MicroSave India Focus Note 42

Microfinance In India: Built On Sales Targets or Loyal Clients?

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Priority Sector Lending

The Reserve Bank of India (RBI) requires domestic and foreign banks to ensure that 40% and 32% of their "net bank credit" is directed to the "Priority Sectors". Domestic banks are required to lend 18% of their portfolio to agriculture, and another 10% to the "weaker sections", which includes small scale farmers, artisans, scheduled castes and tribes and other vulnerable groups in Indian society. Domestic banks with shortfalls in lending to priority sectors must contribute to NABARD's Rural Infrastructure Development Fund (RIDF) – the level of these contributions is mandated by the provisions in the annual Union budget. While banks can usually find large-scale industrial or contract agricultural borrowers to meet their 18% target on a cost-effective basis, they struggle to lend the required 10% to weaker sections, who are usually only able to absorb small (for banks cost-ineffective) amounts of credit.

The core market for MFIs is the very weaker sections as defined by the priority sector lending requirements (PSLR) of the RBI. As such, MFIs offer a tremendous opportunity for the state, (which wants to see these vulnerable groups "financially included" with access to a range of financial services, particularly credit) and to the banks, (which need to achieve their priority sector lending requirements). "The time and energy required to make small loans in the priority sector is huge," says K.R. Kamath, Chairman and Managing Director of state-owned Punjab National Bank, adding that buying loans from microfinance lenders is an easy way of fulfilling priority sector lending obligations. [1] Small wonder then that banks' lending to MFIs is growing so rapidly: Bandhan, for instance, doubled its outstanding loan portfolio to around Rs1,450 crore in fiscal 2010, while Share's loan book grew 81% over the previous year to Rs2,200 crore[1]. New industry players and financial instruments are being created to ease and speed this process.[2]

The Roots and Consequences of Commercialisation

To allow banks to lend this magnitude of funds, many MFIs (including SKS, Share, Bandhan and many others) were encouraged to move from not-for-profit legal forms to become Non Bank Finance Companies. Initially, some of these MFIs were capitalised by a combination of social investors and (controversially) their clients or "members". [3] However, soon private equity funds[4], attracted by the potential for rapid capital returns based on the exponential growth of MFIs, took increasingly large stakes, quickly crowding out the social investors. It is an irony that the socially-focused PSLR should have fuelled the commercialisation of microfinance in India – and fundamentally changed the primary objectives, and language, of the sector.

The vast majority of private equity investors involved in Indian microfinance have short-term goals. Typically, they are looking for capital returns of around 25-30% per annum within 3-4 years: hence the forthcoming IPO of SKS - with Share, Spandana and others expected to follow within the year. Valuation of MFIs seems to be predicated above all on the number of clients they serve, and this has resulted in an unwavering focus on horizontal growth. A strategic business planning exercise conducted by *MicroSave* for one of the large NBFCs resulted in an elegant plan combining limited horizontal growth within a confined geographic area with vertical expansion, to leverage its branch network and serve a wider range of clients and needs within the villages. Within a year, the private equity investors on the NBFC's board had changed the plan to focus exclusively on horizontal expansion and pursuit of ever larger numbers of clients. This type of expansion has often taken MFIs out of their original states or regions into new areas that they understand poorly, and where cultural and language barriers can present very real challenges. For example, many of the southern MFIs have struggled to maintain the quality of their portfolio in the northern states.

But as events in Andhra Pradesh and Karnataka have demonstrated, it is not just new geographies that are challenging MFIs. The pursuit of clients has led to what are generally agreed as undesirable practices: poaching of clients (and sometimes even staff), and instances of the multiple lending floridly described by the Wall Street Journal as "carpet bombing" of over-served areas. One leading Indian microfinance expert, closely involved with several of the NBFCs lamented, "Our microfinance industry has lost its direction and its soul. Now it is dominated by a focus on of sales

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[1] "Farm Loans To Banks By Microfinance Firms See Big Spurt", LiveMint, April 11, 2010
[2] See *MicroSave* India Focus Note 40 "State of Microfinance in India 2010"
[3] See *MicroSave* India Focus Note 41 "Microfinance – Time To Get Back to Basics?"
[4] The first PE investment was made in 2007 by Sequoia Capital, the venture capital firm that backed Google, Apple and Cisco, when it took an $11m stake in SKS Microfinance.

over relationships; quantity over quality; of profits over development".
However, the relentless pursuit of sales in order to increase share valuations has been successful. Some commentators suggest that share valuations of MFIs are well in excess of what might be normally expected, and yet there seems to be remarkable demand for them, even amongst prestigious investors like Infosys mentor N.R. Narayana Murthy's Catamaran fund, which invested Rs. 28.2 crore about ($6 million) in SKS. 2009 alone saw 17 PE investment deals totaling around $160 million and microfinance was the "most attractive sector for investment" (ahead of infrastructure finance) for Fund Managers from around 50 private equity and venture capital firms responding to a poll for Venture Intelligence's March 2010 publication "Private Equity Pulse" in its edition on financial services.

The focus on large scale replication of simple and standardised systems necessary to achieve the type of growth that will satisfy PE investors has meant that, although some experimentation is going on, the larger NBFC MFIs have had limited time for research/ product development and roll out. Additional products mean additional complications for what appear to be already overstretched staff, processes and IT systems.[5] But this standardisation does mean that a very narrow range of clients' needs are addressed. MFIs' clients are left to manage their all their financial services needs - both business and household - with one, working capital, credit product, occasionally supplemented with a short-term emergency loan.

Markets and Clients

This limited choice and mono-product environment is common in most countries when microfinance is taking root in new markets. But no countries in the world have had the sophisticated and extensive capital financing that is currently available in India, at this stage of the development of the microfinance market. As a result, growth rates (and thus the resulting increase in outreach and credit-based financial inclusion) in India are absolutely unprecedented anywhere across the globe. India's remarkable wealth of human capital means that, of all the countries in the world, it has the greatest chance of managing such extraordinary growth rates, but nonetheless signs of stress and challenges are already appearing - with increasing regularity. Events in Krishna, Kolar, Kanpur and, more recently, the coastal districts of Andhra Pradesh all raise concerns.

While these flashpoints seem to have different causes, careful analysis of the issues suggests that the root of the problem almost invariably lies with the relationship between the client and the MFI. Many seasoned observers would argue that effective and sustainable microfinance is built on the relationships between client and institution. This encompasses not just the relationship between the front-line Credit Officers and their groups, but also the depth and diversity of the product relationships. In simple terms, if a client is getting a loan that somewhat meets her needs, she will be somewhat committed to repay it. Whereas if she is able to access a range of financial services that meet a broad spectrum of her needs, delivered by staff with whom she has a deep relationship of trust, she will make all possible efforts to repay any loans outstanding – in order to maintain that valuable relationship.

The dash for growth in India has meant that, in most NBFC MFIs, these critical relationships are almost non-existent. So in Krishna and Kolar many clients were happy to follow injunctions not to repay loans; and in Kanpur, Nirman Bharti's clients had nothing to lose when they chose not to repay their loans. Elsewhere in the world, attempts by Government officials or religious groups to intervene and disrupt the operations of MFIs with real customer relationships and loyalty are greeted with protest marches and the surrounding of offices, as has been shown in Bangladesh, Uganda and elsewhere. It is difficult to imagine SEWA Bank's clients tolerating the bank being shut.

A Change is Going to Come?

Strong relationships and in-depth understanding of the needs of clients are also key to addressing the problems of multiple borrowing and over-indebtedness. The new NBFC apex organisation, MFIN is encouraging its members to limit their lending to a total of Rs.50,000 per client, and stipulating that a maximum of three MFIs should lend to any one client. This, it is believed, will limit the credit risk faced by the MFIs. In most mature markets, MFIs graduate clients into individual lending relationships, which allows them to spend the time to build the relationships, assess the debt absorptive capacity of the household (because MFIs are, inevitably, lending to households not individual clients) and lend larger amounts (where appropriate) for the client's business. In addition to these tailored credit services, MFIs also diversify the range of services they offer to encompass insurance, savings and even remittance services – probably through m-banking platforms that are inappropriate for group-based lending. This significantly deepens the relationship with the clients and increases client loyalty and commitment to the MFI. One wonders if this approach might not prove necessary in India too.

[5] See *MicroSave* India Focus Note 25 "Dinosaur and Rabbits"

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