment, which leads to poverty reduction • Women are not excluded from the benefits of microenterprise development
Purpose • Development of a more formal, extensive and effective microfinance sector on a national scale serving poor women and men	• SIDBI Foundation demonstrates that microfinance is a viable business area for SIDBI by end of programme • Microfinance sector as a whole growing more rapidly than economy as a whole, with increasing geographic coverage • Substantially wider range of methodologies, products used and institutions involved in delivery of microfinance in India by end of programme • Appropriate legal structures available to MFIs by end of programme • Improvement in livelihoods of poor households/enterprises/communities attributable to microfinance services	• Foundation and SIDBI annual reports • Sector analysis will indicate broad development of sector and feed into project monitoring and reviews • Project documentation available with SIDBI Foundation and Foundation Partners and broader sector analysis • Government laws and guidelines promulgated; MFIs registered appropriately • Impact assessment studies commissioned by SIDBI Foundation/DFID	• Macroeconomic stability maintained • Microfinance is delivered in a manner that supports enterprise development (right clients, right products) • Other essential services will be provided to support microenterprise growth and investment

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
Outputs 1. SIDBI Foundation becomes a substantial, capable, efficient, and financially viable operation	• SIDBI Foundation has adequate, capable staff in place (in line with timeframe of business plan) • SIDBI Foundation has appropriate systems in place for client identification, appraisal, monitoring, decision-making and evaluation (by QTR 2, PY 1) • SIDBI Foundation given appropriate legal status within two years of the first phase review • SIDBI Foundation has high quality performing portfolio (NPA < 5 percent) of at least INR 5 billion by end PY 7 • Average client financing (SIDBI Foundation → MFI) at least INR 50 million by PY 7 • SIDBI Foundation covering all operating costs, costs of capital, depreciation, etc. from interest on loan portfolio and other operating income by PY 3 (level 3 sustainability) • New SIDBI Foundation financial products diversify and expand its business (equity, lines of credit, etc.)	• Annual project reviews • First annual project review • SIDBI Foundation annual report • As above • As above • Performance against business plan, overall return on capital, profits made and reinvested in SIDBI Foundation/SIDBI • Performance of equity and new products. In SIDBI Foundation annual reports and continuity of products	• Other institutions (APEX , MFIs and FFIs) follow SIDBI example • Sector will reach point where it can continue to grow without external subsidies on the same scale as MFSP
2. The SIDBI Foundation's partner microfinance programmes significantly increase scale, outreach and sustainability, with an appropriate legal basis to conduct financial services	• SIDBI Foundation clients provide appropriate, high-quality microfinance services to at least 2 million urban/rural poor (> 70 percent women) by PY 7 • MFIs improve sustainability by END OF PROGRAMME: At least 3 MFIs at level 4 sustainability, at least 25 MFIs at level 3 sustainability • SIDBI Foundation clients borrowing > INR 20 million operate within legal framework that recognizes the legitimacy of their financial operations from PY 4	• Periodic reports from MFIs to SIDBI Foundation • Outreach data compiled by SIDBI Foundation on an annual basis, impact assessment MFIs audited under international best practices criteria (CAMEL-S or equivalent) • Annual reports of SIDBI Foundation	• Microfinance sector as a whole expands as a result of SIDBI Foundation example • SIDBI Foundation and partners can diversify from SHG focus

Narrative Summary	Objectively Verifiable Indicators	Means of Verification	Assumptions
3. A selected number of FFIs initiate/consolidate sustainable microfinance services (FFI = UCBs, RRBs, NBFC, CBs, local area banks, etc.)	• Strategy document from market investigation to determine opportunities by end PY 1 • # FFIs operating profitable microfinance services by END OF PROGRAMME • # FFIs sharing significant proportion of TA costs by END OF PROGRAMME • Leverage: FFI investments in microfinance > # times SIDBI Foundation investments in FFIs	• Foundation Strategy document available/ reported in annual review • Annual reports of FFIs • Annual project reviews. Project monitoring studies. • As above	• Other FFIs able and willing to respond to examples • FFIs provide services relevant to poor women and men • The Government of India liberalizes financial markets so that microfinance can be profitable for more FFIs
4. Capacity of training and service providers enhanced and widely available to SIDBI Foundation clients and potential clients	• Substantially increased number and operations; scale of training; institutions offering microfinance courses/programmes • Substantially increased number and operations; scale of recognized consultants offering microfinance advice • Quality of services provided improves substantially • Increased cost recovery by service providers	• Annual reports/publications of major capacity-building institutions/MFIs Project monitoring studies and evaluation • Project reports of MFIs; Project monitoring studies and evaluation Project monitoring of MFIs - reports, studies and evaluation • Project monitoring of service providers - reports, studies and evaluation	• MFIs not ready and open to absorb training and advice • MFIs get other inputs in addition to training, etc., assistance in a timely manner • Increasing number of MFIs willing to pay for quality training and technical
5. Positive influence on the policy environment for microfinance	• Production of high quality, influential recommendations on key issues, such as: • Draft legislation providing for appropriate legal forms for MFIs • Regulation and supervision of MFIs • Deregulation of interest rates • Tax status for MFIs • MFI networks active and effective • Number of bankers actively participating in and sharing costs of workshops/exchange visits held to compare experiences • Lessons from impact assessment and monitoring supports informed policy-making	• Documents published and disseminated • Project annual reviews • As above • Published policy documents in line with project recommendations and findings	• Microfinance sector aware of potential opened up by policy reform • Willingness of MFIs to promote financially sustainable microfinance that formalizes over time • FFI sector will become more flexible and demand-driven, with continued liberalization of financial markets

Notes :
Level 3 sustainability: the institution covers its operational costs, loan losses, depreciation, inflation, and actual costs of funds.
Level 4 sustainability: covers level 3 costs, plus generates an adequate return to attract commercial capital.
NPA : Non-performing assets.
PY : Project Year.
QTR : Quarter.

QUANTITATIVE INPUTS, TARGETS AND KEY PROGRAMME FACTORS

Objectives: The overall goal of the programme is to expand the horizontal and vertical outreach of microfinance institutions and programmes and mainstream them in terms of their access to resources available in the financial sector so as to enhance the access of the poor to microfinance services. The purpose of the programme is to contribute to the development of a more formal, extensive and effective microfinance sector on a national scale, serving poor women and men and to assist in the evolution of an appropriate enabling environment for the development of sustainable microfinance institutions.

Target Group: Embrace all strata of poor who are in need of microfinance. The programme will finance both rural and urban poor and men and women. IFAD's financing, however, will be restricted to the poor households of rural and semi-rural areas. The coverage will be national.

INDICATIVE DEVELOPMENTS

	Unit	Yr-1	Yr-2	Yr-3	Yr-4	Yr-5	Yr-6	Yr-7	Total
No. of active clients									
Large MFIs	No. '000	10	22	32	40	46	50	50	50
Medium MFIs	No. '000	15	30	37	41	41	43	40	40
FFIs	No. '000	0	0	1	2	4	7	10	10
National workshops	No.	1	1	1	1	1	1	-	6
Regional workshops	No.	1	1	1	1	1	1	1	7
Policy Studies	No.	-	2	2	3	1	1	-	9
Action-research studies	No.	-	6	8	10	12	12	1	48
Action-research pilot	No.	-	1	2	2	1	-	-	4
Network support	No.	2	4	4	4	3	2	-	19
Subloan disbursement									
Large MFIs	INR. Mill	104	183	319	443	704	1000	1233	3986
Medium MFIs	INR. Mill	37	74	93	129	148	175	164	820
FFIs	INR. Mill	-	-	36	84	199	386	648	1354
Cumulative savings of all MFIs	INR Mill	18	58	131	248	424	653	926	926

STRATEGY

The programme design promotes:

(i) institutional and financial sustainability of MFIs in order to maximize outreach and to enable them to access to mainstream sources of funding;

(ii) involvement of FFIs in microfinance to bring microfinance into the mainstream of the financial sector; and

(iii) institutional and financial sustainability of the SFMC by establishing a prudent financing structure.

In line with this, the programme design focuses on two key themes:

(i) capacity-building to create adequate institutional capacity and understanding of microfinance among the key stakeholders within the sector; and

(ii) on-lending to MFI/FFIs.

PROGRAMME COSTS	USD Mill.	%
Capacity-building	21.3	17
Credit for microfinance	99.8	80
Policy, advocacy and action-research	3.1	2
Contingencies	10.3	8
Total	**133.4**	**108**

FINANCING	USD Mill.	%
IFAD	22.0	16.5
Cofinancier (DFID)	23.4	17.6
Borrower (SIDBI)	88.0	66.0
Total	**133.4**	**100**

BENEFICIARIES	
Members	1 256 000
Borrowers	541 000

INSTRUMENTS
Training
Technical Assistance
Operational support
Mentoring support
Loan funds
Capacity-building
Action-Research and studies
Networking

SFMC PERFORMANCE (7th Year)	
Debt equity	2.45
Capital adequacy	33%
Spread	2.3%
Return on avg assets	10%
Return on equity	18%
Operation viability ratio	1715%
Financial viability ratio	132%
Economic viability ratio	118%

COSTS AND FINANCING

Expenditure Accounts by Components
Totals Including Contingencies
(INR million)

	Capacity Building of Microfinance Sector	Credit for Microfinance Programmes	Policy Advocacy And Action Research	Total
I. Investment Costs				
A. Investment credit	-	5 376.5	-	5 376.5
B. Training	126.6	-	16.5	143.1
C. Technical assistance, consultancies and studies				
Technical assistance	301.7	-	21.4	323.1
Consultancies	96.7	-	10.8	107.5
Studies	1.0	-	103.6	104.6
Subtotal technical assistance, consultancies and studies	399.5	-	135.8	535.2
D. Operational grants	320.0	-	-	320.0
E. Equity contributions to MFIs	231.1	-	-	231.1
Total programme costs	**1 077.1**	**5 376.5**	**152.3**	**6 605.9**
Taxes	-	-	-	-
Foreign Exchange	32.9	-	11.7	44.6

Disbursement Accounts by Financier
(USD million)

	IFAD		DFID		SIDBI						For.	Local	Duties &
	Amount	%	Amount	%	Amount	%	Amount	%	Amount		Exch.	(Excl. Taxes)	Taxes
1. Investment credit	22.0	20.3	-	-	86.2	79.7	-	-	108.2	80.7	-	108.2	-
2. Training	-	-	3.0	100.0	-	-	-	-	3.0	2.3	0.4	2.6	-
3. Technical assistance, consultancies and studies	-	-	11.3	100.0	-	-	-	-	11.3	8.4	0.6	10.7	-
4. Operational grants	-	-	6.8	100.0	-	-	-	-	6.8	5.1	-	6.8	-
5. Equity	-	-	2.4	51.4	2.3	48.6	-	-	4.7	3.5	-	4.7	-
Total	22.0	16.4	23.5	17.6	88.5	66.0	-	-	134.0	100.0	1.0	133.1	-

FLEXIBLE LENDING MECHANISM AND CONDITIONS FOR SUBSEQUENT LENDING

1. The programme aims to climb the steps of development ladder in phases and will closely evaluate the ability of MFIs to evolve an appropriate legal form, become financially viable and move towards self sufficiency before major funding is committed. The programme will adopt the Flexible Lending Mechanism, allowing for thorough testing and reviewing of the programme activities during the first three years before entering its second phase. To this end, a minimum performance benchmark is stipulated for SDBI/SFMC. It will take all reasonable measures to ensure that its non-performing assets (NPA) under SFMC operations (including, but not limited to, those loans made as a result of the IFAD loan) will be limited to 7%. IFAD will reserve the right to suspend further disbursements if this level of performance is not achieved.

2. An intensive review of programme progress will be carried out by SIDBI, IFAD and DFID at the end of PY3; authorization of further draw-downs from the IFAD loan for the second phase will be dependent upon the attainment and confirmation of the following:

- The SFMC has adequate and capable staff in place, has developed efficient and effective management systems, including a rigorous MIS, and demonstrates adequate managerial capacity.
- The SFMC has been given an appropriate legal status and registered with the appropriate governmental authorities, preferably with wider ownership structure, or an acceptable plan to do so no later than the end of PY 4 after the first phase review has been submitted to and agreed upon by IFAD.
- The SFMC has achieved financial sustainability covering all operating costs, cost of capital, depreciation, etc. from interest on its loan portfolio.
- SFMC's portfolio comprises at least 12 large MFIs and 25 medium MFIs.
- MFIs supported are on course to achieving financial sustainability in line with their business plan projections and that these MFIs have made substantial progress in establishing separate legal entities for their microfinance activities.
- The SFMC has developed a strategy for involving FFIs more effectively in microfinance and has entered into negotiations with at least one FFI to participate in the programme;
- The SFMC has developed adequate mechanisms for providing mentoring and other services to medium MFIs.
- The SFMC has made substantial progress in developing at least two specialized microfinance resource agencies for providing long-term courses and four agencies providing specialized short courses in microfinance.
- The SFMC has launched a number of policy studies to address some of the major issues identified in the development of the microfinance sector and has initiated action-research activities.
- The SFMC has established the procedures for impact assessments that, *inter alia,* will include setting up client panels.

3. Until the first phase review is undertaken, the IFAD loan will be used to reimburse 70% of the incremental credit disbursed, subject to a maximum ceiling of USD 8.0 million. Once IFAD management agrees that satisfactory progress has been made, the remainder of the loan funds will be authorized for the draw-down to the extent of 30% of the incremental credit.

ORGANIZATION AND MANAGEMENT

A. Programme Organization, Executing Agency and Management

1. The SIDBI will be the borrower and overall executing agency for the programme. The responsibility for implementation will lie with the SFMC. Presently, the SFMC is not a separate legal entity but is functioning as a separate department within the SIDBI, reporting directly to the Executive Director/Managing Director. It will have a separate balance sheet nested within the SIDBI balance sheet from the financial year 1999-2000. Based on its performance and progress towards a viable volume of business, the SFMC is expected to become an independent entity with appropriate legal status before the end of PY5.

2. Initially, the management structure of the SFMC will comprise three divisions: financial services, capacity-building and policy and action-research. In PY6, a new products division and resources management division will be added. The SFMC will have an initial staff complement of 13, which is expected to grow to 44 by PY7. The majority of the staff will initially be based at the SIDBI head office at Lucknow. Relationship managers will be posted at certain strategic locations depending on the regional concentration of business. Over time, more activities will be decentralized to the regional offices; they will be responsible for 80% of the clients by PY7. Some of the staff will be drawn from the existing cadre of professionals in the SIDBI; others will be recruited from outside through multichannel recruitment methods. These will include campus recruitment from specialized institutions and from the open market through advertisement.

3. The SFMC has an exclusive advisory board that consists of experts, MFI practitioners and senior management officials of the SIDBI and a separate credit committee with authority to sanction credit applications up to INR 100 million (USD 2.4 million). The main task of the advisory board is to advise on policy issues for the foundation. The programme will bring together a wide array of service providers for assisting the MFIs in developing their capabilities. The SFMC will select and shortlist the service providers. Mentors will be contracted to provide intensive support to medium MFIs.

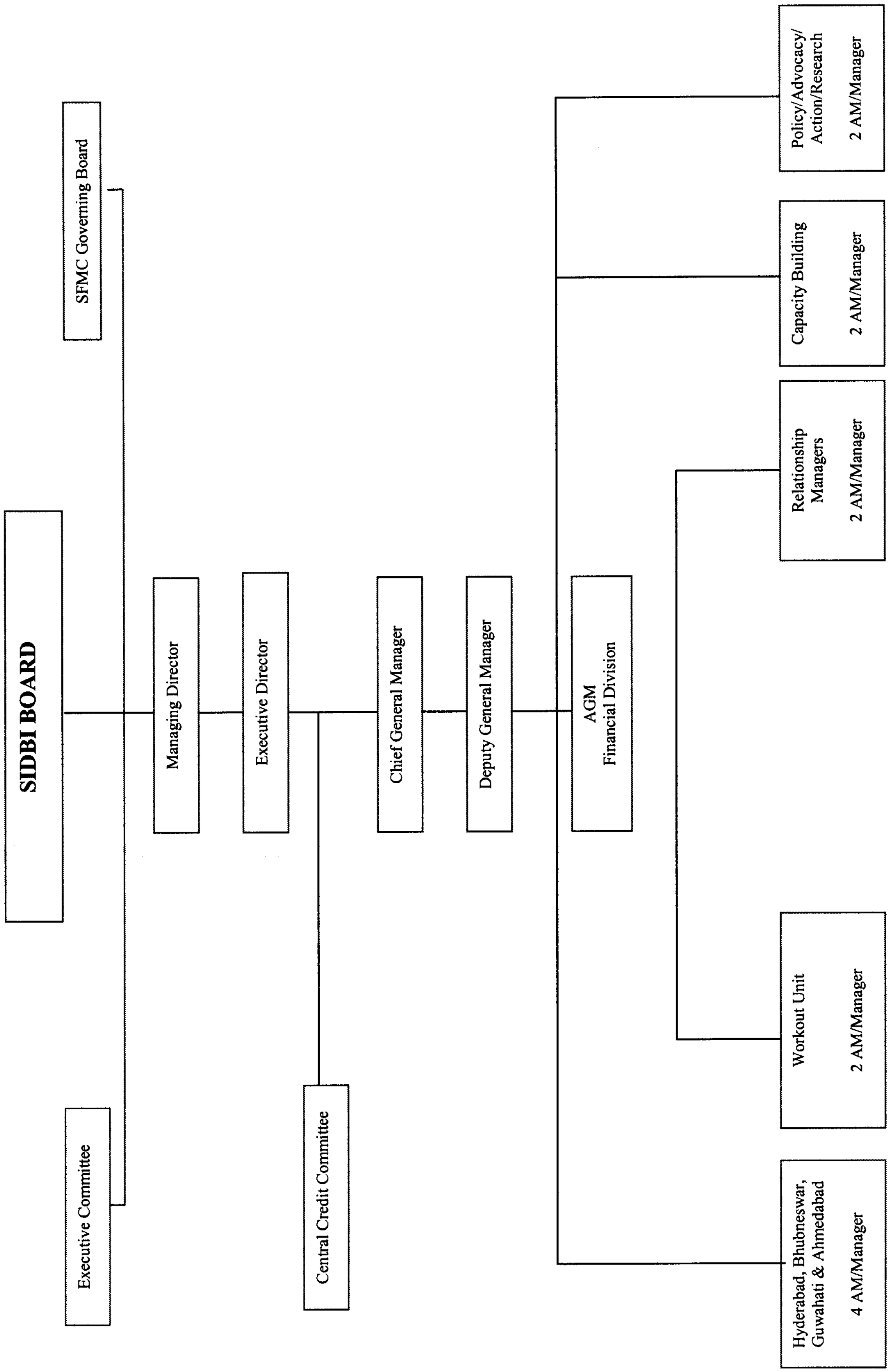
B. Implementation Arrangements and Flow of Funds

4. The SFMC will support specialized microfinance institutions that have a good track record, sound management practices, organizational capabilities, pro-poor orientation and growth potential. Non-governmental organizations (NGOs) with similar attributes that are committed to developing professional, viable and sustainable microfinance programmes, and are willing to create a separate microfinance entity for the purpose will also be eligible for assistance. The loan will be approved by the SFMC's credit committee based on the rigorous appraisal of the loan proposal and the business plan and resources forecast by the relationship managers and rating by independent agencies. The authority to approve loans and also expenditure under capacity-building assistance will rest with the Central Credit Committee - II of the SFMC. Until the SFMC is established as a separate legal entity, SIDBI will continue to delegate this committee with the authority to approve credit applications up to INR 100000 million.

5. The loan agreement will be signed between IFAD and the SIDBI with the latter responsible for the foreign exchange risk. The Government of India will guarantee the loan. The SIDBI will open a special account in a bank of its choice. While the authorized allocation in the Special Account will be up to USD 2.0 million, it will be limited to USD 1.0 million until the aggregate amount of withdrawals from the loan account *plus* the aggregate amount of all outstanding special commitments entered into by IFAD equals or exceeds USD 2.5 million. On receipt of the claims in INR from the SFMC, the SIDBI will settle eligible claims in INR by withdrawing on equivalent amount in USD from this account. IFAD will replenish the special account from time to time as per the request of the SIDBI.

APPENDIX VIII

SIDBI FOUNDATION ORGANIZATION CHART (YEAR 1)



ECONOMIC AND FINANCIAL BENEFITS

1. The programme will benefit an estimated 1.26 million women and men. Of these, 70% are women and 80% poor; over 540,000 households are expected to borrow under the programme. In addition, the SHGs will recycle the savings among themselves as loans. All these beneficiaries will benefit indirectly from the capacity-building inputs provided by the programme to the MFIs/FFIs. Loan size per borrower will vary between INR 500 and INR 25 000, with a median size of about INR 14 500. This will contribute to ensure that the majority move out of poverty.

2. The financial returns to programme beneficiaries are expected to be substantial. Based on the impact evaluation studies of SIDBI's previous microcredit scheme, microcredit helped to increase the turnover and enhance incomes for a majority of the women borrowers. The high repayment rates at high rates of interest are also an indication of the great profitability of the activities financed. With access to successive and larger loans, the income will grow progressively over time. Virtually all these clients will be able to increase their savings. Increased turnover, income and savings lead to further benefits, including: retrieval of pawned goods, repaying other (higher interest) loans; reducing vulnerability to natural disasters and family emergencies; higher spending on children's education; improving nutrition; and improvement in the overall standard of living.

3. The programme will benefit women by significantly increasing their economic and social empowerment. The qualitative benefits accruing to women from access to financial services will include: (i) access to alternative livelihood opportunities; (ii) increased autonomy and control over household income; (iii) improved status in the society and the household; and (iv) the ability to take collective action to address social and gender oppressions. In addition, improved financial standing of women will directly result in improved nutrition and schooling of children.

A. MFIs

4. The programme will have an active clientele of 50 large MFIs, 40 medium MFIs and 10 FFIs by the end of the programme. Total disbursement to the beneficiaries from the these 90 MFIs and microfinance programme of 10 FFIs is expected to be in the range of INR 6 160 million (USD 141 million), of which the SFMC and IFAD will fund about USD 99.0 million.

5. The programme is expected to support the MFIs in reaching operational sustainability by addressing the main constraints for expansion and sustainability of microfinance services. The programme support directed towards capacity-building, and the provision of on-lending funds to expand the loan portfolio will enhance outreach as well as viability and sustainability of the MFIs. Changes in the legal and regulatory framework contemplated will enhance the ability of MFIs to mobilize resources from the market and also mobilize savings. The liberalization of lending rates is likely to have a positive impact on the viability of the MFIs.

6. The financial performance of client MFIs will improve substantially during the programme period, chiefly because of the rapid expansion of the lending portfolio reducing the lending cost and the availability of the capacity-building grant to offset the deficit in operation during the initial years. The MFIs will start earning a return on equity from PY 4-5. By PY 10, the rate-of-return on equity is expected to reach a level of 23%. The operating expense as a percentage of average outstanding will decline from 37% in the first year for the SHG model to 5.1% in the tenth year. In respect of the solidarity group model, the operating expense as a percentage of average outstanding will decline from 60% in the first year to 8% in the tenth year.

B. Viability and Sustainability of the SFMC

7. SFMC projections indicate a comfortable debt-equity and capital-adequacy ratio during programme life. The debt-equity ratio will increase from a very low level of 0.09 in the first year to 2.45 in the seventh year. The capital-adequacy ratio, at the end of seventh year, will be a high 33%. The effective spread will be about 1% in the second year and 2.3% in the seventh year. The loan outstanding of SFMC is projected to grow at a rapid pace during the initial years due to the existence of high unsatisfied demand for loan funds in the sector. The rate of growth will be 119% in the second year, which will taper-off to 41% in the seventh year. The assets of SFMC are expected to grow at the healthy rate of 35-40% in each year.

8. The SFMC is expected earn operating profit from the very first year of the programme. This will be related in good measure to the ability of the SFMC to draw funds from its parent (SIDBI) at 10%, and ability to invest the corpus at 11%. The return-on-average assets is projected to grow from 4% in the second year to about 10% in the seventh year. The return-on-equity is projected at 2.6% in the second year; with the expansion of the portfolio in the seventh year, the return-on-equity will be 18%, which is considered adequate.

9. The SFMC will be able to achieve operational, financial and economic viability from the programmes second year. The operational viability ratio[6] will increase from 92% in the first year to 1715% in the seventh year. The financial viability ratio[7] is projected to be about 43% in the first year. The economic viability ratio[8] is projected at 42% in the first year, increasing to 100% from the second year onwards. As per the proposed business plan, the SFMC will be able to achieve viability from the second year onwards, even if all the funds required for its lending operations are borrowed at the current market rate of 11%.

10. The sensitivity analysis of SFMC's performance to changes in lending rates, decline of loan disbursement, increase in loan loss provision and increase in administrative expenses on the overall viability of SFMC indicate the deterioration of the performance (Scenario 1 and Scenario 2). This can be reversed by increasing the on-lending rates to MFIs (Scenario 3).

(i) **Scenario 1 - Outstanding Loan Portfolio of SFMC declines by 15% and loan loss provision increases to 4%:** Under this scenario, the SFMC will be able to achieve financial viability from the third year and the economic viability remains a possibility only in the fifth year.

(ii) **Scenario 2 - Outstanding Loan Portfolio of SFMC declines by 15%, loan loss provision increases to 4%, and administrative expenses increase by 10%:** The performance of SFMC will further deteriorate under this scenario. The achievement of financial viability will be postponed to the fourth year and the SFMC will be able to reach economic viability marginally from the fifth year.

(iii) **Scenario 3 - Outstanding Loan Portfolio of SFMC declines by 15%, loan loss provision increases to 4%, administrative expenses increase by 10%, and the lending rates increase to 12% for first four years and 12.5%**

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6 Interest income as % of non-financial operating costs.
7 Interest income as % of operating cost, including financial expenses.
8 Interest income as % of operating cost, including financial expenses plus imputed economic cost (11%) of the entire funding base.

thereafter (assuming that the SIDBI fund cost has declined to 10%): The deterioration in Scenario 2 above can be reversed with the increase in the on-lending rate from the present 11% during the first four years to 12% and 12.5% thereafter. Under such circumstances, the SFMC will reach financial viability and economic viability from the third year.