CODE OF CONDUCT ASSESSMENT FOR MICROFINANCE SECTOR

A Macro and Micro View on MFI's Compliance to Code of Conduct

This report presents macro and micro view on MFIs' compliance to the Code of Conduct and Fair Practice Code prescribed by MFIN, Sa-dhan and RBI. The report is prepared based on the code of conduct assessment study done for fifty Indian MFIs by five different consulting companies.

By *MicroSave*

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Abbreviations

AP – Andhra Pradesh

ADDO – Approval, Documentation, Dissemination and Observance

BoP – Bottom of the Pyramid

BC – Business Correspondent

COC – Code of Conduct

COCA – Code of Conduct Assessment

CGT – Continuous Group Training

CCs – Cluster Coordinator

GRT – Group Recognition Test

KYC – Know Your Customer

MFIN – Microfinance Institutions Network

MFIs – Microfinance Institutions

MIS – Management Information System

MD – Managing Director

NBFC – Non Banking Finance Company

PFRDA – Pension Fund Regulatory Development Authority

RBI – Reserve Bank of India

SIDBI – Small Industries Development Bank of India

SPM – Social Performance Management

UM – Unit Manager

Executive Summary

Industry associations of MFIs, such as Sa-Dhan and MFIN developed a code of conduct for MFIs, with support from SIDBI and other institutions, after the RBI mandated fair practice code came into existence in the year 2013. The objective was to provide normative inputs to MFIs on the expected level of responsible finance/lending. SIDBI moved a step ahead and took upon itself the responsibility to bring seriousness in implementing the code of conduct and fair practice code. Ever since SIDBI supported the Code of Conduct Assessments (COCA), more than 50 MFIs, big and small, have been covered and provided inputs on their current state of play in terms of code of conduct as also the way forward. To bring together the COCA assessment for 50 MFIs, SIDBI commissioned *MicroSave* for a study on the sectoral learning that can be gleaned from COCA, the format of COCA assessments going forward and the overall lessons that can be drawn from these individual assessments. This report presents the consolidated findings of code of conduct assessments (COCA) for fifty MFIs across India. The MFIs are a mix of different sizes and different legal statuses working with microfinance clients across the country.

The COCA reports are analysed from three different dimensions – by size, in terms of outreach; by legal structure; and by the geographical presence of MFIs. In terms of size, MFIs are grouped into three Tiers – Tier 1, Tier 2 and Tier 3. Out of fifty MFIs, 28% are Tier 1, 26% Tier 2 and 46% are Tier 3 MFIs. In terms of legal form, a majority of the MFIs assessed (64%) are NBFCs followed by Section 25 Companies and Societies (12% each). Only 2% of the MFIs are co-operatives and the remaining 10% are registered as trusts. Only 14% of the MFIs assessed are operational in more than 10 states, while 4% of the MFIs have operations in 5 to 10 states. This leaves 82% of the MFIs, which have their operations spread out in up to 5 states.

The following five broad indicators have been considered while analysing compliance to the code of conduct:

1. Integrating social values in MFI operations
2. Credit processes and policies
3. Human resource development and management
4. Transparency and fairness
5. Regulatory compliance

MFIs have scored an average rating of 77% on "integrating social value into operations". The score is given based on the assessment of MFIs intent and action towards double and triple bottom lines. It is found that almost all the MFIs have a pro poor mission and vision and a vibrant board which bring diversified experience to the governance of the MFI. About 54% of the MFIs have more than one third independent board members, a sign of healthy corporate governance. MFIs have started diversifying their product range, however, more needs to be done in this areas. MFIs need to undertake concerted efforts by collaborating with banks, PFRDA and insurance companies to offer savings, pension, and a diverse range of loan product(s) and not just income generating loans. Housing, water and sanitation and emergency loans are a few products which are on top of the customers' mind.

On "credit process and policy indicators" MFIs have got an average score of 76%. The objective of scoring MFIs on this indicator was to see how well MFIs are doing in terms of focusing on the bottom of the pyramid, avoiding unnecessary competition and over

indebtedness. The score is given based on the availability, robustness and adaptation of the various processes and policies related to area selection, client selection and loan appraisal. MFIs are doing fairly well on this parameter. However, assessment of client repayment capacity is an area that needs further strengthening.

“Human capital” indicator has scored high with an average rating of 81%. This indicator is rated based on quality of staff training, staff behaviour with clients and staff awareness on code of conduct. MFIs seem to understand the importance of staff training and have institutionalised orientation training, on the job training and refresher training system to train their staff. A few MFIs have also conducted dedicated training on code of conduct for their staff. The COCA team did not find any compliant related to staff behaviour during the course of the study, which shows that MFIs have become more sensitive and serious about the need to maintain a healthy staff - client relationship. MFIs have developed policies on staff visits to clients’ residence/place of business as well as on management of delinquency and have documented them in the operations manual. This helps maintain a healthy and acceptable staff-client interaction while dealing with delinquent clients. In 94% cases it was reported that staff are aware of the code of conduct; however the level of awareness needs improvement.

MFIs are faring well on “transparency and fairness”. Client data security, client feedback, product and service offerings, fairness and transparency of price, and client education are the indicators used to determine MFIs’ performance on “transparency and fairness”. MFIs are found to keep client data confidential - they have separate section in loan application forms to obtain client consent on sharing information with credit bureau(s) and with insurance companies. In case of automated MIS, data access is password protected. However in some cases, branch staff shares the password with each other defeating the purpose of password protected access.

A majority of MFIs have listed toll free numbers to register customers’ complaint. The number is printed on passbooks and clients are advised to use the number in case they have any complaint(s). A few MFIs have defined turnaround time to resolve customer complaints however there are quite a few who still have an informal system of handling client’s complaints. In these cases, MFIs do not record customer complaints and pass on complaints verbally to the concerned department(s). This is an area where MFIs can do better by recording, analysing, resolving and reporting the status of customer complaints to the board and to the senior management.

The following are a few recommendations, which are worth considering establishing better code of conduct in the microfinance sector:

- MFIs must widen their offerings in terms of financial products and services. A wider basket of loan products - for emergency, housing, water and sanitation as also savings, insurance and pension products are needed in the Indian microfinance market. This will greatly increase depth of outreach and will significantly de-risk the client as also the microfinance sector as a whole.
- RBI may come up with more reasonable and practical household income criteria, as inflation has rapidly eroded the current level of income and its implementation is being followed more in letter than in spirit. A more practicable income criterion which can be implemented in letter and in spirit needs to be evolved;

- SIDBI and other lenders and investor may encourage MFIs to have more than one third board members as an independent members; the greater presence of women on the board is also known to empirically strengthen client focussed delivery of services;
- MFIs should cross verify information received from the credit bureau to avoid over indebtedness; this weakness inherent in the microfinance model, indeed in its target segment, has brought the sector to the brink once in the past. All efforts must be made to ensure that that client over-indebtedness does not happen ever again

1. Section 1 - About the Study

1.1. Background and Objective

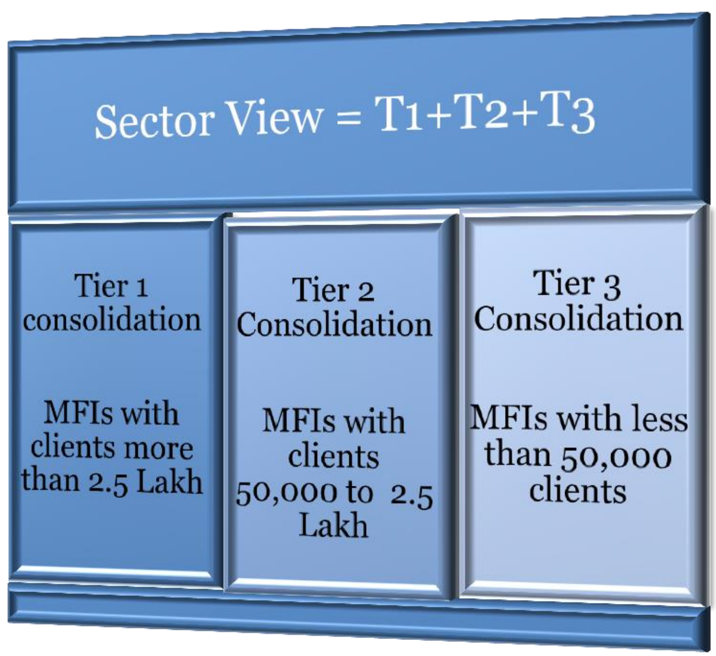
In February 2013, RBI released the fair practice code for the microfinance institutions (MFI) in India. The industry associations of MFIs, such as MFIN and Sa-dhan, responded to this by immediately coming up with a unified code of conduct for their member institutions, aided in no small measure by institutions such as SIDBI and IFC. The aim of the code of conduct guidelines was to provide normative inputs to MFIs on expected levels of responsible lending. SIDBI, being the apex institution in the sector, took upon itself the responsibility to bring seriousness amongst MFIs towards the implementation of the industry code of conduct. SIDBI nudged its partner MFIs to implement the code of conduct and supported the efforts with generous grant support.

SIDBI commissioned a host of rating and technical consulting entities, viz., MCRIL, SMERA, M2I, ACCESS ASSIST and ICRA, to support code of conduct assessments (COCA) of MFIs. These five institutions developed their own COCA tools to gauge the level of MFIs' compliance to the prescribed code of conduct. Though the framework, methodology, and approach differed between these five institutions, the design of the assessment tools were based on the same fair practice code and code of conduct issued by the central bank and the industry associations.

In total, 50 MFIs from across India were covered under the COCA study. These MFIs comprised different legal structures and sizes. In a way they represented the entire Indian microfinance sector. This report consolidates the findings from 50 COCA assessments supported by SIDBI and brings out, at a consolidated level, compliance to the prescribed code of conduct and fair practice code in the Indian microfinance sector.

1.2. Report Structure

This report is divided into five sections. This section describes the background and objective, report structure, approach and methodology and limitations of this report. Section 2 covers MFIs' profile - including outreach, legal forms, and geographical coverage. Section three and four cover macro and micro view on compliance to the code of conduct. The last section contains recommendations to further ensure compliance to the prescribed code of conduct.



1.3. Approach and Methodology

Considering the varied sizes and outreach of microfinance institutions, we followed a three tiered approach to consolidate the COCA reports. Each tier is defined based on the number of clients managed by MFIs. Tier 1 comprises large MFIs managing more than 250,000 lakh clients. Tier 2 comprises medium sized MFIs - those managing between 50,000 to 250,000 clients, and Tier 3 comprises small size MFIs managing less than 50,000 clients.

The three tier approach has been followed to see if compliance with code of conduct (CoC) varies with the size of MFIs. The three-tiered analysis is further consolidated and analysed to understand overall compliance with CoC by MFIs across the country.

We have considered two more levels of analysis: the legal structure of the MFI and its geographic presence. This is to ascertain if compliance with code of conduct differs with legal structure or if the performance on CoC is differentiated across geographical lines.

Consulting companies have used different indicators, grouping of indicators and scale to rate the MFIs' performance on CoC. To consolidate the report, *MicroSave* has considered the following five major indicators:

1. Integrating social values into operations
2. Credit process and policies
3. Human resource development and management
4. Transparency and fairness
5. Regulatory compliances

The five major indicators are further divided into sub indicators which are closely mapped to minor indicators used by the five different consulting companies which have carried out the CoC assessments. The major indicators and sub indicators have been arrived at on the basis of analysis of the indicators used by the five consulting companies.

The consulting companies have used different scales to rate MFIs on CoC, and hence we have converted all ratings into a percentage scale for the purposes of comparison and consolidation. In order to consolidate qualitative information and comments against each indicator, we have used tally sheet based frequency distribution. The frequency distribution helped us to analyse the occurrence of various observations/responses against each indicators across assessment reports. Measuring frequency of an indicator leads us to a score against each parameter. To highlight specific observations, caselets have been drawn from the different reports. These caselets are inserted in the relevant sections of the reports to enable on-ground practices to be reflected in the report. The following benchmark table illustrates the relationship between the score and the performance of MFIs in terms of level of compliance to code of conduct.

Performance Score Range	Performance Definition
100%-80%	Excellent Compliance
79%-70%	Good Compliance
69%-50%	Moderate Compliance
Below-50%	Low Compliance

1.4. Limitation of the report

The analysis in the report has been based on the average score and the observations made in the COCA reports of the fifty MFIs whose reports were analysed. Five consulting companies have used different frameworks, indicators and scoring systems to assess compliance to the code of conduct by the MFIs. Due to these variations, it was challenging to consolidated observations of different studies into the selected five broad parameters. Hence, we advise that the scores may not been seen in isolation but read along with specific qualitative observations from the COCA reports. Linking the scores with qualitative descriptions under each parameter will enable a more comprehensive understanding of the state of CoC in an MFI.

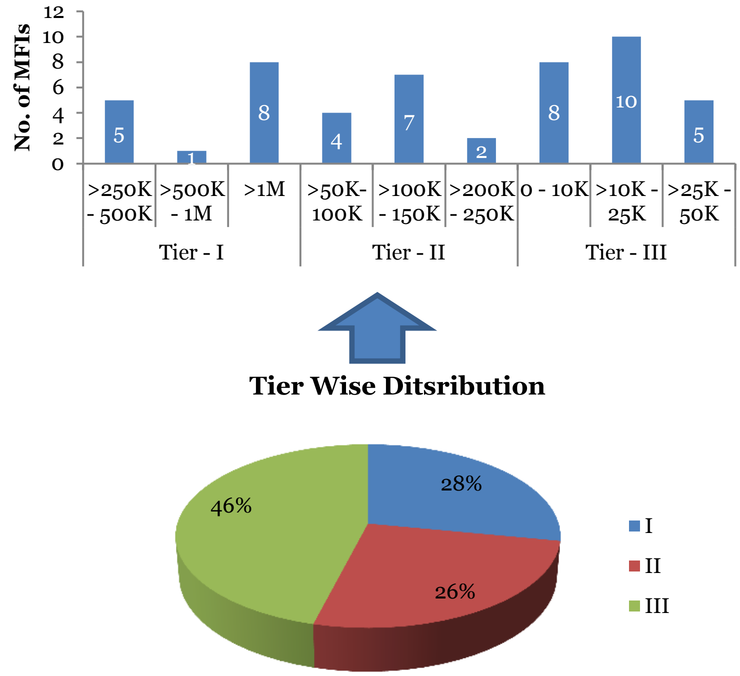
The COCA assessments of fifty MFIs were done at different points in time spread over the years 2010 to 2014. Performance of MFIs whose CoC assessments were done in in earlier years may have changed and may not be reflective of current practices. Wherever SIDBI has commissioned a second round of COCA, which has been the case with a few MFIs, we have used the most recent COCA reports available for the MFIs to make the observations more relevant.

Readers are requested to keep these limitations in mind while drawing any conclusion from this report.

2. Section 2 - MFIs Profile under the Study

2.1. Outreach

Out of fifty MFIs studied, 28% fall under Tier I, 26% under Tier II and the remaining are Tier III MFIs.



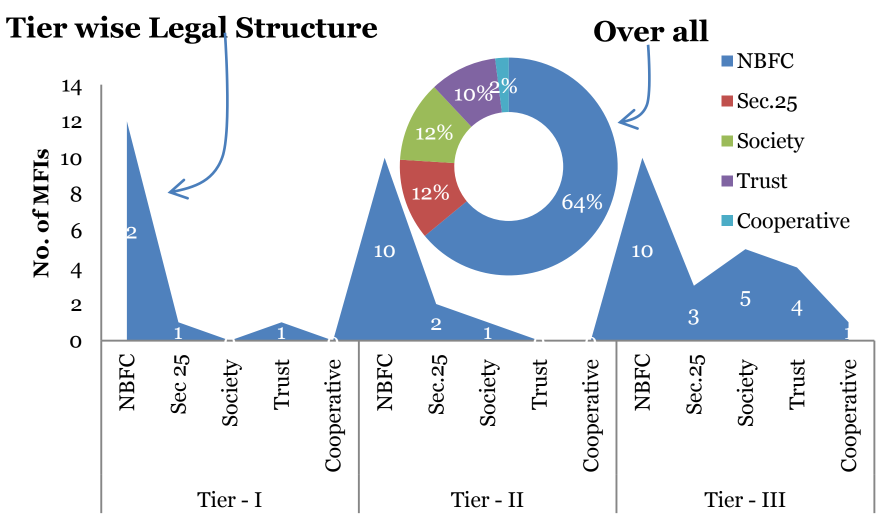
Under Tier I, about 8 MFIs have more than 1 million clients, followed by 5 MFIs having between a quarter to half million clients. Only one MFI has between half to one million clients.

In Tier II, majority MFIs have between 100,000-150,000 clients followed by MFIs having between 50,000 to 100,000 clients. Only two MFIs have between 200,000 to 250,000 clients.

In Tier III, a majority of the MFIs have between 10,000 -15,000 clients, eight MFIs have below 10,000 clients and five MFIs have clients in the range of 25,000 – 50,000.

2.2. Legal Form

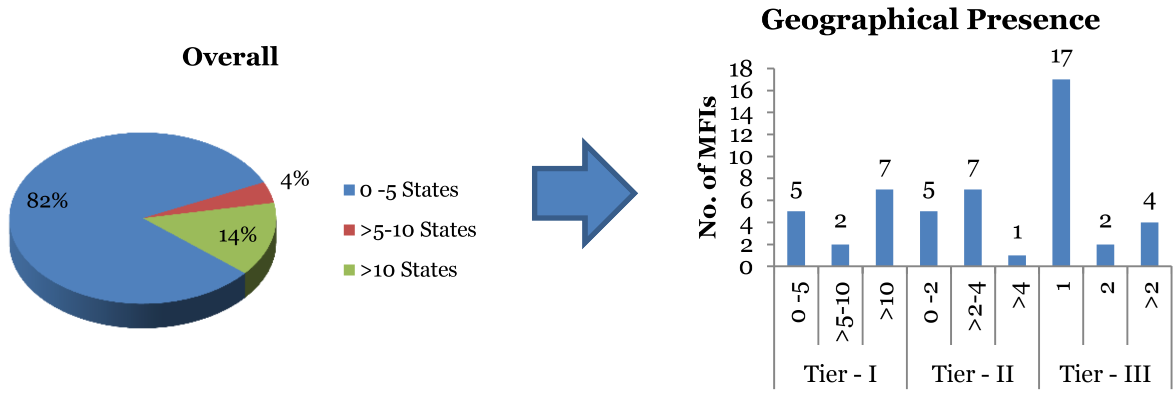
A large chunk (64%) of MFIs are NBFCs, followed by Section 25 companies and Societies (12% each). Trusts are in smaller proportion and constitute just 2% of the MFI sample.



Trusts, Co-operatives, and Societies are largely clustered in Tier 3, while NBFCs are the leading legal structure across all the three Tiers – reflective of the general move of MFIs towards the NBFC legal format.

2.3. Geographical Coverage

Out of the fifty MFIs, 82% have their operation in up to five states. 14% have operations in more than 10 states, while 4% MFIs have their operations spread-out in six to ten states.



In Tier III, 17 out of 23 MFIs have their operations limited to only one state. Only one MFI in Tier III has spread in five states, which is maximum spread in Tier III. In Tier I, one MFI has its geographical spread across twenty states; however, seven of the Tier I MFIs have operations in more than ten states. After the AP crisis, MFIs seem to have learnt their lesson; some of the MFIs, such as SKS and Spandana, were at one time on the verge of collapse as large chunk of their portfolio was concentrated in Andhra Pradesh. Now, MFIs have spread out their operations across many states as a concerted risk management measure.

3. Section 3 – Macro View of Code of Conduct

This section describes consolidated performance of the MFIs on compliance with the code of conduct prescribed by Sa-dhan and MFIN and the fair practice code prescribed by RBI for NBFC MFIs.

The performance has been analysed on five parameters which include integrating social value into operations, credit process and policies, human capital, transparency and fairness and compliance with regulatory guidelines. The five parameters encompass key indicators of the prescribed code of conduct and the fair practices code. Indicators used in different COCA reports are consolidated under these five main categories.

The rating on each of these indicators has been culled from the fifty COCA reports prepared by five different consulting companies and the average rating is reported here. There is significant variation in the reporting structure of five consulting companies as they have not rated the MFIs on exactly the same parameters. We have chosen commonly used indicators to bring about a synthesis despite variances in approach adopted by different consulting companies.

3.1. Integrating Social Value into Operations

This indicator measures the intent and action of MFIs towards double and triple bottom lines. It describes MFIs' role in the social upliftment of their clients as well as environmental impact of their operations, if any. In various COCA reports, this has been measured through MFIs' mission and vision to gauge the focus of the MFIs' on the bottom of pyramid segments and whether the mission and vision statements talk about social and/or environmental achievements apart from the delivery of financial services. The intent could also be reflected in the constitution and quality of the Board. The action of the MFIs to translate the social and environmental aspects of their mission and vision was gauged by looking at the range of the products; if it offered products such as emergency loans which helps protect the client in emergencies and loans for solar lamps and smokeless *chullahs* which have larger health and environmental impact not just on the client but on the community, at large. Further,

Integrating Social Value in to the Operations

The COCA team observed the following representative example of integration of social value into operations:

One of the MFIs conducts one social day in every quarter across all its regions of operations. The social days conducted are focused mainly on health camps, eye checkups, planting trees, water and sanitation etc. Every region covers close to 200 beneficiaries in these camps. This MFI has tie-ups with local hospitals and eye clinics to provide free health checkups. In addition, clients are offered life insurance products by paying a premium of 0.5% of the loan amount and Rs. 100 p.a. for their spouse. The life insurance scheme is Janshree Bima Yojana, a product offered by LIC.

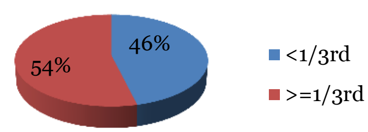
the MFIs could translate their intent by offering credit plus services including health facilities, financial and environmental education; specific activities which engage clients and community and social and environmental upliftment; institutional processes and tools to measure social performance.

On this indicator MFIs have scored an average rating of 77%. The MFIs are rated on four attributes; policy and procedure approval, documentation, dissemination and observance (ADDO).

3.1.1. *Rational for Score*

3.1.1.1. *Approvals*

Almost every institution has its mission and vision aimed at the bottom of the pyramid (BoP). MFIs have vibrant boards with the number of board members ranging from three to fifteen. A large number of MFIs have diverse boards with quite experienced board members. Board members mainly come with financial sector background and are from banks, investment and venture capital firms, advisory and consulting companies. Some board members have background in social and development sector and information technology. In most cases they actively participate in the affairs of the board.



Independent board mebers

It is reported that 54% of MFIs have more than 1/3rd independent board members. This is an area where Indian microfinance sector can do better; independent board members add a lot of weight to the board by looking at executive decisions from different angles without any bias and/or fears in order to help the institution attain its objective set out in its mission and vision. Independent board members also help MFIs to align their stated intentions with actions. In many cases, it was observed that MFIs discuss compliance to the code of conduct in board meetings, which has resulted in improved compliance towards code of conduct across the microfinance sector.

More than half, about 60%, of the MFIs have approved policies for offering credit plus services. This includes financial literacy, environmental literacy, extending support to educate clients' children, organising health camps, and extending savings product through business correspondent model (BC). Commitments to these interventions have helped microfinance institution showcase their social orientation to various stake holders, especially to their clients.

Almost one out of every ten MFIs offers emergency loan and four out of every ten offers housing and water & sanitation loan. This is not satisfactory, considering the size and growth of microfinance sector in India; however it is a step forward. Almost all the MFIs still seem to have a growth model, which is heavily dependent on a single product. Emergency loan is a lifeline for low income clients, who still depend on money lenders for their financial needs in times of emergency. Loans for housing, water and sanitation helps to improve living conditions of the target community in rural, semi urban and urban area. With improved technology, MFIs are probably better placed to increase their product array.

3.1.1.2. Documentation

All the MFIs have documented mission and vision which are supposed to provide strategic direction to them. Mission and vision of MFIs are largely focused on the bottom of the pyramid and underserved segment. Products, process and policies details are documented in the form various manuals such as operations and human resource management manuals.

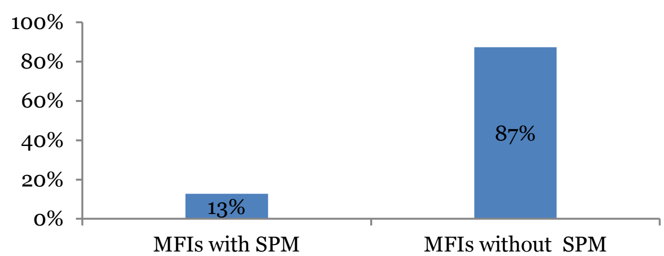
About half of the MFIs have independent committees, at least an audit committee of the board. However, only about one third of the MFI reports have mentioned documented functional responsibility for board members. MFIs will have more accountable and active governance if they are able to assign specific functional responsibilities to Board members. Codes of conduct assessment (COCA) reports do not talk about the frequency of board meetings and participation of board members at the meetings. This is a critical information to assess the quality of governance and the board's commitment towards steering the institution in the right direction.

3.1.1.3. Dissemination

Largely MFIs have displayed unified Code of Conduct at their offices including the various branch offices. In some cases however, it is reported that Code of Conduct is not in vernacular and its display is not appropriate. Only a few MFIs have dedicated staff training on unified Code of Conduct. However, MFIs generally train their staff on Code of Conduct during orientation and refresher trainings. Many MFIs use opportunities such as weekly and monthly staff meeting and one to one interactions with supervisors and field staff to train their front line staff on these aspects. Code of conduct is also discussed with clients during group trainings, collection meetings and other trainings and workshops.

3.1.1.4. Observance

Few MFIs (13%) have social performance management (SPM) systems and some have also created separate social performance department. There are MFIs, though only a few, having a separate SPM committee of the Board. SPM system is critical for MFIs to proclaim their commitment towards social objective of the organisation.



MFIs having SPM system

About 11% of the MFIs offer emergency loan to their customer. There are two prevalent schools of thought about emergency loan. In case of emergency, clients generally fall back on costly loans from money lenders and hence, one school of thought says that MFIs must serve this critical need of clients and offer loans for emergencies. The other school does not undermine the importance of emergency loans but they feel that they are difficult to administer because of the following reasons –

- Emergency loans are prone to be misuse by staff; there are many reported cases where staff have used emergency loan to cover up defaults on repayment of current loans;
- MFIs cannot provide emergency loan exactly when client needs this, as client disbursement happens either at the centre meeting or at branch on a pre-determined date and time;
- Emergency is a relative term and therefore it is difficult to define and decide on what constitutes an emergency situation.

With improved internal control systems and advancement in technology, however, MFIs can overcome these challenges and increase their product array. Emergency situations can also be clearly defined, especially health emergencies.

Credit process and policies

In one of MFI branch located in a highly competitive area, the COCA team found that there was no mention of any other borrowing by clients in any of the loan files in the branch. However, during our interactions, several clients revealed that they had taken loans from other MFIs as well, with some having loans from two other MFIs.

In another MFI, there exists a policy wherein the institution explicitly states that it will not be a second lender to any client having loan from another institution. However there were instances where they were the second lender; it was in any case difficult to determine this status as they were not a member of the credit bureau.

In almost all the cases MFIs have trained their staff on the client selection process. Better-trained staff ensures that the client selection is in line with the defined client selection criteria. This helps further the MFIs' commitment towards the poor.

About three fifth of the MFIs submit compliance on Code of Conduct report to the Board. This indicates that code of conduct has been accorded priority in MFIs' agenda.

3.2. Credit process and Policies

Credit process and policies comprise two sub indicators - client origination and loan appraisal. Both the indicators are rated separately and together assess the MFI's pro-poor approach. This indicator assesses if the MFI is able to focus on BoP segments and protects the interests of the clients by protecting them from over indebtedness. Pro poor approach can be assessed by looking at the MFI's client selection process to check if it is able to filter non-poor clients. MFIs' capability to protect client interest can be assessed by looking at the MFIs' loan approval processes and checking if the processes are capable of avoiding multiple lending and over indebtedness.

3.2.1. Client origination

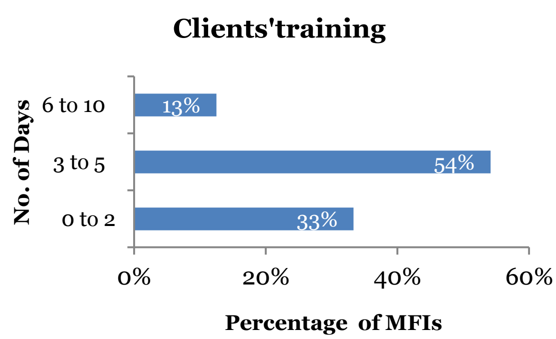
MFIs have scored an average rating of 76% on client origination. The score has been given based on the following indicators:

- Availability and robustness of area selection parameters and processes. The parameters should be able to filter out those areas which are highly competitive and have non-poor clients;
- Availability and robustness of client selection parameters and processes. MFIs score high, if the parameters are able to filter out non-poor clients;
- Robustness of pre loan disbursement training to the clients. Training should able to make client aware about the loan details including eligibility, price, documents required and other terms and conditions
- Who are involved in client selection and if there are any inducements that influence staff behaviour

3.2.2. Rational for Score

3.2.2.1. Approvals

Almost all the MFIs have approved policy for client selection. Most (almost 100%) of them follow the RBI approved income criteria for client selection.[1] MFIs rely on self-declared income from the clients and do not use any tool to verify clients' household income. It is reported in some of the COCA reports that clients have more income than what they have declared in the loan application.



The self-declaration approach looks faulty by design as there is a potential conflict of interest. On the one hand, if clients declare their income above the prescribed limit, they will not be able to access a loan while on the other hand loan officers/MFIs will never verify clients' declared income to be higher than prescribed, as they will lose potential clients. Clients who have better income will in all likelihood be able to repay their loans.

Almost all MFIs have a policy to verify clients' identity by taking prescribed KYC documents. There were cases, however, where clients struggled to provide proper KYC documents. In such cases, clients get their identity proof verified by local authorities such as the *Gram Pradhan*. Such KYC falls in line with RBIs guideline.

Many MFIs have a policy to avoid intensely competitive areas. The policy has been introduced to avoid being the third lender and to avoid situation of over indebtedness for clients. Pre loan disbursement training is one of the critical components of the client origination process. Generally MFIs conduct continuous group training (CGT) to orient clients on MFIs loan policies,

[1] Clients' household income should be below Rs.60,000 in rural area and Rs.1.2 lakh in the urban area

loan terms and conditions, importance of loan utilisation and on time payments etc. This helps MFIs to inform and educate the clients and deepen their trust and relationship. Earlier, in most MFIs, this training used to be conducted for 7 days, one hour each day, but MFIs have since reduced the training duration to achieve operational efficiency. The number of training days have also been reduced on account of informed clients owing to increased competition. About one third of the MFIs spend only 1- 2 days on client training, which appears inadequate to orient clients on loan policies and procedure. However, more than half of the MFIs spend 3-5 days on client training which seems to be sufficient from the point of view of training clients on basic product policies and processes. A few MFIs supplement client training with a separate client education program. The quality, effectiveness, and viability of such training programmes, however, is unknown.

Weakness in Internal Control

One of the observation's the COCA team came across was that one of the MFI staff gave Rs.25,000 to Rs.30,000 as loans to five clients. The loans were structured in such a manner that each client received two loans of Rs15,000 each or one loan of Rs15,000 and another loan of Rs10,000. These loans had the same duration (12 months) and the same repayment frequency (fortnightly). The concerned staff member had the understanding that by opening separate loan accounts, compliance with the RBI's directive is ensured. This indicates weakness in internal control within the organization.

Based on the findings of this assessment, the MFI has initiated steps to increase the repayment duration of all loans over Rs. 15,000 to 24 months. The company has also initiated a comprehensive training of all the field staff to ensure comprehension of and compliance with RBI's guidelines.

3.2.2.2. Documentation

Almost in all cases, MFIs have documented policies and processes for client selection. They have documented village selection process and criteria which largely cover socio economic status of the area, infrastructure – road, transportation facility, bank network, competition and law and order in the area. MFIs avoid discriminating the geographical areas based on caste or religion.

MFIs also have documented client selection criteria which include age, number of years since the client has lived in the area, track record of social behaviour, availability of identity proof, capacity to repay the loan, amount and loan taken from number of MFIs and poverty status.

3.2.2.3. Dissemination

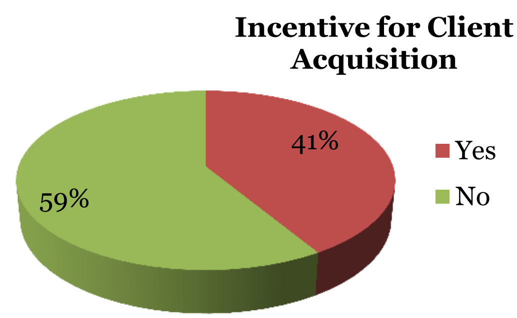
MFIs train their field staff before they are deployed to the branches. They make sure that staff know the mission, vision, values, operational processes, and code of conduct, and how to deal with client's particularly in adverse situations. MFIs do it through orientation training and refresher trainings. On the job training, coaching by supervisors and handholding training are also the methods used by MFIs to train their staff.

COCA reports inform that all the MFIs have systems to train their staff on various processes including client selection. MFIs train their staff through orientation training which is organised just after staff recruitment. More than half of the MFIs have included code of conduct in the staff training curriculum and some of the MFIs have organised dedicated training to train their staff on code of conduct.

3.2.2.4. Observance

COCA reports have documented about the incentive policies the MFIs have for acquiring new clients. Incentives on client selection motivate the field staff to achieve the target to maximize benefits. The negative fallout of the incentives schemes is that overzealous client selection drive may lead to inappropriate recruitment of clients. In cases where supervisors such as branch managers' incentives are also aligned with the incentive of the loan officers the malpractice perpetuates.

We find that about 41% of the MFIs pay incentives on client selection. MFIs introduce such incentives at the beginning of their operation to reach critical mass. Though such an inducement can potentially lead to adverse client selection, it can be mitigated by putting proper internal controls in place. Internal controls can be ensured through internal audit and periodic checks by supervisors who are not directly influenced by the monetary incentives.



About 53% of the MFIs provide incentives for managing and maintaining good portfolio quality. This aspect can potentially keep staff under continued pressure and some of the pressure can be in-turn passed on to clients. MFIs have detailed processes to handle delinquency and this to some extent abates the risk of violating the code of conduct.

It is reported that MFIs have not involved agents for client selection, however a few COCA reports mention that MFIs do not have explicit policy to avoid involvement of unauthorised persons/agents in the client recruitment process. Lack of an explicit policy and an incentive structure that encourages larger outreach can induce staff to take the help of unauthorised persons in group formation.

About nine out of every ten MFIs conduct second level of check to make sure the client selection is in line with prescribed criteria. MFIs call this process as group recognition test (GRT), which is typically conducted by branch managers or the next level of field supervisors. In some cases, internal audit team also randomly checks the quality of client selection.

MFIs endeavour to avoid multiple lending; they do not want to be the third lender to any of the borrowers. With few exception (not more than 5%) MFIs are members of the credit bureau; they seek information from the credit bureau about the client's current loan liabilities and take this into consideration it before sanctioning the loan. A few big MFIs has inbuilt de-duplication system built into their management information system (MIS) which help them check if a client is trying to take loan from different centres using the same ID.

The COCA team observed that MFIs are over reliant on credit bureau information and do not cross verify the information during loan appraisal. As a result, in a few cases, clients are able to manage loan from more than two MFIs.

3.2.3. *Loan Appraisal*

Stringent loan appraisal system ensures effectiveness of the MFI in checking over indebtedness of the clients. MFIs have scored an average rating of 75% on this indicator owing to their decent loan appraisal system. The following key parameters are considered while rating loan appraisal system:

- MFI policy to check over indebtedness
- Compliance with RBI's guideline; explicit efforts not to be the third lender
- Loan appraisal process
- Tools and technique used by MFIs to assess clients' capacity to repay
- Competency of MFI's loan sanctioning authorities

3.2.4. *Rational for Score*

3.2.4.1. *Approvals*

Almost all the MFIs have shown commitment to check over indebtedness and have board approved policies for it. MFIs have shown more commitment to address the issue of over-indebtedness after RBI formulated guidelines on the issue.

A majority of MFIs have put in place prescribed policies and modules for staff training. They train their staff on loan appraisal process and techniques through orientation, on job and refresher trainings.

Three out of five MFIs have approved loan policies, wherein they have defined upper cap for loan in different loan cycles. Generally MFIs define upper cap, based on quick assessment of economic status and repayment capacity of their targeted client segments. They allow gradual increment in subsequent loan cycles based on client's repayment history and comfort in repayment of the last loan. Though this is not a full proof method to check over indebtedness - as clients may have varied repayment capacity - MFIs use this method as a rule of thumb, because it is a cost effective method to put first level of check on over indebtedness. With the credit bureau information on amount and loans from number of MFIs, this system is good enough to rely on.

3.2.4.2. *Documentation*

MFIs (almost 100%) have written down policies to avoid over indebtedness. About 89% of the MFIs have mentioned they will not be the third lender to any client. To comply with this policy they seek and check data from the credit bureau before sanctioning any loan. Though a few MFIs operating in highly dense and competitive markets have become third or even fourth lenders, they have tried to ensure that the total indebtedness per borrower is within the stipulated limit of Rs.50,000. This practice violate the RBI's guideline of not to be third lender to any borrower.

About eight out of every ten MFIs have a format to capture client income and expenditure related details, which is generally a part of loan application and appraisal form. MFIs collect this information during the loan application and appraisal process. A few MFIs also use cash flow format to assess client repayment capacity. In general, MFIs use quickly collected income and expenditure data to assess client repayment capacity.

MFIs have documented process for loan approval. Some of the MFIs have delegated loan approval authority to operations supervisors including Branch Manager, Area Manager and above, however others have centralised loan approval system. Both the systems have their pros and cons. Former speeds up the loan approval process while the latter has better control on loan approvals.

Loan Appraisal by Branch Manager

In February 2012, five members of Center no 42 at one of the Branch of MFI "A" received loans of Rs45,000 each. At the time of disbursement all the clients had loans from MFI "B" (Rs10,000 to Rs 15,000). Some of these clients also had loans from a third MFI "C". After the loan disbursement from MFI "A", it was likely that total indebtedness of clients was in excess of Rs.50,000. Review of loan documents of the group revealed that loan amount from MFI "B" was mentioned.

Subsequent to the loan disbursement from MFI "A", the group members also availed loans from a bank (Rs10,000 each) which is in retail microfinance. Total monthly loan installment for most of the group members for the MFIs and bank taken together was about Rs 4,000. Monthly household income recorded by the MFI "A" for the clients was only Rs.5,000 for each household.

The concerned Branch Manager of MFI "A" had halved the loans (Rs 45,000) while computing overall indebtedness, as loan was to be repaid in 24 months. Another branch manager with whom the assessment team interacted also had the same understanding. This shows, the sector has varied understanding of over indebtedness.

3.2.4.3. Dissemination

MFIs organise training for staff and train them on loan assessment processes and techniques. At the time of joining, staff members are provided orientation training and some MFIs assign mentors to provide on the job training. MFIs also arrange refresher training to train their staff on new policies, review the old policies and build specific skills - such as client selection, loan assessment and customer relationship. While orientation training covers the basics of loan appraisal, MFIs that provide on the job training or refresher training, fulfil the purpose to some extent.

COCA reports that MFI staff depend on the information furnished by clients on income, expenditure, and assets. Quality of such information may affect the outcome of loan decisions. Implications of poor quality information may be negative if credit approval decisions are taken centrally. However, very few MFIs have built staff abilities to assess clients' repayment capacity based on the cash flow assessment. Largely MFIs assess repayment capacity based on assets and income sources; speed of decision making and operational cost effectiveness seems to the basis for client repayment capacity assessment. However, these may not be the best indicators for repayment capacity as income varies with seasons and in most cases assets do not generate cash. MFIs should look for quick cash flow assessment tools to determine clients' repayment capacity.

HR internal management (policies and procedure)

The COCA team reviewed a MFI where proper recruitment process are followed for each level of staff – written test and personal interview. Recruitment is conducted with reference checks. Regular appraisal of CO is done every 12 months. The monthly incentives were calculated on the basis of a transparent performance review (portfolio quality, outreach, conduct, discipline and punctuality of the staff). Also annual bonus was not linked to disbursement. In the same MFI a dedicated system of grievance redressal was also observed.

4.4. *Observance*

MFIs use various methods to check over indebtedness. This include putting cap on loan size for different loan cycles, analysis of client repayment capacity through assets and income sources, cash flow assessment; verifying client liability (loans) through credit bureau, auditing the quality of loan appraisal and approvals through internal audit processes and verifying client repayment history its own MIS.

In 60% of cases it is reported that MFIs have defined maximum loan amount for different cycles and in 70% of cases MFIs carry out credit bureau checks to ensure, client do not have loan from more than two lenders and that the maximum loan liability is within Rs.50,000. However, MFIs who cross check quality of loan assessment through its internal audit team are reported (about 43%) to be less in number.

Proper loan sanctioning is critical for MFIs. It does not only enable them to conform to the code of conduct but also protects MFIs from a contaminated portfolio. A few COCA reports highlight the importance of loan utilisation check but limit their observations a 'yes' or a 'no' i.e. whether the MFI carries out the loan utilisation check or not. COCA reports are silent on the quality of loan utilisation checks as also on any innovative practices that MFIs may have adopted in this area. COCA reports are also silent on the recording and use of loan utilisation information at the aggregate level at MFI head offices. It is important for MFIs to use loan utilisation information and track the loan usage; this will discourage client form taking unnecessary loans and will also give valuable information to the MFI on sectors / sub-sectors where credit is being channelised.

3.3. Human Capital

Microfinance is a human intensive business which is heavily dependent on the quality of interaction of field staff with the client. To protect the client as well as its own business interests, as there are reciprocal benefits of treating customers with respect, MFIs need to focus on training and on making their staff better in client relationship management.

COCA studies have reported an average rating of 81% for MFIs on this parameter, which is good for the microfinance sector. In the study, quality of human capital is reported under staff conduct, human resource, code of conduct and HR strategy heads, which cover the following parameters –

- MFI policies and process with respect to staff training
- Quality of staff training; measured through staff awareness on process and policies
- Training and staff awareness on Code of Conduct and Fair Practice Code
- Staff behaviour with clients

3.3.1. Rational for Score

3.3.1.1. Approvals

MFIs understand the importance of quality of staff; generally they hire them straight out of college and take them through their pre-designed orientation training. Orientation trainings are generic in nature and cover topics such as institutional mission, vision and value, product policies and processes etc. MFIs try to give institutional overview as part of this training.

MFIs have prepared their own unified code of conduct training modules which are in line with code of conduct of Sa-dhan/ MFIN and RBI's and fair practices code. MFIs have included code of conduct training module as part of their orientation training, a few MFIs however organise dedicated training sessions on this topic. In the unified code of conduct, MFIs emphasise on staff behaviour with client and on listening to client grievances. Almost all MFIs train their staff well on these aspects, which indicates that the unified code of conduct has been a worthwhile effort and down-stream implementation, at least in terms of staff training, is commendable.

A majority of COCA reports have missed out reporting on staff grievance redressal mechanism in the MFIs. Satisfied staff will service clients happily, therefore it is imperative to examine MFIs' staff grievance handling mechanism in COCA studies.

MFIs exercise proper care while recruiting staff from other MFIs, they look for relieving and 'no dues' letter from the relieving MFIs and also perform reference checks. However, it is reported in a few COCA reports that MFIs have a policy to post newly recruited staff in the same working area in which they had been working. They do so within a year of recruitment and this practise seems to be prevalent for credit officer and even for even for Branch Manager level positions. Though MFIs probably do this to make the working environment convenient for staff, this is against the code of conduct and has potential to lead to unhealthy competition in the region.

3.3.1.2. Documentation

MFIs (almost 100%) have a documented policy on staff conduct, which details staff interaction with clients. MFIs have the code of conduct displayed at branches or at least a document clearly listing the code of conduct is available at MFI branches. In about 40% of the cases, it is reported that MFIs have inserted code of conduct in their operations manual which are accessible to branch staff. Written document on code of conduct helps branch staff to clarify their doubts and is more helpful for new recruits.

In about half of the cases, MFIs have a policy which defines staff visiting hours to clients' location either residence or business. This policy protects delinquent clients' from undue social abuse and mental stress and has been a positive fallout of the code of conduct guidelines. Since MFIs have in the past, been at the receiving end for their high-handedness in dealing with delinquent clients, the policy on prescribed staff visiting hours' helps in building a positive image about the MFI with its clients.

3.3.1.3. *Dissemination*

In a majority of the cases, MFIs have displayed written code of conduct at their branches. Proper display together with staff training, increase the possibility of better implementation of code of conduct. As mentioned earlier a majority of MFIs train their staff on code of conduct in different ways. MFIs have also incorporated code of conduct in hand books and manuals which is a reference point for the branch staff. In a majority of cases, MFIs have made manual and hand book accessible to their staff by keeping a copy of it at their branches.

MFIs supervisors such as Area, Divisional and Zonal Managers discuss code of conduct and ethical microfinance practices during their monitoring visits. This makes a strong impact on staff and makes them practice it while dealing with clients.

3.3.1.4. *Observance*

Clients have informed COCA teams that MFIs staff behaves well with them. No specific case of misbehaviour has been reported in any of the COCA reports. However in a few cases, clients have reported service related concerns such as delayed or denied insurance claims. This is an area where MFIs can negotiate better with insurance companies.

About half of the MFIs pay incentive to their staff for managing on time repayment and maintaining portfolio quality. However, despite this, the COCA team did not report any cases of high handedness. In a few cases it is reported that MFIs have listed staff conduct as one of the parameter for staff incentive calculation, which is a positive development amongst MFIs. Audit and supervisory teams of a few MFIs are watchful of staff behaviour with clients and it is a major item on their check list.

In nine out of every ten cases MFIs have trained their staff on staff conduct and code of conduct. In 94% of the cases it is reported that staff are aware of the staff conduct and code of conduct, which confirms the positive impact of staff trainings. However, only in a quarter of cases staff awareness was found high while in three fifth of the cases it was medium. MFIs need to think how training on code of conduct can be made more effective for staff.

Many of the MFIs have a policy to avoid lateral entry at the level of field supervisors and to give promotion opportunity to field staff. This policy helps MFIs to retain trained resources that are helping MFIs to strengthen institutional values.

3.4. Transparency and Fairness

Post the Andhra Pradesh (AP) crisis, transparency and fairness have become critical aspects of MFI's operations. Both RBI and industry associations, Sa-dhan and MFIN, have emphasised this aspect in their code of conduct and fair practice code, respectively. MFIs have also become vigilant on these aspects and are trying to performer better on these parameters. Most of the COCA studies have assessed MFIs on the following two aspects:

- Client data security
- Client relationship and feedback

Other parameters such as product and services offerings, price fairness and transparency, and customer education and its effectiveness are also used.

3.4.1. Client data Security

Sharing client data and information without client consent is considered unethical practice both under the code of conduct and the fair practice code. COCA study has assessed this parameter by assessing the following key indicators:

- MFIs' policies on client data security
- MFIs' ability to protect client data from unauthorised access
- MFIs' effort to make their staff aware about importance of client data security
- Safe keeping of physical documents

MFIs' have scored an average of 82% on this parameter, which can be considered as a commendable score. This indicates microfinance institutions have near fool-proof systems for client data security and client confidentiality.

3.4.2. Rational for the Score

3.4.2.1. Approval

In about seven out of every ten cases, MFIs have approved policy regarding client data security, while others are silent on the client data security policy. In case of automated MIS, MFIs have defined access rights and have kept access password protected. However, in some cases it is reported that branch level staff share the password amongst each other, which defeats the purpose of secured access. In cases where documents are kept in physical form, MFIs have a defined policy on custodian and safekeeping of documents.

MFIs have a section in loan application form to take client consent to share client information with the insurance company and the credit bureau. However, in a few of COCA reports it is mentioned that MFIs have overlooked this client consent section.

3.4.2.2. Documentation

In more than half of the cases, MFIs have incorporated data security policy in its operations manual. This enables better clarity for the employee on aspects of client data privacy. Quite a good number of MFIs have incorporated client data security policy in their fair practice code.

3.4.2.3. Dissemination

Apart from including client data security policy in operations manual, MFIs' supervisory staff also discuss these policies in staff weekly or monthly meetings, as the case may be.

3.4.2.4. *Observance*

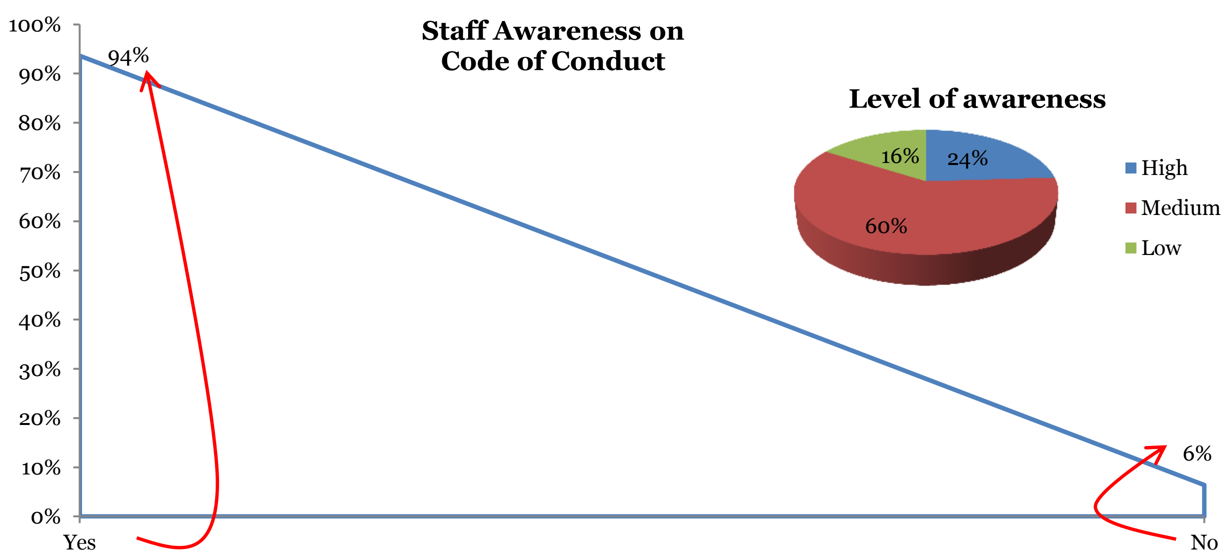
In case of automated MIS, MFIs have a good system for data security. More than half of the COCA reports state that MFIs have password protected data access. They have given data modification right only to senior officers in the IT department or to senior operations managers.

In case of physical documents, it is reported that MFIs try to keep these safely at branches. In some cases, MFIs have centralised data processing systems with entire client related documents stored at the head office. In case of centralised documents keeping, clients' documents are safe and access is limited to authorized person. However, in some cases, where physical documents are kept at branches, adequate access control measures have not been developed. This may lead to misuse of client information by staff or even by outsiders.

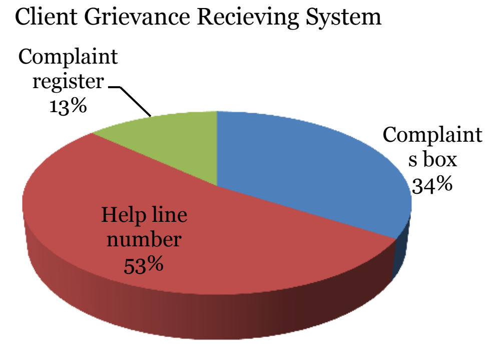
It is reported that the MFIs' branch staff have good level of awareness and understanding of the importance of client data security. In case of automated MIS, MFIs have proper systems in place for data backup; which mitigates the risk of data loss in case of any unexpected events. The MFIs' internal audit team also checks for compliance with data security policy during branch audit.

3.4.3. *Client relationship and feedback*

It is argued that a half-hearted approach of MFIs in terms of client relationship has in the past, brought disrepute to the sector. In the first phase of growth of the microfinance sector, (pre-AP crisis) many MFIs had very good growth prospects. They were focused towards growth in outreach and loan books, and in maintaining timely repayments. Customer service and client relationship were not areas of attention and as a result, during and post the AP crisis, MFIs were blamed for many of the problems/challenges faced by clients and/or by their spouses. The general opinion was that if MFIs had spent time to establish better relation with clients, the situation could have been handled a lot better.



Nevertheless, the sector learnt its lessons quickly and included client relationship and proper feedback mechanism as one of the major components of the code of conduct.



In the COCA study reports, MFIs have scored on an average 71% on this aspect, which shows MFIs seriousness on better client relationship management. The score on this indicator has been given based on analysis on the following key indicators:

- MFI policy on customer grievance redressal
- Quality of grievance mechanism
- Action taken on customer grievance
- Customer awareness and use of grievance redressal mechanism
- Staff awareness and sensitisation on grievance redressal mechanism
- Board sensitisation on customer grievances
- Cross verification of effectiveness of grievance redressal mechanism

3.4.4. *Rational for the Score*

3.4.4.1. *Approval*

MFIs have board approved policies for customer grievance redressal. The policies cover aspects such as setting up of customer grievance system, protocol for grievance redressal and compliance with grievance redressal policy.

Policies also cover mechanism for customer to raise issues and concerns with a designated officer. A majority of MFIs have a toll free number and a complaint box; some MFIs have instituted a system of complaint register. Many MFIs have assigned dedicated officers to receive client complaint through a toll free number and pass it on to respective authority for resolution. Some of the MFIs have defined turnaround time for complaint resolution.

Staff interaction with clients

In one reviewed MFI it was observed that the scope of internal audit needs to be augmented with inclusion of checks on staff conduct, grievance redressal and on client awareness. Further, in the internal audit reports, clients' awareness of loan conditions and pricing were not being verified.

In another MFI, the COCA team observed that the contact numbers of UMs/CCs and MD were noted on the loan cards and members were aware that they can reach out to these people in case of any grievances/complaints. The MFI also follows a practice of branch visits for disbursements and open forums which allows customer to interact with branch managers and other senior staff. There is, however, a need to put in place a toll free number for customer to avoid calling cost at customer end and a structured process for receiving, tracking and resolving the complaints received within a specified time frame.

In a few cases, MFIs have included customer grievance redressal in their audit check list. During the audit, auditors check if customers know about the grievance redressal mechanism and whether the customers have some unresolved grievances.

3.4.4.2. Documentation

MFIs have documented policies in the form of office memo, circulars and/or or insertions into the operations manuals. However there were cases where grievance redressal policies were not detailed adequately. For example, policies lacked details of how the customer grievance will be processed and resolved, how to know the extent and severity of the grievance and the grievance redressal turnaround time etc.

In all cases where MFIs have a help line number, the number has been printed on the loan passbook. This gives the client immediate access to the grievance reporting window. Many MFIs have made efforts to let client know about the help line number as well as the mechanism for using it. This has come out as an effective way of grievance reporting.

3.4.4.3. Dissemination

MFIs have oriented their staff on client grievance redressal system. In about 94% of the cases it is reported that staff are well aware about the grievance redressal system and its importance. It is also reported that staff are sensitized through meetings and interaction with supervisors on handling customer grievances with care.

*3.4.4.4. **Observance***

In 78% of the cases, it is reported that MFIs have a system to cross verify action taken on client grievance, largely through the process of internal audit.

Though in 70% of MFI clients (with 50 MFIs as the universe) are using the grievance redressal system, however, usage by number of clients within the MFI is low (based on actual complaints received and registered). Not surprisingly, the complaint box has emerged as a redundant system, hardly any complains are ever found in the box. Help line number has come out as the most effective tool for clients to raise their concern; however more promotion of this mechanism as well as active and timely complaint resolution will enable clients to build trust on this channel.

In half of the cases, it is reported that customer complaints received through help line number are recorded. In other cases, staff at HO receive the customer complaint and pass them on to the respective officers immediately. In a few cases, MFIs do not record the customer complaint and these institutions state that action is initiated forthwith. In a few cases, MFIs also record the action taken on customer complaints which is a very healthy practise and needs to be encouraged across the sector.

In some of the cases, MFIs present a summary of customer complaints and action taken to its board members. There is a case highlighted in the COCA report where board members visited the clients to get to know first-hand information about aspects such as staff behaviour and MFIs performance on customer service.

3.5. Compliance with RBI's Guidelines

In general, MFIs are in compliance with RBI's guidelines and COCA reports came across very few cases of non-compliances. These areas include compliance with guidelines on loan tenure, collateral free loan, membership of and reporting to credit bureau, client household income and flexibility to clients on aspects such as repayment frequency.

Instances of non-compliance in each above mentioned category was one or two, except for the category of collateral, household income and flexibility on repayment frequency. In these category instances of noncompliance was 4-5. In one specific case, MFI clients had to make a fixed deposit in a bank and lien was marked to the MFI in order to access the loan from the second cycle onwards. This is clearly against RBI guideline of collateral free lending.

In case of household income, MFIs take self-declaration from clients and generally the declaration is below the RBI's prescribed limit. However, in many cases, the COCA team found clients income to be much beyond what they had declared. Clients are prone to making such false declaration in order to access the loan and MFIs will do well to follow guidelines in letter and in spirit.

MFIs have purportedly given flexible repayment options to their clients; however in many cases, it is reported that MFIs just have a single repayment option, which also is against RBI guidelines. Nevertheless, the COCA team did not find any complaint from clients on the repayment frequency options.

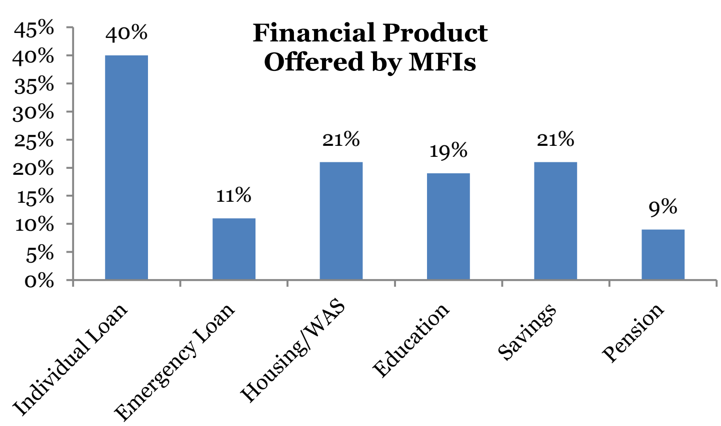
3.6. Other Observations

Apart from the observations above, the COCA team have also made observations on product offerings, product pricings and client awareness on product and service details. These observations are critical to understand MFIs' commitments towards poor clients.

3.6.1. Product Offerings

Apart from regular income generating loans and life or credit linked insurance, MFIs are also offering other financial products.

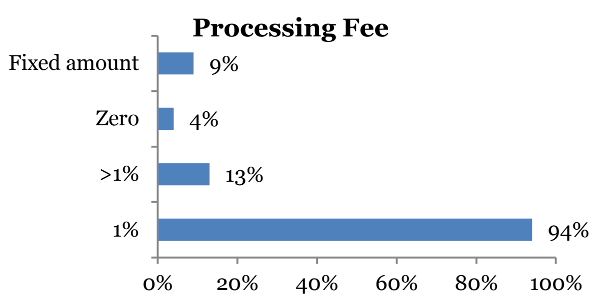
A majority of MFIs have added individual loan products for mature clients who look for bigger loans as compared to what they are offered in groups. Generally, these clients also do not like to attend the centre meetings.

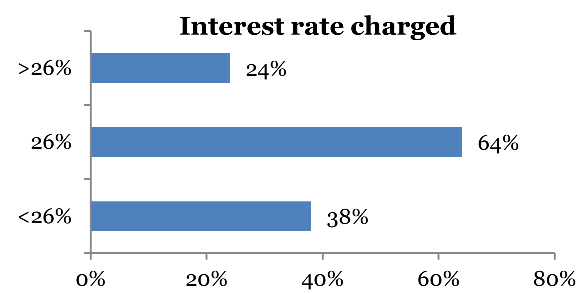


Very few MFIs, about 11%, have introduced emergency loan to fulfil critical emergency needs of the client. In case of emergency, clients still rely on traditional money lenders and borrow at higher interest rate. Increasingly, MFIs are adding special loan products for house repair and for maintenance, water and sanitation infrastructure and education of client's children. These loans are helping clients improve their living standards. With the help of business correspondence model offered by banks and pension scheme promoted by Pension Fund Regulatory Development Authority (PFRDA), MFIs have also been able to offer savings and pension products. Though these two products are in their initial phase, they have good potential and could, if promoted well, become the preferred products for clients.

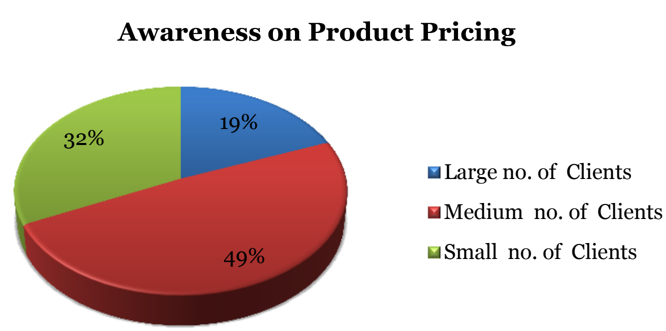
3.6.2. Product Pricing

Largely, MFIs have pegged interest rate at 26% but there are MFIs who charge more or less than 26% on their loan products. Also, there are cases where MFIs charge 26% on group loan products but charge a different rate on other loan products such as individual loans. In some





cases it appears that MFI interest rate is less than 26%, because of the loan term; however, effective interest rate goes beyond 26%. For example, some MFIs display their interest rate as 12.5% (flat) per loan term with 45 weeks loan term. The effective interest rate, in such cases, comes to approximately 27% per annum, though the impression given is that interest rate is around 25%, if the remaining loan is assumed to be for a year.



However, MFIs communicate declining interest rate along with flat rate and ensures that clients remember both the interest rate. Clients, particularly illiterate clients, understand flat interest rates better than the declining mode, as they have been used to this method for long – a reason MFIs furnish to defend their decision to continue communicating flat interest rate.

As far as the extent of awareness on loan terms is concerned, in 19% of the MFIs, a large proportion of the clients have basic awareness on product features such as interest rate, loan term and number of instalments to be paid. In about one third of the MFIs, awareness on product features is limited to small proportion of clients and in about half of the MFIs, awareness on product features is restricted to medium proportion of the clients.

COCA teams have reported that MFIs are putting their best effort to make clients aware on product price, terms and conditions and benefits through group training, during loan disbursement and other special meeting/trainings and workshop.

4. Section 4 – Micro View on Code of Conduct

It is important to analyse variations in compliance to code of conduct, if we group MFIs based on outreach, legal structure and geographical presence. In this section analysis is done by grouping MFIs based on:

a. Outreach – Tier 1, Tier 2 and Tier 3;
b. Legal status – NBFC, Section-25 companies, Society and Trust; and
c. Regional presence – presence in five states or less, presence in between five to ten states, and presence in more than ten states.

In each grouping, MFIs' average score on seven key indicators are taken and compared. For example under outreach groupings, performance of each Tier is assessed based on the score given in COCA reports on 7 key indicators – *client origination, loan appraisal, loan pricing, client data security, staff conduct, client relationship and feedback and integrating social value in to the operations*. Score mentioned for the seven indictors are an average score of MFIs under the particular Tier. Finally, overall rating and consolidated scores are provided to each of the 7 indicators.

4.1. Analysis based on outreach

In the table below MFI rating is aggregated based on the outreach. Tier 1 rating is an average rating of group of MFIs who have more than 2.5 lakh borrower, similarly rating for Tier 2 is an average rating of MFIs who have more than 50 thousands but less than 2.5 lakh borrowers, and Tier 3 rating is an average rating of MFIs who have less than 50 thousand borrowers. Overall rating is total rating scored by 50 MFIs on overall performance on code of conduct.

Outreach

	Tier -1	Tier -2	Tier-3	Consolidated
Overall rating	79%	77%	75%	77%
Client origination	81%	77%	73%	76%
Loan appraisal	76%	75%	75%	75%
Loan pricing	78%	80%	77%	78%
Client data security	87%	83%	76%	82%
Staff Conduct	86%	80%	75%	80%
Client relationship and feedback	72%	69%	69%	70%
Integrating social value in to the operations	76%	79%	75%	77%

From the table above it is clear that overall MFIs' performance on COC is improving as their outreach is increasing. This may be because as they grow they have capacities to hire professional managers, and are able to build better systems and processes. Growth in size is known to add to the bottom line of MFIs which enables them to build capacities and invest in strengthening system and processes. Tier 1 MFIs have scored high on all systems and processes related indicators such as client origination, loan appraisal, client data security, client relationship and feedback and staff conduct.

Tier 2 MFIs have scored higher than Tier 1 and Tier 3 MFIs on two indictors; loan pricing and integrating social values into operations. This indicates that Tier 2 MFIs have consolidated and focused more on creating value for the customer by rationalizing price and communicating product feature well and also by adding social values into its operations.

4.2. Analysis based on legal structure

The overall rating is on an upward trend when we move from less regulated to highly regulated legal entities, i.e. trust, society, section 25 companies, to NBFCs. NBFC and section 25 companies have scored equal on overall rating however on the seven key indicators the ratings across these two legal formats are marginally different.

Legal Structure					
	NBFC	Section - 25	Society	Trust	Consolidated
Overall rating	77%	77%	76%	73%	77%
Client origination	77%	77%	76%	68%	76%
Loan appraisal	76%	79%	77%	65%	75%
Loan pricing	79%	82%	75%	69%	78%
Client data security	83%	81%	72%	74%	82%
Staff Conduct	82%	72%	77%	77%	80%
Client relationship and feedback	71%	63%	71%	71%	70%
Integrating social value in to the operations	75%	79%	79%	81%	77%

On the loan appraisal and pricing, Section 25 companies have scored better than the other three legal formats. This indicates capacity to do product pricing exercise and also willingness to pass on the benefits of lowered costs to the end clients. On staff conduct and client relationship and feedback, Section25 MFIs have scored less than the other three legal formats. This is difficult to explain; perhaps it is a result of laxity arising from the flux in which Section 25 staff find themselves as they move from an NGO mind-set to a more corporate approach needed for microfinance. Score on 'integrating social value in to operations' is on upward trend if we move from NBFCs to not-for profit entities such as section 25, trust and society. This is easier explained as no for-profit entities have a mandate towards achieving social goals and are generally more focussed on business aspect.

4.3. Analysis based on regional presence

In this section, analysis was taken up to understand if geographical expansion has an impact on compliance with the COC. For this purpose, MFIs are grouped based on geographical spread and an average score is considered. MFIs are grouped in three categories; category one is group of MFIs with operations in up to five states, second category comprises those with operations in 6 - 10 states and the third category has institutions with operations in more than 10 states.

Regional Presence				
Presence in No. of states →	0-5	>5-10	>10	Consolidated
Overall rating	76%	88%	77%	77%
Client origination	75%	85%	80%	76%
Loan appraisal	74%	96%	78%	75%
Loan pricing	78%	94%	74%	78%
Client data security	81%	80%	87%	82%
Staff Conduct	78%	88%	89%	80%
Client relationship and feedback	70%	88%	67%	70%
Integrating social value in to the operations	78%	80%	65%	77%

From the table above, it seems that MFIs with their presence in 5-10 states perform better than the other two group of MFIs. However, as a caveat, this group comprises only two MFIs and both of them seem to be doing well in terms of adherence to COC. However, if we compare the first group of MFIs with the third group of MFIs, larger MFIs having presence in more than 10 states get a better overall score.

The first group of MFIs have scored better on a few such as loan pricing, client relationship and feedback and integrating social value into operations.

In the above three tables a pattern based on three different grouping is highlighted. It will be worth exploring such pattern in future COCA studies. If such a pattern depicts a trend which becomes visible after a few more COCA study, SIDBI may consider a separate study to understand the reasons for the emergence of such a pattern

5. Section 5 - Recommendations

Going forward, the following recommendations may be worth considering:

- SIDBI with other lenders may encourage MFIs to comply with the condition of having at least one third independent board members. One way of doing this will be to make this a part of the loan conditions. At present, only 54% of the MFIs have one third independent board members;

- Considering the maturity of the microfinance market in India, MFIs must look forward to widening their products bouquet. MFIs continue to be focussed on income generating loans with only 10% of the MFIs offering emergency loans and 40% offering other loan products such as housing, water and sanitation. A few MFIs are offering savings (21% MFIs) and pension (9% MFIs) products in collaboration with banks (as BC to banks) and as agents of PFRDA. However, these products are in their initial stages and need much more effort from the MFI as also from bank and the PFRDA to enable greater off-take.

- RBI may come up with a more reasonable and practical criteria with regard to household income of clients. To comply with the current RBI prescribed income criteria for rural and urban areas, MFIs take self-declaration from clients. Accepting self-declaration is a mere formality, as COCA study teams came across cases where the clients declared income is far more than the RBI's prescribed limit. There can be two major reason why MFIs are casual when it comes to income criteria:
    1. First, before RBI prescribed an income criteria, MFIs had been servicing clients with incomes above the threshold. After RBI guidelines came into effect, it became difficult for the MFIs to jettison these clients. Also, strict adoption of this criterion will restrict growth.
    2. It is difficult and cost ineffective for MFIs to put in systems to assess household income of clients.

- MFIs should cross verify credit bureau information before granting loan to clients. MFIs are heavily reliant on credit bureau information and do not cross verify the information received from the credit bureau. There are cases where clients have duped the MFIs and managed to take loan from more than two MFIs;

- MFIs should train their staff on quick cash flow assessment techniques to determine client repayment capacity. In many cases it is reported that MFI staff decide loan amount based on income and asset information furnished by clients. Income and assets based technique may not be prudent considering seasonality and the fact that not all assets generate cash. As stated earlier, relying on clients to self-certify household income is not a very good practise;

- It will be good to come up with a structure of COCA reports so that there is uniformity in further rounds of COCA study irrespective of the consulting company to which it has been entrusted. This will smoothen the report consolidation process and enable SIDBI to get more robust and meaningful outcome at a sector level. SIDBI may give thought on *MicroSave* proposed COCA structure appended in ***Annexure -2*** below.

6. Annexures

Annexure 1: Name and Legal Status of Reviewed MFI

MFI name	Legal Status
Lupin	Trust
Mahashakti	Trust
Prayas	Trust
SKDRDP	Charitable Trust
YVU	Trust

MFI name	Legal Status
AMCCS	Cooperative

MFI name	Legal Status
AMPL	NBFC
Arohan	NBFC
Arth	NBFC
ASA	NBFC
Asmitha	NBFC
Bandhan	NBFC
BFL	NBFC
BSFL	NBFC
BSS	NBFC
Equitas	NBFC
ESAF/ EMFIL	NBFC
FFSL	NBFC
Janlakshmi	NBFC
Margdarshak	NBFC
Mimo	NBFC
Mudra MF	NBFC
Pahel	NBFC
RGVN	NBFC
Sahayog	NBFC
Saija	NBFC
Sambandh	NBFC
Shikar	NBFC

SKS	NBFC
SML	NBFC
Sonata	NBFC
Spandana	NBFC
Suryodaya	NBFC
SVCL	NBFC
Swadhar	NBFC
Ujjivan	NBFC
Utkarsh	NBFC
Uttrayan	NBFC

MFI name	**Legal Status**
BMC	Section 25
CMC	Section 25
Humana(HPPI)	Section 25
Sanghmitra	Section 25
Swayamshree	Section 25
SWWS	Section 25

MFI name	**Legal Status**
Belghoria	Society
Chanura	Society
DCBS	Society
GBK	Society
Seba-Rahara	Society
SUWS	Society

MFI name	**Legal Status**
Lupin	Trust
Mahashakti	Trust
Prayas	Trust
YVU	Trust

Annexure 2: Proposed COCA Study Indicators

Indicators	Explanation	Scope
Governance	The indicator will help to assess the Governance structure with in MFIs. This will also assess the alignment of the board members' individual vision with institutional vision, board members' competency and commitment to support the institution in achieving its vision	Assessment of- • Board composition and the proportion of independent directors • Board members individual vision and its alignment with institutional vision • Board members qualification and experience • Board member time commitment and availability
Integrating Social Value in to Operations	This indicator will assess MFIs intention and intent towards social mission. It will assess how well MFI has positioned itself on social mission and if it stand for it	• Review of mission, vision and value of the MFI to assess extent of social commitment • Review of product and services, including non-credit, to assess if the MFI is able to fulfil the diverse client needs • Assessment of the extent of investment to take care of social responsibility • Assessment of the coverage – breadth and depth – of social activities • Assessment of the staff, management and board buy in for the social commitment • Assessment of board's involvement in policy formulation on social commitment and their oversight on adherence of the same

Credit Process and Policies	It will help to assess the MFI's policies and practices from client souring to loan disbursement. It will throw light on MFI's client segment focus; strength of the systems and process which ensures MFI is getting same set of clients which MFI is intended to;	• Review of following polices-
		  ○ Geographical expansion
		  ○ Client selection
		  ○ Client training
		  ○ Loan appraisal including credit bureau checks
		  ○ Loan disbursement
		  ○ Post disbursement supervision and audit

	MFI's expansion strategy and its commitment to reach un-reached areas and avoid over indebtedness; system and staff strength to assess the right repayment capacity of the borrowers and sanction loan accordingly; MFI's effort to make terms and condition clear before offering its product and services etc.	• Review of system and process for above points • Review of staff understanding and capacity to follow the system and carry out the policies • Verification of the impact of policies, process and systems at staff and clients end
Human Capital	Assessment of human capital will give an insight about MFI's strategy to source and trained the human capital. The indicator will also give an idea how staff are treated by MFIs – whether MFI has effective staff grievance redressal system or not	• Assessment of staff recruitment, on boarding and training system • Assessment of HR policy and procedure and its effectiveness • Assessment of staff readiness to execute code of conduct • Assessment of staff buy in for the code of conduct • Assessment of adequacy of training given to staff in client selection, credit appraisal (including cash flow based), client monitoring etc. • Assessment of staff grievance redressal system
Transparency and Fairness	This indicator will help us to know how transparent and fair MFI is with clients. It will cover MFI's policy for customer data security; MFIs effort on customer education; client understanding on product terms and conditions and pricing etc.; MFI's policy and system for customer grievance redressal	• Assessment of client data security system • Assessment of MFI's effort on customer education • Assessment of clients' understanding on product terms and conditions and price • Assessment of customer grievance redressal system
Compliance with RBI's Guidelines	This indicator will assess the extent of MFI compliance with RBI's guidelines	• Assessment of compliance with RBI's guidelines