IFMR Capital

Underwriting Guidelines for Microfinance Group Loans

Definition of Group Loans

For the purpose of these underwriting guidelines, Group Loans are defined as loans that are made based on the following criteria:

- Loans are provided to Joint Liability Groups (JLG). Members of a joint liability group should self-select themselves; group must not be formed by coercion or external influence. If any one or more member(s) in a group defaults in repayment of a loan, then other group members agree to jointly bear the responsibility of repaying such amount on behalf of the member(s) who has/have defaulted.

- The group should receive adequate training in the form of compulsory group training and their understanding of the product, processes and joint liability should be tested through a group recognition test before sanctioning the loan.

- Total tenor should not exceed 24 months

- Loan size should not be more than INR 50,000;

- Loans are repayable in weekly, fortnightly or monthly instalments

Eligibility Criteria

Criteria	Standard
Governance, strategy and organisational aspects	The promoters must have credible reputation and have a past track record proving their ability to raise financial resources in the form of equity, sub ordinated debt and senior debt from the market. If the capital structure has any contribution from Mutual Benefit Trusts or other such entities by the way of which it is intended that the clients/borrowers can benefit from ownership of or significant financial stake in the microfinance institution, such cases should be evaluated based on the criteria listed out in Annexure 1.
	The Originator should have a Board consisting of members with relevant experience and should have at least one Independent Director. The Board should play an active role in guiding management.
	Audited financial statements must be available within three months of audit. Audit must have been conducted by a reputed firm.
Loan Data Collection	Client information and supporting proof filed and/or recorded in the system. Details on each loan be recorded in the system of the Originator Name and address of the borrower Unique client identification number Group and centre number, where applicable Loan cycle Initial Loan amount Loan purpose Current outstanding balance Interest Rate Any other fees and charges collected Due and actual instalment payment and dates Amortization type/term to maturity Late payment: amount and dates Default: amount and dates

<table>
<tr><th>Criteria</th><th>Standard</th></tr>
<tr><td>Customer Protection</td><td>The Originator should have clearly stated processes and policies to protect customer interests.
The Originator must have put in place systems for grievance redressal providing for inter alia:

1. Direct, independent access to higher authorities within the organization, for clients to share their grievances and feedback.
2. Independent team that complies and reports on grievances/feedback to the senior management.
3. Policies for redressal of grievances within reasonable time.
4. System for internal audit/monitoring department to check on grievance redressal.

The product features, rules and regulations, including those related to the effective interest rate, upfront fees and other charges, any security or pledge against the loan, penalties for delay in repayment or for prepayment/pre-closure, must be clearly mentioned in the loan agreement and/or sanction letter, as per RBI's Fair Practices Code for NBFCs.

The Originator should not use or encourage strong arm tactics for collections of payment of overdue amounts
The Originator must clearly communicate to borrowers regarding:
1. Interest and other charges associated with the loan product.
2. Interest provided(in any) on security deposits or other deposits.
3. Returns, lock-in periods, surrender/pre-closure charge, administrative charges and other deduction and applicable terms and conditions for any saving/pension schemes offered, either in-house or in partnership with external agencies.
4. Premium paid to insurance companies, in case of credit-linked life insurance or other insurance products offered to the borrower.</td></tr>
<tr><td>Legal Form</td><td>NBFC-MFI, NBFC and section 25 Companies providing group loans are eligible</td></tr>
<tr><td rowspan="3">Operating process
&
Performance</td><td>Operating Efficiency: Each field officer must be responsible for a reasonable number of clients. This must be in keeping with the business model of the Originator, the lending model, methodology, disbursement methodology, time required for the field officer to travel and conduct business</td></tr>
<tr><td>Each new client must be adequately informed and trained to know the company, the loan product, and their risks and responsibilities under the loan via processes like the compulsory group test and the group recognition test, where applicable.</td></tr>
<tr><td>The field staff must collect proof of name and address from each client and this proof must be admissible under the RBI "Know Your Client" guidelines. The relevant guidelines are available at http://rbi.org.in/scripts/BS_ViewMasCirculardetails.aspx?id=4354

The field staff must physically verify each clients details by visiting their home, supported by interviews with group members, family members and neighbours. They must verify and collect the following information on these visits

1. Name and address
2. Occupation, Income and debt of the household
3. KYC documents provided</td></tr>
</table>

Criteria	Standard
Operating process & Performance	Clients must be made aware of the stipulation under any power of attorney that they sign. Each member should sign a demand promissory note to endorse the loan
	Each loan must be recorded in a loan agreement that sets out the borrower's and if applicable, the groups obligations (a "group" being the set of people that co-guarantee each other). The loan agreement must clearly specify that clients in the group are jointly and severally liable to repay each other's loans
	No member of the group should be given a higher size loan or any other form of incentive for group formation and collections
	The product features, rules and regulations, including those related to effective interest rates, upfront fees and other charges, any security or pledge against the loan, penalties for delays in repayment or for prepayment/pre-closure, must be clearly mentioned in the loan agreement and/or sanction letter, as per RBI's Fair Practices Code for NBFCs.
Systems	The Originator must have MIS software. The MIS software must be tamper proof, with differential access for staff at different levels.
	The Originator must have a clear process for collecting & collating accounting information from the branches and consolidated accounting statements. Consolidated financial statements should be ideally prepared at least on a monthly basis.
	All the customer level and loan level information must be stored in an electronic format.
	The system should have the capability to generate a unique client identification number and a unique loan number
	The MIS must provide for a clear process for checking the Demand-Collection- Balance(DCB) and any balance must be reported to the HO immediately
	The MIS must be capable of 'flagging' of loans to different funding sources. MIS should also provide the ability to change the 'flagging' from one source to another.
	The system must be able to correctly report on pre payments, default and other exceptions(including dropout, transfer of client accounts) as well as PAR and ageing PAR.
Financial Performance	The Originator must have a capital adequacy ratio of at least 15%, measured as defined under the Prudential Norms prescribed for NBFCs by the Reserve Bank of India. The Originator must regularly map its Asset-Liability Mismatch (ALM) and must have means of financing negative mismatches (i.e., liquidity gaps).

Guidelines for Evaluation

In addition to the Eligibility Criteria laid out above, IFMR Capital will undertake a more detailed study of the Originator's business as per the underwriting guidelines below

Criteria	Standard
Legal Form	The legal structure of the Originator should preferably be an NBFC, NBFC-MFI or Section 25 Company as the structure provides for: • Regulation • Incentive structure due to the presence of shareholders • Capital adequacy • Ability to raise additional capital
Governance, strategy and organisational aspects	The Originator should have a Board with relevant experience and with at least one Independent director. The Board should play an active role in guiding the management.
	The Originator should have a business plan including financial projections. The projections should be supported by(for a period of at least 6 months): i. Details of new geographies for expansion, including branch locations ii. Details of geographies for exit, including branch locations iii. Fundraising plans – debt and equity
	The Originator should have created a strong level of management below the promoters and the Chief Executive Officer ensuring that the business is not overtly dependent on a few key people
	The Originator must have clear delegation of authority, and oversight mechanism to ensure these are properly adhered to
	The Originator should have a clearly defined recruitment policy for field staff and staff at other levels. This policy should be followed, with the involvement of senior HO staff & regional level field staff.
	The Originator should have appropriate/adequate training for loan officer and middle management staff.
	The training for loan officer should consist of adequate field level and classroom training
	The Originator should have put in place a proper process for hand-over of customer relationships and job responsibilities in case of change in front-line staff on account of transfer, termination or general attrition. Specific cases of such hand-over should be checked by the internal audit or risk management team of the Originator at least on a sample basis.
	The Originator should have support functions such as finance, accounting, HR, IT, internal audit apart from credit and operations

Criteria	Standard
Origination Process	The Originator should have a defined process for new branch opening which captures information on economic activity, credit culture and history of political/ administrative interference Negative areas identified by the Originator should be listed. Reasons and record of the same should be maintained
	The field staff should collect the following information: Education, occupation of household members including age and school status of each child Household income and expenditure including nature of income(daily wage, salary, agricultural income), income volatility measured by the data on the range of income(average, low, high) during the year Infrastructure including availability of electricity and access to healthcare and sanitation Assets including type of dwelling, ownership of land and house, ownership of agricultural land, milk animals, poultry, TV, radio, agricultural implements, tractor, bicycle, jewellery, bed, utensil. Liability including prior loan, repayment history and loans from other sources
	Members of a Joint Liability Group should self-select themselves; group must not be formed by coercion or external influence. If any one or more member(s) in a group defaults in repayment of a loan, then other group members agree to jointly bear the responsibility of repaying such amount on behalf of the member(s) who has/have defaulted. The Originator should attempt to form groups in which there is parity of joint liability. For example, the difference between loan size within a group should not be too high as this might in turn dilute the joint liability
	Maker-checker arrangement should be in place to ensure that the group training and group test is not done by the same staff
	The centre and group leader should be elected by the group and not appointed by the field staff
	Loans should be disbursed at the branch in the presence of the branch manager and loan officer
	The Originator should have a process to check loan utilization which should be done within reasonable time after loan disbursement.
	The Originator should maintain records of loan utilization check
	The Originator must have a clearly defined policy for follow up on over due groups
	The Originator should not encourage the use of strong arm tactics and should not employ external agents for recovery
	The Originator should record and monitor client attendance and the same should be entered in the MIS

Criteria	Standard
Internal Audit	The Head of the internal audit team should have at least five years of audit experience.
	The team should have members with experience in operations, accounts, finance and MIS
	The strength of the internal audit team should be adequate to ensure regular audit of all branches and Head Office
	A comprehensive audit must be conducted on all branches, periodically with mix of planned as well as surprise audit
	Originator should have an internal audit score model and the frequency of audit should linked to the branch performance Issues highlighted during the audit should be shared with the branch and action report should be filed at the branch The Head of internal audit should directly report to the Board via the audit committee
Systems	All customer level and loan level information should be stored in a electronic format with periodic backups, and should be regularly updated to a centralized location(i.e up to date regional data should be available at HQ)
	The system should be able to retrieve accurate information in a timely manner and have restricted access as per the company hierarchy, i.e employees at each level mist have access to only the information that they need
	The system should be able to track historical loan information on each individual client
	All data such as client asset information, late payment, defaults, additional deposit amounts should be recorded in the centralized electronic system
	Adequate process controls should be in place to ensure data integrity during transfer of data from manual to electronic format
	The system should have the capability to provide data to Credit Bureau in the required format
	The system should have the capability to perform a client level “de dupe” for loan disbursement to the same client
	The system should be able to monitor and track portfolios to manage risk
	The system should be able to generate reports such as collections, disbursements by branch/hub, client history, product summaries, hypothecated portfolio, portfolio by loan purpose/tenor/clients profile/loan officer, portfolio at risk, defaults. Timely access to such reports should be facilitate business and operational decisions

Criteria	Standard
Risk Management	The Originator should have adequate insurance cover to protect it against risk of fraud, natural disasters and other unanticipated damage
	The Originator should be a member of credit bureau and loan disbursement should only be done after processing client information available through credit bureau.
	Interest Rate Risk: The Originator should use appropriate interest rate risk management technique, including interest rate hedge as needed. The Originator should maintain a low equity duration which is a measure of interest rate risk/sensitivity and is calculated as the ratio of the weighted average duration of assets and the weighted average duration of liabilities
	Liquidity Risk: The Originator should maintain a robust liquidity position, as assessed by the analysis of static liquidity(projected month on month cash outflow and inflow in terms of maturity of assets and repayment of existing liability, assuming no further inflow of external funds and no further disbursement of new loans)
	Currency Risk: The Originator should use appropriate currency/exchange rate risk if applicable
	The Originator should demonstrate ability to continue operations in the following stress scenarios: • Inability to access additional funding for a period of 6 months • Increase in benchmark interest rate of 2% •Decline/increase in currency value of 20% • Increase in default rates of 3% for a period of 12 months
	Reputation Risk: The Originator should have a process in place for customer grievance in a timely manner. The Originator should have clearly laid down policies for its staff to interact with clients at the time of origination, collections and follow up with delinquent clients. The policies should mention/specify inter alia: 1. The place and time of meeting clients, for origination and collections(e.g policies allowing staff to visit clients residence or place of work only during business hours) 2. The nature of interaction with clients(e.g staff should interact with clients always maintaining a sense of respect, dignity and empathy; and use of force or inappropriate language should be discouraged) 3. Avoiding visiting clients for any business related interaction(origination, collections, training etc) when there has been a bereavement in the clients household or neighbourhood; 4. At the time of origination or thereafter, not collecting any document(s) other than those required for the purpose of KYC or as security(in case of secured products) and as explicitly provided in the loan agreement

Criteria	Standard
Financial & Operational Performance	The promoter should have adequate stake and control in the company
	The Originator should maintain multiple sources of funding
	The Originator must have a capital adequacy ratio of at least 15%, measured as defined under the Prudential Norms prescribed for NBFCs by the Reserve Bank of India.
	The Originator must regularly map its Asset-Liability Mismatch (ALM) and must have means of financing negative mismatches (i.e., liquidity gaps)
	The volatility of PAR, as measured by the maximum historical PAR (>30 days) on loans originated at different points of time and the variation between the PAR from different origination periods and different geographies must not be significantly different or high
	The Originator should have loan loss provisions as stipulated by RBI
	The Originator should maintain a robust liquidity position, as assessed by the analysis of static liquidity (projected month-on-month cash outflows and inflows in terms of maturity of assets and repayment of existing liabilities, assuming no further inflow of external funds and no further disbursement of new loans).

Definition

Capital Adequacy	Ratio of tangible net worth(less retained first loss default guarantee and investment in related or subsidiary entity) to risk weighted assets
De Dupe	Process that uses matching logic to eliminate file records that are duplicate in the system
Default	A loan is considered in default if the borrower has not made any payment for that loan for a period greater than 30 days for weekly and fortnightly and 90 days for monthly instalment
Equity Duration	Ratio of the weighted average duration of assets and the weighted average duration of liabilities
Mutual Benefit Trust	A vehicle for channelising deposits from the company's clients into the capital of the company
Portfolio at Risk	Ratio of loan amounts overdue to total loan balance outstanding

Promoters	Initial equity investors who continue to remain whole time executive directors on the Board of the Company
Volatility of Default	Annualised standard deviation of default measured using weekly, fortnightly or monthly data since inception, or using default data for the 3 years.
Weighted Average Annual Default Rate	Combined outstanding balance at time of default for all loans that has fallen into default at any time during the fiscal year(excluding loans that were already in default at the start of the fiscal year) divided by the sum of all scheduled principal payment due during the fiscal year

Annexure I

Governance	Chairperson of MBT not to be an appointed but elected representative of the members of the MBT Decision making and management of Trust funds should be left to the Board of Trustees. The Board of Trustees should consist of a mix of elected and nominated members (and not 100% nominated) The Managing Trustee should be a non-voting member of the Board and should not participate in decisions/resolutions related to the Originator.
Management of MBTs	MBT accounts to be audited by an independent audit firm. Day to day management of the MBT must be done by professional staff remunerated by the MBT.
Nature of Investment	Investment in the company through the MBTs should be in form of preference shares and tier II capital
Investment Policy for MBTs	All MBTs should have an investment policy that must be approved by the Board of Trustees. The investment policy must provide for diversification of investment across a basket of investment options based on risk and returns.
Distribution of Returns	The Trust Deed should provide for distribution of returns to members either in proportion to the member capital fund contributed or equally, as each MBT may decide. The procedure for any group withdrawing its membership and capital contribution from the MBT must also be put in place. When further round of equity is raised MBT members must have the option to redeem the preference share at the new price offered.

Annexure II

Non-Banking Financial Company-Micro Finance Institutions (NBFC-MFIs)- RBI/2011-12/290 DNBS.CC.PD.No. 250/03.10.01/2011-12 (as modified from time to time by RBI)