MicroSave India Focus Note 75

Microfinance in India – Is Business Correspondent the Way Forward?

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Microfinance in India is going through turmoil. The turmoil is, in some measure, because of the rapid growth of microfinance institutions and the consequent government response, leading to drastic changes in the regulatory environment in Andhra Pradesh (AP). These two factors put together are largely responsible for the problems currently facing the microfinance sector.[1] However, from every upheaval, something new (and perhaps better) emerges - this paper explores the potential shape and direction of the microfinance sector in India, post the now famous "Andhra crisis".

The direct group lending methodology, under which MFIs borrow bulk loans from banks and, in turn, lend smaller loans to people in the low-income segment, has its own set of flaws. While the loans are reflected on the books of the MFIs, up to 80-85% of an MFI's assets are created from resources that come from banks as term loans, with the equity capital contributing the balance 15-20%. The microfinance industry was, until recently, a highly profitable industry as the demand for credit from the underserved segment was more or less price inelastic. In this situation, MFIs could charge reasonably high interest rates and generate returns on equity of 25% and above. This, in turn, led to high growth and higher valuations of MFIs as they were seen to operate in a sellers' market with limitless possibilities for growth.

By the fourth quarter of 2010, with the "Andhra Crisis" and the consequent non-payment by clients, banks suddenly realised that most of the exposure in field was from money that they had extended as credit. As a result, default, in the field, on loans from MFIs would soon lead to default by the MFIs on banks. Since the loans extended to MFIs were collateralised on the very portfolios they were financing, they were poorly secured.

Thus banks were left holding 80% or more of the credit risk, whereas equity investors and promoters were holding only up to a maximum 20% of the risk. The returns ratio in the business has, however, been the inverse, with the majority of the returns going to the equity investors and banks loading the usual debt pricing on credit extended to the sector. Bankers were happy because targets for priority sector lending were being met on account of the microfinance portfolio.

This will now change and a new model for microfinance delivery may emerge in India. While the risk return equation is one of the reasons for reworking the model, the other is the political risk that has become so clear in Andhra Pradesh, and has on more than one occasion, loomed as a threat in other states. Lenders, and indeed investors, cannot be sure that such political interference will never again happen in another geography. Indeed, the political risk in microfinance can possibly never be fully mitigated even with regulation; the possibility of a state political establishment posturing as the saviour of the poor and consequently blocking recoveries cannot be ruled out.

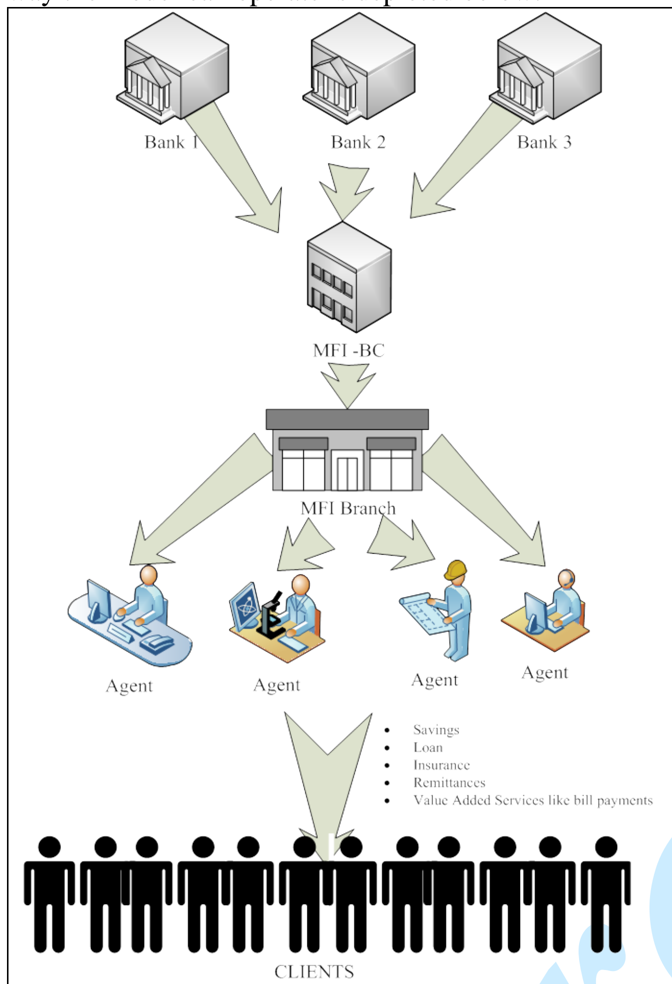
The possible solution is to have MFIs as agents of banks operating as Business Correspondents (BCs). The way the model can work is for banks to use the outreach and the efficient distribution structures that MFIs have established. However, as an off-shoot of banks, the channel can be used to not only push credit, but also to offer a much wider range of products - savings, credit, insurance, pension and remittances. The model can de-risk MFIs from a variety of risks such as the political and operational risks that came to the forefront in AP. Local political interests will find it difficult to interfere at an operational level with agents of banks, regulated by RBI. MFIs as BC model will also ensure greater degree of oversight from banks (and hopefully RBI) than has been the case with the bulk lending model currently in vogue. At the same time, MFIs as agents of banks will be able to offer clients with a wider range of products. Even happenings in Kolar district in Karnataka where a section of the borrowers refused to repay on account of interventions from local religious leaders[2] can be de-risked to some extent. In a multi-product environment, it will difficult for any section of the stakeholders to suddenly put brakes on the operations of MFIs. The MFI would not only be offering credit but would also be the front end for savings deposits and withdrawals, as well as for pension and for insurance services – thus broad-basing their relationships with clients.

A tiered model with local merchants at the front end, MFI acting as 'super-agents' and banks at the back-end should evolve into a lower delivery cost model. Under the new regulatory guidelines, with interest and margin caps, the outreach of typical group microfinance, and outreach in far-off areas, will be constrained. MFIs will not be able to

[1] See *MicroSave* India Focus Notes 41 "Microfinance - Time to Get to Back to Basics?" and 43 "Commercialisation of Microfinance in India: Is it all Bad?"

[2] See *MicroSave* India Focus Note 55 "The Andhra Pradesh Crisis: Three Dress Rehearsals … and then the Full Drama"

address remote clients unless some form of local agent structures are integrated into the delivery methodology. Local *kirana* (grocer) shops, medical shops, teachers etc. can be agents for MFIs, who in-turn act as agent aggregators and managers for banks, to enable technology backed delivery models with lower delivery costs. The way the model can operate is depicted below:



The benefits that the model presents for MFIs are:

1. The model significantly de-risks MFI operations. Operating as agents of banks almost entirely removes political risk from the equation. Banks and their agents come under the sole purview of the Reserve Bank of India, and the possibility of state government interference will be significantly minimised if not altogether eliminated – particularly when poor people's savings are involved.
2. MFIs will be able to offer a wider range of products and thus to meet the real financial needs of the clients rather than pushing credit alone and optimistically claiming that it is for entrepreneurial activities.
3. Savings is service that is universally needed by people in the low income segment. Offering the poor a range of savings, pension and remittance services will create higher degree of client satisfaction, and thus customer loyalty and reduced default. The savings history of clients will also enable better credit appraisal and will help (to some extent) address the problem of multiple borrowing.
4. BC relationships ride on either card- or mobile phone-based technology as the front end. This will enable better and more efficient cash management at the MFI end. Currently 1-3 % of the total cash at the MFI is typically either in transit or stacked in vaults in the numerous branches. This can be an instantaneous process riding on technology.
5. The BC relationship will also open up the possibility of appointing agents in villages to offer savings and pension services. While client origination can remain with the MFIs, agents can deal with day-to-day operations and settlement can take place with the MFI on a daily basis. This should reduce the cost of operations, and the economies achieved can be passed on to clients.
6. MFIs can build efficient channels to offer financial services and work with multiple banks to reach the under-banked/unbanked segments. Banks will be interested in such tie-ups not only because of the regulatory pressures, but also because once they begin servicing this segment, they will realise the potential that it holds.

The benefits that the model presents for banks are:

1. Banks are struggling to establish agent networks that can profitably and reliably service the low income, unbanked segments of the economy. While they have been successful in opening accounts, they have not been as successful in promoting transactions. As they expand the range of services and seek to drive credit through agent channels, banks will have to depend on MFIs that understand this segment and have built systems and processes to serve it.
2. Banks can reflect the assets and liabilities in their books thus enhancing their balance sheets. Banks can increase the spread and share the risk-return of lending to the low income sector with the MFIs in a more realistic manner.
3. Banks will partner with MFIs that have built much more cost-effective outreach channels. The operating expense for an MFI branch that can service 2,000 – 3,000 clients is in the range of Rs.5-600,000 per annum. One entry level officer in a bank will cost as much. Banks, on account of cost considerations alone, will struggle to directly service the low end market; tie-ups with MFIs provide tremendous opportunities.
4. The banking regulator will be more satisfied when it knows that banks have their skin in the game. If banks use and monitor MFIs as banking agents this will inspire confidence in the regulator that they are maintaining the requisite oversight and due diligence.

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