MicroSave India Focus Note 40

State of Microfinance in India 2010

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May 2010

Reaching the Unreached

Microfinance industry is set to reach new heights. With superlative growth numbers in a period of economic downturn, the sector has come to attention of a wider range of investors. Despite the widespread liquidity crunch, the SHG-bank linkage and the group lending microfinance institution (MFI) models recorded impressive increase both in terms of number of households reached and volume of loans. During the year 2008-09 6.9 million new members were added under SHG model taking the total membership tally to 54 million. Meanwhile, in the same period, MFIs added 8.5 million new members, taking the total client base to 22.6 million. The total outstanding microfinance loans including credit to SHGs by banks amounted to Rs.359.39 billion as on March 2009: a growth of 30% over last year. By the end of March 2009, these numbers in combination constituted 1.29% of gross bank credit of scheduled commercial banks[1]. However the regional bias still exists: the north and eastern India are still largely underserved, and many areas in the north and north-east regions remain entirely untouched.

The deeper penetration in new and existing areas has opened many organisations to new and diverse risks. These risks come in the form of multiple lending, large loan size disbursement in poorer markets, migration of borrowers and so on. These risks are further exacerbated by the fact that, with the focus on achieving numbers, poaching of groups and multiple lending has become common within Indian microfinance. Sporadic warning signs have been seen in south where concerted resistance from clients to making repayments in the face of multiple loans is growing. The standardised lending systems, loan amounts, and weekly meetings/repayments can create problems for clients' business (due to inappropriate loan sizes and terms) and domestic problems (due to the repeated group meetings) and in some cases overwhelming debt. The Kolar standoff in Karnataka generated international headlines and showed that outside intervention of this form could yet disrupt the growth and development of the industry.

The Commercialisation of Microfinance

The sector continues to see many not for profit MFIs transforming to become for profit Non Bank Financial Corporation's (NBFCs). This move has been driven by the need to raise additional debt (which is readily available from commercial banks seeking to meet their priority sector lending requirements) and, in some cases at least, a desire to make profits. The NBFC legal form allows banks to lend to MFIs with greater confidence, and the MFIs to attract outside equity and thus leverage still greater debt. It also offers venture capital/private equity (PE) funds and the MFIs' promoters an opportunity to seek substantial capital returns[1] – despite India having some of the most efficient MFIs, offering services at some of the lowest interest rates in the world.

Amid the heated discussion surrounding interest rates in India, the importance of generating positive returns to underpin sustainable growth, and thus expand financial inclusion is often lost amid the passion and rhetoric.

Given the growth and maturity dynamics, the sector has become a viable investment option with commercial investors overwhelming the investments made by patient social investors. This is reflected in the high equity valuations that the sector has experienced, and corroborating this fact was reflected in the large PE investments made in MFIs. The investments increased by over \$380 million[2] in the six year period between January 2004 and December 2009, with almost 88% of this equity flowing in last two years. This investment reflects 7% of the entire investment in banking financial services and insurance (BFSI) sector.

These profit-focused equity investments, together with the growth of specialised financial service providers like IFMR Capital and Grameen Capital India, have increased, diversified and deepened MFIs' links with the formal financial sector. Many large and increasingly sophisticated deals including a variety of forms of securitisation, non convertible debentures (NCD), commercial paper, purchase of loan books and subordinated debt-based lending have already been completed, and IPOs are anticipated from SKS and at least 3-4 other of the larger NBFCs.

Clearly IPOs are the preferred exit route for many of the PE investors – and, if SKS's model is followed, also for the MFI's promoters[3]. Indeed, today an IPO is the inspiration and ambition for a growing number of MFIs and their promoters. Valuations seem to be likely to follow a telco-based model and thus based on the number of clients on an MFI's books – resulting in huge incentives to rollout and hard-sell standardised products without reference to the needs (or other debts)

[1] Srinivasan, N., "Microfinance India: State of the Sector Report 2009", Sage Publications, 2010.
[2] Venture Intelligence, "Private Equity Pulse on Financial Services", 2009.

of the clients. Small wonder there is chorus of concern about the future and direction of microfinance in India. The increased size and profile of the financial service sector and micro finance sector in particular has also stimulated the Reserve Bank of India (RBI) into action. In the midst of global liquidity crisis in 2008, the RBI increased the CAR - the ratio of capital to risk weighted assets - for NBFCs MFIs from 10% to 12% by March 2009. This requirement is expected to grow to 15%, and other measures may be looming as RBI and the Ministry of Finance display increasing discomfort with the direction the microfinance industry is taking.

Life Cycle Needs

The growth and competition in MFI industry, has been accompanied by limited creation of new products and services to address other unmet needs of MFIs' clients. Where offered, the services are extended either directly or by acting as a bridge between third party providers – saving, remittances, and micro insurance.

With the global attention on financial inclusion, savings services have come into the spotlight. In the two years from 2007, the number of SHGs with saving accounts at formal sector banks has grown by 44% to 5.99 million. The balance in these accounts has increased to Rs.54.47 billion in March 2009 - a growth of 55% over the 2007 numbers[1]. Much work has also been done under the business correspondent channel of the banks (see next section).

Some MFIs have started to work on individual lending products. Developing effective individual lending programmes is complex and time-consuming[4] – and is not for those focused on rapid growth[5]. Nonetheless, as the Indian microfinance market matures MFIs will need to develop new products and services to retain their customers in the face of competition.

E/M Banking and Business Correspondent

Technology is set to revolutionise the sector – but the potential still remains to be realised. Pilots are on-going to test the use of biometrics, smart card and mobile devices to offer saving, remittance and insurance services and to test mobile-based MIS. All are aimed to reduce costs and improve the reliability of operations in the field. These innovative uses are being encouraged and facilitated by the RBI slowly liberalising the regulations governing the appointment of business correspondents (BC) to provide banking services to the unbanked. In addition to allowing merchant establishments, insurance agents, retired teachers etc. to act as BCs for the banks, the RBI recently announced that it would allow trial of "reasonable fees" levied from the end users of the service. Banks seem unsure how to respond to this offer, but it is likely that once SBI or one of the other larger scheduled commercial banks has defined what is reasonable as a fee, others will quickly follow.

Despite all the work, many challenges remain to be addressed. The total number of no frills account opened between April 2007 and May 2009 was 25.15 million, of which only 11% (2.77 million) are operational[6]. The government has now started routing welfare payments through the "No Frills" saving accounts, and encouraging the banks to put technology in place and to use BC channels to serve customers. This, it is hoped, will stimulate financial inclusion and reduce the "leakage" and corruption in more traditional approaches to distributing welfare payments.

Social Performance Management

The push for growth, increasing competition, increasing over-indebtedness of clients, aggressive collection practices and the entry of investors (both social and commercial) looking for returns have brought Social Performance - or putting mission into practice - into focus. Some MFIs have started, with varying degrees of conviction, to review their emphasis on the social and financial bottom lines. However, Social Performance Management (SPM) has remained largely focused on the poverty levels of clients served rather than the quality of services provided to those clients – to the detriment of both the clients and the MFIs serving them.[7]

Conclusion

With the exponential grow rates, and race for horizontal growth, MFIs' systems and staff continue to be stretched. There is a growing need for the MFIs to address the inherent weaknesses in their systems and processes, and at the same time develop more robust governance to manage the challenges of future. There is a clear need to improve the customer value proposition and offer a broader range of financial services. So, once the initial IPO rush is over, in the long-term at least, it is fair to expect growth of individual lending built on m-banking platforms that also offer the clients access to savings, insurance and remittance services through agency-based arrangements.

[3] See *MicroSave* India Focus Note 41 "Microfinance – Time To Get Back to Basics?"
[4] See for example, *MicroSave* India Focus Note 14 "Challenges of Introducing Individual Lending in India"
[5] See *MicroSave* India Focus Note 25 "Dinosaurs and Rabbits"
[6] Kochhar**,** Sameer, "Speeding Financial Inclusion", Skoch Foundation, 2009
[7] See *MicroSave* India Focus Note 35 "Social Performance Management in India: Seeking a Market-led Approach"