

## Ex Post-Evaluation Brief

### INDIA: Microfinance Facility



Sector	2404000 Informal and semi-formal financial intermediaries	
Programme/Client	Microfinance facility BMZ No. 2008 66 103* Accompanying measure BMZ No. 2008 70 170	
Programme executing agency	An Indian promotional Bank	
Year of sample/ex post evaluation report: 2013/2013		
	Appraisal (planned)	Ex post-evaluation (actual)
Investment expenses	EUR 85.0 million EUR 1.7 mill. (AM)	EUR 85.0 million EUR 0.216 million (AM)
Project support measures (BMZ funds)	EUR 1.7 million	EUR 0.216 million
Financing, KfW's own funds BMZ funds	EUR 85 million Interest rate reduction	EUR 85 million interest rate reduction

\* random sample 2013

**Short description:** The project comprises an interest rate reduced loan (interest rate reducing component consisting of BMZ budget funds and original loan amount from KfW's own funds) with a volume of EUR 85 million to an Indian promotional bank. The project-executing agency operates in part as an apex institution for microfinance institutions (MFIs) and, through its microfinance department, channels the funds to MFIs throughout India. A TA component was also originally planned. Only part (approx. 12%) of this component was used due to the Indian microfinance crisis of 2010.

**Objectives:** The objectives of the FC measure were to support the agency in expanding the portfolio for refinancing MFIs, in particular in previously underserved Indian states, and to ensure the sustainable use of credit products by the microfinance clients. This was intended to contribute to improved access to microfinance products at the end borrower level and thus to demand being better met. This in turn was to create employment and generate income, thus helping to reduce poverty among the population (overarching development goals). **Target group:** The direct target group of the project were Indian MFIs. The indirect target group were the poorer citizens living in rural and urban areas as borrowers of the MFIs, who were to generate higher (household) income as a result of improved investment opportunities. The ultimate clients are almost exclusively women.

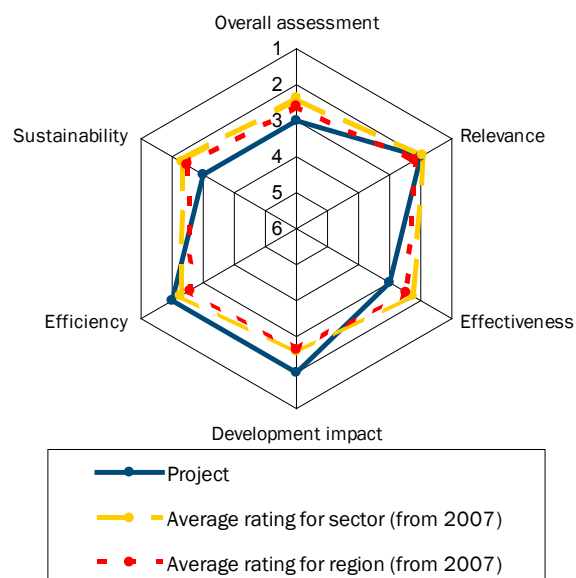
#### Overall rating: 3

The microfinance crisis in India also affected the portfolio of the apex bank, but this has not put its overall sustainability at risk. The apex structure with an established partner in the Indian microfinance market proved to be helpful in making a notable contribution to responsible finance in the microfinance sector.

#### Points to note:

In recent years, the agency has started to strengthen responsible finance practices at the refinanced MFIs through the introduction of a code of conduct assessment. The apex structure of the project means that the FC is reaching a large number of Indian MFIs relatively easily.

#### Rating by DAC criteria



## **EVALUATION SUMMARY**

### Overall rating

It is assumed that the intended objectives will largely be achieved even though the size and quality of the microfinance portfolio at the agency decreased after the microfinance crisis in the Indian state of Andhra Pradesh in 2010. Using the agent, it has proven possible to make a contribution to responsible finance and thus to sustainability in the microfinance sector.

**Rating: 3**

### Relevance

At the time of the project appraisal (PA) in 2009, the Indian microfinance sector was experiencing rapid growth. At the same time, the provision of services by MFIs was very unevenly distributed in different parts of the country. The southern and south-eastern parts of India were already adequately, and as becomes clear in retrospect, even excessively served. Parallel to this, there was great potential for growth in the other states, where the provision rate (measured in terms of the number of households reached by MFIs) often stood below 5% and most market observers estimated the demand to be significantly higher. While the majority of MFIs were at that time expanding their portfolio even in the less well-supplied regions, for reasons of profitability the focus still remained on the southern states, which possessed better infrastructure.

The concept of the project to be evaluated, namely to better meet the demand for microfinance in India, while at the same time aiming to extend the supply geographically to the still underserved regions, is regarded as being relevant even from today's perspective, i.e. after the microfinance crisis of 2010. By law, Indian MFIs are limited in their selection of funding and not permitted to accept savings deposits. The MFIs are therefore dependent upon refinancing from the commercial banking sector or Development Finance Institutions (DFIs). In 2009, the project-executing agency had already gained more than ten years' experience as an entity specialising in microfinance in the Indian market and had a portfolio of approx. 130 MFIs. During the growth phase of the sector, the agency had assumed an important role as a "signal investor" in whose footsteps commercially-oriented institutions often followed. At the time of the PA, the provision of refinancing was a meaningful way for the agency to support the Indian microfinance sector from a less volatile source of funding. It was to be expected that the focus would shift more to underserved regions too, thanks to the specific mission of the agency as a promotional bank. The agency offered an appropriate lever for making a broadly effective contribution to responsible finance, despite the size of the Indian market. The agency also refinances itself via other sources, including the World Bank, with which the FC cooperates closely via the agency to establish responsible finance. The project is based on the BMZ's sector strategy. The relevance is consequently rated as good.

**Sub-Rating: 2**

### Effectiveness:

The stated project objective was to support the project-executing agency in expanding the portfolio of refinanced MFIs, in particular in previously underserved states, and to ensure the sustainable use of credit products by the microfinance clients. When the project was appraised, the indicators 1 to 3 listed in the following table were formulated to reflect the achievement of the project objective. Additionally, as part of the ex-post evaluation (EPE), the indicators 4 and 5, intended to represent the end borrowers' improved access to microfinance, were taken into consideration. These indicators were assigned to the overarching development goals during the PA. However, since they are closely related to the project objective of reaching undersupplied regions, they were also used in the assessment of effectiveness.

<u>Indicators regarding the objective of the FC measure</u>	<u>Status</u>
1) Full disbursement of the loan within 2.5 years of the loan agreement being signed	Achieved
2) Gross non-performing loans (NPL) ratio of the agency's microfinance portfolio remains below 1.5%	Not achieved in 2012 and 2013, achieved previously
3) The portfolio at risk (PAR, 30 days) of the participating MFIs does not exceed 5%	Partially achieved
4) Conclusion of 2.5 million new loan agreements (of the MFIs in the agency's entire portfolio)	Achievement unclear
5) At least 40% of the loan portfolio of the participating MFIs is in the previously underserved regions <sup>1</sup>	Achieved

After the loan was granted, it was disbursed quickly and used by the agency to refinance MFIs shortly before the onset of the microfinance crisis in the state of Andhra Pradesh. Indicator 1 is thus regarded as having been met. The prompt disbursement of the granted funds can be seen as an indication of the demand for refinancing that existed among MFIs at that time. The interest rates of the loans to MFIs were generally somewhat lower than those of commercial funding where this was at all available to MFIs. Especially after the start of the microfinance crisis in Andhra Pradesh, a bottleneck arose in the refinancing of many MFIs throughout the country.

Most of the loans that the agency attributes to the project were granted to MFIs (56% by number, as at the end of 2012) that *only* operate in underserved regions. This constitutes a certain deviation from the profile of the agency's overall microfinance profile in which around half of all MFIs are active solely in underserved regions, just under 40% only in the southern states and the remainder in both regions. With the line to be evaluated here, the agency has thus focused particularly on the demand from underserved regions without, in light of the fungibility of the refinancing, the deviation from the portfolio as a whole prompting doubts about

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<sup>1</sup> As defined internally by the agency, all states are regarded as being underserved, except for the southern states of Karnataka, Tamil Nadu, Andhra Pradesh and Kerala.

whether the agency's business policy also takes undersupplied regions into account in its other business. Indicator 5 is therefore also regarded as having been achieved.

Originally, indicator 4 was formulated to ensure that the MFIs refinanced by the agency would use the funds to finance new loans to end borrowers and not, for example, to restructure refinancing or for other investments. In light of the onset of the microfinance crisis, which at least in the excessively served regions implies the need to consolidate, rather than expand the microfinance portfolios and the sector, it is necessary to consider whether such an indicator remains meaningful. In line with this, the agency's microfinance portfolio, which had grown strongly until 2010, decreased after the crisis struck, returning in 2012 to the level reached in 2009 and continues to contract. Against this backdrop, it cannot be assumed that refinancing funds of the agency played a decisive role in the conclusion of new, i.e. additional loan agreements with end borrowers. Calculated as a gross figure, the loan amount disbursed by the agency's microfinance department to MFIs for refinancing the requested 2.5 million end borrower loans is nonetheless sufficient for indicator 4 to be regarded as having been achieved.<sup>2</sup>

However, this kind of argument would miss the original point of the indicator. To assess the effectiveness, it seems more important to determine whether new end borrowers were reached in the underserved regions, while reduced involvement in the crisis region does not adversely affect the achievement of the objective. As a whole, the portfolio of microfinancing in India has almost doubled since 2009, despite a slight contraction after 2011 (from INR crore 11,734 in 2009 to INR crore 21,245 in 2013). Thus, Indian MFIs now reach significantly more households than they did five years ago. The growth occurred primarily in the underserved regions, while the portfolios in the crisis regions grew far more slowly or even contracted. Since the agency's portfolio has decreased, it only reflects this development of the market as a whole to a limited extent. However, during the difficult restructuring process in favour of underserved regions, it proved impossible at the level of individual institutions to attain growth of the market as a whole. In any case, doubts must inevitably be raised as to whether such efforts are appropriate for achieving rapid additional growth. The project to be evaluated here has made a certain contribution to the restructuring. In that respect, indicator 4 regarding the conclusion of new (in the sense of additional) loan agreements, brought about by the refinancing of the agency, is regarded as largely not having been achieved, but its importance must be put into perspective in light of the microfinance crisis.

Indicators 2 and 3 concern the measurement of the portfolio quality, on the one hand of the MFI portfolio at the agency, and on the other that of the end borrower portfolio at the MFIs. Neither remained untouched by the microfinance crisis. When this hit the state of Andhra

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<sup>2</sup> Between 2010 and 2012, the agency's disbursements to MFIs totalled INR crore 4095 (1 crore = INR 10 million), with an average end lending volume of INR 15,000, equivalent to approx. EUR 200 (the volume is normally between INR 10,000 and INR 30,000). Without revolving these funds this results in approx. 2.7 million loan agreements. As loans to end clients generally have a very short repayment period and thus revolve quickly, technically it could be argued that, as a consequence, far more than 2.5 million "new" agreements were concluded with end borrowers.

Pradesh in October 2010, many MFIs then found themselves in difficulty, partly because the government called on microfinance clients in the state of Andhra Pradesh to cease their payments to MFIs. Essentially, the greater the MFIs' share of their credit portfolio was in Andhra Pradesh, the greater the losses they had to accept. The market in Andhra Pradesh has not recovered substantially since 2010 and many of the MFIs are undergoing restructuring processes. With a time lag, this negative development has also been reflected in the portfolio of the project-executing agency. Due to the restructuring process of a major MFI refinanced by the agency in Andhra Pradesh, the NPL ratio of the microfinance department in 2013 leapt to almost 13%, after it had previously been at a very low level and, until 2012, below the required benchmark. At present, the indicator for the gross NPL ratio has therefore not been reached. However, the appropriateness of this indicator must also be called into question. As the MFI portfolio of the agency does not consist of thousands of small loans, but of a significantly lower number of larger loans to MFIs, the prescribed portfolio quality of an NPL ratio of maximum 1.5% can already be significantly exceeded as the result of a single, relatively large defaulting loan. Given that the agency itself can easily absorb the complete non-repayment of the defaulting loans without its solvency being impaired, indicator 2 is currently regarded as not having been achieved, although this is of no particularly great importance in assessing the effectiveness.

With regard to the quality of the end borrower portfolios, it can be stated that the portfolio at risk (PAR, 90 days) of 7 of the 62 MFIs, which the agency internally assigned to the loan within the framework of the project at the end of 2012, exceeds the 5% threshold. The number of MFIs with a PAR above the 5% benchmark throughout the short period (30 days) is correspondingly even higher. Consequently, the target indicator value has not been achieved, since it requires compliance with the 5% threshold by all refinanced MFIs. However, in light of the situation on the Indian microfinance market, this indicator is regarded as having been over-ambitious within the framework of the ex-post evaluation, even though the demand for low overdue payment rates among the end clients is thoroughly justified as a means of preventing excessive indebtedness. Thus far, only about 12% of the funds from the accompanying measure have been used. According to the agency, this is accounted for by the fact that in the course of the crisis, the funds could only rarely be placed for high-quality measures. But since not all MFIs were affected by the crisis and the need for training and advanced training measures in the Indian microfinance sector is obvious, the low share of funds actually used from the accompanying measure remains surprising.

Overall, in light of the partial failure to achieve target indicators, whose benchmarks were, however, regarded as not always appropriate, and the low use of funds within the framework of the accompanying measure, the effectiveness is only rated as satisfactory.

**Sub-Rating: 3**

## Efficiency

The loan to the agency is denominated in euros. The loans to MFIs are granted exclusively in the local currency (Indian rupee). In addition to the (reduced) interest payments for the loan granted, the agency is obliged to fully hedge the exchange rate risk. Moreover, the FC development loan is secured by a guarantee from the Indian state for which the agency pays guarantee fees. At the time of disbursement, the conditions of the loan were advantageous despite the hedging costs and guarantee fees. The interest rate reduction element has actively contributed to this. Nonetheless, the efficiency of this tool depends on the trend in interest rates and, in particular, on the hedging costs. Although the agency extends refinancing to MFIs efficiently, in the current environment (high costs for currency swaps) the attractiveness of refinancing in a foreign currency has declined significantly.

The apex structure of the partner is a key component in the high efficiency of the project. The agency has decentralised structures (local offices) in all Indian states, generally also with an active microfinance business. The agency also maintains close relationships with many MFIs and umbrella organisations in the microfinance sector (e.g. Sa-Dhan and the Microfinance Institutions Network, MFIN). The employees of the agency's microfinance department often have many years of experience in microfinance and, moreover, after some time rotate between different branch offices. This provided good prerequisites for the agency to estimate the portfolio quality of the refinanced MFIs and adjust the volume and conditions of the loans to the risk. This adjustment has not proven successful in all cases. Despite the involvement of a further entity in the granting of loans to the MFIs, the conditions of the loans are ultimately more favourable for the MFIs than those of most other sources of refinancing. By granting a loan to the agency, the German FC was able to use these decentralised structures indirectly. It was thus possible to significantly increase the volume of the project in comparison to what might have been achieved through the granting of loans to individual MFIs and without having had to undertake costly assessments of the creditworthiness of individual MFIs or perform supervisory functions in relation to them. As regards the allocation efficiency too, the refinancing of the microfinance sector via the selected agency is rated as reasonable, despite the microfinance crisis that developed in Andhra Pradesh shortly after the granting of the loans. On the one hand, the increased focus on the underserved regions was anchored in the objectives system and, on the other hand, the financing was available during a period that, in light of the crisis, was characterised by particular refinancing bottlenecks in the microfinance sector. Furthermore, a more far-reaching impact on the dissemination of the principles of responsible finance was to be achieved via the agency than would have been possible through the support of an individual MFI.

As a result of the increased efficiency gained from decentralisation, the large number of MFIs reached, the rapid channelling of funds to MFIs, and primarily due to the lever for disseminating principles of responsible finance, offered by cooperation with the agency, the efficiency is rated as good.

## **Sub-Rating: 2**

## Impact

The overarching development goal was, by making a contribution to improved access to microfinance products at the level of the end borrower, to contribute to the creation of employment and generation of income and thus to reducing poverty among the population. The indicators selected during the PA to represent the overarching development goals were mostly located at the project objective level and have therefore already been dealt with under 'effectiveness'.

Although the agency's microfinance portfolio has declined since the disbursement of the loan, the project made a contribution to satisfying unmet demand by shifting the focus to previously underserved regions and contributing, as it still does, to the refinancing of the agency during a period in which access to refinancing funds for microfinance was limited as a result of the crisis. The extent to which income and employment are also created in this way can only be verified in this evaluation by reference to the literature, which classifies a lack of access to credit as an important barrier to development for (micro-)enterprises and, within the framework of cross-sectional studies of a number of countries, demonstrates that the development of the financial system contributes to growth. However, the most recent scientific research assumes that the contribution to economic growth stems principally from corporate loans, while loans to private households may indeed help to smooth consumption, but are also accompanied by the risk of excessive debt.

It is difficult to determine precisely the degree to which corporate activities or consumption was financed by the microfinance portfolios of the MFIs, because in the case of typical microfinance clients, company and household budgets are not entirely separated. It may be assumed that, above all, small, micro- and self-employment companies were served, because the microfinance product offered by the MFIs is almost always based on the so-called joint liability group model (JLG) in which individual borrowers within a group guarantee each other's repayments to the MFI. Nearly 100% of the borrowers are women. The repayments are normally made on a weekly basis.

This model, which is usually applied to relatively poor groups of clients, helps the MFIs to keep default rates low despite very small loan amounts and limited loan monitoring (the monitoring is conducted by group peers), but at the same time makes for social pressure within the group. Officially, and also in order to afford a degree of protection against excessive indebtedness for consumption purposes, the loans are always intended to have a defined investment purpose which is appraised by the employees of the MFI on site. Nonetheless, the loans are often used to provide working capital or are being used for the purposes of consumption. In these cases too, it may be assumed that access to formal credit means that the majority of MFI clients no longer have to rely on the services of moneylenders, who are known in India for their uncomplicated provision of financial capital often at interest rates of over 100% p.a. Here too, an indirect increase in income as the result of more affordable formal loans can therefore be achieved.

However, in light of the profile of MFI clients, it is especially important for practices of responsible finance to be complied with not only in respect of transparency and the provision of information about risks, but also with regard to loan monitoring. The large number of clients per loan officer at many MFIs (some dealing with up to 500 clients) gives reason to assume that it is not always possible to apply due diligence in informing clients about the risks involved in borrowing and analysing the ability to repay loans. By working towards the dissemination of responsible finance, the project has contributed to the improvement of these practices. After the crisis, the agency even started to actively evaluate compliance with responsible financing practices among the MFIs. This takes place within the framework of so-called "code of conduct assessments" (COCA), which were introduced with the support of the World Bank and are implemented by external ratings agencies, with the agency taking on part of the costs. Since October 2012, an assessment of this kind must be carried out for each MFI before it can receive funding. As three other banks that are actively involved in the refinancing of MFIs participate in the COCA initiative, about 80% of the market can be covered in this way. In practice, the COCA ratings include a critical evaluation of all the business practices of MFIs. Normally, the critical comments are combined with specific proposals for action intended to improve their practices. The categories address the client-MFI relationship from the perspective of responsible finance. Thus, for example, there is a detailed appraisal of how loan officers' actually deal with the clients or the focus of many MFIs on unrealistic repayment rates of almost 100% is criticised.<sup>3</sup> The ratings done so far demonstrate that many MFIs still have great potential for improvement, for example, in the area of client data protection or in the training of loan officers.

A number of MFIs play the role of an intermediary for commercial banks by collecting private savings deposits. Although the MFIs themselves are not permitted to collect savings deposits, they therewith reduce the transaction costs of saving for their clients. Indirectly, as a form of insurance against shocks for the clients, savings also contribute to the protection of the MFIs' portfolio quality.

In summary, it can be stated that when MFIs focus on micro-enterprises and self-employed entrepreneurs, only limited effects on additional employment can be expected. In particular in comparison to the alternative offered by informal financing via moneylenders, a positive impact on household incomes can be assumed. The practice of group loans may be associated with group pressure and unreasonably harsh measures for the collection of loan payments. However, the agency is working against these undesirable effects with the COCA initiative, which draws the attention of MFIs to any abuse. As in any case borrowers move away from the unregulated sector of the moneylenders and principles of responsible finance are being promoted on a broad scale, overall the primary development impact is rated as good.

## **Sub-Rating: 2**

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<sup>3</sup> The evaluated categories are: 1) Client origination and training 2) Loan pricing 3) Loan appraisal 4) Staff conduct 5) Client data security 6) Client relationship and feedback



## Sustainability

With regard to the sustainability of the project's impact on the microfinance sector and thus on the sustainability of client access to financial services, it is to be asserted that the microfinance department of the agency has, like many MFIs, significantly reduced its portfolio (-39% of outstanding loans between balance sheet years 2010 and 2012<sup>4</sup>), which can be attributed in particular to the scaling back of its involvement in the excessively served states. Nevertheless, or precisely for this reason, the agency remains an important player in the microfinance market, committed to the principles of responsible finance, and a stable partner for many MFIs, not least because the financing of the agency is less volatile than the refinancing offered to the microfinance sector by the commercial banks. It cannot be ruled out that, as a consequence of the crisis, the agency's microfinance portfolio may suffer (further) defaults, but this does not represent a risk to the institutional sustainability of the agency as a promotional bank which, in addition to its function as an apex institution for MFIs, operates in other sectors receiving funding.

The microfinance crisis had a signalling effect in the underserved states on which the agency is now focusing more sharply, e.g. with the project evaluated here. In these regions, the microfinance market is developing more slowly, meaning that it is possible to better prevent or respond to undesirable developments. Thus, two credit agencies specialising in MFI loans have recently been established, which are intended to counter indebtedness among households. While it is true that the databases have so far largely been detached from other sources of credit (e.g. from so-called self-help group loans), serious efforts to achieve more sustainable development are discernible. For example, a client is only permitted to take out loans from a maximum of two different MFIs. By law, any loan from a third MFI is uncollectible. The central bank obliged all MFIs to use the services of at least one credit agency. The market participants expect the sustainable development of the microfinance sector to be safeguarded by the passing into law of the comprehensive new proposal on the regulation of microfinancing (microfinance bill). The bill is pending before parliament. However, owing to the upcoming elections in spring 2014 it is not expected to become actual law soon.

In summary, it may be assumed that the current positive trends in the microfinance sector in the less well served Indian states are significantly more sustainable than the practices prior to 2010, even though the adverse effects of the crisis in Andhra Pradesh are still felt. However, ultimately the direct effects of the microfinance crisis remain largely limited to the state of Andhra Pradesh, while the other southern states are experiencing an orderly contraction of the market for microfinance. The diversification of the development approach through the use of the apex structure has contributed actively to reducing the impact of the crisis for FC too. The sustainability is consequently rated as satisfactory.

### **Sub-Rating: 3**

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<sup>4</sup> In India the fiscal year always ends on 31 March.

## Notes on the methods used to evaluate project success (project rating)

Projects (and programmes) are evaluated on a six-point scale, the criteria being relevance, effectiveness, efficiency and overarching developmental impact. The ratings are also used to arrive at a final assessment of a project's overall developmental efficacy. The scale is as follows:

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|---|---|
| 1 | Very good result that clearly exceeds expectations  |
| 2 | Good result, fully in line with expectations and without any significant shortcomings   |
| 3 | Satisfactory result – project falls short of expectations but the positive results dominate                                     |
| 4 | Unsatisfactory result – significantly below expectations, with negative results dominating despite discernible positive results |
| 5 | Clearly inadequate result – despite some positive partial results, the negative results clearly dominate                        |
| 6 | The project has no impact or the situation has actually deteriorated  |

Ratings 1-3 denote a positive or successful assessment while ratings 4-6 denote a not positive or unsuccessful assessment

### **Sustainability is evaluated according to the following four-point scale:**

Sustainability level 1 (very good sustainability): The developmental efficacy of the project (positive to date) is very likely to continue undiminished or even increase.

Sustainability level 2 (good sustainability): The developmental efficacy of the project (positive to date) is very likely to decline only minimally but remain positive overall. (This is what can normally be expected).

Sustainability level 3 (satisfactory sustainability): The developmental efficacy of the project (positive to date) is very likely to decline significantly but remain positive overall. This rating is also assigned if the sustainability of a project is considered inadequate up to the time of the ex post evaluation but is very likely to evolve positively so that the project will ultimately achieve positive developmental efficacy.

Sustainability level 4 (inadequate sustainability): The developmental efficacy of the project is inadequate up to the time of the ex post evaluation and is very unlikely to improve. This rating is also assigned if the sustainability that has been positively evaluated to date is very likely to deteriorate severely and no longer meet the level 3 criteria.

The overall rating on the six-point scale is compiled from a weighting of all five individual criteria as appropriate to the project in question. Ratings 1-3 of the overall rating denote a "successful" project while ratings 4-6 denote an "unsuccessful" project. It should be noted that a project can generally be considered developmentally "successful" only if the achievement of the project objective ("effectiveness"), the impact on the overall objective ("overarching developmental impact") and the sustainability are rated at least "satisfactory" (rating 3).