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OPENING MARKETS THROUGH STRATEGIC PARTNERSHIPS

THE ALLIANCE BETWEEN ICICI BANK AND CASHPOR

microREPORT #39

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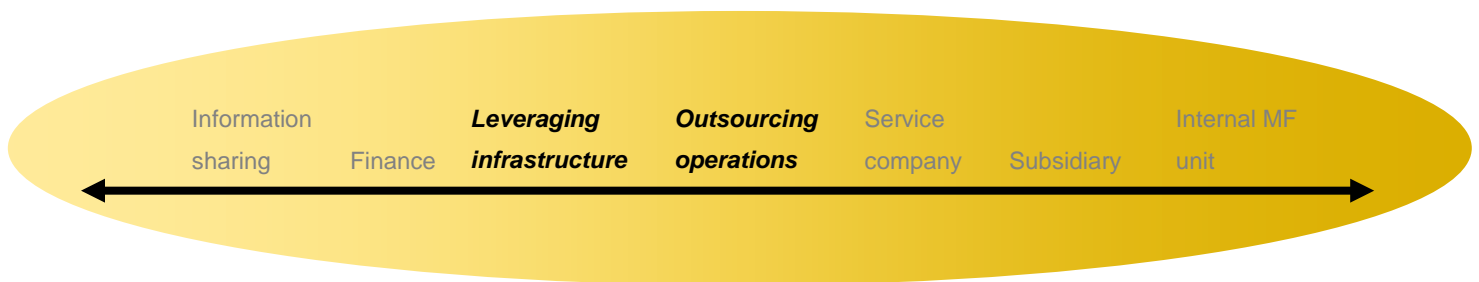
ABBREVIATIONS

ATM	automated teller machine
CASHPOR	Credit and Savings for the Hardcore Poor
CFS	CASHPOR Financial Services
CFTS	CASHPOR Financial and Technical Services Ltd.
CMC	CASHPOR Micro Credit
CRF	Collective Responsibility Fund
DAI	Development Alternatives, Inc.
DSA	Distribution Sales Agents
FY	fiscal year
MBB	MicroBanking Bulletin
MFI	microfinance institution
MIS	management information system
MOU	memorandum of understanding
NABARD	National Bank of Agriculture and Rural Development
NBFC	non-bank finance company
NGO	nongovernmental organization
PAR	Portfolio at Risk
RBI	Reserve Bank of India
SHG	self-help group
SIDBI	Small Industrial Development Bank of India
USAID	U.S. Agency for International Development

FOREWORD

Although linkages formed between formal and informal financial institutions that seek to provide financial services to low-income clients are a relatively new trend, there is a wide range of these relationships occurring in developing countries today. These linkages often occur between more informal, unregulated entities such as nongovernmental microfinance institutions (MFIs) serving low-income clients, and regulated financial institutions including banks, finance companies, and regulated cooperatives. Figure 1 below illustrates a continuum of common linkages observed. Linkages on the left side of the spectrum depict less formal or more one-off relationships; linkages on the right side may involve more formalized contractual or ownership arrangements. The continuum represents important advancements in service provision to the low-income market, and presents possibilities for providing more sophisticated or expansive financial services. Moreover, these linkages serve to overcome institutional or operational obstacles faced by financial institutions, as well as obstacles related to physical infrastructure, geography, limited population density, or regulation.

FIGURE 1: TYPOLOGY OF LINKAGES



As part of the Accelerated Microenterprise Advancement Project Financial Services Knowledge Generation project, Development Alternatives, Inc. (DAI) is undertaking research to document innovative and replicable types of linkages. Specifically, this research focuses predominantly on those types of linkages in the middle of the continuum, where banks or nongovernmental organizations (NGOs) are able to leverage the infrastructure of their allies or where a bank has been able to outsource its services and operations for low-income services to an unregulated entity.

The strategic linkage described in this case study presents an interesting demonstration of how ICICI Bank in India hopes to reach millions of low-income clients in regions where it has no physical presence by outsourcing credit processes to MFIs operating in such regions. Although ICICI outsources operations to more than 30 MFIs, Credit and Savings for the Hardcore Poor (CASHPOR), an MFI with a vision of reaching one million rural poor women in eastern Uttar Pradesh and western Bihar in Northern India (home to 37 percent of India's poorest people), is among the largest with approximately 70,000 active clients. The linkage between ICICI and CASHPOR was selected as the subject of this case study, not only because it typifies the objectives and the mechanics of linkages established between ICICI and other MFIs, but because CASHPOR was among the first MFIs to partner with ICICI and hence has a longer history. It is also a dedicated poverty lender with large-scale visions.

To document this case study, the author, Robin R. Bell of Bannock Consulting (part of the DAI Group), conducted interviews in India with a wide range of key informants in Mumbai, New Dehli, Varanasi, as well as Chandauli and Mirzapur districts.

The author would like to thank friends and colleagues in the Indian microfinance industry who contributed their time and expertise, especially David Gibbons, Chairman of CASHPOR Micro Credit; M.N. Gopinath, Senior General Manager, Head–Retail Infrastructure & Facility Management Groups of ICICI; and their staff who were exceptionally welcoming and forthcoming with information. In addition, the author would like to thank Malcolm Harper and Barry Lennon of the U.S. Agency for International Development (USAID) who also provided background information on ICICI and CASHPOR, and more generally on microfinance in India.

EXECUTIVE SUMMARY

THE ICICI PARTNERSHIP MODEL

In India, there are approximately 1,600 MFIs, of which fewer than 10 have portfolios greater than Rs. 50 million or US\$1.15 million. Both large and small-scale MFIs operating in India have difficulty expanding their operations due to a lack of funds. Commercial banks in India, on the other hand, must comply with “priority sector lending quotas” in which credit is provided to agricultural enterprises (rural sector financing) for exports and to small-scale industries.

ICICI Bank is India’s largest private bank, and is the second largest bank overall with total assets of about Rs. 1.677 trillion (US\$38 billion). ICICI Bank aims to be a leader in every field of banking in India, including corporate banking, foreign transactions, housing, insurance, conventional consumer banking services for the salaried middle class, and banking and finance for micro and small enterprises.

To increase its provision of microfinance and establish its leadership in this last sector, ICICI developed its Partnership Model. Not only was it in ICICI’s interest to have qualifying assets (e.g., loans to microenterprises) on its books to meet its priority sector lending quota, but ICICI wanted to take advantage of the infrastructure of the MFIs that were operating in more rural areas because its network of about 560 branches and service delivery outlets were mainly in urban areas and larger district towns. Furthermore, ICICI’s internal market study revealed that many MFIs operating in the rural areas could not expand their operations due to poor capitalization and lack of funds for on-lending. To address this goal and concern, ICICI developed a model whereby:

- An MFI acts as a service agent of the bank undertaking the loan analysis, processing, and recovery of the loans;
- The bank, as per the Central Bank guidelines, approves all loans based on the recommendations of the MFI;
- The bank advances funds to the MFI in an uninterrupted manner to facilitate the disbursement of loans, all of which is recorded on the bank’s balance sheet and in the bank’s name; and
- The bank shares in the credit risk with the MFI.

CASHPOR is a poverty lender MFI with a vision of reaching one million poor rural women of eastern Uttar Pradesh and western Bihar in Northern India by 2010. It is among the largest MFIs operating in India, serving approximately 70,000 active clients and was among the first MFIs to collaborate with ICICI.

Since its inception, CASHPOR has largely funded its operations with debt financing. It began its operations with an investment of a mere \$30,000 from CASHPOR Technical Services, an affiliate of CASHPOR. The balance of its start-up funds were provided by the Grameen Trust (Bangladesh), Grameen Foundation (USA), and Calvert Foundation in the form of long-term, low-cost subordinated debt. Since then, not only has CASHPOR obtained semi-commercial financing from Indian development banks—National Bank of Agriculture and Rural Development (NABARD) and Small Industrial Development Bank of India (SIDBI)—but it has secured financing at commercial rates from lenders such as Friends of Women’s World Banking, ABN AMRO Bank, HDFC Bank, UTI Bank, and ICICI Bank.

At present, CASHPOR is severely undercapitalized and overleveraged despite the \$1.8 million grant provided by USAID in recent years. In part, this is because CASHPOR has been financing a portion

of its operational deficits with commercial debt (e.g., loans from both SIDBI and ICICI). Despite the availability of commercial financing to CASHPOR, it has not been available in the amounts nor in the timely, uninterrupted manner necessary to achieve CASHPOR's vision of reaching one million poor women in India by 2010. As a result, the partnership developed with ICICI over the past two years has become of great importance to CASHPOR.

THE PARTNERSHIP AGREEMENT

The first memorandum of understanding (MOU) between ICICI and CASHPOR was executed on January 8, 2003, and became operational in April 2003 (the start of fiscal year [FY] 2004). The MOU stipulated that:

- CASHPOR acts as a service agent on behalf of ICICI to set up and manage self-help groups (SHGs) within the areas of Chandauli District and the bordering regions of surrounding districts in eastern Uttar Pradesh.
- CASHPOR ensures that members of the SHGs in districts covered under the MOU would access finance only from ICICI.
- ICICI signs off on all loans and advances the funds to the members of SHG based on the recommendation of CASHPOR.
- ICICI ensures that CASHPOR has sufficient credit to achieve the projected loans outstanding according to its business plan, as approved by ICICI.
- Loans to members of SHGs are at a rate of interest of 12.5 percent (to ICICI) and with a tenor of 12 months.
- CASHPOR collects an up-front fee of 6 percent (or as agreed from time to time) to cover its costs.
- CASHPOR provides a First Loss Deficiency Guarantee up to 12 percent of the proposed limit. In other words, CASHPOR assumes the credit risk or loan losses of up to 12 percent before ICICI shares any of the risk.
- This Deficiency Guarantee can be in the form of a fixed deposit or in the form of an overdraft facility (which carries a penalty rate of 19.5 percent interest as well as a 10 percent up-front commission). CASHPOR opted for the Overdraft facility.

INITIAL AND ONGOING CHALLENGES TO IMPLEMENTATION

ICICI came into the partnership with a range of objectives, including the need for additional qualifying assets to meet its priority sector lending quota, the desire to improve its overall image, and the desire to be the market leader in all market segments, including microfinance. To date, ICICI is very pleased with the performance of the Partnership Model in general and the partnership with CASHPOR, specifically. ICICI identifies the following as successes related to the Partnership Model:

- ICICI's microfinance portfolio is of high quality and is yielding good returns;
- The aggregate volume of its microfinance portfolio totaled more than US\$90 million as of March 2005, thereby establishing ICICI as one of the market leaders;
- The microfinance portfolio contributes to ICICI's priority sector lending quotas although it represents a small percentage of ICICI's total portfolio and does not come close to meeting the requirement that 40 percent of its net credits be made to the sector);

- Both the volume and quality of lending through CASHPOR is fully meeting expectations (as per the CASHPOR’s business plan approved by ICICI); and
- The lending through CASHPOR has helped ICICI establish a name and positive image in eastern Uttar Pradesh and western Bihar, regions and districts where ICICI’s presence is very limited.

CASHPOR came into the partnership with the main objective of securing a reliable, uninterrupted flow of funds. In the opinion of CASHPOR, it has been able to develop a business relationship based on trust and ICICI has fully delivered on all of its commitments to the partnership. In addition, over time, ICICI not only reduced the interest rate and the level of the Deficiency Guarantee, but it also agreed to finance CASHPOR’s operating deficits.

Notwithstanding the partnership’s success, there have been challenges—both initial ones that have been resolved as well as ongoing challenges that remain to be resolved. The initial challenges included, among others:

- Level of risk sharing (who absorbs what losses);
- Flow of funds and reporting requirements; and
- Loan documentation and procedures.

The ongoing challenges include, among others:

- **Exit Strategy.** Although the agreement is renewable, its “short term” structure creates some unease on the part of CASHPOR given that the partnership has become increasingly important for CASHPOR’s operations.
- **Capital Adequacy.** In growing the balance sheet of another institution, CASHPOR generates operating deficits for a period of three to four years, which erodes its capital base. Once CASHPOR breaks even, it still takes an additional two to three years to restore its capital base to its original level. In other words, CASHPOR does not begin to earn real returns for approximately six to seven years.
- **Equitable Alignment of Costs and Benefits.** There should be a more equitable alignment of costs and benefits associated with serving the microenterprise market segment. In other words, CASHPOR should negotiate with ICICI—the institution with total assets of approximately US\$38 billion and financial capacity that dwarfs CASHPOR’s capacity—to share the up-front costs more equitably. If the spread of 8.75 percent is not reduced, at a minimum, the operating deficit loans of Rs. 18 million (approximately US\$400,000) should not be financed at commercial rates.
- **New Product Development.** Another challenge for the partnership going forward relates to product development. Under Reserve Bank of India (RBI) regulations, banks cannot offer safe and accessible savings facilities via non-bank finance company (NBFC) agents (that is, MFIs). This means CASHPOR’s clients do not have access to safe, regulated savings through the partnership structure.

Institutional Capacity Development. Other key challenges faced by the partnership relate more to CASHPOR’s operational issues involved in realizing its mission in general and not to the partnership in particular (e.g. institutional capacity, staff development, and so on).

INTRODUCTION

In India, there are approximately 1,600 MFIs, of which only a few are of significant size. ABN AMRO estimates that 25 to 30 of the MFIs are “bankable,” but of those, fewer than 10 have portfolios greater than Rs. 50 million or US\$1.15 million¹ (hereinafter defined as a large MFI). Indian banks involved in microfinance at the wholesale or second tier level, such as NABARD, SIDBI, and ICICI Bank, estimate that they finance up to 50 MFIs.

During the past decade, the Indian microfinance industry has grown rapidly but not proportionately across the country. Bihar and Uttar Pradesh in Northern India, two of India’s poorest regions, are home to an estimated 37 percent of India’s poorest people, yet CASHPOR is the only large MFI operating there. The other large MFIs operate mostly in Southern India where more entrepreneurial activity is reported.

Both large and small scale MFIs operating in India have difficulty expanding their operations due to a lack of funds. The availability of funds is limited by the MFI’s low level of capital since, as per RBI guidelines, an NBFC cannot borrow more than eight times its net worth. MFIs, which by law should be incorporated as NBFCs, are often caught in a vicious cycle of limited operations, low profitability, and loss making as they struggle to achieve financial self-sufficiency—all resulting in an inability to raise capital. Thus, the MFIs are unable to borrow the funds necessary to increase scale, and in turn, profits and capital (retained earnings).

Commercial banks in India, on the other hand, must comply with the priority sector lending quota which mandates the provision of credit to agricultural enterprises for exports and to small-scale industries. Under the law, priority sector lending by commercial banks (excluding foreign banks) should constitute 40 percent of net bank credit. Banks that are not in compliance compensate by placing equivalent deposits at ‘penalty rates’ with institutions such as NABARD and SIDBI.²

The chronic lack of funds faced by MFIs in India, coupled with the priority sector lending quota for commercial banks, catalyzed the partnership between CASHPOR and ICICI. CASHPOR needed an unrestricted flow of funds that would enable them to achieve scale of operations, yet comply with regulatory requirements related to capital adequacy, and ICICI Bank needed to meet its priority sector lending requirements.

¹ U.S. dollar/rupee exchange rate of 43.62 as of March 31, 2005.

² Funds have a graded interest rate structure depending on the degree of noncompliance or shortfall (e.g., if shortfall is 9 percentage points and above, funds are placed at the bank rate minus 3 percent percentage points).

THE INSTITUTIONS

ICICI BANK

ICICI Bank is India's largest private bank, and is the second largest bank overall with total assets of about Rs. 1.677 trillion (US\$38 billion). ICICI Bank has a network of about 560 branches and service delivery outlets mainly in urban areas and larger district towns, approximately 2,000 automated teller machines (ATMs), and 15,000 employees.³

ICICI Bank was originally established in 1994 as a wholly owned subsidiary of ICICI Limited, an Indian financial institution formed in 1955 through an initiative of the World Bank, the Government of India, and representatives of India's industrial sector that aimed to provide medium and long-term credit to new industry. Between 1994 and 2001, ICICI Bank operated as a wholly owned subsidiary of ICICI Limited, but in 2002, ICICI Limited and its other subsidiaries were absorbed into ICICI Bank through a reverse merger. The reverse merger provided the optimal legal structure for the ICICI group's current universal banking strategy.

ICICI aims to be a leader in every field of banking in India, including corporate banking, foreign transactions, housing, insurance, conventional consumer banking services for the salaried middle class, and banking and financial services for the poor (microfinance).

ICICI began to engage in microfinance in 2002. ICICI's approach to microfinance has taken two forms: the **Bank Led Model** that ultimately evolved into the **Partnership Model**.

The Bank Led Model. In March 2001, ICICI Bank acquired the Bank of Madura, a bank in Southern India with 260 branches. The principal motive for purchasing the Bank of Madura was to acquire its branch network because of the difficulty in securing approval from the Central Bank to open new branches. Of the 260 Bank of Madura branches, 86 rural branches operated with low business volumes.

At the same time, ICICI found that the Bank of Madura was managing 1,204 SHGs⁴ in the state of Tamilnadu. The Bank of Madura's experience convinced ICICI that microfinance loans could be of high quality and that the market would pay comparatively higher interest rates for access to finance. Thus, ICICI identified SHGs as a safe avenue for increasing lending at the 86 underutilized rural branches.

To achieve the desired scale of operation in the rural branches previously owned by Bank of Madura, ICICI opted to test a variation of its existing and highly cost effective model of outsourcing consumer banking services through agents to grow its microfinance business. Instead of contracting separate sales, credit processing, and collection agents, ICICI opted to consolidate these functions into one "manpower providing agency" that would employ the promoters and coordinators engaging them to work in the field under the supervision of ICICI's project managers. The fully loaded salary levels of employees were too high to make the scale-up viable from within ICICI. ICICI contracted one bank staff member, or project manager who would manage six coordinators (agents). The coordinators in

³ By contrast, State Bank of India, the largest Indian bank with total assets of approximately Rs.4,600 billion (US\$105 billion), was originally formed in 1806 and has 14,000 branches and over 200,000 employees.

⁴ In India a self-help group is defined as a group of about 20 people who come together to address their common problems. They make voluntary thrift on a regular basis and use this pooled resource to make small interest bearing loans to their members. The process helps them learn the essentials of financial intermediation including prioritization of needs, setting terms and conditions and accounts keeping. Once the groups show mature financial behavior, banks are encouraged to make loans to the SHG in certain multiples of the SHG's accumulated savings. (NABARD, 2002)

turn supervised 6 promoters (agents), each of whom managed 20 SHGs. In other words, each bank staff member or project manager would be responsible for 720 SHGs or an estimated 14,400 clients (6 coordinators × 6 promoters × 20 SHG = 720 SHG × 20 SHG members = 14,400 SHG members).

By March, 2005, the manpower providing agency was managing more than 18,000 SHGs with a membership of 350,000 and outstanding loans of Rs. 1.6 billion (US\$36.7 million).

Although the Bank Led Model worked well for ICICI in the regions where it had branches, ICICI felt it was not an appropriate model for districts or regions where the bank had no branches or physical presence. Hence, ICICI developed an alternative outsourcing model that could leverage local capabilities. This alternative is referred to this as the Partnership Model.

Partnership Model. Although ICICI did not have branches in rural areas, its internal market study revealed that there were many MFIs like CASHPOR operating in rural areas that could not expand their operations due to poor capitalization and lack of funds for on-lending. At the same time, it was in ICICI's interest to have qualifying assets (e.g. loans to microenterprises) on its books to calculate its priority sector lending quota. To address this goal and concern, ICICI developed the following model:

- The MFI acts as a service agent of the bank handling the loan analysis, processing, and recovery;
- The bank, as per the Central Bank guidelines, approves all loans based on the recommendations of the MFI;
- The bank advances funds to the MFI in an uninterrupted manner to facilitate disbursement of loans, all of which is recorded on the bank's balance sheet and in the bank's name; and
- The Bank shares in the credit risk with the MFI.

Aside from defining its broad objectives for the Partnership Model, ICICI had not developed a business plan nor quantified any measures of success. Regardless, ICICI is very pleased with the performance of the Partnership Model in general. As of March 2005, ICICI had built a portfolio of Rs. 2.4 billion (US\$55 million) through 31 partner MFIs, including CASHPOR, not only one of its first partners, but also among the five largest.⁵

CASHPOR

The CASHPOR group of companies (described in detail under Annex 1, Organizational Structure) has as its vision to provide financial services to one million poor rural women of eastern Uttar Pradesh and western Bihar in Northern India by 2010. CASHPOR uses a group lending methodology whereby it organizes clients into five-person solidarity groups, which are then organized into village-based "centers" consisting of at least six groups.⁶ CASHPOR commonly refers to the centers as SHGs, because ICICI's original Bank Led Model involved SHGs and has continued to use this terminology.⁷ The methodology includes weekly meetings and "stepped" loans that can grow each time a client successfully repays a loan (provided the clients have the capacity to repay a larger loan).

⁵ As of March 2005, CASHPOR managed portfolio of Rs. 87.8 million, accounting for approximately 3.6 percent of ICICI's Rs. 2.4 billion portfolio under the Partnership Model.

⁶ The basic five-member group was eliminated in the Partnership districts where the focus is on the Center. However, the five-member groups are still formed in Mirzapur and Ghazipur.

⁷ CASHPOR's centers do not conform to the definition of SHGs used in India as defined above.

The center approves all individual loans and takes collective responsibility for repayment of the loan. CASHPOR does not accept deposits because it is not licensed to do so.

CASHPOR’s loan products include a loan for income-generating activities with a typical loan term of 50 weeks, and in exceptional cases, loans for marriage or emergency expenses with a typical loan term of less than 25 weeks. First loans are often for Rs. 5,000 (US\$115), an amount sufficient to purchase livestock for milk production, trading, small production of vegetables, bicycle repair, and so on. Repeat loans are generally less than Rs. 15,000 (US\$345).

The effective interest charged on its loans is 26 percent per annum. The structure of the rates varies from district to district as reflected in the table below.

TABLE 1: CASHPOR INTEREST RATE STRUCTURE

	Partnership Districts	Mirzapur	Ghazipur
Interest	12.5%, declining balance (8.75% interest to ICICI, 3.75% commission/service fee to CASHPOR)	20% flat, with rebate for on-time repayment, 26% on declining balance	26%, declining balance
Fees	6% commission	0% ⁸	0%

Since its inception, CASHPOR has largely funded its operations with debt financing. It began its operations with an investment of a mere \$30,000 from CASHPOR Technical Services, an affiliate of CASHPOR. Aside from the minimal investment, CASHPOR funded its operations during the first two years with long-term, low-cost subordinated financing from the Grameen Trust (Bangladesh), Grameen Foundation (USA), and Calvert Foundation.

Despite CASHPOR’s undercapitalization and its high level of accumulated operating losses, Indian banks have been willing to lend to CASHPOR. The key factors contributing to their success in accessing bank finance have included, among others:

- The banks included the low-cost subordinated financing as quasi-equity in their calculation of capital adequacy;
- CASHPOR had a favorable record of accomplishment in its lending operations in the poorest region of India; and
- CASHPOR was willing to give commercial lenders such as ABN AMRO and SIDBI seats on the Board (ex-officio capacity).

Not only has CASHPOR obtained semi-commercial financing from Indian development banks—NABARD and SIDBI—but also it has secured financing at commercial rates from lenders such as Friends of Women’s World Banking, ABN AMRO Bank, HDFC Bank, UTI Bank, and ICICI Bank.

Nonetheless, CASHPOR is severely undercapitalized and overleveraged despite the \$1.8 million grant from USAID that is still in the process of being disbursed. As of March 2005, debt financing on commercial terms to the CASHPOR holdings (see Annex 1 for more information) represented more than 100 percent of CASHPOR’s portfolio (Rs. 252.4 million or US\$6.7 million in commercial debt

⁸ The pricing on CASHPOR’s direct lending portfolio includes no commissions because of the Government of India policy to charge a tax of 10.2 percent on all commissions. Since CASHPOR is legally not the lender but rather is a service agent in the districts that are part of the partnership, it has no choice but to charge commissions and pay the tax.

as compared to its direct lending portfolio of Rs. 182.5 million or US\$4.2 million).⁹ Annex 2 details the commercial debt outstanding (the Rs. 87.8 million [or \$US 2 million] portfolio managed for ICICI is not included in the debt nor in the portfolio outstanding). In part, this is because CASHPOR has been financing a portion of its operational deficits with commercial debt (e.g., loans from both SIDBI and ICICI).

Despite the availability of commercial financing to CASHPOR, it has not been available in the amounts nor in the timely, uninterrupted manner necessary to achieve CASHPOR's vision of reaching one million poor women in India by 2010. The limit on the amounts is clearly due to CASHPOR's weak capital structure and its interest rate policies that do not permit break-even for a period of approximately five years. The timeliness factor is problematic because conventional term loans typically:

- Are time consuming and costly to process;
- Are rigid in amount and tenor (e.g., a commercial bank's conventional way of mitigating risk for such a high risk institution) and have to be replaced by another, requiring that processing be done all over again;¹⁰
- Have inflexible disbursement dates which are often delayed, causing unpredictable and lumpy flow of funds; and
- Have repayment conditions that result in asset-liability mismatches.

For these reasons, the partnership developed with ICICI over the past two years (described below) has become of great importance to CASHPOR—financing four of the six districts in which CASPOR now operates.

CASHPOR began lending in its first district (Mirzapur) in September 1997. By the end of fiscal year March 2003, CASHPOR had 22,164 clients and had achieved financial break-even. Although operations continue to be financially sustainable in the Mirzapur district, the institution as a whole during fiscal years 2004 and 2005 was not operationally or financially self-sufficient because of its aggressive expansion. During fiscal years 2003–2004 and 2004–2005, CASHPOR undertook expansion into five new districts, four of which have been part of the partnership with ICICI.

The key outreach and financial highlights of CASHPOR and the partnership as of March 2005 are presented in the table below.

⁹ The debt of CFTS and CMC is consolidated. Though CFTS sold its "business" to CMC, it did not transfer the entirety of its pre-existing indebtedness (e.g. its subsidized loan from SIDBI or the quasi equity /concessional loans from Grameen Trust, Grameen Foundation, Calvert Foundation, etc.). Even if the debt were not consolidated, CMC alone is also overleveraged – its total indebtedness exceeds 100 percent of its "tangible" assets.

¹⁰ CASHPOR's average credit facility with conventional banks is Rs. 10 million. More recently, on an exceptional basis, it received a facility of Rs. 30 million from ABN AMRO (February 2004) and Rs. 50 million from SIDBI (March 2005). Still, such facilities are comparatively smaller than the Rs. 200 million open ended facility of the Partnership.

TABLE 2: PARTNERSHIP OUTREACH AND PERFORMANCE INDICATORS

Outreach and Performance Indicators	Consolidated	Direct Lending Districts (Mirzapur & Ghazipur) (On Balance Sheet)	Alliance Districts (Chandauli, Buxar, Ballia & Mau) (Off Balance Sheet)
March 31, 2005 USD			
Number of Active Credit Clients	68,229	44,490	23,739
Gross Credit Portfolio	6,195,437	4,183,242	2,012,195
Average Loan Amount Outstanding	91	94	85
Portfolio in Arrears (>30 days)	252,441	239,725	12,716
Portfolio in Arrears/Gross Portfolio	4.1%	5.7%	0.6%
CASHPOR Operating Income	1,308,811	999,122 ¹	207,554
ICICI Interest	96,635	N/A	96,635
Total Operating Income (Alliance Level)	1,405,446 ²	999,122	304,189 ^{1,2}
Operating Expenses	1,450,846	603,859 ¹	495,365 ¹
Operating Expenses/Average Portfolio	31%	17%	40%
Interest Expense (as per CASHPOR P & L)	642,663	429,167	76,224
Interest Expense (pass through to ICICI)	96,635	N/A	96,635
Loan Loss Provisions	86,489	86,489	0
Total Expenses (CASHPOR)	2,179,998	1,119,516	571,589
Total Expenses (Consolidated Alliance)	2,276,633 ²	1,119,516	668,223 ²
Total Expenses (CASHPOR)/Average Portfolio	46%	32%	46%
Total Expenses (Consolidated Alliance)/Average Portfolio	48%	32%	54%
Operational Self-Sufficiency (CASHPOR)	60%	89%	36%
Operational Self-Sufficiency (Consolidated Alliance)	62%	89%	46%
Number of Credit Officers	398	146 ¹	252 ¹
Total Number of Personnel	438	171 ¹	303 ¹
% Credit Officers/Total Personnel	90.9%	85.4%	83.2%
Active Credit Clients/Credit Officer	171	305	94
Active Credit Clients/Staff Member	156	N/A	N/A

¹ District level only. Does not include HO allocation

² Includes interest income/(expense) passed on to ICICI (not reflected on P&L)

The scale of CASHPOR's credit operations has more than tripled during the past two years, both in terms of number of clients and in terms of outstanding portfolio. CASHPOR has achieved this high level of growth while simultaneously tightly controlling loan delinquency. Portfolio at risk (PAR) greater than 30 days past due as of March 31, 2005, was 4 percent.

In the original district of Mirzapur, CASHPOR maintains its policy of requiring a Collective Responsibility Fund (CRF). Whenever a client fails to make a loan payment, each member of the group is charged a weekly Rs. 2.00 fee and each Center member an additional R. 1.00. This fee continues until either the member has repaid the loan or the accumulated fees are equal to the delinquent loan balance. Fees are refunded to the members when the client repays the loan. CASHPOR opted not to require a CRF in the subsequent five districts and performance would suggest that it is not required to maintain high repayment rates. In fact, as of March 2005, Mirzapur had the highest PAR (7.3 percent), despite the CRF.

A comparison of CASHPOR's performance to international benchmarks published in MicroBanking Bulletin (MBB) for medium non-financial institutions in Asia and "new" institutions indicates that CASHPOR is achieving reasonable levels of efficiency. MBB's peer group of medium non-financial institutions in Asia is the size category comparable to CASHPOR given that these institutions have on average approximately 40,000 loans outstanding as of 2003. The peer group categorized as "new" institutions, on average, have been operating for three years. Although CASHPOR is technically not a new institution, five of its six districts (comprising 82 percent or approximately 5/6 of the credit officer positions) launched operations in the past two years. Moreover, all four of the partnership districts were launched during the same period (three of which were launched in FY 2005). Hence, both CASHPOR and the partnership have many of the same characteristics of new institutions even though the mature district of Mirzapur operates at standards comparable to mature MFIs.

TABLE 3: CASHPOR PERFORMANCE COMPARED TO MBB BENCHMARKS

	CASHPOR	Medium Non-Financial Institution in Asia	New Institutions
Operating Cost Ratio (Operating Expenses/Average Portfolio)	31%	22%	31%
Loan Per Credit Officer (Consolidated)	171	318	146
Mirzapur District	470	318	N/A
Chandauli District	153	N/A	146
Ghazipur District	148	N/A	146
% of Credit Officers to Total Personnel	90%	64%	53%

As shown in Table 3, the operating cost ratio for the institution as a whole was 31 percent compared to an average of 22 percent for medium non-financial institutions in Asia or an average of 31 percent for "new" institutions. The productivity of credit officers (e.g. the number of loans per credit officer) also showed similar trends. Although on a consolidated level, CASHPOR's average number of loans per credit officer is 171, CASHPOR's average number of loans per credit officer in the Mirzapur district is 470 as compared to an overall average of 318 for medium non-financial institutions in Asia. The rapid pace of hiring in the new districts reduces CASHPOR's overall productivity levels because CASHPOR begins operations in a new district with 80 new credit officers. Given that CASHPOR expanded into two districts in fiscal year 2004 and three more districts in fiscal year 2005, the reduction in overall productivity is more a timing issue (e.g., the newest district of Mau ended FY 2005 with loans per credit officer of only 18). The average number of loans per credit officer in the Chandauli and Ghazipur districts, which were started in fiscal year 2004, is 153 and 148 respectively as compared to an average of 146 for "new" institutions. CASHPOR's personnel allocation is lean: credit officer staff in relation to total personnel is 90 percent as compared to an average of 64 percent for medium non-financial institutions in Asia.

OPERATIONALIZING THE PARTNERSHIP

THE FOUNDATION OF THE PARTNERSHIP

In 2002, ICICI approached CASHPOR to form a partnership that would allow ICICI to expand its client base in eastern Uttar Pradesh by outsourcing its micro loan credit process to CASHPOR. ICICI and CASHPOR agreed that CASHPOR would act as a service agent on behalf of ICICI. Although a regulatory framework does not actually exist in India to permit such a partnership or agency between a commercial bank and an NBFC, the Central Bank has tacitly accepted such partnerships given that it clearly wants to promote small-scale credit, particularly in the rural areas.¹¹

ICICI and CASHPOR each had its own objectives in forming this partnership. ICICI's objectives for all its partnerships including its partnership with CASHPOR were:

- Meeting its priority sector lending quota by obtaining additional qualifying assets through partnership with one of India's largest MFIs.
- Improving opportunities for India's poor while gaining new bank customers in northern India, (a region in which ICICI had a limited presence), who would remain loyal to the bank which first served them. Microfinance is seen as an effective and immediately profitable form of customer development.
- Generating a loan business of US\$12 billion in the next 10 years.¹²

CASHOR's objectives included:

- Sourcing a reliable, uninterrupted flow of funds in order to achieve its ambitious growth of outreach to the poor. ICICI was offering comparatively large-scale, open-ended funding commitments in accordance with the financial requirements projected by CASHPOR in its business plan. The small term loans, which CASHPOR had limited access to from conventional lenders did not meet these needs.

The first MOU between ICICI and CASHPOR, which was executed on January 8, 2003 and became operational in April 2003 (the start of FY 2004), stipulates that:

- CASHPOR acts as a service agent on behalf of ICICI to set up and manage SHGs within the areas of Chandauli District and the bordering parts of surrounding districts in eastern Uttar Pradesh.
- CASHPOR ensures that members of the SHGs in districts covered under the MOU access finance only from ICICI.¹³

¹¹ Notwithstanding, the Central Bank has very clearly prohibited commercial banks from offering safe and accessible savings facilities via NBFC agents (MFIs). Recent speeches by the Finance Minister, however, indicate the willingness of the Government of India to consider revising its policy in this regard.

¹² Draft paper prepared by Malcolm Harper. Confirmed in interviews with ICICI management.

¹³ For this reason, CASHPOR structures its operations by district—four of the six districts, in which CASHPOR currently operates, are financed by ICICI exclusively under the Partnership. ABN AMRO is financing 100 percent of expansion in the Ghazipur district together with a portion of the expansion in Mirzapur district.

- ICICI signs off on all loans¹⁴ and advances the funds to the members of SHG based on the recommendation of CASHPOR. (In actuality, CASHPOR requisitions the funds based on projected requirements, and ICICI disburses funds to CASHPOR, which then disburses them to the clients).
- ICICI ensures that CASHPOR would always have credit limits sufficient to achieve the projected loans outstanding according to its business plan, as approved by ICICI (the initial credit limit was set at Rs. 25 million or approximately \$575,000).
- Loans to members of SHGs are at a rate of interest of 12.5 percent (to ICICI) and with a tenor of 12 months¹⁵.
- CASHPOR collects an up-front fee of 6 percent to cover its costs¹⁶.
- CASHPOR provides a First Loss Deficiency Guarantee up to 12 percent of the proposed limit. In other words, CASHPOR would assume the credit risk or loan losses of up to 12 percent before ICICI would share in the risk.
- This Deficiency Guarantee could be in the form of a fixed deposit or in the form of an overdraft facility (which carries a penalty rate of interest of 19.5 percent as well as a 10 percent up-front commission). CASHPOR opted for the overdraft facility.

First Loss Deficiency Guarantee

- The nature of the Deficiency Guarantee, which specifically defines how risk will be shared among the institutions, has evolved over time. In the original model developed by ICICI, ICICI bore the normal losses (e.g. the first 2 to 3 percent) and the MFI bore all the abnormal losses (e.g. anything above the 2 to 3 percent).
- This model was not implemented in part because ICICI would have had to charge a higher interest rate to absorb the 2 to 3 percent of estimated normal losses, but also because the MFIs wanted to quantify the maximum amount of risk that they would share or absorb. As a result, it was agreed that the MFIs would absorb the first level of risk, and thereafter ICICI would bear the risk. The top performing MFIs bear losses in the range of 8 to 10 percent; all others bear losses in the range of 12 to 18 percent.

MECHANICS OF THE PARTNERSHIP

Risk Management. ICICI selects partner MFIs, such as CASHPOR, that have substantial outreach and high-quality microfinance portfolios. The appraisal and selection process is essentially based on the quality of the portfolio and of the MFI's accounting and information systems, rather than on the financial strength of the MFI itself. In other words, institutions like CASHPOR who have high repayment rates, a low PAR, and a reasonably functional management information system (MIS) reporting capacity are ideal candidates whether or not they are financially viable. ICICI is in effect lending to CASHPOR's customers, and not to CASHPOR itself.

¹⁴ Although it was not confirmed as fact, several sources interviewed noted that agency relationships with respect to loan approval were abolished by law more than 25 years ago, thereby requiring banks to sign off on loans.

¹⁵ ICICI is legally the lender. One hundred percent of interest paid by the clients is to be remitted to ICICI, the lender, not CASHPOR, the service agent. Hence, ICICI dictates the interest rate.

¹⁶ The commissions are meant to cover CASHPOR's or the service agent's costs. Although ICICI does not dictate the rate, it does have its perception with respect to acceptable cost levels given its prior experience with SHG clients in Southern India and it does want to ensure that agents acting on their behalf do not cause them reputational harm. The negotiated fee of 6 percent gives CASHPOR a spread commensurate with its effective spread on its other lending. In other words, the service fee of 6 percent is comparable to the net interest income percentage. The actual percentage is negotiable should the situation change.

ICICI closely monitors the performance of its portfolio and receives standardized monthly reports from the MFIs. If CASHPOR or any other MFI were to collapse, ICICI could potentially have difficulty in recovering 100 percent of the loan balances outstanding. Their monitoring procedures give them early warning of any serious problems. One measure that ICICI uses to mitigate this exposure is to establish the Deficiency Guarantee at levels considerably higher than the institution's historical PAR.

Methodological Adjustments. ICICI came into the partnership with a proven record of working with SHGs in southern India using its Bank Led Model. It already had a defined concept of the SHG lending methodology. However, ICICI quickly realized that it was important to give a great deal of flexibility to its partners and not standardize its approach with respect to methodology. Whereas the operational modalities of the partnership may be defined and a bit more standardized, ICICI felt that, in terms of methodology, it would be best to respect the individuality, maturity, and expertise of the partner MFIs.

Thus, CASHPOR operates with the same methodology in the partnership districts as for its own portfolio. The adjustments that have been made relate to operational aspects that CASHPOR wanted to pilot test for its own reasons (e.g. the district model, no cash policy, and elimination of the collective responsibility fund and five-member subgroups), not because such changes were imposed by ICICI. Other changes, such as the pricing structure had to be made because CASHPOR is now acting as a service agent and not a lender, and is required to pay taxes on all service fees (although not on interest income). Understandably, the loan documentation is different in the partnership districts given that the lender is ICICI and not CASHPOR.

Flow of Funds. Working out the logistics of funds flow took some time to develop and evolve. The original MOU stipulated that ICICI should advance loans to the members of SHG on the recommendation of CASHPOR. In actuality, CASHPOR submits a consolidated requisition of funds to ICICI on an as needed basis. ICICI disburses the amount requisitioned to CASHPOR. CASHPOR, in turn, disburses the loans to the clients via other rural banks that actually have a presence in the districts where CASHPOR operates.

Although ICICI accrues interest on the loan from date of disbursement to CASHPOR, CASHPOR does not accrue interest on the loan to the client until it is actually disbursed to the client. This "pipeline" interest is borne by CASHPOR.

Consolidated repayments are made monthly to ICICI, irrespective of whether the client has repaid the installment on time. The actual amount paid to ICICI by CASHPOR that remains recoverable from ICICI loan clients as of March 2005 was Rs. 554,658 (US\$12,715, or 0.6 percent of the portfolio).¹⁷ Despite the fact that the Deficiency Guarantee is presumably in place to absorb such losses, in practice it is never used to offset such losses.

Documentation. One of the most challenging aspects of working with commercial banks that use traditional approaches to lending is convincing the legal departments to simplify their operations. Traditional collateral does not apply and whereas agreements need to be complex for commercial lending to protect the bank's interests, loan agreements need to be simple when working with low-income and often uneducated or illiterate clients.

In the case of the partnership, ICICI prepared an MOU and other documentation pertaining to the transaction between ICICI and CASHPOR, as is common in commercial lending. ICICI's challenge

¹⁷ Although CASHPOR maintains the amounts recoverable from ICICI clients on its balance sheet, it does not carry any loan loss provisions on its books relating to risks in the partnership portfolio. It also has not recognized any expenses for actual amounts paid or potential loan losses on its income statement.

was working out acceptable loan agreements and documentation procedures with respect to stamp duties for the microenterprise clientele. Not only did the agreements need to be simplified (e.g., reduced from 10 pages to 1) and in Hindi (as opposed to English), but ICICI could not conceivably sign every agreement as in the case of commercial loans.

As a result, the following approach and documentation were developed:

- Three officers of each SHG sign ICICI's one-page loan agreement and each member signs the annexure that details the loan amount attributable to them;
- Each individual member of the SHG signs a one-page declaration regarding the interest rate which includes a single paragraph acknowledging what is paid to ICICI and what is paid to CASHPOR, together with a text box containing 20 signature lines;
- Each individual member of the SHG signs a promissory note to ICICI (a half-page, perforated) and a receipt of the promissory note (the other half of the perforated page); and
- CASHPOR's unit manager and credit officer also sign the receipt of the promissory note.

OUTCOME OF THE PARTNERSHIP

During the first two years of the partnership, CASHPOR and ICICI expanded their microfinance operations into four new districts (Chandauli, Ballia, Buxar, and Mau) in eastern Uttar Pradesh and in western Bihar as well. The amount of money onlent under the partnership grew so rapidly that the allocated on-lending funds of Rs. 25 million (approximately \$575,000) for the first year of operations were exhausted in less than 10 months. Pursuant to its agreement to provide an uninterrupted flow of funds, ICICI then provided additional open-ended credit facilities of Rs. 200 million (US\$4.6 million). ICICI has also reduced the Deficiency Guarantee to 8 percent of the credit limit and reduced the interest rate payable to 8.75 percent (although the customer still pays 12.5 percent, of which 3.75 percent is now payable to CASHPOR to offset the costs of loss provisions, commitment fee, and pipeline interest). ICICI's rate of 8.75 percent is marginally below prevailing market rates.¹⁸

In addition to the open-ended credit facility for on-lending, ICICI approved a loan to CASHPOR in the amount of Rs. 18 million (approximately US\$400,000) to fund a portion of CASHPOR's operating deficits in districts financed by the partnership (Buxar and Ballia). Each of the two tranches has a 60-month loan term with a 42-month grace period—sufficient time for CASHPOR to break-even and to begin to generate the cash flow necessary for repayment. The first facility of Rs. 10 million has an interest rate of 9 percent and the second facility has an interest rate of 9.85 percent.

As of March 31, 2005, the four partnership districts had 23,739 active clients with a total portfolio of Rs. 87.8 million (\$2 million). See Table 4 for details. The growth in clients during the past two years represented 52 percent of CASHPOR's total growth in clients and 46 percent of its growth in total portfolio.¹⁹

¹⁸ ABN AMRO indicates that market rates for similar loans are estimated to be between 9 and 12 percent; ICICI indicates that its SME lending rates are 10 to 11 percent.

¹⁹ This includes both direct lending by CASHPOR and the lending managed on behalf of ICICI.

TABLE 4: PORTFOLIOS OF FOUR NEW PARTNERSHIP DISTRICTS, MARCH 2005

	Chandauli	Ballia	Buxar	Mau	Total
Borrowers	11,641	7,604	3,827	667	23,739
Portfolio (USD)	987,150	635,967	323,400	65,678	2,012,195
Average Loan Outstanding (USD)	85	84	85	98	85

It was expected that the uninterrupted flow of funds offered by the partnership would enable CASHPOR to achieve higher levels of outreach and efficiency than in the conventionally financed districts. Thus far, this has not proven to be the case. As can be seen in Table 5, the outreach of the partnership district of Chandauli is very comparable to the conventionally financed district of Ghazipur, which commenced operations at approximately the same time. Although the partnership district of Chandauli is achieving lower operating cost ratios, this is not necessarily a function of the partnership. Rather, it is more a function of the delivery model that was tested in the partnership districts only.²⁰

TABLE 5: PARTNERSHIP VERSUS CONVENTIONALLY FINANCED DISTRICTS, MARCH 2005

	Chandauli District Partnership	Ghazipur District Conventionally Financed
Borrowers	11,641	11,107
Loans Outstanding	987,150	987,358
PAR	1.2%	0.04%
Operating Cost /Average Portfolio	27%	40%

While the reliable, uninterrupted flow of funds offered by the partnership did not necessarily enable CASHPOR to achieve higher levels of outreach and efficiency at the district level, cash flow management and operational procedures at the Head Office involved in sourcing funds have been greatly simplified.

²⁰ In Chandauli, CASHPOR employs a decentralized district model. It has one district office and no branches. It hires one district manager and four unit managers. Each unit manager supervises up to 20 credit officers who report to the district office one day per week and otherwise work and live in their assigned zone. As of March 2005, Chandauli district had 1 district manager, 4 unit managers, and 76 credit officers). In Ghazipur, CASHPOR employs its traditional branch model; branch offices with branch managers were retained. As of March 2005, Ghazipur had 10 branch managers supervising 75 credit officers.

MEASURES OF SUCCESS

Just as the objectives of each institution are different, so are the measures of success. ICICI essentially came into the partnership with a range of objectives, including the need for additional qualifying assets to meet priority sector lending quota, the desire to improve its overall image, and the desire to be the market leader in all market segments, including microfinance. Aside from defining its broad objectives, ICICI had not developed a business plan nor quantified any measures of success. Notwithstanding, ICICI is very pleased with the performance of the Partnership Model in general and the partnership with CASHPOR, specifically. ICICI identifies the following as successes related to the Partnership Model:

- ICICI's microfinance portfolio is of high quality and is yielding good returns;
- The aggregate volume of its microfinance portfolio totaled more than US\$90 million as of March 2005, thereby establishing ICICI as one of the market leaders;
- The microfinance portfolio contributes to ICICI's priority sector lending quotas although it represents a small percentage of ICICI's total portfolio and does not come close to meeting the requirement that 40 percent of its net credits be made to the sector;
- Both the volume and quality of lending through CASHPOR fully meets expectations (as per the CASHPOR's business plan approved by ICICI); and
- The lending through CASHPOR is establishing ICICI's name and image in eastern Uttar Pradesh and western Bihar, regions and districts where ICICI's presence is very limited.

CASHPOR came into the partnership with the main objective of securing an uninterrupted flow of funds. CASHPOR recognized that mutual trust would clearly be a condition precedent for this to occur. In the opinion of CASHPOR, it has been able to develop a business relationship based on trust and ICICI has fully delivered on all of its commitments to the partnership. Hence, the partnership has been highly successful.

In the first year, CASHPOR on-lent its funds more quickly than expected and although this caught ICICI unaware, ICICI quickly approved additional credit in honor of its commitment. ICICI's ongoing commitment in this regard has enabled CASHPOR to effectively manage its cash flow and focus on expanding its outreach as fast as institutionally possible without worry of funding.

ICICI has also proven to be quite flexible and open to ongoing negotiation and resolution of problems—hallmarks of a good partner. For example, with time ICICI began to launch similar partnerships with other comparatively large MFIs, that were not only more financially sound than CASHPOR, but also were more aggressive in the negotiation of terms. Despite CASHPOR's comparatively weaker position, given the size of its operations, ICICI passed on the more favorable terms that the other partners have demanded to CASHPOR. Moreover, when CASHPOR needed funding to cover its deficits in new districts, ICICI agreed to lend it the funds.

LESSONS LEARNED AND RECOMMENDATIONS

The partnership between ICICI and CASHPOR has been successful in part because the institutions have been able to navigate successfully the common pitfalls for partnerships (see text box). Although ICICI developed the concept and launched the model without a business plan, the expectations for the specific partnership between ICICI and CASHPOR were established in CASHPOR's business plan.

Aside from the roles and responsibilities of each partner that were defined in the MOU, the more critical elements to its success were the:

- Commitment of senior management of both institutions;
- Communication between the two institutions that allowed mutual trust to develop; and
- Flexibility within both institutions that allowed the partnership to adapt to changing circumstances.

Common Pitfalls for Partnerships

- Wrong partner
- Over-optimism
- Lukewarm commitment
- Poor communications
- Undefined roles
- Unclear value creation
- Vague agreement
- Little relationship building
- Weak business plan

Data Quest and Booz Allen & Hamilton

Senior managers of both partners have been committed to championing the linkage, advocating for the changes required to improve the partnership, and ensuring that appropriate resources are dedicated to it. Both parties have been able to count on each other to honor their commitments and make every effort to deliver what was promised. For example, CASHPOR prioritized staffing of the Chandauli district over the Ghazipur district to ensure that it met its targets—even exceeded them—thereby requiring ICICI to honor its commitment of providing an uninterrupted flow of funds. Since that time, CASHPOR has consistently delivered a high-quality portfolio with good returns to ICICI, and ICICI has continued to meet CASHPOR's needs for funding. As situations arise, both institutions deal with each other in good faith, fostering improved commitment and trust between the parties. In short, the partnership has created a win-win situation.

Despite the success of the partnership, the following key issues should be resolved to make the partnership not only more successful for both institutions, but also more replicable in India and on an international level.

Exit Strategy. Whereas the current MOU does not specify a specific term of the agreement, the tenor of the advances as per Annexure IV, Terms & Conditions, shall not exceed 24 months (individual loans would be for a tenor of 12 months; the final disbursement of loans would be done within 12 months). The agreement is renewable, but its “short-term” structure creates some uncertainty on the part of CASHPOR.

The partnership has become increasingly important for CASHPOR's operations, and in a very real sense, they are becoming dependent on ICICI. A change in management or strategic direction of ICICI that would cause the bank to retract from the microfinance market could seriously jeopardize CASHPOR's operations as it is highly unlikely that CASHPOR would be able to replace the ICICI funds with conventional debt quickly. As a result, CASHPOR is actively trying to identify other potential financial partners to reduce this dependence.

Capital Adequacy. The growth of CASHPOR's portfolio is off balance sheet; thus, CASHPOR, in theory, does not have to be overly concerned about its leverage ratio. Regardless, its capital adequacy remains a serious issue. In growing the balance sheet of another institution, CASHPOR generates operating deficits for a period of three to four years, which erodes its capital base. Once CASHPOR breaks even, it still takes an additional two to three years to restore its capital base to its original level. While ICICI receives good returns at the outset, CASHPOR does not begin to earn real returns for approximately six to seven years.

In the interim, its capital adequacy is adversely affected in two fundamental ways.

- CASHPOR's limited capital is eroded to build an off balance sheet portfolio for another institution; and
- The reduction in capital is funded with a commercial rate loan (e.g. the Rs. 18,000,000 loan provided by ICICI to CASHPOR to cover operating deficits). This increased indebtedness in relation to the reduced equity actually increases CASHPOR's leverage for an off balance sheet activity.

Reducing operating deficits and shortening the period of time it takes to break-even will be a key challenge going forward. To do so, CASHPOR may need to charge higher rates of interest. Its net financial spread available to cover operating costs and generate a reasonable return on capital is approximately 16 percent. Such spread may be sufficient to cover the costs in the Mirzapur district, but it takes several years to achieve such scale in each new district. The average large-scale non-financial institutions in Asia have operating cost ratios (in relation to their average portfolio) of 15 percent;²¹ for medium-sized non-financial institutions in Asia, the average ratio is 22 percent.

Alternatively, CASHPOR needs to source additional equity or quasi-equity to fund such deficits rather than finance such deficits at commercial rates. Attracting outside capital from private sources generally requires more attractive returns than what CASHPOR can offer. Identifying additional donor sources, though increasingly limited, may be its best option now.

Equitable Alignment of Costs and Benefits. CASHPOR has been willing to accept its weak equity position even though it jeopardizes the financial capacity of its organization not only because it perceived itself to be in a comparatively weaker bargaining position, and because its paramount concern is to serve one million poor women. In a sense, CASHPOR is working for the primary benefit of ICICI and their clients, with virtually no benefit accruing to CASHPOR for six to seven years—assuming CASHPOR is able to source the equity capital that it needs to survive that long.

ICICI, on the other hand, has been able to obtain qualifying assets toward meeting its priority sector lending quota that are of high quality and are yielding returns of at least 8.75 percent (less ICICI's operational costs) compared to the alternative of placing deposits with NABARD at penalty rates of interest as low as 3 percent (the bank rate is currently at 6 percent less a penalty of 3 percent). ICICI also has been able to gain new bank customers who will remain loyal to the bank that first served them, and it has established ICICI's name and image in eastern Uttar Pradesh and western Bihar, regions and districts where ICICI's presence is very limited.

Going forward, there should be a more equitable alignment of costs and benefits associated with serving the microenterprise market segment. In other words, CASHPOR should negotiate with ICICI, the institution with total assets of approximately US\$38 billion and financial capacity that dwarfs

²¹ CASHPOR's number of clients as of March, 2005 was less than 25 percent of the average number of clients of the large-scale non-bank financial institutions in Asia reporting to the MBB in 2003.

their capacity, to share the up-front costs more equitably. If the spread of 8.75 percent is not reduced, at a minimum, the operating deficit loans of Rs. 18 million (approximately US\$400,000) should not be financed at commercial rates. Otherwise not only does CASHPOR risks not surviving the six to seven years to reap any of rewards, but ICICI runs the risk that the loans advanced to fund such deficits may never be repaid.

New Product Development. Another challenge for the future of the partnership relates to product development. Under Central Bank regulations, banks cannot offer safe and accessible savings facilities using NBFC agents (MFIs). ICICI is licensed to offer savings account services, but its small branch network does not provide nationwide access to savings for microfinance customers. Even if it were possible legally, CASHPOR is not eager to be a savings agent for the bank because of problems associated with cash handling and fraud. CASHPOR instituted a “no cash” policy last year that stipulates that credit officers cannot handle cash. In so doing, CASHPOR has transferred the burden of cash handling to the SHG, which must physically make the payment in the SHG’s bank branch office (or in rare cases, at CASHPOR’s district office).²² Given CASHPOR’s lean administrative staffing model at the district-level, it is not equipped to receive deposits from many clients, nor is the district office conveniently located to many of its clients. The only physical way to take on savings in a meaningful way would be via the credit officers, and that would introduce an entirely different level of internal controls, systems, and procedures that CASHPOR does not currently have.

Institutional Capacity Development. Other key challenges faced by the partnership relate more to CASHPOR’s operational issues involved in realizing its mission and not to the partnership. Institutional capacity and staff development are always a challenge for a rapidly growing institution such as CASHPOR, no matter the structure of financing. CASHPOR has a well-defined policy and approach with respect to human resource development, such as structured classroom and on-the-job training, and management capacity building, such as providing concrete, measurable targets and incentive plans. CASHPOR can now train approximately 90 staff at a time; it is trying to expand that capacity to 200 so that it can continue its expansion in accordance with its business plan.

More importantly, CASHPOR faces operational issues with the rural banks operating in the districts where its clientele reside. Whereas ICICI has a progressive approach toward serving the microenterprise market, it has practically no branches in the districts where CASHPOR operates. Thus, CASHPOR is forced to deal with banks operating in these areas that do not share ICICI’s vision or its interest in serving such clientele. Such branches frequently impose many obstacles on the clients, including:

- Delaying transfers from the Varanasi branch (where CASHPOR’s Head Office is located) to the local district branch where the SHG is located) for up to two weeks;
- Restricting the number of CASHPOR clients it will serve in any given day, thereby further delaying disbursement and complicating loan repayment; and
- Providing poor service to the clients.

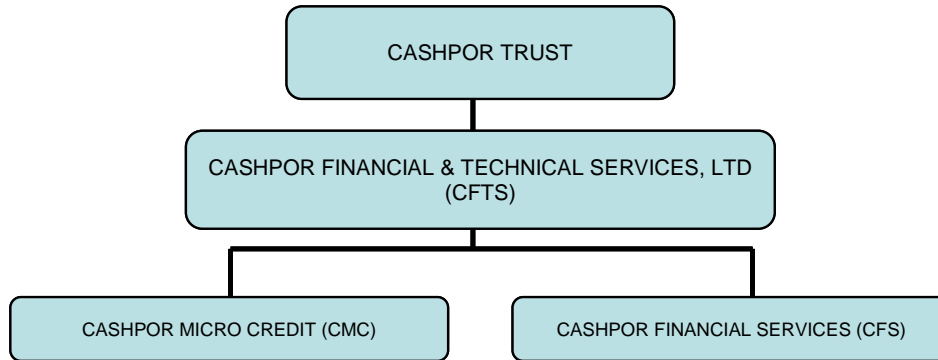
Regardless of its longevity, the partnership between CAHSPOR and ICICI presents an innovative financing model for others to consider. Not only are the two partners happy with the arrangement, but also the Partnership Model is now being replicated throughout India with ICICI and other commercial banks. As global microfinance markets deepen and grow more competitive throughout the world, the incentive to form these types of partnerships will undoubtedly increase.

²² In most cases, such bank branches are not ICICI’s as they have very little presence in the areas where CASHPOR operates.

ANNEX 1: ORGANIZATIONAL STRUCTURE

CASHPOR Trust, a public charitable trust registered with the Registry of Trusts in New Dehli, is the owner of CASHPOR Financial and Technical Services Ltd. (CFTS). CFTS started its Grameen replication program in September 1997 in the Mirzapur District of Uttar Pradesh in northern India. In December 2003, CFTS converted to a holding company that owns two institutions, CASHPOR Micro Credit (CMC) a Section 25 company²³, and CASHPOR Financial Services (CFS), an NBFC. The group of companies is collectively referred to hereunder as CASHPOR.

FIGURE 1.1: CASHPOR ORGANIZATIONAL CHART



CFS's licensing application is still pending, so it is not yet operational. Once CFS becomes operational, CFS will undertake all of CASHPOR's direct lending operations. CMC will undertake only the service company activities performed on behalf of partnership partners such as ICICI. However, in the interim, CMC has to perform all the lending activities, because CFTS received notice from the Central Bank that its microfinance business was an NBFC activity for which CFTS did not have a license. CFTS had no choice but to sell its microfinance business to CMC.

²³ Section 25 companies may make individual loans that do not exceed Rs. 50,000 (US\$1,150), but they cannot intermediate savings. Though they are permitted to earn a profit, they are not permitted to distribute earnings.

ANNEX 2: COMMERCIAL DEBT SCHEDULE

TABLE 2.1: COMMERCIAL DEBT SCHEDULE

Name of Bank/ Institution	March 2004 Rupees	March 2005 Rupees	Interest Rates
CFTS			
Secured Loans			
SIDBI	32,077,600	9,000,000	1–11% ¹
NABARD	7,500,000	0	9%
ICICI Bank	7,200,000	0	14%
UTI Bank	18,750,000	0	13%
HDFC Bank	3,666,667	0	13%
Bank Overdrafts	346,243	0	
Unsecured Loans			
Grameen Trust, Bangladesh	14,227,133	14,227,133	0–2%
Grameen Foundation, USA	12,927,250	12,927,250	0–2%
Calvert Foundation	2,233,500	2,186,000	3%
Citibank, India	10,561,625	4,400,677	8%
Total CFTS	109,490,018	42,741,060	
CMC			
Secured Loans			
Friends of Women World Banking	50,000,000	62,142,856	13.5–14.5%
ABN AMRO	24,430,000	86,970,000	9.5–12.25%
HDFC Bank	0	17,500,000	13%
SIDBI	0	45,000,000	9%
Bank Overdrafts	19,881,958	18,383,074	6%
Unsecured Loans			
ICICI	0	18,000,000 ²	9–9.85%
Total CMC	94,311,958	247,995,930	
Consolidated Total CMC and CFTS	203,801,976 (US\$4,695,898)	290,736,990 (US\$6,665,222)	

¹ Commercial rate financing at 11% were paid off in FY2005. The transformation loan used to finance operating deficits at a rate of interest of 1% remains outstanding.

² Loan used to finance operating deficits in partnership districts. Does not include Rs. 87.8 million of managed loans for ICICI, which bear interest at 8.75%.

ANNEX 3: INTERVIEWS CONDUCTED

CASHPOR

Sanjoy Desgupta
Chairman, CASHPOR Trust
Director, CASHPOR

Prof. David S. Gibbons
Chairman, CMC

J.S. Tomar
Managing Director, CASHPOR

Anup Kumar Singh
General Manager, Mirzapur District

Rakesh Kumar Dubey
Deputy General Manager for Business Planning, Fund Mobilization and MIS

Trilok Nath Shukla
General Manager, Administration

Ms. Vandana
Finance & Accounting

Mr. Nirmal
MIS

Uma Shankar, together with other credit officers and client centers
Chandauli District

Vinay Pratap, together with other credit officers and client centers
Mirzapur District

ICICI BANK

M.N. Gopinath
Senior General Manager, Head – Retail Infrastructure & Facility Management Groups

Vikas Chandra Jha
Manager, Rural Micro Banking and Agri Business Group

ABN AMRO BANK

Moumita Sen Sarma
Vice President, Head – Microfinance, India

B. Srinivas
Manager, Micro Finance

Maneesha Chadha
Manager, Micro Finance

SIDBI

Rajendra Agrawal
Assistant General Manager

BIRLA SUN LIFE INSURANCE

Bipul Chatterjee
Senior Manager, Rural Business

OTHER

Brij Mohan
Development Consultant and Advisor, SMFC, SIDBI