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Guest Opinion:

For India's Microfinance Institutions, Governance Is The Key To Sustained And Scalable Growth

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Guest Opinion:

For India's Microfinance Institutions, Governance Is The Key To Sustained And Scalable Growth

*(**Editor's Note:** This Guest Opinion article was authored by S. Venkatraman and T. Raj Sekhar of CRISIL Ltd., the Mumbai-based affiliate of Standard & Poor's Ratings Services. The thoughts expressed in the Guest Opinion are those of the writers and do not necessarily reflect the views of Standard & Poor's.)*

Governance-related issues constitute the biggest challenge to the sustainability of India's microfinance institutions (MFIs). The most progressive MFIs, and a few newly established players with strong private investor support and sound governance practices, are setting industry standards and benchmarks. But they're still the minority. CRISIL Ltd. believes the majority of MFIs need to reorient and strengthen their governance architecture--from legal structures, to board composition, to internal controls--if they are to survive and continue to grow.

Over the past decade, the microfinance sector in India has grown in size, prominence, stature, and visibility through the increasing participation of international and domestic banks, private equity investors, donors, and the private sector. Their key objective is to provide small-ticket financing on a sustainable basis while enhancing the economic status of less-advantaged sections of society. Development institutions, such as the National Bank of Agricultural and Rural Development and the Small Industries Development Bank of India, have also played an important role in paving the way for funding and institutional strengthening of Indian MFIs.

Institutional structures and governance practices among Indian MFIs are quite varied and differ significantly from mainstream financial intermediaries because many of them are incorporated under a wide range of legal structures. And a lack of clarity in regulations and low transparency compound the problem. Moreover, many MFIs, particularly those that have evolved from nongovernment organizations (NGOs) into "NGO-MFIs," are still struggling to strike the right balance between their social and business goals, two seemingly conflicting objectives. This often results in poor internal control systems, a lack of accountability, and suboptimal performances--as analysis of our gradings indicate.

CRISIL's MFI Assessments And Grading

CRISIL provides risk assessment and diagnostic services for MFIs to measure, manage, and mitigate their business, financial, and governance risks. Our grading of MFIs reflects our assessment of their ability to conduct operations in a scalable and sustainable manner, and is not an opinion on their debt-repayment capability. We assign grades on an eight-point scale, with 'mfR1' being the highest and 'mfr8' the lowest. A high grade denotes a greater degree of scalability and sustainability. CRISIL uses its proprietary MICROS methodology to evaluate MFIs' management, institutional arrangement, capital adequacy and asset quality, resources and asset liability management, operational effectiveness, and scalability and sustainability. This grading scale applies globally and has no sovereign or country risk assessment constraints.

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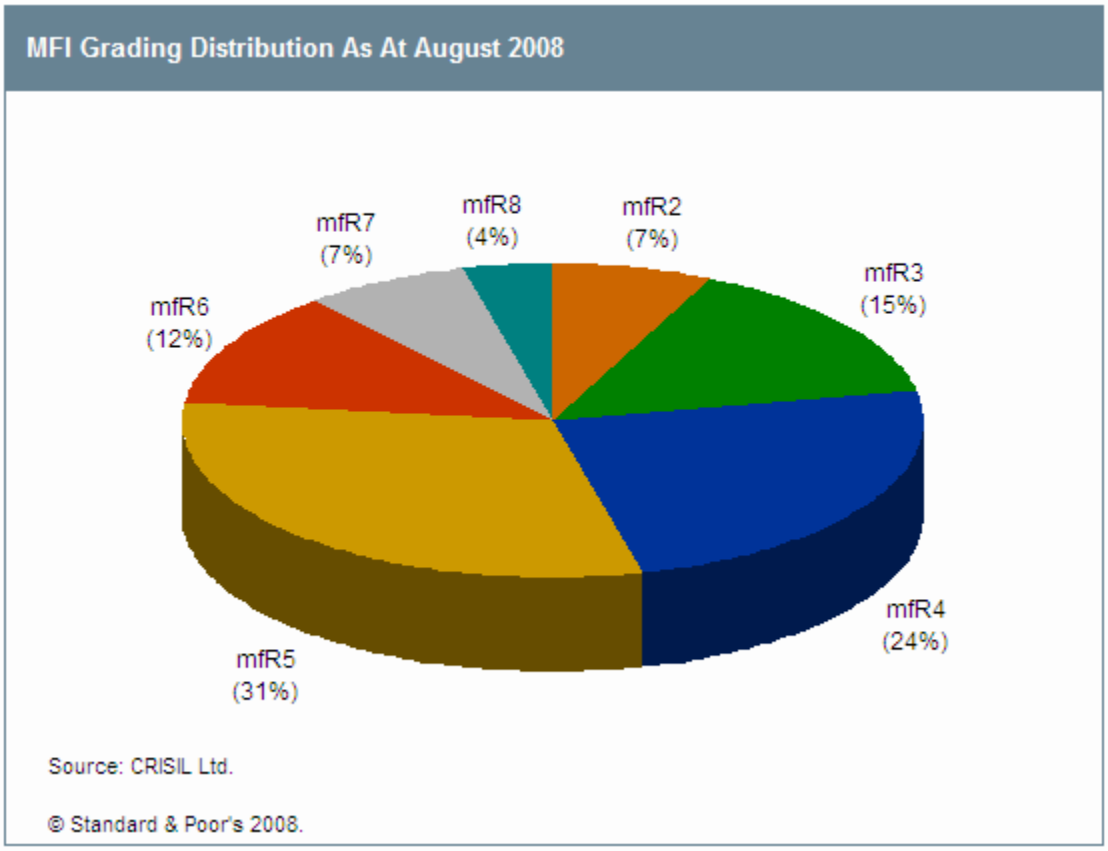
Many MFIs have a long way to go…

As at August 2008, CRISIL had graded about 100 MFIs, which included most of the large and prominent players. Currently, only about 46% of MFIs qualify for a grade of 'mfR4' or higher, and no MFI meets the top grade of 'mfR1' (see chart 1). The median grade of 'mfR4' reflects a satisfactory level of management quality, financial performance, and funding stability. Distribution is not biased by the age of an institution. Several relatively young MFIs are in the upper bracket, and almost an equal number of older MFIs remain in the lowest grade bracket despite having operated for several years.

Chart 1



…but governance is improving

Market demand or the availability of funding don't seem to be constraints on the growth of microfinance in India. The development of village-level infrastructure through the various development schemes of the Indian government, increasing urbanization, and the joint efforts of NGOs and public sector banks have helped expand commercial opportunities at the rural and semi-urban level. In turn, this has enhanced the capacity to absorb microfinance. Microfinance's strong visibility and the acknowledged interest of international investors in MFIs have boosted the availability of funding for MFIs.

CRISIL believes that investors are particularly concerned about the quality of management and standards of corporate governance, given that most approach microfinance projects with a long-term perspective. In our experience, governance quality and institutional arrangements are critical in differentiating higher-grade MFIs from the rest. Other than sustained improvement in a financial risk indicator, such as capital adequacy, management

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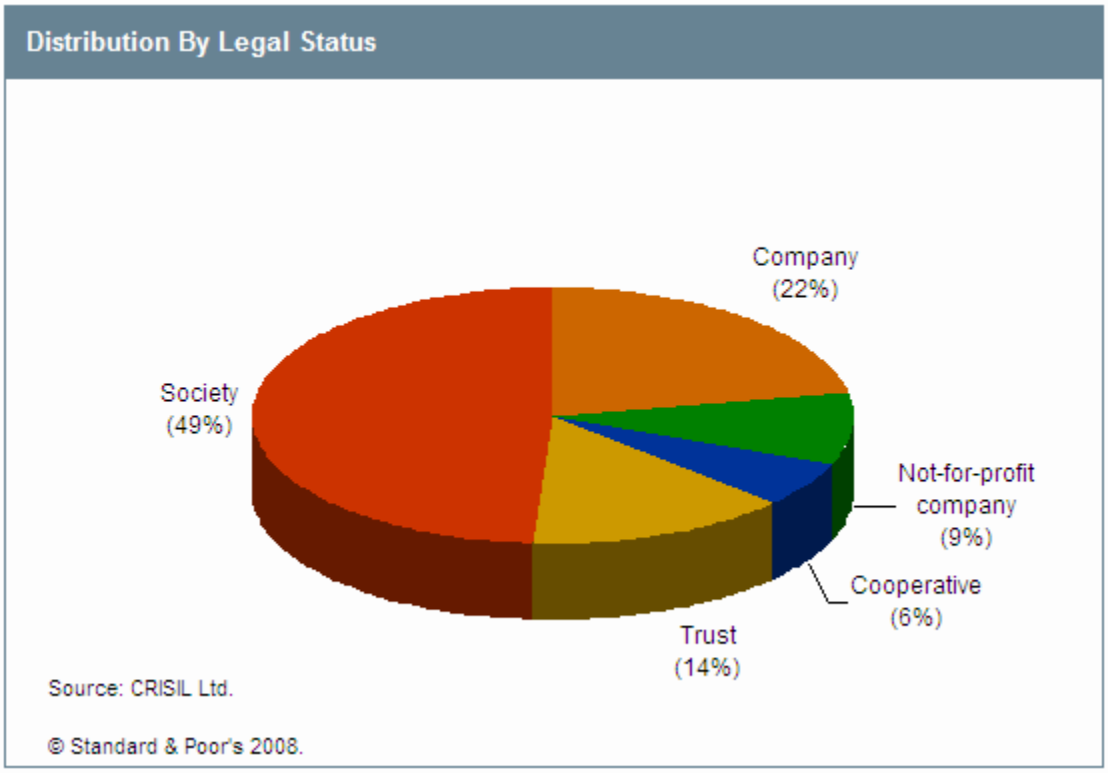
factors have become increasingly instrumental in helping MFIs transition from lower to the higher grades in CRISIL's grading spectrum.

In our opinion, the greater the exposure that Indian MFIs have had to mainstream financial markets--both domestic and international--the greater their awareness of the importance of improved corporate governance. However, it's evident from CRISIL's assessments that the majority of MFIs in India are still below the median, if measured against the yardstick of acceptable corporate governance standards--whether it pertains to management structures and control, management information systems, disclosure standards, or board composition.

Legal structures may deter many institutional investors

The majority of the MFIs are structured and registered as societies, cooperatives, trusts and not-for-profit companies (see chart 2). Companies (as denoted by the Companies Act) account for just 22% of CRISIL's MFI grading assessments. The governance practices of these MFIs are to some extent comparable with the good governance practices of mainstream corporations.

Chart 2



The legal structure and attendant regulatory requirements of an MFI have a strong bearing on governance practices because they influence management practices and the level of transparency. Other than a formal company structure, all other legal structures, such as trusts and societies, suffer from the lack of any meaningful regulation and disclosure standards. This also creates a virtuous cycle/vicious cycle phenomenon: MFIs that have the willingness and minimum capital funds to embrace a corporate structure as a nonbanking finance company can more easily attract outside investors, which in turn encourages better governance and disclosure standards. In contrast, MFIs that are either unable (for lack of adequate sponsor funding capacity) or unwilling to convert to a corporate

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structure tend to remain "closed" to transparency and improved governance standards, and therefore continue to be unable to attract outside capital.

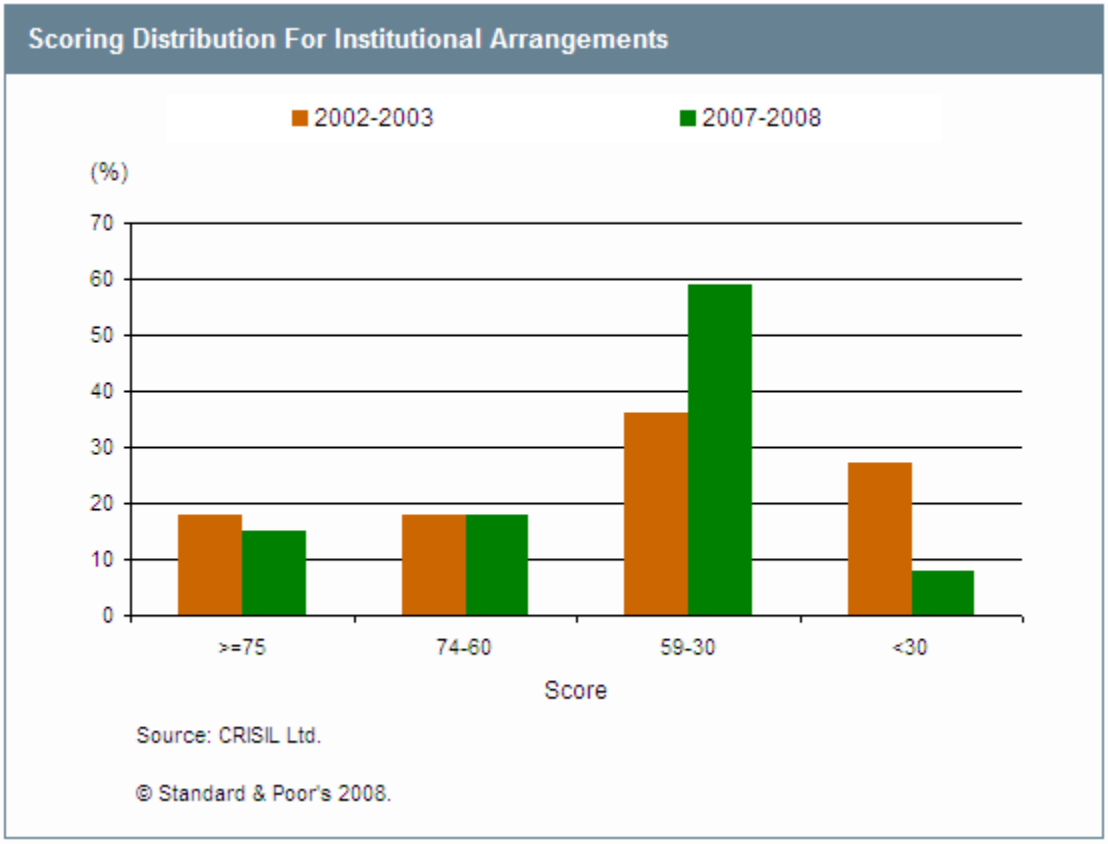
Analyzing institutional arrangements

CRISIL assesses management depth and governance quality under the heading of "institutional arrangement." Typical management and governance characteristics of MFIs are scored in bands with a maximum score of 100 (see table).

Typical MFI Management And Governance Characteristics

Score for institutional arrangements	Characteristics
>75	Promoter(s) with a strong track record and recognition in microfinance and/or the financial sector. Solid management team, with good internal systems and controls. Experienced, high-profile, and diversified board. Evidence of sound governance practices.
74-60	Promoter(s) with good working experience and profiles in the field of microfinance and/or the financial sector. Well-trained operations team, but tendency for high dependence on promoters or top functionary. While the board is broad-based and governance practices are fair, they have some scope for being strengthened.
59-30	The board's diversity, depth, and independence are limited. While management is effective, it has a high dependence on the main functionary. There is significant scope for improvement in governance practices, quality of disclosures, and internal controls.
<30	Promoter-managements have a limited track record in microfinance. Weak board with low independence, and high possibility of significant influence by chief functionary. Management track record in managing microfinance programmes is poor. Weak governance practices, quality of disclosures, and internal controls.

Chart 3



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While some MFIs have made big strides toward improving their governance standards, the vast majority of MFIs still have a way to go. For two time periods separated by five years (2002-2003 and 2007-2008), the score bracket of "59-30" seemingly indicates significant improvement over time, largely due to the upward movement from the lowest score bracket of "less than 30" (see chart 3). But champions of the MFI cause may be disappointed about the lack of positive change in the upper score brackets of "74-60" and "greater than 75."

A large number of MFIs fit into the middle and lower end of the scoring spectrum, due to their weak and largely nonindependent board compositions, the chief functionary/promoters' heavy influence on an organization's decisions, the absence of adequate internal control systems and policies, and the poor quality of disclosure in financial statements. It's not surprising that MFIs structured as companies typically have high and above-average scores on institutional arrangements.

Difficulties In Balancing Social And Commercial Objectives

In CRISIL's opinion, the relatively new sheen that microfinance has acquired in India as an economically viable--even moderately profitable--scalable and sustainable lending activity applies to only some MFIs. These are typically structured as nonbanking financial companies, with notable participation from private equity funds. Many are new and have begun their operations on a relatively clean slate, focusing adequate attention on establishing a strong board and internal control systems.

With donor and grant-funding drying up and related voluntary services dwindling, microfinance has become a key activity for several NGO-MFIs. However, the managements of many of these entities have not adequately adapted and equipped themselves to manage this evolution, with the result that governance, disclosure, and accountability have suffered in many cases. The boards of these organizations continue to have a strong developmental and social project bias and limited microfinance or banking experience. They typically comprise chief executive officers of other NGOs, school teachers, academics, and other prominent members of the local community. While the contributions of such members are critical for guiding the MFIs' social objectives, their preponderance on a board, to the virtual exclusion of members with banking or accounting experience, often results in weak accounting and risk management practices.

Unless these NGO-MFIs make board and management changes to drive a reasonable commercial orientation into their operating philosophy and mission, the benefits of good internal control systems and transparency aren't likely to materialize. Ultimately, this will hinder the sustainability of their operations.

The Path Ahead

Given India's size and demographic profile, and the availability of funding and good demand, microfinance has the hallmarks to become a successful practice. In our opinion, the relatively new breed of private-equity-supported MFIs look well equipped to scale up sustainable operations. But unless the vast majority of well-established MFIs bring about some fundamental shifts in the governance architecture, the sector as a whole will not be able to develop in a sustainable fashion--and may fail to live up to its strong potential.

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