INDIAN MICROFINANCE: Swimming Fully Clothed!

Eric Savage, Abhijit Ray & Abhishek Fogla

Along with the growth of social enterprises, India has seen its microfinance industry flourish. No longer merely dependent on donor and aid money, poor borrowers have begun demonstrating their creditworthiness, attracting commercial funders encouraged by this sea-change. The authors explore the world of Indian microfinance and the benefits of swimming fully clothed.

About the Authors

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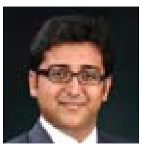

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The phenomenal success of microfinance has been strongly facilitated by the Indian Government, including the Reserve Bank of India (RBI), which furthered financial inclusion and nurtured MFIs over the years. The foremost initiative is the guideline on priority sector lending for all banks, which has incentivised debt funding to MFIs, even during the recent crisis.

Warren Buffett famously said, *"You only find out who is swimming naked when the tide goes out."* [1] The recent global economic crisis left many industries exposed to the falling tide. However, the Indian microfinance industry has proven to be buoyant and has emerged thriving, or "fully clothed". This is quite appropriate in a country where people are often fully clothed even when they swim in the waters of Varanasi's ghats and elsewhere.

Until five years ago, the Indian microfinance industry was primarily sustained by donations/aid as commercial funders had little confidence in the repayment capacity of poor borrowers. Since then, this industry has proven itself to be highly profitable and these poor borrowers, who are largely unaffected by global macroeconomic shocks, have now withstood the test of time, their creditworthiness demonstrated by their continuous strong repayments.

RECESSION PROOF GROWTH

The Indian microfinance sector has experienced massive growth, with both the number and size of microfinance institutions (MFIs) having exponentially multiplied in the last few years. Despite the economic crisis, the portfolio and client outreach of MFIs grew by 97% and 60% respectively in 2009, implying a gross portfolio of more than Rs. 11,700 crore (US$2.57 billion[2]) and a clientele of 17.9 million active borrowers as on 31st March 2009.[3] This translates into an average loan outstanding of Rs. 6,500 (US$143) and the numbers in aggregate reflect the fortune at the bottom of the pyramid. However, to mix metaphors, this is just the tip of the iceberg as well– MFIs have reached only 3.5% of the poor in India[4], signifying that there is an immense untapped terrain, yet to be explored. Growth has largely been skewed towards Southern India and microfinance is not as well-developed in other areas of the country. We describe below what has driven this strong, recession proof-growth, as well as some of the sector's challenges.

GOVERNMENTAL SUPPORT

The phenomenal success of microfinance has been strongly facilitated by the Indian Government, including the Reserve Bank of India (RBI), which furthered financial inclusion and nurtured MFIs over the years. The foremost initiative is the guideline on priority sector lending for all banks, which has incentivised debt funding to MFIs, even during the recent crisis. These guidelines mandate that a Domestic Scheduled Commercial Bank (DSCB) must have 40% of its Adjusted Net Bank Credit (ANBC)[5] financing in certain sectors and for purposes which the Government classifies as national priorities, which includes supporting MFIs. In case these targets are not met, DSCBs must invest the shortfall with the Rural Infrastructure Development Fund (RIDF), which currently locks in the funds for seven years. The rate of interest paid is inversely proportional to the shortfall and currently varies between 3% and 6%, or below the inflation rate.

Additionally, the dedicated and sustained efforts of state-owned developmental financial institutions like Small Industries Development Bank of India (SIDBI), National Bank for Agriculture and Rural Development (NABARD) and Rashtriya Mahila Kosh (RMK) have been indispensable in fostering Indian microfinance. Normally, these institutions are among the first debt funders to MFIs and agricultural financing institutions. SIDBI has been one of the biggest lenders to MFIs and has also infused substantial amounts of equity in many of them, thus reinforcing the Government's commitment to microfinance.

In the near future, the proposed creation of a national unique identification number system will make it feasible to track credit histories, exposures and developmental indicators of individual borrowers. The current Indian government has roped in Mr. Nandan Nilekani, who was most recently the CEO of Infosys Technologies, the Indian software giant, to spearhead the programme, which will truly be a nation-building initiative.

The Government can continue to play a positive role in these developments by enacting legislation that allows the larger MFIs – which are Non Banking Finance Companies (NBFCs) and have robust systems and processes – to mobilise savings deposits.

STRONG REPAYMENTS

The consistently robust repayment performance of the underlying clientele is the most impressive aspect of Indian MFIs. Overall default rates are much lower than most banks – often lower than 1%. The reasons are manifold:

1. Non-payment would mean cutting off the poor borrower's cheapest source of funding. It is extremely difficult for the poor to get loans from banks or other traditional financiers. The obstacles are many and include the lack of documents like tax returns and account books of businesses, corruption and kickbacks demanded by bank officers and very lengthy waiting periods between loan application and approval, if at all. Informal sources, such as loan sharks, charge cut-throat interest rates, often several hundred per cent more than the rate at which they can procure funds from MFIs and often require them to pledge land ownership documents, household jewels or other valuable assets.

2. India is still a highly community-centric society, which makes social collateral (peer pressure) very effective. The concept of honour and respect within society is deeply rooted in the Indian psyche and willful default may invite condescending glances, humiliation and even ostracism. This is especially true in rural areas, the very communities best served by MFIs.

3. The demand for micro-borrowers' goods and services is typically stable, often comes from others in the same economic stratum and is largely unaffected by global economic conditions. Microfinance helps stimulate the economy at the grassroots level.

4. For most micro-borrowers, the return on investment is much higher than the cost of debt. Since the initial capital which a micro-entrepreneur starts with is so low, to say that the internal rate of return (at which they are able to deploy funds) is staggering would be an understatement. A fruit vendor in a city who starts out with an inventory of Rs. 2,000 (US$44) and is successful in selling off his entire stock at Rs. 2,200 or US$48.5 (net of expenses and wastage) earns 10% return per day. While this isn't a lot on which to live, the annualised non-compounded return works out to an impressive 3,000%.

There has been some degree of concern about lending by multiple MFIs to the same borrower, especially in urban areas. The lack of a national platform to share credit data on borrowers belonging to the bottom of the pyramid has thus been a challenge that the sector has been grappling with. The Credit Information Bureau India Limited (CIBIL), an effort spearheaded by the Government of India and the RBI, with a database of over 155 million records and a membership base of over 200 financial institutions, has just entered into an agreement with 31 leading MFIs to set up a credit information bureau for micro-borrowers.

INCREASING FUNDING OPTIONS

Most Indian MFIs have not yet been permitted to mobilise deposits. This has left MFIs with little choice but to largely mobilise term loans from banks and on-lend the funds to the micro-borrowers. In practice, this means that MFIs borrow in bulk from the banks – usually in tens or hundreds of millions of rupees – and these loan facilities usually have repayment tenures varying between two and five years. The MFIs then cut up this funding into small amounts

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and give them as loans to hundreds of thousands of micro-borrowers over a one-year duration. The average loan size varies from Rs. 5,000 to Rs. 8,000. For their part, micro-borrowers repay the loan in weekly installments. The MFIs in turn usually repay the loans to the banks in quarterly installments or in some cases, monthly installments.

Of late, there have been instances of certain larger MFIs issuing listed debt instruments like commercial paper and non-convertible debentures. A 2009 media report[6] stated that MFIs were looking to raise Rs. 1,000 crore or US$220 million this financial year through the issue of such instruments. Such securities (a) augment the investor universe by overcoming regulatory constraints and liquidity concerns; (2) reduce the cost of funding as a direct consequence of this increased universe and (c) enhance the probability of funders taking exposure for longer tenures, which will help fund micro-housing and other products having longer terms. Securitisations are on the increase, banks are enhancing exposure to MFIs and the emergence of guarantee funds is facilitating debt funding to the smaller players.

OPPORTUNITIES BEYOND CREDIT

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INCREASING EFFICIENCY

Microfinance is a manpower-intensive business, which makes the cost of providing services at the doorsteps of customers quite high. Historical trends show that the operating expense ratios[7] of most MFIs have been consistently diminishing, primarily because of the advent of information technology and the increase in staff productivity. Teledensity[8] in India has been growing at breakneck speed, touching 37% (430 million subscribers) as of 31st March, 2009. Mobile banking is expected to be the next revolution in Indian financial inclusion, especially considering the incredible success that countries like Kenya have had.

CHALLENGES

The biggest challenges of the sector are (a) lack of professional managerial expertise – this is rapidly changing as a battery of professionals has entered the microfinance sector; (b) political interference – isolated cases of interference by local administrative bodies exist; (c) general concerns that the poor by definition must have a hard time making repayments – as discussed above, this has not proven to be the case and (d) relatively poor infrastructure, higher illiteracy rates, gender inequality and lack of economic opportunity in the north and the east of the country (vis-à-vis Southern India), where financial inclusion is most needed.

Though the Indian government has steadily nurtured the growth of the sector over the years, the national objective of total financial inclusion might be better achieved if the following points are emphasised:

Strategy

- ✔ **Corporate Structure:** The 20 biggest MFIs contribute more than 85% of the sector's outreach and almost all of these are non-deposit taking NBFCs. Most NBFCs are not permitted to mobilise deposits and converting to a bank has its own challenges. These include the vast amount of initial capital needed and permission required of the regulator to open every new branch. At the same time, mobilisation of deposits is the most effective way to lower cost of funds. A separate structure could be identified to address these issues and the Indian Government has been debating setting up a structure called the "Micro Finance Organisation" with the ability to mobilise deposits. However, the ambit of this term might exclude existing NBFCs, which contribute the

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lion's share of present outreach as well as a share of projected growth. Permission given to MFIs for raising deposits should be very tightly regulated and should be only given to those with very good quality operations, lest an MFI default on public money.

- **Microinsurance:** Microinsurance is an area where there is huge opportunity for business growth as well as mitigating the risk of unforeseen liabilities of the economically disadvantaged. Insurance – be it life, health, cattle, crop, weather or for other assets – is the need of the hour, and it is imperative to establish a concerted strategy to: (a) incentivise existing insurers to extend microinsurance policies; (b) incentivise new insurance players to focus entirely on microinsurance and (c) actively leverage the distribution network offered by Indian MFIs.

- **Mutual Fund Investments:** The ability of the poor to invest in micro/mini mutual funds or traditional investment vehicles is severely constrained because contributions in cash are not permitted. Permitting cash collections might have immense positive ramifications to the overall economy, which would include (a) substantial build-up of savings at the lowest echelons of society; (b) decreased interest on loans given heightened liquidity in the system; (c) enhanced ability by the poor to purchase more expensive items of household consumption and for mini-businesses to invest in equipment or assets which they could ill-afford hitherto and (d) a general reduction in illiteracy, disease and crime because of better living conditions.

- **Mobile Banking:** Given the rapid growth in the number of Indian mobile phone users and demonstrated success of mobile banking products like M-PESA in Kenya, it is critical that India develops a national roadmap for mobile banking and branchless banking. Important concerns which need to be addressed are (a) security of financial transactions; (b) poor quality of network connectivity and coverage in rural areas; (c) unavailability of local languages on mobile phones and (d) the need for a voice-based solution (vis-à-vis those which require written input).

Governance

- **Board/Independent Directors:** Better corporate governance is needed for MFIs, especially the smaller ones. The level of participation by independent directors should be increased.

- **Regulatory Audits:** The frequency and intensity of regulatory audits should be increased. Repeated unearthing of serious malpractices should invite strict chastising, including revoking the license of the MFI in question.

Operations

- **Training Centres for Human Capital Development:** Perhaps one of the most severe impediments of MFI growth (especially in underdeveloped areas) is the availability of trained local staff. Training centres meant for developing such talent would serve the dual purposes of, (a) promoting the growth of the sector and (b) providing a stable livelihood to tens of thousands of rural families.

- **Sophisticated Loan Appraisal Capability:** Indian microfinance is overwhelmingly focused on group lending which requires less sophistication vis-à-vis higher ticket loans given to individuals. As such, it is imperative to build loan appraisal expertise for Micro, Small & Medium Enterprises (MSMEs) including cash flow analysis, business risk gauging, evaluating sufficiency of pledged collateral and ascertaining areas of loan utilisation. While much of microcredit extended by MFIs presently funds animal husbandry, trading and petty services, individual lending might catalyse the growth of small scale manufacturing, which will provide significant employment opportunities.

- **Data Collection:** Standardised data collection formats can help build up business intelligence on a nationwide scale over time, and will also facilitate the tasks of credit bureaus.

Social Performance Measurement

- **Measuring Impact:** Indian microfinance institutions should individually and collectively put more effort into measuring the social impact of their work in order to justify the industry, combat negative press stories and protect against unfavorable regulation. Anyone working on the ground for an MFI knows that their work can often be life-changing for their clients. This needs to be more rigorously documented.

Funding

- **Debt Capital:** Presently, the majority of Indian microfinance funding is term loans from banks. Lending to MFIs for on-lending up to Rs. 50,000 (US$1,100) per borrower is classified as a priority sector advance and this continues to be one of the chief motivating factors for banks to lend. However, these targets are annual and thus the industry experiences a heavy flow of funds towards the end of the financial year. This results in skewed growth patterns of MFIs, such that they are often starved of funds in the first half of the financial year. Changing the pattern from annual to quarterly funding would go a long way towards smoothening out the growth of this critical sector.

- **Affordable Housing Finance:** Longer term funding at sustainable costs should be actively made available to MFIs in order to significantly expand affordable housing space and provide a much-needed impetus to core infrastructural development in the country. The government could potentially consider establishing a fund or extending the scope of Credit Guarantee Fund Trust for Micro and Small Enterprises (CGTMSE) to partially or fully guarantee such longer term loans to MFIs or set up a specialised apex funder (possibly under the auspices of the National Housing Bank) to route all such loans to MFIs financing of affordable housing.

CONCLUSION

Microfinance is all around us – from the massive shantytowns of Mumbai and the rural hamlets in the distant north-east of India to the housekeeper in a typical Indian kitchen. The Indian microfinance sector is a fantastic double, and often triple, bottom line investment (profit as well as social and environmental impact). However, as can be seen, there are still many challenges to be overcome.

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1 Berkshire-Hathaway Inc. Warren E. Buffett, Chairman's Letter to Shareholders, Annual Report, February 28, 2002. http://www.berkshirehathaway.com/2001ar/2001letter.html.

2 US$1 = INR 45.5 (as at March 26, 2010).

3 Sa-Dhan, The Association of Community Development Development Finance Institutions. Bharat Microfinance Report - Quick Data 2009.

4 Microfinance Information Exchange, Inc. (MIX) and IntellecapAsia. Microfinance Analysis and Benchmarking Report 2008.

5 Net Bank Credit plus a special class of bond investments.

6 Namrata Acharya. "Microfinance institutions plan to raise Rs 1k cr through debt." *Business Standard*, July 14, 2009. http://www.business-standard.com/india/storypage.php?autono=363806.

7 Operating expense ratio of an MFI is the total annual operating cost to its average portfolio outstanding over the year.

8 Teledensity is the number of telephones to people.