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IMPLEMENTATION OF THE FIRST CYCLE OF THE NATIONAL MICROFINANCE SUPPORT PROGRAMME UNDER THE FLEXIBLE LENDING MECHANISM

I. INTRODUCTION

1. The purpose of this information note is to comply with paragraph 13 of the Flexible Lending Mechanism (FLM) guidelines (EB 98/64/R.9/Rev.1), which stipulates that "for each FLM loan and prior to the end of each cycle, IFAD management will decide whether to proceed to, cancel, or delay subsequent cycles. Management will inform the Board accordingly".

2. The overall objective of the FLM is to introduce greater flexibility into IFAD's project design and implementation in order to: match the time frame with pursuit of long-term development objectives when it is judged that a longer implementation period will be required to meet such objectives; maximize demand-driven beneficiary participation; and reinforce the development of grass-roots capacities. The specifics of an FLM loan include: (i) a continuous and evolving design process through implementation of distinct, three-to-four-year cycles; and (ii) clearly defined preconditions, or "triggers", for proceeding to subsequent cycles.

3. This information note reports on the progress of the National Microfinance Support Programme (Loan 538-IN) in achieving the first-cycle triggers. Its contents are based on the results of the first-cycle review and supervision mission jointly fielded by the United Nations Office for Project Services (UNOPS) and IFAD.

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II. BACKGROUND

4. The National Microfinance Support Programme (NMSP) was approved by the Executive Board under the Flexible Lending Mechanism in May 2000. The loan agreement was signed in February 2002 and became effective on 1 April 2002. The total programme cost is USD 134 million, of which USD 22 million (SDR 16.35 million) is IFAD financing, USD 23.5 million is a grant from the Department for International Development (DFID) of the United Kingdom of Great Britain and Northern Ireland and USD 88.5 million is domestic financing.

5. Domestic financing is provided in the form of loans and equity by the Small Industries Development Bank of India (SIDBI). While IFAD and SIDBI will jointly finance the on-lending funds, DFID will fund the entire capacity-building component on a grant basis. IFAD's loan to SIDBI is guaranteed by the Government of India. The programme coverage is nationwide and is being implemented by the SIDBI Foundation for Microcredit (SFMC) over a seven-year period in two phases. UNOPS is the cooperating institution.

6. The first cycle was reviewed by a joint IFAD-UNOPS team led by IFAD in collaboration with the Loans and Grants Administration Unit of the IFAD Office of the Controller in September/October 2005. DFID joined the mission for discussions on policy issues with the Reserve Bank of India and leading financial institutions, as well as during the wrap-up meeting. After a thorough assessment of performance, the review mission confirmed that the requirements of the majority of indicators, laid down as triggers to move to the next and last cycle, had been substantially met.

7. The programme was approved under FLM policy based on certain risk factors (assumptions) such as:

- willingness of microfinance institutions (MFIs) to promote financially sustainable microfinance that formalizes over time;
- MFIs are ready and open to absorb training and advice;
- formal financial institutions (FFIs) are willing or able to follow the example of NMSP; and
- the FFI sector will become more flexible and demand-driven with continued liberalization of financial markets.

III. ACHIEVEMENTS OF THE FIRST CYCLE

8. In response to a significant level of unmet demand for financial services, microfinance has been growing fast, even beyond SIDBI's expectations. As the first institutional lender to MFIs, SFMC has built a market and created an enabling environment for other FFIs to join in. It is widely acknowledged that by encouraging and paying for MFI ratings, SFMC brought legitimacy to the MFIs. These ratings have helped MFIs to approach FFIs for both debt and equity funding. Based on data for March 2005, the average share of SFMC in the total external borrowings of 69 partner MFIs stood at 27%, indicating active participation of FFIs and funding sources to finance the balance.

9. There has been impressive growth in the volume of SFMC lending to MFIs, almost doubling each year since financial year 2004. The cumulative total disbursement since inception was USD 76 million as of 15 September 2005. The outstanding loan amount as of 30 June 2005 stood at USD 42 million. SFMC hopes to achieve 100% portfolio growth for the next two years as well. The distribution of outstanding loans as of end March 2005 showed that Andhra Pradesh, Tamil Nadu, Gujarat and Karnataka had the largest share (84%), with the rest of the states making up the remainder (16%). These figures show a skewed distribution of the SFMC loan portfolio, wherein underserved

states display lower absorption rates. SFMC has developed a strategy to rectify this imbalance during the next cycle.

10. Some of the MFI partners of SFMC have shown considerable growth, with yields on portfolios ranging from 10% to 36%, with the maximum concentration (10 MFIs) being in the band of 18-30%. Transformation loans by SFMC have helped the MFIs with much needed quasi capital to register as non-bank financial companies (NBFCs) or other legal forms. This product has assisted, and continues to assist, eligible MFIs to upgrade their status. The analysis of portfolio size and unmet demand shows that there is considerable scope for expanding the operations of MFIs, particularly those with large memberships.

IV. COMPLIANCE WITH THE CONDITIONS PRECEDENT TO THE SECOND CYCLE

11. The loan agreement specifies the following indicators as triggers for confirmation of funding and subsequent detailed design of the second cycle of the programme. The triggers and their current status are as follows:

(i) **The lead programme agency shall 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 (MIS) and demonstrates adequate managerial capacity.** There has been steady growth in the number of staff at SFMC, currently 25 staff at the head and branch offices. This includes five young professionals hired for the purposes of the programme. According to the business plan, SFMC was to have a staff of 33. The work pressure on staff is high. In line with the fast development of the sector, staff capacity will have to be strengthened. SFMC's management system is rigorous (as well as time consuming in approving loans) and this provides a level of comfort for other FFIs, including the private sector, to lend to MFIs. Although SFMC has its own governing body, policy decisions relating to SFMC's business are taken by SIDBI. Most of SIDBI's operational MIS has been computerized, including SFMC's work. Regular rating of MFIs through the two rating agencies supported by SFMC provides sufficient financial information about partner MFIs.

(ii) **The lead programme agency shall have achieved financial sustainability covering all operating costs, cost of capital, depreciation, etc., from interest on its loan portfolio.** SFMC's financial results are separately reported by SIDBI and duly reflected in SIDBI's annual reports. As per the income and expenditure statement of SFMC for the financial year 2004-2005, the interest income from operations was USD 2.7 million and interest on borrowings was USD 1.1 million. The establishment expenses on a lump-sum basis were USD 350 000 and other expenses were USD 72 000. The profit was USD 1.2 million for the year.

(iii) **The lead programme agency's portfolio at the time of the first-cycle review shall comprise at least 10 established MFIs and 25 emergent MFIs.** Response to this trigger is combined with that of trigger (iv) below.

(iv) **There are clear indications that the MFIs supported are on course to achieve 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 is dealing with 65 active MFI clients. Nearly half these clients have had growing portfolios with SFMC over the past three years. Others are showing a decline or stagnation in their portfolios. A review of sustainability

indicators[1] in 52 MFIs showed that 9 are at level 4; 21 are at level 3; 18 are at level 2; and 4 are at level 1. Of the 39 IFAD-funded MFIs, 5 are at level 4; 16 are at level 3; 15 are at level 2; and 3 are at level 1. Moreover 19 MFIs have either transformed themselves into legal entities (NBFCs, etc.) or are in the process of doing so. The transformation loan of SFMC has assisted and continues to greatly assist MFIs to upgrade their status.

(v) **The lead programme agency shall have developed a strategy for involving FFIs more effectively in microfinance and shall have entered into negotiations with at least two FFIs to participate in the programme.** So far, five FFIs have been provided lending support by SFMC, although two of them are no longer SFMC partners. More impressive is the substantial increase in the involvement of commercial banks (especially private banks) with MFIs. A major private bank, ICICI Bank, is now a significant provider of finance to MFIs.

(vi) **The lead programme agency shall have developed adequate mechanisms for providing mentoring and other services to emergent MFIs.** With the aim of providing mentors/resource persons for the sector, SFMC organized a consultants' workshop in 2001. Most of the participants were engaged by SFMC to conduct capacity-building needs assessments (CBNA) on partner MFIs. Some of the consultants have also been engaged by MFIs to provide mentoring services to them. It is widely acknowledged that by encouraging and paying for MFI ratings, SFMC brought legitimacy to the MFIs. Facilitating exposure visits and establishing technical cooperation between emergent and leading MFIs are among the other achievements of the programme. SFMC has recently extended support to the Indian Institute of Management, in Bangalore, to set up a tailor-made mentoring support system known as the "incubator project".

(vii) **Substantial progress shall 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 has enabled three management institutes – the Institute of Rural Management in Anand, the Xavier Institute of Management in Bubaneshwar, and the Indian Institute of Forest Management in Bhopal – to provide long-term courses in microfinance as part of the post-graduate management degree. These institutes are offering microfinance as an elective subject and graduates are finding placement with the leading MFIs. There are a number of short-term training providers. However, only two of them (Friends of Women's World Banking – FWWB and M–Tril) are rated high by the MFIs concerned. The others seem to be providing a general overview of microfinance rather than the specific skills needed by MFIs.

(viii) **The lead programme agency shall have launched a number of policy studies to address some of the major issues identified in the development of the microfinance sector and shall have promoted action-research activities and converted some of these into pilot-scale experiments.** One of the significant contributions of SFMC in the policy arena was in holding annual conferences. Each year, SFMC has picked a relevant and important theme for the conference. It has invited experts from within and outside the country to participate in the conferences and has also built a strong interface

[1] As per the Consultative Group to Assist the Poor (CGAP) definitions, level 4 – financial self sufficiency, covers all operating and financial expenses adjusted for cost of funds and subsidies; level 3 – operational self sufficiency, covers all operational and financial expenses; level 2 – covers operating expenses excluding cost of funds; and level 1 – not operating expenses.

with practitioners. The SFMC annual conference has been acknowledged as the most significant event in which the sector comes together. However, SFMC has not capitalized on the gains from these conferences. It needs to develop a clear strategy for making inroads in policy forums. Nonetheless, it is a recognized fact that through its capacity-building efforts the programme has been very successful in creating an enabling environment for the microfinance industry.

(ix) **The procedures for impact assessment shall have been fully established and functional with client panels set up and operational.** SFMC has launched a two-stage, longitudinal socio-economic research effort to measure the impact of the programme. The stage-one study results show that the programme as a whole is reaching 1.3 million clients, of whom the majority (95%) are women. It was also found that services are concentrated in the more developed southern and western regions (89%), against 11% in the north-east. About 77% of MFI activities are concentrated in rural areas. On the whole, the first-stage study provided useful information on the effectiveness and outreach of the programme. Although the findings are encouraging, the study also showed the challenges facing SFMC for deepening its outreach. The second-stage study has been commissioned to Agricultural Finance Ltd. of Mumbai.

V. LESSONS LEARNED

12. A review of the successful achievements and performance of the first cycle highlights a number of lessons that need be addressed during the second cycle of the programme as follows:

- The demand for microcredit has been phenomenal. Expansion of the microfinance sector has been much faster than expected. Competition is becoming intense. SFMC needs to streamline and synchronize loan and grant approval processes. Standalone capacity-building grants are needed for underserved states.

- While recognizing the contribution of SFMC in giving market legitimacy to the sector, MFIs would like SFMC to be quicker in responding to their financial and institution-building needs.

- The success of the programme owes a great deal to having started in states with more conducive policy environments and well-functioning NGOs and other service providers. This has enabled SFMC to gain experience with workable models and approaches. Equipped with such experience, the programme should intensify its efforts to extend its outreach to underserved states.

- It is not sufficient to stimulate the generation of knowledge on microfinance issues. Such knowledge has to be transformed into strategies to influence sectoral policy directions and be effectively followed up by SFMC.

- The contribution of SFMC to shaping the policy framework for microfinance has been limited. With the dominant presence of the National Bank for Agriculture and Rural Development in shaping national policies, SFMC needs to adopt a more proactive role in policy issues to shape the future of microfinance.

- It was envisaged that SFMC would be hived off from SIDBI, assuming independent legal status by programme year 4. Achievement of this objective is very unlikely in the near future, given the fast growth of the sector and increased interest of FFIs to compete with each other in the market place, including SIDBI.

VI. CONCLUSIONS

13. The programme was placed under the Flexible Lending Mechanism to allow for thorough testing and reviewing of the programme activities during its initial years before entering the second cycle. As the programme climbed the steps of the development ladder in phases, it was to closely evaluate the ability of MFIs to evolve into an appropriate legal form, become financially viable and move towards self-sufficiency before major funding was committed.

14. IFAD management considers that there is now a firm basis for continuation of the programme. The Government of India has shown clear commitment to the success of the programme throughout its implementation and is willing to scale it up. IFAD is committed to supporting this endeavour.