PEARLS
SAHULAT SECTOR REPORT

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Based on Audited Financial Statements of - 2017-18

Department of Research & Training
Sahulat Microfinance Society

Abbreviation & Definition

1	IFCCS	Interest free Cooperative Credit Societies
2	OVERALL MEDIAN	Over all median has been arrived by arranging numbers (grading marks) of all nine IFCCS in ascending order (smallest to highest number) and middle number (marks) has been taken as overall median of the sector.
3	PEARLS	Protection, Effective Financial Structure, Asset Quality, Rate of Return & Costs, Liquidity, Signs of Growth
4	RBI	Reserve Bank of India
5	WOCCU	World Council of Credit Unions

Preface

Sahulat Microfinance Society, New Delhi is a registered society under Societies Registration Act, 1860. The Society was established in 2010 to promote interest free microfinance cooperative institutions in self-sustaining mode and to serve the people belonging to disadvantaged sections of society, meaning thereby whose daily or weekly earnings enable them to operate thrift deposit accounts and who need microfinance to enhance their earnings. On the initiative of the Society, some existing interest free cooperative credit societies were affiliated and some new cooperative credit societies were created under the state cooperative society acts (both old and new liberal acts) or the Multi-State Cooperative Society Act 2002.

As on date, altogether 26 registered interest free cooperatives with 63 branches operating in different parts of the country are affiliated to Sahulat. Out of these 26 cooperatives, only nine have been selected for assessment under PEARLS indicators because at least three years' data from Balance Sheet are required for comparative assessment. Some of our affiliated cooperatives are either in existence for less than 3 years or their 3 years Balance Sheets are not available with us.

This is the first ratio analysis report based on the FY 2017-18 Audited Financial Statements of interest free cooperative credit societies working in different parts of India. PEARLS indicators are tools designed for objective monitoring of financial performance and management guidance for credit institutions. These indicators take into account only the audited statements of accounts data for generating different ratios under the heads of (1) **P**rotection, (2) **E**ffective Financial Structure, (3) **A**sset Quality, (4) **R**ates of Return & Costs, (5) **L**iquidity, and (6) **S**igns of Growth.

One indicator of RBI has also been included in the report to know the microfinance status of our affiliates by determining the average loan size. Qualitative Shariah Compliance Performance has been assessed on four different indicators. In total 17 indicators have been assessed in the above mentioned three categories. A grading system has been devised by Sahulat and marks have been allocated to each 17 indicators considering the significance it has in the profitability and sustainability of the financial institutions. Accordingly IFCCS have scored marks on each ratio and the IFCCS status has been comparatively studied based on overall median marks achieved by the sector.

We express our sincere gratitude to our affiliates who have been very participative in the development of this report by providing their audited reports and related information and also taking their precious time to verify and correct the data gathered from the annual report for ratio analysis.

We are thankful to C.A. S. S. Quadri for his expert input on ratio analysis and feedback on the report. We highly appreciate the contribution of Research and Training Department led by Mr. Fasih Ahmad who undertook data collection, compilation, analysis and report writing activities and he was actively assisted by Mr. Anas Ahmad.

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PEARLS Standards

PEARLS are financial ratios or indicators that can be used to evaluate health of a cooperative credit institution. The list of selective indicators and their significance are given ahead.

There are 13 key indicators under the six broader heads of PEARLS out of which, we have selected 7 key indicators. Additionally, we have selected 3 non-key PEARLS indicators. Some of the selected indicators were tweaked, and some new indicators were derived that can become key indicators for interest-free operations; hence, in total with 2 new key indicators and 1 microfinance indicator we analyze 13 indicators in this report. The selection and tweaking of indicators were made mainly due to two reasons: (1) Some of the indicators are not relevant to interest free credit institutions if taken as-is, and (2) our affiliates presently do not maintain some of the accounting data required for deriving some key ratios of PEARLS, e.g. loan delinquency. Selected PEARLS and derived indicators of this report present a comprehensive objective status of our affiliates, which would help in better understanding of the status of the IFCCS sector, still in a nascent stage in India.

While ratios provide an objective appraisal, they are not a guarantee of financial stability. Key reasons why this might be the case include, firstly, that there may be practices in a cooperative credit institution that hide important financial weaknesses. For example, there may be understating of weak loans by continuous rescheduling and making them look like they are performing better than they actually are; and secondly, that even strongly performing entity with good financial ratios can be subjected to shocks such as a sudden collapse in the value of the investments, buildings, high inflationary trend, an economic crisis or fraud. Thus, while ratios can provide a good indication of the financial health of a cooperative credit society, it is important not to rely exclusively on ratio analysis. Some other aspects of assessment include on-site examination covering the key elements of loan book appraisal, internal controls and governance.

List of Selected PEARLS &RBI Indicators

S. No.	Indicators	Ratio	Formula	Goal
	P: PROTECTION			
1	Protection level of Members' Savings	**P6A**	[(Total Assets+Allowance for Risk Assets) - (Delinquent loan>12m+0.35 (Assumed) x Delinquent loan 1-12 m (Assumed)+Other Liabilities)+ Problem Assets to be Liquidated)] / (Total Deposits) in%	Min 125 %
	E: EFFECTIVE FINANCIAL STRUCTURE			
2	Ratio of Loan Portfolio in Total Assets	**E1**	(Total Gross Loans Outstanding-Total Allowance for loan losses)/Total Assets in%	70-75%
3	Ratio of Savings Deposit against Total Assets.	**E5**	Total Saving Deposits/Total Assets in%	75-85%
4	Ratio of Total Members Shares against Total Asset	**E7**	Total Share Capital/Total Assets in%	Max. 15%
5	Ratio of Institutional Capital against Total Assets	**E8**	Total Institutional Capital/Total Assets in%	5% Min
	A: ASSET QUALITY			
6	Percentage of Non-earning Assets excluding cash and Bank	**A2B**	(Asset in Liquidation + Non-Earning Fixed Asset + Prepaid Expenses + Account Receivables +Refundable Advances) / Total Assets in%	<=5%
7	Net Zero Cost Fund against Non-Earning Asset	**A3**	(Net Institutional Capital +Transitory Capital) / (Non-Earning Asset - Cash & Bank)	<=5%
	R: RATE OF RETURN & COSTS			
8	Demand loan Income against Demand loan expense	**RS1**	(Cost Recovery on Demand Loan) / (C Y Demand Loan Expenditure +P Y Demand Loan Expenditure/2)	100%

9	Business Loan Income against Operating Expense	**RS2**	(Income on Business Loan) / (C Y Business Loan Expenditure + P Y Business Loan Expenditure / 2)	130%
10	Operating Cost Ratio against Average Total Loan Asset	**R9**	(Total Operating Expenses - Provisions for loan losses) / [(Total Loan Assets of current year-end + Total Loan Assets of last year-end)/2]	<=10%
L: LIQUIDITY				
11	Adequacy of Liquid Cash Reserves	**L1**	Total Earning Liquid Investments + Total Non - Earning Liquid Assets - Short - term Payables / Savings Deposits in%	Min 22%
S: SIGNS OF GROWTH				
12	Growth rate in Total Asset	**S11**	(Total Asset at current year-end / Total Asset at last year-end) - 1 in%	>Inflation + 10% (16%)
MICROFINANCE				
13	Average Loan Size	**ALS**	Total Loan Disbursed during the year / No of Borrowers	MF lending

Due to interest free nature of IFCCS, many ratios were not applicable and some ratios have been either tweaked in their formula or in goal and some have been derived by Sahulat to assess the interest free aspect of IFCCS. Below are the details of the kind of changes made in the respective ratios.

PEARLS Ratios: R9, S11 ratio has been used without any modification in the formula and goal;

PEARLS Tweaked Ratios: P6A, E1, E5, E7, E8, A2B, A3 and L1 ratios have been either tweaked in their formula or goal has been revised to compliment IFCCS unique requirements;

Sahulat derived PEARLS Ratios: RS1 and RS2 ratios have been derived to measure the rate of return from interest free perspective and accordingly goals have been fixed.

Grading Parameter for Sahulat Affiliates

Motivation plays a vital role in the growth and development of any individual or organizations life. It encourages and provides needed energy and will power to work hard and move towards achieving the desired goal. It is in this spirit that Sahulat, as a facilitating and promoting organization, has decided to motivate and encourage its affiliate to move forward in achieving its mission by adhering to financial efficiency, financial prudence, financial inclusion and Shariah parameters. With the above objective of identifying and rewarding efficient and prudent Sahulat affiliate, a grading system has been devised in which financial performance, microfinance and Shariah parameters have been assigned 1000 marks. Each parameter has been assigned marks based on its importance of sustainability and relevance to the IFCCS. The marks assigned to the three major heads have been further divided based on the critical ratios and its relevance in the functioning of the society.

List of Selected PEARLS & RBI Indicators

Indicator	Marks Allotted to Ratios	% of Marks Allotted to Ratios	Total Marks allotted to Sub-sector	% of Marks Allotted to Sub-Sector	Total Marks	% of Total Marks
Financial Performance			750	100%	750	75%
Protection **(P)**			125	**17%**		
Effective Financial Structure **(E)**			210	**28%**		
E1	58	27.62%				
E5	58	27.62%				
E7	50	23.81%				
E8	44	20.95%				
Asset Quality **(A)**			80	**11%**		
A2B	55	68.75%				
A3	25	31.25%				
Rate of Return **(R)**			210	**28%**		
RS1	65	30.95%				
RS2	100	47.62%				
R9	45	21.43%				
Liquidity **(L)**			125	**17%**		
Microfinance					100	10%
Shariah Compliance					150	15%
Total Marks					**1000**	**100%**

Financial stability of an organization is the paramount milestone to achieve the organizational objectives. An organization that is not financially sustainable and prudent cannot aspire to achieve its micro financing and Shariah compliance objectives. Hence, in the total of 1000 marks, 750 marks (75% of total grading marks) have been allocated to financial performance. The 750 marks have been further divided into 12 important indicators. Microfinance has been allocated 100 marks (10% of total marks). Shariah Compliance has been allocated 150 marks, which is 15% of total grading marks.

Rationale of distribution of marks on Grading Parameter

There are five rationales on which marks have been allocated on the grading parameter as follows;

1. Grading marks have been allocated in full if an IFCCS has achieved the prescribed goal.
2. If the IFCCS has achieved less than the prescribed goal and it does not have any serious implication on the indicator, meaning does not threaten or risk the existence of IFCCS; in such cases, grades have been reduced in arithmetic proportion in order of the distance from the goal.
3. If the IFCCS has achieved less than or more than the prescribed goal and it has the serious implication on the indicator, affecting the existence and sustainability of the IFCCS; in such cases grades have been reduced in a non-linear proportion.
4. Marks for some indicators have been deducted both in arithmetic and in non-linear progression depending on the implication of the increase or decrease of ratios on overall financial structure of the organization.
5. IFCCS is disqualified from the evaluation process if it is found to be recovering more than the actual cost in 'service charge' based loan portfolio and profiteering in business loan including lower solvency level, which can seriously dent the capacity of IFCCS to repay its liabilities.

Financial performance 750 marks (75% of total marks 1000)

Protection (P): indicator has been assigned 125 marks out of 750 marks. It is very important for a financial institution to be able to repay deposit of its members and cover liquidation cost in the unlikely event of its closure. Hence, 17% marks has been assigned to this indicator out of 750 marks.

Effective Financial Structure (E): has been assigned 210 marks out of 750 marks, which accounts to 28% marks assigned to financial performance. An effective financial or balance sheet structure of an IFCCS leads to efficiency, profitability and improves the quality of asset. The PEARLS system measures assets, liabilities and capital, and recommends an "ideal" structure for a credit cooperative.

Asset Quality (A): Quality of asset indicates that a financial institution has how effectively deployed its fund in earning asset and how much of its fund is non-earning assets. Therefore, this ratio has been assigned 80 marks out of total marks of 750 which are 11% of the total marks.

Rate of Return & Costs (R): Rate of return evaluates income generated by an IFCCS and expenses incurred on their operation, which in effect helps the organization to achieve its profitability and sustainability. This is a very important indicator and accordingly it has been assigned 210 marks, which is 28% of total marks.

Liquidity (L): Liquidity plays a key role in day-to-day operations for a financial institution and adequate liquidity is paramount for its smooth functioning. Accordingly, this ratio has been assigned 125 marks (17% of total marks of 750).

Sing on Growth (S): Sign of growth has not been allocated any marks in this grading parameter.

Microfinance Indicator 100 marks (10% of total Marks - 1000)

A financial organization, which aspires to provide micro financing products to the underprivileged masses, has to ensure that it is really serving the micro needs of deprived section of society. As per RBI notification, an organization functioning in microfinance activities can lend a borrower with a rural household annual income not exceeding ₹1,00,000 and annual income not exceeding ₹1,60,000 with an urban and semi-urban household. A loan of ₹60,000 can be disbursed in the first cycle and of ₹1,00,000 in the subsequent cycles; however, in no case total indebtedness of the borrower should exceed more than ₹1,00,000. Education and medical expenses will be excluded while arriving at the total indebtedness of a borrower. Sahulat has benchmarked the RBI goal as micro loaning and affiliates offering loans under this benchmark will be given 100 marks for their commitment to microfinance goal.

Shariah Compliance Indicator 150 marks (15% of total Marks - 1000)

Interest free Cooperative Credit Societies (IFCCS) have been primarily established with the objective of providing interest free micro financing products and services hence, it must strive to make its products and services in compliance with Shariah norms and guidelines so that objective of members of availing interest free financial services are maintained. It is generally perceived that the besides pricing, interest free component could also be the driver for most members to associate with these organizations. Therefore, it is even important for these IFCCS to maintain a high degree of Shariah compliance. To assert above stated importance, 150 marks i.e. 15% total marks of grading parameter have been assigned to Shariah compliance head.

Qualitative marking under Shariah compliance has been distributed according to the stages of the Shariah compliance of a particular cooperative (please see table ahead).

Sector's Overall Marks (indicator wise)

FY 2017-18

S No	Ratio		Goal	Max. Grading Marks	Overall Median Grade
1	**P6A**		Min 125%	125	**125**
2	**E1**		70-75%	58	**44**
3	**E5**		75-85%	58	**51**
4	**E7**		Max. 15%	50	**31**
5	**E8**		5% Min	44	**11**
6	**A2B**		<=5%	55	**55**
7	**A3**		>=100%	25	**6**
8	**RS1**		100%	65	**8**
9	**RS2**		130%	100	**38**
10	**R9**		<=10%	45	**17**
11	**L1**		Min 22%	125	**94**
12	**ALS**		MF lending	100	**100**
13	**Intent to be compliant**			30	**45**
14	**Initial Shariah Audit done**	14(a) Demand Loan		30	
		14(b) Business Loan		30	
15	**Implementation**			30	
16	**Implementation Complete**			30	

Constraints

The first constraint faced by the Research and Training Department of Sahulat was that it could select only those vital indicators from PEARLS for which our interest free cooperative credit societies maintain the relevant data. For example, lack of required data for three key indicators (P1, P2, & A1) out of 13 key PEARLS indicators. These left out indicators are related to maintenance of Loan Delinquency>12 months & Delinquency<12 months & >30 days for which provisions should be made in our credit societies for protection of Liabilities.

Another constraint in the assessment is related to lack of uniform system of accounting and reporting and translation of statutory audit report of societies of Maharashtra. However, we have tried to derive authentic data from the audited reports of respective IFCCS.

The third constraint is related to short age group of our 17 affiliates and non-availability of required three years' audit reports. IFCCS with only two years of existence have not been included in comparative trend assessment. It is to be noted that at least three years' accounting data is required for comparative assessment on PEARLS indicators.

Sector Report
FY 2017-18

Strong Areas of the Sector

Growth Story of the Sector:

It is satisfying to note that sector has grown more than four times of WOCCU prescribed goal i.e. greater than the inflation rate + 10%. The average growth (in total asset) of the sector is 44%, which, if adjusted with annual inflation rate of 6%, is 38%. One IFCCS is pulling back the sector average with its soft growth.

Solvency:

The positive aspect of the sector is also reflected from its solvency (Protection) position. The median of marks for solvency (Protection) is 100 for the sector, which is right on the target. However, one IFCCS is marginally away from the goal.

(Solvency/Protection is a position of an IFCCS at a given date with the objective that in the event the organization needs to shut down its operation, then the total assets should cover the total deposit including liquidation expenses. It is important to note that despite having impressive solvency level Sahulat affiliates do not maintain correct asset quality.)

Non-Earning Assets:

Non-Earning Asset is on the target; however, one IFCCS is the outlier as reported ahead in deposit mobilization indicator, and another has acquired fixed assets in the current year resulting in breaching the goal of non-earning assets.

ALS (Average Loan Size):

The average loan size of the sector is exceedingly well and within the RBI microfinance guidelines. The ALS is on target as overall median mark of the sector is 100 marks. All IFCCS in the sector have scored full marks on grading parameters.

Concern Areas of the Sector

The concern areas of the sector have been divided into three zones according to its nature of gravity.

(Gray Zone)	(Yellow Zone)	(Red Zone)
Areas which are of concern and can be addressed with strategic interventions	Areas which are of concern and can be addressed with strategic intervention and regular/quarterly follow up	Areas which are of quite serious concern and should be addressed with immediate strategic interventions and aggressive implementation and regular/monthly monitoring.

(Gray Zone)

1. Deposit Mobilization:

On the deposit mobilization front, the sector is behind the goal of 58 marks as the overall median marks of all 9 affiliates for this indicator is 44. Median has been able to achieve only 80% of the goal. Four IFCCS have scored full marks whereas three IFCCS are marginally away from the goal and remaining two are outliers. One outlier IFCCS has huge fixed asset, which makes its ratio of deposit in total asset quite skewed.

2. Loan Portfolio

Loan portfolio in total asset of the sector is also behind the target as the median marks are 44 out of 58 marks. Sector has achieved only 76% median of the goal marks as two IFCCS are outliers in this indicator. One outliers IFCCS has over deployed the fund whereas the other has under-deployed the fund affecting the entire sector adversely.

3. Liquidity

Liquidity management of the sector is also behind the target as the median marks are 94 out of 125 marks. Sector has achieved only 75% median marks of the total marks as three IFCCS are outliers in this indicator. The three outliers IFCCS have scored only 50 marks as they have more than double the required liquidity ratio consequently affecting the entire sector adversely. In this indicator none of the IFCCS have achieved the prescribed goal marks of liquidity.

4. Share Capital:

Share capital in total asset of the sector is behind the target as the median marks are 31 out of 50 marks. Sector has achieved only 62% median of the goal marks as three IFCCS are outliers in this indicator. One outlier IFCCS has scored less than half of the target and another two have scored only minimum marks due to negligible percentage of share capital in total assets.

5. Income from Business Loan:

Income from Business Loan of the sector is way behind the target as the median marks is only 38 out of 100 marks (38%). Out of 6 IFCCS* only one IFCCS has been able to score significant marks whereas remaining five IFCCS have scored less than 50 marks and as a result, the median has got skewed due to these four IFCCS.

Income from business loans are legitimate source of income (Profit) for IFCCS to build its institutional capital and help in grow its operations. * Only 6 IFCCS have business loan products.

6. Qualitative analysis of Shariah Parameters

Shariah parameter of the sector is behind the target as the median marks are 45 out of 150 marks. The sector has achieved 30% median marks of the total marks. The two basic parameters, first intent to be compliant and second service charge collection lower than the actual cost; have been achieved by all IFCCS making the sector as a whole Shariah complaint. However, on remaining parameters, except for one IFCCS others have not been able to work; hence, these indicators seem skewed. The sector needs to devise the plan to implement scientific costing method and also correct some issues in business loans (due to poor understanding) at the earliest to make this indicator healthy.

7. Net Zero Cost Fund:

Net zero cost funds (Institutional Capital + Transitory Capital) should be more or equal to Non-earning asset. Net zero cost fund ratio is quite below the target as the median marks is only 6 out of 25. Median has been able to achieve only 24% of the goal. Two IFCCS have scored full marks and one has scored 22 marks whereas remaining 6 IFCCS are outliers, as four have scored minimum marks only i.e. 3 and two have scored 6 and 13 marks respectively.

(Yellow Zone)

1. Institutional Capital

Institutional Capital of the sector is way behind the target as the median marks is 11 marks out of 44 total marks. Sector has achieved only 25% median of the total marks. Except for three IFCCS, remaining six IFCCS have either scored only minimum marks or slightly more than the minimum marks. The six outlier IFCCS have either zero or negligible institutional capital. This suggests that majority of IFCCS have not been able to make profit from their operations. One IFCCS has made good amount of provisions for loan losses and consequently has not been able to build its institutional capital.

(Red Zone)

1. Operational Cost

Operational Cost is the most serious concern area of the sector as almost the entire sector has incurred huge operational cost on operations. The median mark of this indicator is 17 marks out of 45 total marks. The sector has achieved merely 38% median of the total marks except three IFCCS, which have scored full marks and remaining six have incurred more than double the goal adversely affecting the sector.

2. Cost Recovery from Demand Loan

Cost recovery from Demand loan is the second most serious concern area for the sector as the entire sector has not been able to recover the cost on demand loan from the borrowers. The median mark of this indicator is only 8 marks out of 65 marks. Sector has achieved only 12.3% median of the total marks. Only two IFCCS have recovered more than 80% of the cost and other three more than 60% marks. Remaining four IFCCS have recovered less than 40% cost incurred on the demand loan.

All IFCCS under study must improve this ratio at the earliest by recovering actual cost through instituting scientific costing method. Actual cost should be within the prescribed limit of <= 10% of loan portfolio.

3. Asset Classification (Loan Delinquency)

Balance sheet and other reports do not provide the data on the level of delinquency of loans. Only two IFCCS have provided allowances for loan losses, and that too negligible in comparison to their gross loan portfolios. Non-recognition of bad loans is a big risk for the financial institution as the management would not be able to take timely and appropriate measures to address the bad assets. This may lead to large-scale default of the loan portfolio even leading to collapse of the organization.

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