GROWTH OF INDIAN MICROFINANCE:
A CASE-STUDY-BASED REVIEW OF TRENDS AND CHALLENGES

By

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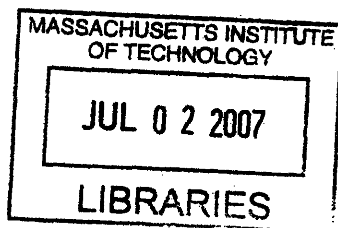
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VENKAT MAROJU

Submitted to the MIT Sloan School of Management on May 11, 2007 in partial fulfillment of the requirements for the Degree of Master of Business Administration

ABSTRACT

The microfinance industry in India experienced extraordinary evolution throughout the 1990s and into the new century, and it is now entering a new phase of rapid expansion. But there is still a huge gap between the demand for and supply of microfinance services in India. With its enormous population of poor people, India is attracting increasing attention from commercial players and government agencies, both of which are instrumental to furthering the growth of microfinance.

This study reviews the current state of microfinance in India using the case-study approach. Two examples were chosen as representatives of the most prevalent forms of microfinance delivery—the Grameen model and the Self Help Group model. The two cases also represent two diverse schools of thought that dominate the worldwide microfinance industry: for-profit commercial microfinance institutions (MFIs) and not-for-profit NGO MFIs.

The study discusses evolving legal structures, strategies, financing models, and operating models used by Indian MFIs to rapidly grow their operations in order to fulfill the huge unmet demand. It also covers the legal, financial, and operational challenges facing MFIs, and concludes with recommendations for remedial measures and policy changes that are required to support the urgent need to expand microfinance services in India.

Thesis Supervisor: Gabriel R. Bitran
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CHAPTER 1

Introduction

1.1 Thesis Objective

Poor people are traditionally perceived as non-candidates for financial services. However, by providing financial services to the poor with appropriate methods suitable to them, the poor can begin to lift themselves out of poverty.

Microfinance has proved to be a viable tool for alleviating poverty in many parts of the world. India has one of the largest populations of poor people in the world, and over the past decade, microfinance has begun to attract increasing attention from many mainstream players in India contributing to the growth of the industry.

Microfinance players in India include various microfinance institutions (MFIs), non-government organizations (NGOs), commercial banks, government agencies, and multilateral funding agencies. Microfinance in India is now entering a new phase of rapid expansion, especially with the entry of mainstream players such as commercial banks, as well as favorable governmental regulation and innovative delivery models such as Self Help Group Bank linkage programs.

The objective of this thesis is to review the current state of microfinance in India, using the case-study approach. Two examples were chosen as excellent representatives of the most prevalent forms of microfinance delivery—the Grameen model and the Self Help Group (SHG) model.

The two cases also represent two diverse schools of thought that dominate the worldwide microfinance industry. The first one representing the new generation, for-profit, minimalist MFIs that focuses on financial sustainability and rapid expansion; the other one is a more traditional, not-for-profit MFI focused on development and offering microfinance as one of several services in their broader menu of social services that includes livelihood promotion and capacity building.

My goal is to capture some of the trends, opportunities, and challenges facing MFIs in order to capitalize the huge opportunity that microfinance industry presents in India. I conclude with several recommendations.

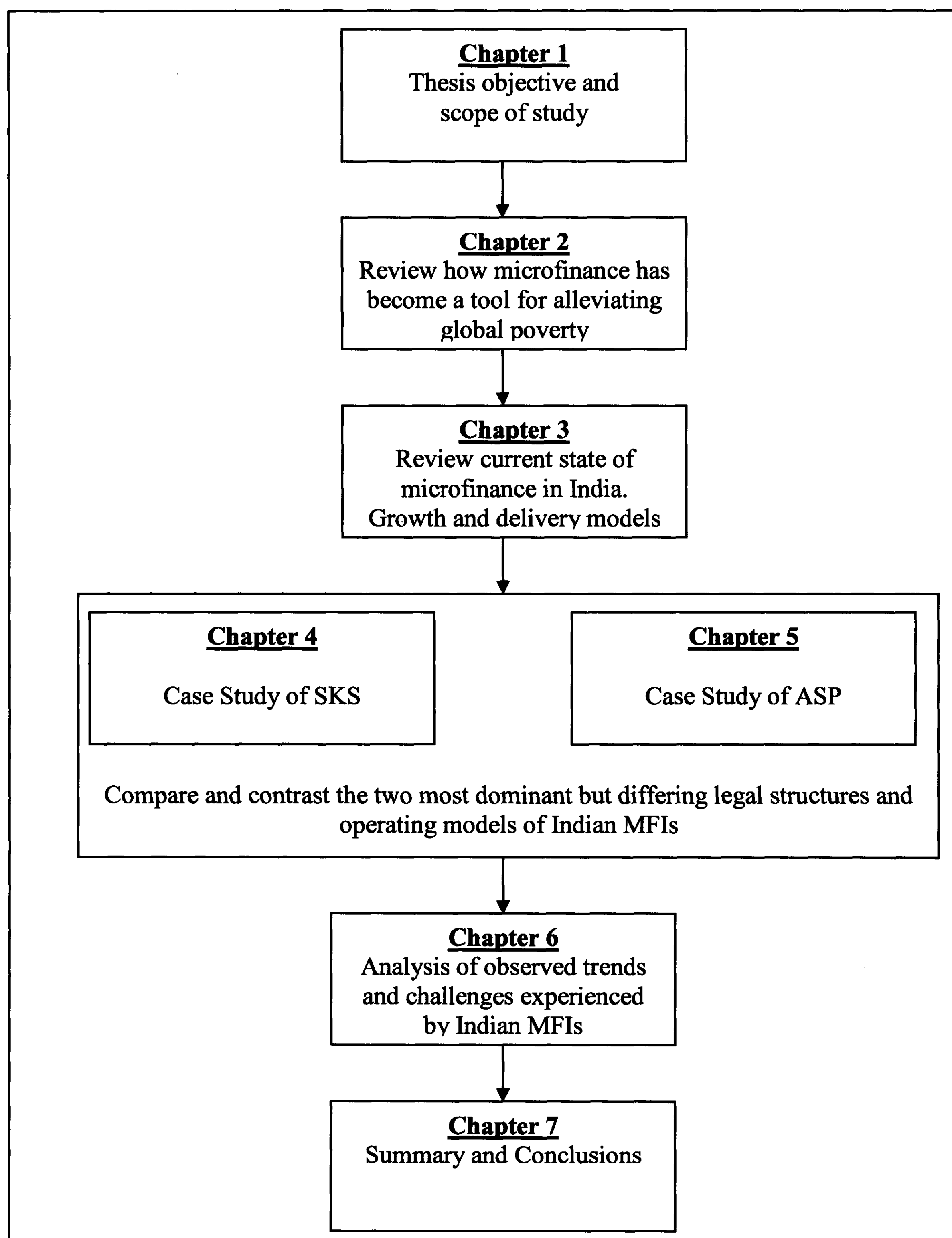
1.2 Scope

The scope of this thesis is limited to microfinance in India, although there are occasional references to the global literature. Most of the discussion is presented in the context of MFIs, both for-profit and not-for-profit. An analysis of the impact of microfinance is not within the scope of this study. The information presented here is based on the author's observations and findings during visits to India, combined with various discussions with numerous MFI leaders, government officials, commercial bankers, and technology providers. These interviews and discussions were conducted during January and February, 2007.

1.3 Thesis Structure

The structure of the thesis is shown in Figure 1.1.

Fig 1.1 Thesis Structure



Chapter 2 discusses how microfinance at the worldwide level has evolved to become a viable tool for alleviating global poverty.

Chapter 3 reviews the current status of microfinance in India, focusing on growth factors and successful delivery models and strategies that have evolved over the past three decades.

Chapter 4 is a case study of SKS Micro Finance Pvt. Ltd (SKS), a for-profit, minimalist MFI. The case study presents details of the organizational structure of SKS and strategies it uses to accelerate growth. A detailed review of SKS operations is also provided.

Chapter 5 is a case study of Ankuram Sangamam Poram (ASP), a non-profit NGO. The case study focuses on the structure, strategies, and operations, especially highlighting the cooperative nature of this NGO organization and the operational differences that result compared with SKS.

Chapter 6 discusses key trends, opportunities, and challenges that Indian MFIs are experiencing as the entire industry enters a new phase of rapid growth.

Chapter 7 offers a concluding summary and my observations and recommendations.

CHAPTER 2

Microfinance and Poverty

2.1 Introduction

One definition of "microfinance" is the methods and processes used to provide financial services to low-income people, including credit, savings, insurance, and remittances. Microfinance is a fast-growing, highly recognized tool for alleviating poverty, and it has become an integral strategy for developing countries. The institutions and organizations that offer these services are called microfinance institutions (MFIs).

Microfinance emerged in the 1970s as NGOs and various types of cooperatives began to offer financial services to low-income people—those who are traditionally considered not viable customers for the typical range of banking services because they lack collateral. By providing credit rather than grants, MFI providers become sustainable by circulating available resources, thus helping MFIs to reach out to many more low-income households. Considerable academic and professional research has been done on the topic of microfinance and its impact on the development process (see, for example, Fisher and Sriram, 2002; Tsai, 2004; and Dasgupta, 2005).

2.2 Microfinance: A Tool for Alleviating Global Poverty

In 2006, the Nobel Peace Prize went to Professor Yunus Muhammad, the pioneering founder of the microfinance movement, and the United Nations declared 2005 the year of microfinance. Each is testament to the fact that microfinance has had a positive impact on the lives of poor people. According to Jonathan Morduch, Chairman of the United Nations Expert Group on Poverty Statistics, "Microfinance stands as one of the most promising and cost-effective tools in the fight against global poverty."[1] There is no doubt that microfinance has become a major tool for alleviating poverty in developing economies.

Half of the world's population—three billion people—live on less than $2 per day, and they are unable to achieve minimum basic living conditions. Such abject poverty means this large segment of the population suffers from malnutrition, lack of health care, substandard housing, and illiteracy. Poverty is trapping future generations in a vicious cycle without hope or opportunity.

With small so-called "micro loans" (amounts less than $100) used to generate income by investing in a new or existing business, the poor are able to improve their economic condition and begin to work their way out of poverty. It is well documented that when low-income people have access to affordable capital, they are capable of utilizing their entrepreneurial skills to earn a living and support their families; some have even become highly successful business owners.

Contrary to traditional thinking, recipients of microfinance have demonstrated a high loan repayment rate, which shows that many poor people are indeed bankable and capable of transforming their lives if given affordable credit. Such lending disproves all conventional

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[1] Micro Credit Summit Campaign Report, 2005.

thinking about lending to the poor, and proves that microfinance can be one of the most sustainable and effective tools in the fight against global poverty.

A study of three Bangladeshi MFIs showed that a 40% reduction in moderate poverty in rural Bangladesh could be attributed to microfinance (Khandker, 2005). The study further proved that the spill-over effects of microfinance on non-participants was also positive. Microfinance enables low-income people to experience upward economic mobility and, more important, helps them move from survival mode to planning mode.

Traditional banking processes and systems have proved ineffective in providing universal access to credit. There are many economic, infrastructural, and last-mile issues that prohibit traditional banks from reaching out to the poor. The fundamental reason why commercial banks do not provide loans to low-income people is because they do not have sufficient assets that can be used as collateral or guarantee. Microfinance institutions came into existence to bridge this gap by offering collateral-free loans.

Microfinance first started in the 1970s and enjoyed early successes in Bangladesh and Bolivia. In India, SEWA bank was an early pioneer in providing financial services to low-income people in the 1970s. For the past 30 years, the worldwide microfinance industry has evolved through innovation and experimentation to become a major industry with its own trade associations, annual conferences, professional groups and online resources dedicated to microfinance. Several proven best practices and methodologies have evolved through the years and they continue to be replicated and adapted to suit local needs.

According to the Microcredit Summit Report 2006, it is estimated that 3,133 microfinance institutions worldwide report that 113 million people are receiving the benefits of microfinance. Among these 113 million of people, almost 82 million were the poorest at

the time of their first loan. Of these poorest clients, more than 84% are women. Assuming five persons per family, 82 million poor clients reached by the end of 2005 have in fact affected some 410 million family members. Table 2.1 shows the growth of MFIs and the total number of clients during the past decade. The number of clients reached grew at an average rate of just over 34%.

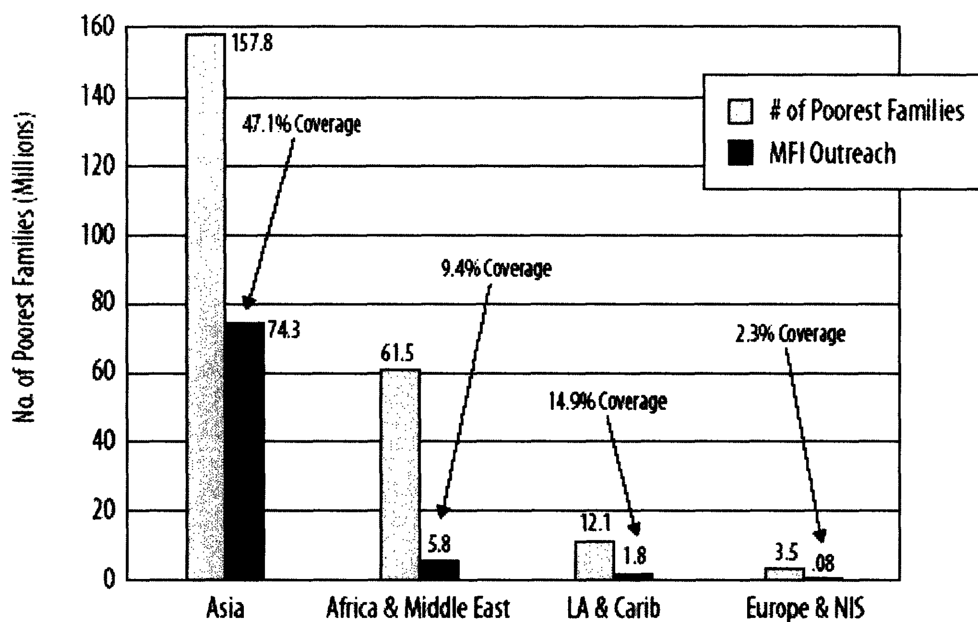
Table 2.1 Growth of MFIs and Number of Clients, 1997-2005

Year	Number of Programs Reporting	Total Number of clients reached	Number of poorest clients reported
12/31/97	618 institutions	13,478,797	7,600,000
12/31/98	925 institutions	20,938,899	12,221,918
12/31/99	1,065 institutions	23,555,689	13,779,872
12/31/00	1,567 institutions	30,681,107	19,327,451
12/31/01	2,186 institutions	54,932,235	26,878,332
12/31/02	2,572 institutions	67,606,080	41,594,778
12/31/03	2,931 institutions	80,868,343	54,785,433
12/31/04	3,164 institutions	92,270,289	66,614,871
12/31/05	3,133 institutions[a]	113,261,390	81,949,036

Source: State of the Microcredit Summit Campaign Report, 2006.

Figure 2.1 shows the number of families living in poverty in various regions of the world (i.e., those living on less than $1/day adjusted for purchasing power parity) and the number of poor families utilizing microfinance in each region, at the end of 2005. Asia has the highest percentage of poor people, amounting to 157.8 million families; it also has the highest MFI coverage ratio of 47.1%. Africa follows with 61.5 million poor families but only 9.4% of MFI coverage. Latin America and Europe have 12.1 and 3.5 million poor families, respectively, with 1.8% and 0.08% of MFI coverage, respectively.

Fig. 2.1 Regional Breakdown of Access to Microfinance



Source: State of the Microcredit Summit Campaign Report, 2006.

Clearly, microfinance is a powerful tool in the battle to alleviate poverty worldwide. In most developing countries, microfinance is embraced by local governments, multilateral agencies, and for-profit and non-profit MFIs. There remains, however, a large variation in the level of outreach and quality of microfinance services available among different countries of the world.

CHAPTER 3
Poverty and Microfinance in India

3.1 Poverty in India

India is home to more than 1.1 billion people and, according to UNDP statistics, 34% of the Indian population lives below the poverty line. This means 374 million people live on less than $1 a day and do not consume more than 2,100 calories a day. In addition, 80% of India's total population (880 million or 150 million households) lives on less than $2 a day (UNDP, 2006).

Although the population continually migrates from rural areas to urban areas, 70% of India's population still lives in rural areas. Lack of access to financial resources and few (or no) productive assets are the major causes of poverty among rural Indian people. High levels of illiteracy, poor health care coverage, and limited access to social services are common among the rural population.

In addition, the long-established hierarchical caste system is still very much intact in India's rural society. This system excludes the lower-caste population known as *dalits* and the "most backward classes" (also known as MBCs) from mainstream economic activities, which leaves them in destitution. Most are marginal farmers, landless laborers, and artisans who do not own any productive assets. Dalits constitute 25% of India's population, and 80% of them are very poor and considered the most disadvantaged section of India's population.

Depending on the social group they belong to, rural women in general are also among the most disadvantaged people in Indian society. Thus, dalit women are double victims—suffering both caste and gender bias—and they are the most vulnerable of all.

Despite the fact that the Indian economy has experienced impressive growth rates of 6% to 8% over the past 15 years—due in large part to the massive liberalization of economic policies in 1991—opportunities for the unskilled and the illiterate are not increasing fast enough compared to opportunities for the highly skilled labor, thus creating a lopsided growth in the economy and further worsening the gap between the rich and poor. The current economic expansion is primarily confined to the major urban areas, so the economic condition of the rural population remains unchanged. New job opportunities are created in the highly skilled service sectors, such as information technology, business process outsourcing, and research and development, but again, these jobs are mostly confined to urban areas, which prevent rural people from accessing even indirect employment.

3.2 Microfinance Demand and Supply

"*The annual credit demand by the poor in India is huge. The supply of microfinance services is growing but needs exponential growth to come anywhere close to meeting the demand*" (Sa-Dhan, 2006).

In the past decade, both the number of MFIs and the outreach of microfinance have grown rapidly, but there is still a huge gap between the demand for and supply of financial services for low-income Indian people. Assuming the average demand for credit per household to be $500 (Rs 21,000[1]), the total potential demand for credit is estimated at $75 billion. Many studies show that extending credit to the poor on reasonable terms can produce

[1] Exchange rate used throughout this thesis is Rs. 42 = US$1.

a significant reduction in poverty. However, in spite of the large network of commercial banks and cooperative banks in India, none are especially successful at serving the financial needs of the poor. The "All India Debt and Investment Survey" (1991) conducted by the Reserve Bank of India concluded that although institutional credit to rural households has increased steadily. However, people with low income continue to depend on non-institutional credit, typically from money lenders who charge exorbitant interest rates. The survey showed that total credit use from formal sources increased from 29.2% in 1971 to 56.6% in 1991, compared to credit from informal sources, which decreased from 70.8% in 1971 to 39.6% in 1991(Fisher & Sriram, 2002). One can conclude that although there is an increase in use of credit from formal sources, a sizable rural population and mostly low-income households continue to depend on the informal sources for their credit needs.

3.3 The Growth of Microfinance

Although the Indian government has long supported banking, bank penetration to the rural poor is very limited. The single most important reason for this lack of penetration is overall unfavorable banking policies. But a major breakthrough occurred when government policies were liberalized, which included support for lending to self-help groups—typically 15-20 members who form a cooperative and act as a joint liability group.

India has a well-established formal banking sector with a wide network of branches. However, the majority of the population is not served by the formal banking sector for various economic, legal, and infrastructure reasons. Lack of collateral and reaching the last mile in rural areas are the two most significant issues. Until economic reforms in 1991, the Indian government banking policy was highly regulated. After 1991, the government made

poverty alleviation a priority and expanded the banking network into rural areas. Banks were compelled to lend to people in the lower-income levels, thereby increasing the supply of credit to rural people. However, regulated and highly subsidized interest rates have caused high default rates—on the order of 40%—making lending to the rural poor not sustainable.

In 2004, a task force studying the revival of cooperative credit institutions (Task Force, 2004) concluded that the systems and procedures of India's traditional banking system, which were primarily designed for business and industrial financing in urban areas, had serious limitations, especially concerning the need to reach the last mile when dealing with the rural poor. One fundamental issue highlighted in the report was that banks offer credit based on collateral rather than on trust. Lack of collateral assets is a fundamental problem for the poor.

In 1991, the Indian government embarked on a massive campaign to liberalize the nation's economy. The government initiated a series of financial-sector reform policies that helped commercial banks expand into new markets based on their viability rather than directed by government policy. Successive new policy initiatives from the central government and state governments created a conducive atmosphere for the growth of microfinance and rural credit supply in India. Some of the key policy changes that helped the microfinance credit supply and the overall industry are:

- In 1996, Reserve Bank of India (RBI) deregulated interest rates for small loans (defined as those below Rs 200,000) made by cooperative and regional rural banks.
- In 2000, RBI declared that lending to MFIs would be a top priority.

- In 1995, the government of Andhra Pradesh state—a pioneer in the cooperative movement when it passed the Mutually Aided Cooperative Societies (MACS) Act—granted autonomy to the cooperatives. Soon several other states passed similar laws.
- In 1998, the Small Industries Development Bank of India (SIDBI) set up its Foundation for Micro-Credit, with initial capitalization of Rs 1000 million.

Reserve Bank of India data shows that over the last decade, the banks' outreach to small borrowers (defined as those seeking less than Rs. 25,000) has progressively declined, both as a proportion of credit and in terms of total bank accounts. Making financial services accessible to the rural poor required a new and innovative ways to operate compared to traditional banking processes. Microfinance institutions have thus emerged as key providers of financial services for low-income families.

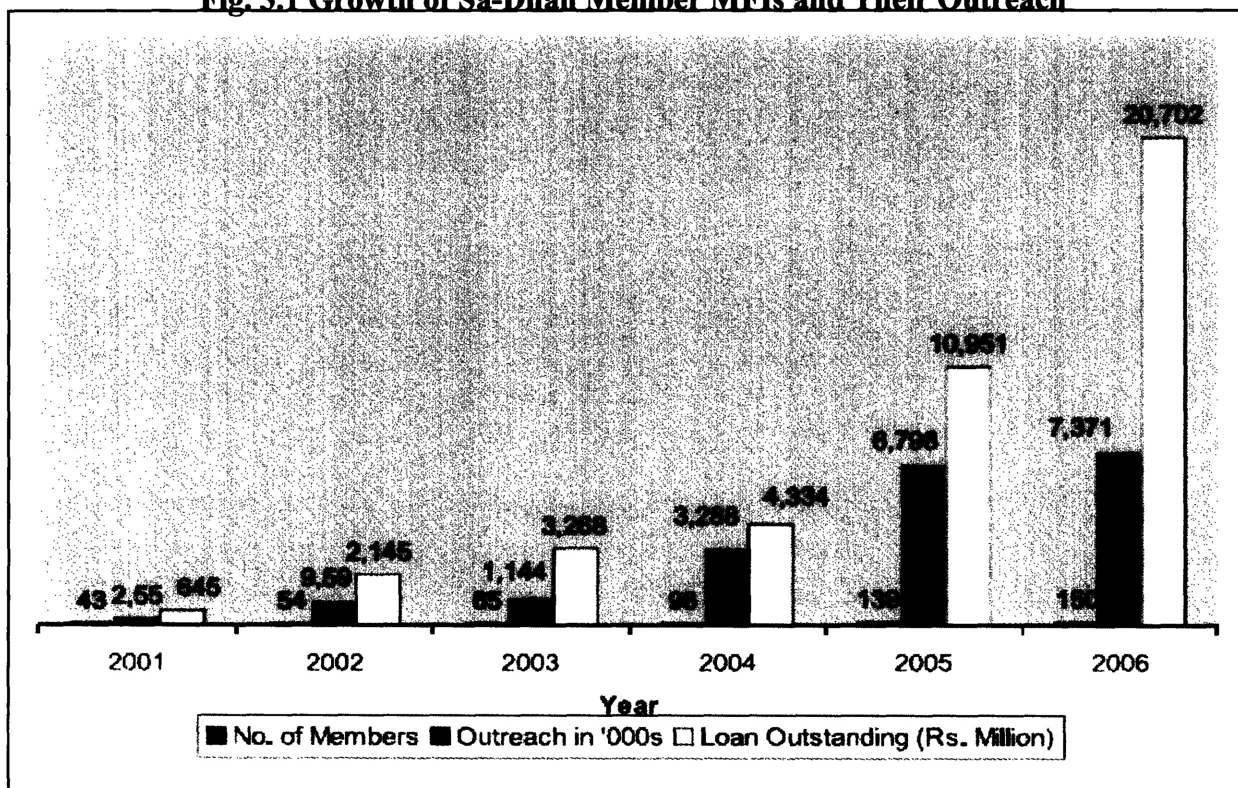
Modern forms of microfinance have only recently arrived in India, despite several successful microfinance programs in Bangladesh and Latin America. And microfinance activity in India has taken off during the past decade, and is currently at an inflection point. The supply of microfinance services is growing rapidly but the gap between demand and supply is still very large. According to several microfinance practitioners the current outreach is estimated to be $4.8 billion versus total demand of $75 billion. Therefore, there is a huge unmet demand for credit, which presents an attractive market opportunity for MFIs and investors.

Building on the early successes of the Self Help Group (SHG) movement, the government-owned National Bank of Agriculture and Rural Development (NABARD) aggressively supported the expansion of the SHG movement. High repayment rates and the proven positive economic impact of SHGs were key success factors, creating a virtuous cycle

of increasing enthusiasm among bankers and government agencies. Today, the SHG movement in India consists of 1.4 million groups with 20 million members (Arora 2005), and the movement is largely responsible for increasing the supply of microfinance services in India.

Figure 3.1 shows the growth pattern of Sa-Dhan (Industry Association of Community Development Finance Institutions in India). All major MFIs in India are members of this organization. Sa-Dhan membership and their combined outreach are good indicators of the growth of the microfinance industry in India. Sa-Dhan membership grew at an impressive rate of 250% between 2001 and 2006; during the same period, the combined outreach of their member MFIs and the gross loan portfolio experienced phenomenal growth of 2,791% and 3,110%, respectively.

Fig. 3.1 Growth of Sa-Dhan Member MFIs and Their Outreach



Source: Side-by-Side, A Slice of Microfinance Operation, 2006.

3.4 Indian Microfinance Models

Most of the MFIs in India originally began as NGOs that offered microfinance as an additional service. Today, over 1,000 NGOs and MFIs work in the microfinance sector in India (Sinha & Patole, 2002). During the last decade there has been tremendous growth in the number of MFIs in India, and most of the new ones are commercial microfinance institutions that are quite minimalist in their approach. Minimalist MFIs are those that focus on providing financial services to the poor in a financially sustainable way, and these MFIs typically do not offer non-financial services such as capacity building, livelihood promotion, or technical and marketing support. Most of the new generation of MFIs in India are minimalist MFIs.

There are different models of microfinance institutions operating in India. Most involve different agencies; commercial banks, NGOs, and local and federal governments. The most common practice is group lending, in which MFIs work with organized groups, and these groups act as intermediaries to conduct financial transactions with individuals. Only a small percentage of them deal directly with individuals. The most important aspect of these groups is the assumption of joint liability for loans taken by clients.

The two most common models are Self Help Groups (SHGs) and the Grameen Model. The core concept behind both types is similar, but they differ in several operational aspects.

3.4.1 Self-Help Groups

Self Help Groups typically consist of 15-20 people, 90% of whom are women who belong to the same village. Addressing the issue of why most members are women, Mohammed Yunus, founder of Grameen Bank told United States Congressional Forum, “Women have plans for themselves, for their children, about their home, the meals. They

have a vision. A man wants to enjoy himself" (Katherine and Richey, 2003). When finances are made available to women, it is fairly certain that surplus money will be put back into improving the household income.

The average size of SHGs in India is about 17. These groups are typically organized and promoted by NGOs, government agencies, and commercial banks. In India, SHGs are the best established and most predominant model, accounting for 70% of microfinance in India. SHGs are managed by the members themselves, although NGOs or government agencies usually provide training and capacity-building services until they are self sufficient and able to operate the group.

An important aspect of SHGs is their focus on regular savings by group members. SHGs typically pool their savings on a regular basis and then use the funds for loans to individuals in need. Interest rates are set by the groups themselves and administration—including disbursement, collection, and bookkeeping—is all done by group members. Individual groups may organize into federations in order to exchange funds between individual groups that have a demonstrated need. An SHG in need of additional funds may borrow from an SHG that has surplus funds, based on mutually agreed repayment terms.

SHGs open saving accounts in the group's name with an MFI or bank and deposit excess funds after required loans are distributed among group members. These deposits help the group qualify for a bank loan. As a registered group, SHGs can borrow money from a bank, and that money is used by the group to supplement its own funds for lending to members of the group.

Commercial banks that lend directly to SHGs have experienced tremendous growth, especially following a highly successful SHG-bank linkage program pioneered by NABARD

in 1992. In this model, MFIs act as a facilitator and intermediary between the commercial banks and the SHGs. In some cases, MFIs also act as a financial intermediary between the banks and SHGs, carrying the loan portfolio on their balance sheet.

According to NABARD, by end of the March 2006, 22.38 million SHGs (on a cumulative basis) have been active borrowers of the banking system covering more than 32.98 million households. NABARD, with its special emphasis on 13 priority states, has credit links with more than million SHGs in these states, which account for 45% of the total number of SHGs in India.

The number of SHGs has grown rapidly over the past 10 to 15 years, with an average annual growth rate of 82%. Having achieved its initial target of reaching 1 million SHGs in 2004 three years ahead of its target date, NABARD has set a target of connecting 2 million SHGs by 2008 covering 140 million house holds (Kumar 2005). The SHG-bank linkage program pioneered by NABARD had a huge impact on expansion in the microfinance sector in India. The total loan amount disbursed through these groups has an average annual growth rate of 110% (Fouillet & Augsburg 2007).

3.4.2 Grameen Model

The Grameen Model is a replication of a successful microfinance delivery model developed by Grameen Bank in Bangladesh. In this model, loans and other financial services are provided to village groups that have five or more members. Like the SHG model, the Grameen model works mostly with women. More than 20 MFIs in India use the Grameen model with minor variations to suit their local conditions. SKS and SHARE are two leading MFIs in India, both of which use the Grameen model.

Here is how it works. First, groups of five prospective borrowers are formed into a Joint Liability Group. Credit provisioning begins with a loan to only two of the five members in the group, and group leaders decide which member will receive the loan. Repayments are collected weekly by MFI field staff in village center meetings. Repayment in small amounts at weekly intervals has proved to be effective for achieving high repayment rates. In addition, the social pressure of other members who attend the weekly center meetings acts as social collateral, ensuring almost 100% repayments. The collective responsibility of the group serves as collateral for the loan and in case a borrower does not repay a loan, the other group members are responsible for repayment. Sometimes these groups of 5 are federated into a center, each comprised of about 20 members, and the centers may be further federated into branches.

The Grameen Model requires a dedicated, special-purpose organization and weekly visits by MFI staff to the centers. Most of the operations and bookkeeping are done by the MFI staff, including decisions on setting the terms of loans—in contrast to SHGs where the members do most of their own administration and bookkeeping. The different operating features of SHG and Grameen models are provided in the Appendix.

In Chapters 4 and 5, two case studies are presented, which compare and contrast the two models discussed here. The cases represent differing schools of thoughts that have evolved in the microfinance industry in India: (1) traditional non-profit NGOs delivering microfinance services as part of their larger development focus, and (2) a new generation of for-profit MFIs focused on financial sustainability and accelerated growth in order to expand the outreach.

CHAPTER 4
Case Study: SKS Microfinance Pvt. Ltd.

4.1 Introduction

This chapter presents a case study of SKS Micro Finance Pvt. Ltd (SKS). SKS is a for-profit MFI and uses the Grameen model. Information about SKS was obtained from discussions with its founder and CEO, Vikram Akula, in India and at MIT. I also visited SKS headquarters in Hyderabad in January 2007 and interviewed a few members of the SKS staff.

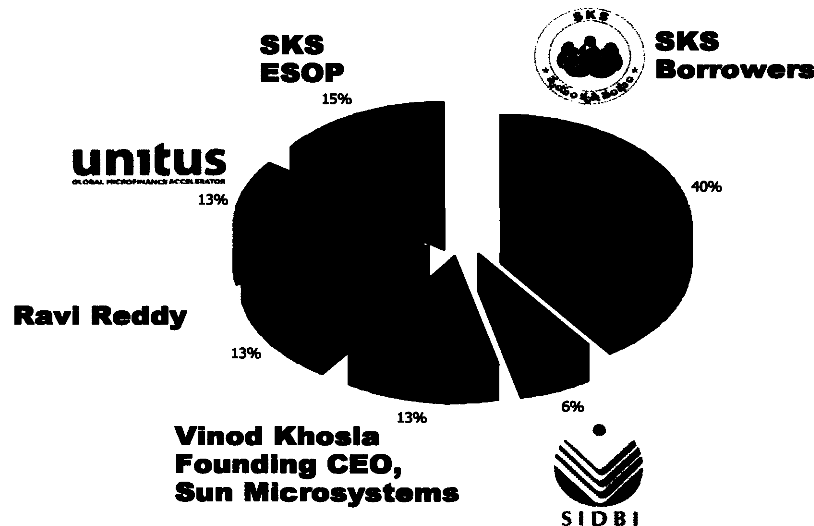
4.2 Overview of SKS

SKS is one of a new generation of MFIs, and one of the fastest-growing MFIs in the world, experiencing a 165% growth rate in 2006. As of April 30, 2007, SKS serves 632,000 clients in 11 Indian states and has an outstanding loan portfolio of $68 million (SKS website). SKS has 304 branch offices and nearly 2,000 employees, and it is currently growing at a rate of 30 branches per month and 60,000 new clients per month. SKS has disbursed more than $155 million since it started operations in 1998. It enjoys an extraordinary on-time repayment rate of 99%. SKS uses a version of the Grameen model.

SKS was founded in 1998 by Vikram Akula, in the Telangana region of Andhra Pradesh state in southern India. Its initial operations focused on rural areas of Telangana, one of the poorest regions of India. Telangana's rural population depends primarily on agriculture and related economic activities; the population is largely landless laborers and marginal farmers. Telangana is continually drought-prone, and has limited irrigation facilities, which is a major cause of economic backwardness, subjecting half of its population to abject poverty (Rao, 2003).

When it started in 1998 it was a non-profit organization, but it converted to a for-profit Non Banking Finance Company (NBFC) in January 2005. NBFCs are for-profit financial organizations regulated by the Reserve Bank of India (RBI). NBFCs raise their capital investment from commercial investors and global capital markets in the form of equity and debt. Since the transformation of SKS into an NBFC, it has successfully attracted capital for its first round of equity investment from well-known people and institutions such as Vinod Khosla, Unitus, and SIDBI. The equity ownership of SKS as of February 2007 is shown in Figure 4.1. SKS converted the grant money it received prior to becoming an NBFC into equity ownership by its clients and borrowers.

Fig. 4.1 Ownership Structure of SKS

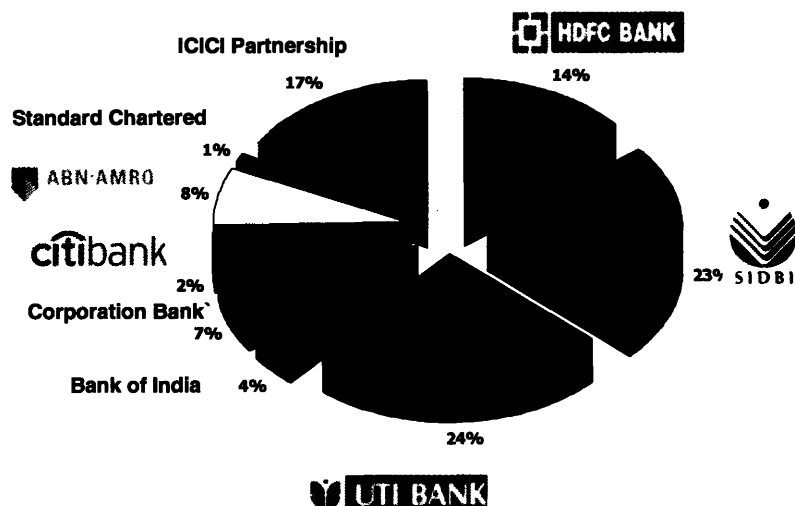


NOTE: The ownership structure shown here is prior to the second round of equity investment, which brought $11.5m and was led by Sequoia Capital on March 29, 2007. Other investors in this round included Unitus Equity Fund, Vinod Khosla, Ravi Reddy, and Odyssey Capital.

Source: Akula, 2007.

Leveraging the external equity investment of $3.2 million, SKS raised more than $45 million in debt from commercial banks in India and abroad. SKS's high leverage ratio (more than 14) indicates a typical MFI that is trying to leverage its limited equity to raise debt for lending. Figure 4.2 shows the composition of external debt borrowed from various banks and financial institutions. It is interesting that Citibank provided its first MFI loan in India to SKS, and HSBC provided its first-ever MFI loan to SKS. The funds borrowed from ICICI Bank are through its partnership model. In the partnership model, MFIs do not own the loan portfolio, so in this case SKS does not own the loan but acts as a service provider while the loan shows up on ICICI's balance sheet.

Fig. 4.2 Debt Raised by SKS from Commercial Lenders



Source: Akula, 2007.

4.3 SKS Strategy

SKS's strategy is to offer financial services to the poor in a financially sustainable way so SKS can scale its operations and reach millions of non-bankable poor people in India. SKS's strategy is based on three principles:

1. Profit-oriented model
2. Standardized and scalable best practices
3. Technology that automates operations.

In the following sections, these three strategies are discussed in detail.

4.3.1 Profit-Oriented Model

Recognizing that traditional methods of microfinance are difficult to scale due to their over-dependence on grant money, SKS offers its financial services to the poor in a financially sustainable way that earns profit while creating social good. This is a key point when accessing funds from commercial institutions. As discussed in Section 3.2, in India alone, the total demand for credit by the poor is estimated to be $75 billion, yet the current supply of micro lending is less than $5 billion—clearly, a huge gap between demand and supply. The only practical way to bridge this gap is by channeling funds from global capital markets in the form of equity investments and debt.

As part of its strategy, SKS transformed itself into a for-profit NBFC regulated by RBI. This for-profit status increases the comfort level of commercial banks and other financial institutions that might consider lending money to SKS, making them more willing to take higher risks and more comfortable about increasing their funding to SKS. NBFC status also enables SKS to raise equity investments not only from traditional banks but also from venture capital and private equity firms. Equity investors can have ownership in the firm and receive returns in the form of dividends from retained earnings. Equity capital is essential for raising debt, but often it is a major constraint for MFIs in general and especially for NGOs.

4.3.2 Standardized and Scalable Best Practices

SKS deploys standard, scalable best practices in order to reduce costs and quickly scale its operations. It uses the Grameen model lending methodology to mitigate risk. It also identifies relevant, well-defined best practices and replicates them repeatedly,

applying them to customers facing processes such as village selection, center formation, and financial transactions, and to non-customers facing processes such as branch office operations and recruitment and training of employees. Further detailed description of some of the best practices of SKS will be reviewed below in Section 4.4.

4.3.3 Using Technology to Automate Operations

SKS is a pioneer in using technology to automate its microfinance operations. As early as 2002, SKS was using smart cards to automate its field transactions. Its Management Information System (MIS) is developed in-house to automate transactions at the branch level as well as back-end operations and management reporting. This includes a portfolio tracker, an accounting module, and management reporting.

All the transactions conducted in local villages are entered in the MIS system at the branch office. This information is immediately passed to headquarters servers wherever Internet connectivity exists. If no Internet access is available, the branch office transactions data is burned to a CD every week and sent to headquarters for consolidation. The MIS system improves the efficiency of branch office operations by eliminating manual recording and tracking of transactions. The increased visibility and timely update of portfolio information helps senior management respond to potential problems in a timely manner.

At headquarters, the data is consolidated into one database for generating summary reports for management. Several reports that monitor performance are also used to support management decision making. In addition, several ad hoc reports are continually generated by the internal IT department to support the unique requirements of

the funding agencies. SKS has a strong internal IT department staffed by 33 people: 8 are at headquarters and rest are located at branch offices.

4.4 Operations

SKS operates in a hub-and-spoke model that mandates a branch office for every 20 to 30 villages. A typical branch office is staffed by 6 to 10 loan officers (Kumar, 2007). Each branch office is equipped with a computer and the Portfolio Tracker application system. Riding on motorbikes, the loan officers go to the villages every week to deliver the financial services.

A typical MFI operation can be classified into customer-facing field operations and non-customer-facing, back-office operations. SKS customer-facing operations include (1) village selection, (2) center formation, and (3) financial transactions. Non-customer-facing operations include branch office operations.

4.4.1 Village Selection

When SKS targets a new village, the branch office staff goes to the village and conducts a survey to better understand local economic activity and the level of poverty in the village. The staff also assesses the political stability of the village and determines its accessibility via road. Once a decision is made to begin operations in the village, a projection meeting is conducted where the staff introduce the SKS organization and its philosophy regarding micro loans to the villagers. As a follow-up, SKS staff also conduct sessions with individuals and smaller groups on an as-needed basis.

4.4.2 Center Formation

Once the village is selected, the next step is to form joint liability groups (JLG) of five members each. Like many microfinance institutions, SKS deals exclusively with women. The group members are usually known to each other and should be comfortable acting as guarantors for each other. This is the core concept of the Grameen model, where the group acts as collateral for individual loans and if any one of them defaults, the rest of the group members are responsible for paying off the loan.

A number of JLGs are grouped into what is called a Center for each village. A typical center may consist of 4 to 12 JLGs, and each village may have one or more centers. The center acts as another layer of joint liability for individuals and for the JLGs. Group members in the center go through compulsory training on the SKS group lending methodology before they can start conducting transactions.

4.4.3 Financial Transactions

SKS field assistants and loan officers visit each center every week. There they facilitate center meetings, where the weekly financial transactions, collections, and new loan disbursements are completed. Transactions are recorded on paper. In the past, SKS tried to automate the field transactions using the smartcards, but could not go further with the technology owing to regulatory issues and financial viability. Thus, it is a very labor-intensive and high-cost proposition to meet every customer, every week, at their doorstep. However, the Grameen model has found that weekly collection process is a best practice with the rural poor, who are more comfortable paying small amounts more frequently rather than larger amounts over longer periods. Dealing with large volumes of smaller

payments is one reason for the high operating costs of MFIs, which ultimately results in higher interest rates for the end clients.

4.4.4 Branch Office Operation

Before the field assistants go to the village centers, they take a print-out from the MIS system that lists all the collections and loan disbursements for the day. At the end of the day the field assistant returns to the branch office and enters all the day's transactions in the Portfolio Tracker, which takes 15-20 minutes. The new information is sent back to headquarters daily via the Internet (where there is connectivity), or weekly by CD (if there is no Internet connectivity).

4.5 Products

SKS currently offers various micro loans and micro insurance products. SKS previously offered savings product as well, but had to stop when SKS was transformed into an NBFC. RBI rules are not favorable for NBFCs wishing to offer savings products.

Table 4.1 lists products currently offered by SKS. The majority of loans are offered to meet the working capital needs of small enterprises and are for income-generation purposes only. These include income-generating loans (IGL), mid-term loans (MTL), and individual loans. Both IGLs and MTLs are offered through the group lending model, whereas individual loans are offered outside the group lending model. Individual loans are relatively a new product offered by SKS and are offered to those who have moved out of subsistence levels. The loan is offered following a thorough due diligence of the individual's business and a personal guarantee. Interest-free emergency loans are

also offered to SKS clients to cope with extreme financial situations, such as hospitalization and/or death. Repayment terms for such loans are determined on a case-by-case basis.

SKS offers insurance products to cover all loans provided to clients. Coverage is for the entire term of the loan and covers both principal and interest. Insurance is offered to all SKS clients and costs 1% of the total loan amount. The plan covers the life of the member and his/her spouse. This product is offered through collaboration with the Life Insurance Corporation of India. SKS covers almost 1.2 million people with its insurance product.

Table 4.1 SKS Product Offerings

Type of Product	Purpose	Terms	Interest Rate (Effective)
Income Generating Loans	Small Enterprise	Starting at Rs 10,000 ($230) 50 weekly repayments	25-30%*
Mid-Term Loans	Small Enterprise	Starting at Rs 10,000 ($230) 50 weekly repayments	25-30%
Individual Loans	Small Enterprise	Starting at Rs 20,000 ($460)	23%
Emergency Loans	Emergencies	20 weeks bullet repayment	0%
Insurance	Loan Cover Insurance for member and husband	1% of loan amount	NA

* The prime lending rate for Indian banks is around 13%. That rate is a good benchmark for consumer loans.

Sources: Akula, 2007; Ramalingam, 2007.

CHAPTER 5

Case Study: Ankuram Sangamam Poram

5.1 Introduction

Ankuram Sangamam Poram (ASP) is a non-profit NGO focused solely on *dalitbahujans*, who are the lowest strata in the Indian caste system and constitute 80% of India's population. The overwhelming percentage of *dalitbahujans* in India are poor or very poor.

I visited ASP in January and interviewed Jyothi Neelaiah, CEO of ASP and H. Dayanand, General Manager of ASP. The information in this case study is based on their interviews, information available at the ASP website, and several e-mail exchanges and telephone conversations I had with Neelaiah.

ASP is a multi-faceted NGO organization involved in livelihood promotion, capacity building, and microfinance. In this study, I focus mainly on its microfinance operations in an effort to compare and contrast ASP with commercial MFI entities such as SKS.

5.2 Overview of ASP

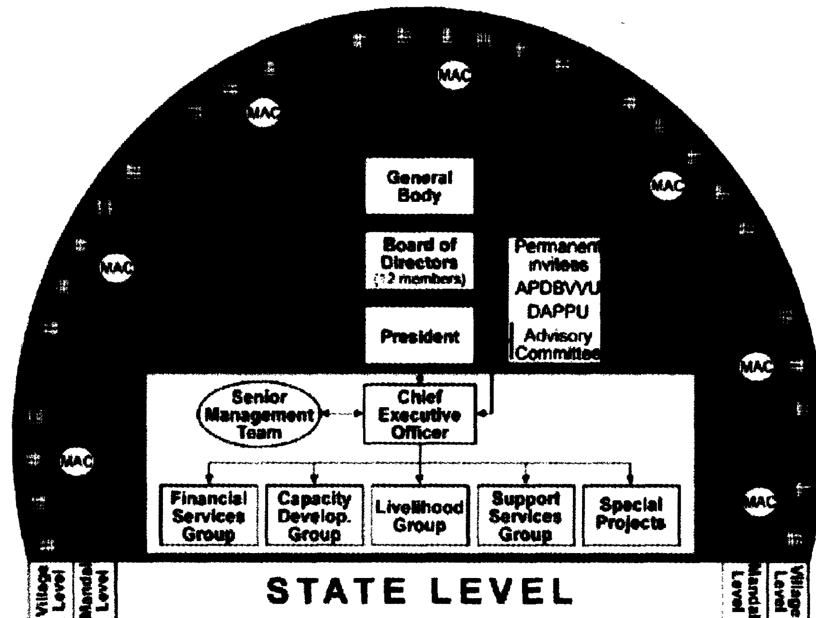
ASP is a non-profit organization founded in 1998 by J. Neelaiah by bringing together 165 cooperative societies, and it is based on the SHG model. ASP's primary focus is empowering the *dalitbahujans*, mostly in rural areas, by providing credit, livelihood training,

and support for their capacity-building activities. Microfinance is one of the services ASP provides, which is an integral part of its overall strategy to economically uplift the *dalitbahujans*.

ASP has 80,000 members spread over 1,500 villages in 85 mandals (a mandal is a local government unit consisting of 15-20 villages) in the state of Andhra Pradesh in south India. ASP focuses on savings and has so far accumulated savings worth Rs 12 crores ($2.8 million). It also has loans outstanding of Rs 20 crores ($4.65 million) with a repayment history of 90-95%. According to Neelaiah, the client base is growing at a rate of 20% per year. ASP has a total of 310 employees of which 55 are located at the headquarters in Hyderabad and the rest are located at the mandal offices. Each mandal office has an average of three employees.

ASP is registered as a Mutually Aided Cooperative Society (MACS) in Andhra Pradesh and with its 165 cooperative societies it formed a group of several village-level SHGs. The general body of ASP is made up of all the presidents of the mandal-level MACS, who elect a board of directors from the general body. The organization structure of ASP is shown in Figure 5.1 below.

Fig. 5.1 Organization Structure of ASP



Source: www.ankuram.com/structure.htm

5.3 Strategy

J. Neelaiah, ASP's founder, stated the firm's strategy as the following:

> *The primary strategy is mobilization of the* dalitbahujans, *especially women; their organization as a network of independent and inter-dependent cooperative micro-finance organizations, and their capacitation for self-managed delivery of a wide range of sustainable micro-finance and livelihood services.*

ASP has a three-pronged strategy to achieve its objectives:

- Focus on the poorest *dalitbahujan* women
- Use an institutional approach at each level of the organization, i.e., SHG, Mandal-level MACS, and the ASP federation. Client owned, operated, and used community organizations.

- Deliver a range of financial services such as savings, credit, insurance and non-financial services such as capacity development and livelihood promotion.

5.4 Operations

ASP operates as a three-tier, hierarchical model: ASP, Mandal-level MACS, and the SHGs—and it also has three primary operating themes: Ankuram, Sangamam and Poram.

- *Ankuram* means "a tender shoot." This theme focuses on the livelihood and small-enterprise activities in the farm and non-farm sectors where women and men can become members.
- *Sangamam* means 'meeting point." This theme focuses on microfinance and offers savings and credit activities exclusively for *dalitbahujan* women.
- *Poram* means "anvil." This theme focuses on the leather artisans, helping to improve their economic activity by training and market linkages.

In this thesis, I focus on the *Sangamam* aspect, which offers microfinance services to the poor. These services can best be described by discussing activities in the three tiers of the ASP organization, i.e., at the ASP, Mandal-level MACS, and SHG levels.

5.4.1 Self Help Groups

At village level, an SHG is typically formed with 15 to 20 members, with one or more SHGs per village. SHGs are self-managed groups that elect two members as leaders to represent their SHGs in the mandal-level MACS. Leaders also conduct bi-weekly meetings, administer financial transactions, and manually record them in the books. Leadership is

rotated among the members every year. SHG members abide by certain group norms such as mandatory attendance at bi-weekly meetings and compulsory savings every month.

The most important aspect of the SHGs is pooling the members' savings and rotating the money within the group to meet individual needs. Therefore, each member of the SHG must agree to compulsory savings of Rs.30 ($0.7) per month. Additional savings above and beyond the prescribed minimum is encouraged. The pooled money is distributed as small loans to members in need of credit for small enterprises and for various consumption needs. Loans larger than Rs.6,000 ($140) are obtained from the parent MACs.

5.4.2 Mandal-level MACS

A Mutually Aided Cooperative is a legal entity under the Mutually Aided Cooperatives Societies (MACS) Act of 1995 in Andhra Pradesh state. Within the ASP structure, each mandal has one registered MACS, and all SHG members within that mandal become members. The general body of the MACS is represented by two leaders from each SHG, who in turn elect 11 to 15 board of directors; the general body also elects a president. One-third of the board of directors retires every year, making room for new leadership. The board of directors meets once a month.

Each MACS is staffed by three full-time professional employees who guide the MACS leadership and supervise the SHGs. With its legal status, MACS acts as an intermediary to access external credit and other non-financial services for its members and as links to government agencies and development programs. The key success of the MACS lies in its financially self-sufficient operations. MACS receive a 4% commission on the lending it provides to SHGs. The costs for accessing credit are totally borne by MACS, although the

parent federation provides partial support for non-financial services undertaken by the MACS.

5.4.3 ASP Federation

The ASP federation itself is registered as a MACS under the Andhra Pradesh State MACS Act. It functions as a federation of all mandal-level MACS. The ASP federation's general body is made up of presidents of mandal-level MACS who elect a board of directors from the general body.

ASP headquarters is staffed by 55 people, most of whom are computer literate. The primary function of the federation is to develop the processes and systems for operating the individual MACS and SHGs. The federation also develops various savings, credit, and insurance products, as well as the operating processes used by the MACS. The federation maintains relationships with various financial institutions and commercial banks and raises credit on an as-needed basis.

ASP has raised credit with financial institutions such as ICICI, Basix, and UTI. The current external borrowings of the ASP federation are around Rs. 8 crores ($1.9 million), which is provided to MACS for downward lending to SHG members. The average cost of funding for the federation is 11.5%, which is loaned to MACS at 17%, which in turn is loaned to the SHG members at 21%.

5.4.4 Technology

Very little technology is used at ASP. At the SHG-level and mandal-level MACS, transactions are recorded and tracked using the customary manual bookkeeping style.

However, uniform and consistent processes are followed across all SHGs and MACS. ASP operates in 11 districts and there is one computer in each district. There are about 20 computers in ASP headquarters and 30 of the 55 staff at headquarters use computers regularly to perform their daily duties.

The Excel-based Portfolio application and Tally accounting software are the two primary applications used. Portfolio is used to track loans provided from ASP headquarters to mandal-level MACS. It is granular enough to provide individual loan information. Excel reporting capabilities are used to generate management reports. ASP is actively looking to upgrade to a more sophisticated core banking solution and MIS system. However, ASP is taking a wait-and-see approach to automating the field operations until a viable, cost-effective solution emerges in the market.

CHAPTER 6

The Indian Microfinance Industry: Trends and Challenges

6.1 Introduction

Microfinance providers in India have enjoyed significant growth during the past decade, with the past three to five years witnessing even greater acceleration. However, as discussed in Chapter 3, the demand for microfinance services far outweighs the supply, which indicates that there is large growth potential for microfinance in India. In order to capture this opportunity, however, the microfinance industry needs to overcome some major challenges. This chapter explores the trends and challenges the MFIs are experiencing as they seek to scale up microfinance services in India.

6.2 Trends

As the Indian microfinance industry matures and enters into a phase of high growth, several trends can be observed. Trends in three areas are discussed below:

- Commercialization
- Operations
- Technology

6.2.1 Commercialization

According to a 2005 report by Sa-Dhan: "The MFIs that are operating in the form of a company (NBFC/Section 25) are leading the growth. The MFIs that are in the form of a society/trust are more in numbers but are much slower in their growth" This tremendous business opportunity due to the gap between demand and supply is attracting entrepreneurs, commercial investors, and professional managers to the microfinance industry. As a result, the industry as a whole is becoming increasingly commercialized. Traditionally, the industry has been operated largely by not-for-profit NGOs, and primary funding was provided by multilateral and government institutions.

Some trends in commercialization, discussed below are:

- Increasing numbers of for-profit MFIs
- Commercial banks are offering funding
- Equity financing is beginning to appear

➔ Number of For-Profit MFIs is Growing

Traditional MFIs, operated by NGOs, are hugely dependent on donor or grant money from multilateral and government organizations and most of this type of funding is limited and cannot be scaled. In order to begin filling the enormous unmet demand for microfinance services, MFIs need to scale up their operations at an accelerated pace. As stated in Chapter 3.2, the current supply does not cover even 10% of total demand in India. But the growth of the MFIs can happen only when they generate sustainable profits, thus helping to fund additional investments but also helping to borrow money from capital markets for downward lending. Hence, the larger, successful MFI organizations that registered initially as not-for-

profit trusts or societies are now transforming into for-profit non-bank finance companies (NBFC). SKS is one such example, transforming itself from a non-profit society to an NBFC.

The for-profit nature of MFIs tends toward better governance, as they are subjected to more stringent and transparent accounting practices as specified by RBI. This leads to increased comfort levels among commercial banks that are considering lending to NBFCs.

At the same time, NBFCs also can raise external equity investment, which is essential for MFIs to leverage and borrow debt for lending. SKS recently completed the second round of equity investment of $11.5 million (Rs 506m), led by U.S.-based venture capital firm Sequoia Capital.[1] SKS is planning to leverage this equity investment to raise more debt to support its aggressive growth rate of more than 100%. This trend of equity investments into for-profit MFIs is expected to continue as more and larger MFIs convert to for-profit NBFC status.

In spite of the advantages of converting to NBFCs, many non-profit MFIs are not able to make the conversion to NBFCs for two reasons:

1) NBFCs must have a minimum start-up capital of Rs 20m (or $465,000), which is beyond the reach of most Indian MFIs.
2) NBFCs are subjected to very stringent requirements for raising savings, which is the primary source of low-cost funding for smaller MFIs. Lack of savings places them at a disadvantage of raising debt from commercial banks at higher interest rates.

To understand the distribution of MFIs with respect to their total loans outstanding, only 27 of 117 MFIs (23%) reported data to Sa-Dhan in 2006, and they have total outstanding loans of more than Rs 50m (~$1.19 million). Only 7 of 117 MFIs are

[1] <http://www.sksindia.com/07mar29.htm>.

incorporated as NBFCs, and one other MFI is incorporated as a local area bank (LAB), which requires an even higher capitalization of Rs 50m. Smaller MFIs cannot convert to NBFCs because of this capitalization requirement as well as the inability of NBFCs to raise savings.

The MFI community in India has recommended the creation of an alternative new class of financial institutions for smaller, for-profit MFIs, with a suggested lower capitalization requirement of Rs 1 million (~$238,000).

Another important factor that would enable MFIs to convert to NBFCs would be to provide the ability to raise savings, with certain safeguards (Mahajan, 2002). The savings mobilized from their clients would help MFIs reduce their cost of funding; otherwise, the only source would be to borrow bulk money from commercial banks at higher interest rates, which ultimately results in higher interest rates to the end clients.

➔ Commercial Banks are Increasing the Supply of Funds

Many commercial banks in India and abroad are increasingly participating in funding microfinance activities in India, which has been traditionally supported by government agencies such as NABARD. Almost all large India-based banks—ICICI Bank, HDFC Bank, UTI Bank, Bank of India, Canara Bank, Andhra Bank, and many others—have actively funded and continue to increase their portfolio of microfinance loans. Foreign banks, such as Citibank, ABN-Amro, and Ing Vysya, have also significantly increased their funding to MFIs.

ICICI Bank: Partnership Model

ICICI Bank is by far the leading commercial bank providing finance to MFIs directly or indirectly. ICICI developed an innovative partnership model with MFIs, in addition to its active direct debt financing to MFIs. In this model, ICICI leverages the expertise of MFIs' core competency of providing financial services in rural areas and uses the MFIs as agents or service providers. Loans to end users are held on the ICICI books, and MFIs merely provide services—conducting due diligence, issuing loans, and collecting repayments. MFIs are paid fees for these services. ICICI has achieved great success in expanding its reach to the rural poor by using this model, providing $227 million worth of loans to 1.2 million rural households using this partnership model (Duflo, 2005).

➔ **Securitization**

ICICI Bank was the first to use securitization of microfinance loan portfolios as a means of providing financing to MFIs. ICICI Bank bought a portion of the microfinance portfolio of SHARE Microfin Ltd, one of India's largest MFIs operating in southern India. As part of the deal, ICICI bought the receivables of the existing loan portfolio, for which it paid $4.9 million. Grameen Foundation USA provided a collateral deposit of $325,000. The end result for SHARE was that the cost of funds was 4% lower than borrowing directly. In addition, SHARE continues to service the loans it sold to ICICI and collect service fees—a win-win situation for everyone. This arrangement not only provides additional finances for new loans but also continues to gain revenue from existing loans.

On the global front, the $180 million, asset-backed securitization of the microfinance loan portfolio of Bangladesh Rural Advancement Committee (BRAC) was a major step

toward opening another avenue for MFIs to reach out to the global capital markets. The deal was financed by Citibank, Netherlands Development Finance Company, and KfW Entwicklungsbank.[2] In another major international securitization deal, BlueOrchard Finance and Morgan Stanley collaborated to provide $106 million of structured finance to 22 MFIs in 13 countries across Europe, Asia, and Latin America.[3]

➔ Equity Investment

Equity investment in MFIs is at a very nascent stage in India, although a number of venture capital organizations focused on microfinance and the social sectors have appeared recently. Some notable ones are: Bellwether Fund, Lok Capital, Aaviskhar, Intellecap, and Grameen Capital. Bellwether Fund focuses exclusively on microfinance, raising $10 million to make equity and debt investments in 11 MFIs. ACCION International, a major global microfinance investor and promoter, began an India-focused fund in partnership with Unitus.[4]

The most significant equity investment so far has been SKS's second-round financing. SKS raised equity investment of $11 million lea by Sequoia Capital, making SKS the largest venture-backed MFI in the world. As new MFIs start up quickly, existing MFIs are scaling up their operations at an accelerated pace. There is a critical need to attract equity investment and leverage it to raise debt and maintain capital adequacy norms. One issue facing MFIs that try to raise equity investment is accurate valuation methods. Lack of clear

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[2] Micro Capital Monitor, July 11 2006, Issue# 1

[3] http://www.microcapital.org/cblog/index.php?/archives/285-BlueOrchard-Finance-and-Morgan-Stanley-Partner-in-106-Million-Landmark-Financing-Deal-for-Microfinance-Investment.html#extended

[4] http://www.accion.org/media_press_releases_detail.asp_Q_NEWS_E_21

exit strategies for MFIs also discourages typical venture capital investors, who want to cash out within 5 to10 years.

By underwriting microfinance activities with new models of investment such as those discussed in this section, commercial banks are expected to play a key role in providing the much-needed funding for micro-credit in India.

6.2.2 Operations

As the microfinance industry grows at an accelerated pace in India, the scale factor presents opportunities as well as challenges. MFIs are adopting professional management principles and industry best practices in their operations, and they are increasingly leveraging the latest technologies to improve their field operations as well as at the back offices.

➔ MFIs operating efficiency is improving

As shown in Table 6.1 below, the Indian microfinance industry, in the aggregate, achieved an operating self sufficient (OSS) measure close to 110.3% by the end of 2005 (Sa-Dhan, 2006). A 100% OSS means the MFI is earning enough interest income to cover its total costs—a combination of the cost of funds, cost of operations, and cost of loan losses (or cost of risk). This is a positive indicator of the maturing the entire industry to near sustainability, although the outreach is still relatively small.

Among the 74 MFIs it studied in 2005, Sa-Dhan reported that 14 had become OSS and the rest were between 70%-99% OSS. This is an important trend among Indian MFIs, especially the larger ones. It means they are becoming financially self sufficient and generating profits that will enable allow them to expand their operations.

Table 6.1 Performance Measures of MFIs in India (2004-2006)

Fiscal Year	**Operational Self Sufficiency (%)**	**Operating Cost Ratio (%)**	**Total Cost Ratio (%)**
FY 2004	72.8	20.0	34.9
FY 2005	110.32	15.43	24.9
FY 2006	104.64	15.43	23.39
Sa-Dhan recommended benchmarks	> 100	< 20	< 30

Source: Sa-Dhan, 2006, adapted by the author.

In addition, the MFIs are improving their operating and financing costs, which are reflected in improvements in two key ratios: Operating Cost Ratio (OCR)[5] and Total Cost Ratio (TCR).[6] OCR has improved 4.57% points from FY 2004 to FY 2005 and remained constant in FY 2006. TCR has improved significantly, almost 10% points from FY 2004 to FY 2005 and 1.51% points from FY 2005 to FY 2006, which indicates that performance improvement achieved in FY 2006 is due mainly to low-cost financing from commercial banks.

Due to the doorstep service of microfinance, operating costs are very high, and any efficiencies gained in field operations have a great impact on overall MFI performance. MFIs employ multiple strategies to contain costs and improve efficiency. Several key elements drive these efficiencies and improved performance:

- Horizontal and Vertical Growth: The growth strategies of MFIs include horizontal and vertical growth. Horizontal growth is achieved by growing geographically, while vertical growth is achieved by offering multiple products to the same clients or increasing the size

[5] Operating Cost Ratio = Total Operating Costs / Average Outstanding Portfolio.

[6] Total Cost Ratio = Total Costs / Average Outstanding Portfolio.

of loans. The later strategy has the clear advantage of leveraging the same field staff for multiple and higher-value transactions (e.g., credit, savings, insurance, remittances) during the same visit to clients. Geographical expansion is usually done in contiguous areas to minimize the cost of serving additional clients. Of course, adding more clients in the existing geographical area has obvious operating efficiencies, and all MFIs seek new clients in their existing coverage areas.

- Low-Cost and Longer-Term Financing: MFIs can access low-cost funding due to increased competition among the commercial banks and an increased supply of funds. Banks are lending at lower interest rates; and the larger MFIs can arrange longer-term bulk loans that have a positive impact on their operating efficiency. Long-term financing allows MFIs to spread the lending risks over a larger client base and offers more diversified products and use of funds.
- Professional Management: Indian MFIs are attracting and recruiting management professionals from business schools and the financial services industry. As the larger MFIs transform into full-fledged financial institutions with operations in multiple states, they require professional management in order to operate as a viable business. And as the outstanding loan portfolio grows, the management of MFIs is driving systematic improvements in loan asset portfolios, which in turn impacts operating efficiency. There is evidence that MFIs are increasingly adopting a corporate organizational structure, and titles such as Chief Operating Officer, Chief Financial Officer, Vice President of Technology or Chief Technology Officer, and VP of Human Resources are becoming more common. SKS recently organized its top-level management and added titles such as Vice President of Finance, Vice President of Operations, and Vice President of

Technology (Akula, 2007). ASP recruited a 20-year financial services veteran from Canara Bank to head its microfinance program. The CEO of ASP said that transforming its microfinance operations into an NBFC is one of the primary goals, and that requires professional managers from the financial services industry to make it happen Neelaiah, 2007).

6.2.3 Technology

➔ Slow to Adopt

Technology adoption among the MFIs is relatively low, with even some of the successful ones lagging behind. The smarter, more visionary MFIs have leveraged technology to reduce operating costs in the field, improve management decision making, and improve overall financial performance. Using MIS systems, some MFIs can accurately estimate transactions costs for a specific financial product so they can better predict and control the costs.

Some early technology adopters, such as SKS and BASIX, have pioneered the testing and use of new technologies, such as smartcards, PDAs, and advanced communication technologies beyond MIS systems. Costs and legal issues have prevented even these advanced companies from deploying these solutions beyond the pilot stage. SKS believes technology is a key component for rapidly scaling its operations and becoming more cost effective. Several other MFIs, including ASP use computers and software applications such as MS Excel to track their loan portfolio and management reporting.

It is estimated that only the largest 20 of more than 200 MFIs have some type of MIS, but the trend is clearly on the upswing.

➔ **Financial Information Network and Operations**

The most important technology development for the Indian microfinance industry is the launch of Financial Information Network and Operations (FINO). A collaboration between IBM and I-flex, FINO was developed as a comprehensive, end-to-end solution for automating field operations and core banking solutions. Their solution roadmap also includes the development of a credit bureau in the future.

FINO was spun out of ICICI Bank as an independent company in June 2006, and it owns 30%. The other equity investors include International Finance Corporation, NBARD, Indian Bank, Corporation Bank, and Sovereign Global.

FINO leverages multi-function, personalized smartcards and biometric authentication to automate field operations. Smartcards will eliminate the need for customer passbooks and also serve as proof of identity. Other key banking solutions automate portfolio tracking and traditional banking transactions, and include comprehensive management reporting capabilities.

FINO has already conducted several pilots with MFIs, and it is in the initial stages of production deployment. MFIs who have already signed up with FINO include KAS Foundation, Spandana, and SEWA Bank. In addition, several banks have adopted this solution. Cost is still a concern, even for large MFIs. Initial enrollment costs include the cost of smartcards and enrollment fees for each member. MFIs also need to buy hand-held devices for the field staff. The operating cost is charged as a percentage of transaction monies.

This solution is very comprehensive, but whether MFIs can utilize all the functionality is questionable. In addition, the efficiency gains in field operations are also hard to justify given that most smaller MFIs use simple products and repayment terms for an

entire group or village. Typically, MFIs use exception-based recording in the field, which is quite efficient and less time-consuming.

However, by leveraging its strong relationships with Indian MFIs and its deep knowledge of microfinance operations, FINO is well positioned to capture the rapidly growing microfinance market. FINO has set aggressive targets for expanding its outreach, targeting 2 million customers by the end of 2007, and 25 million customers within 5 years.

6.3 Challenges

There is ample evidence of tremendous growth possibilities for the Indian microfinance industry. However, in order to realize this growth, MFIs and the industry as a whole need to overcome significant challenges in the coming years. The following sections discuss some of the challenges facing the industry and the ways it is trying to overcome these challenges.

➔ High Interest Rates

One of the primary challenges of the industry is high interest rates, which often attract negative attention from politicians and public advocacy groups, and leads to government intervention. The unfortunate suicide death of several MFI clients in Andhra Pradesh in 2006 is a black mark on the entire industry. This incident caught the attention of the national and international media, and eventually led to intervention by the state government, which eventually set a ceiling on interest rates charged by MFIs.

In their defense, MFIs have to be financially sustainable in order to grow their operations and reach the millions of poor people not yet served by the industry. Clearly, there

is a delicate balance between profitability and interest rates charged to end clients. For example, SKS typically charges an effective rate of 24%, while ASP charges 21% to their end customers. In comparison, traditional banks provide consumer loans to creditworthy customers with interest rates in the range of 10-15%. This means poor people pay almost double the interest paid by a creditworthy middle or upper-income customer. Consider, however, that before MFIs started operating in their current form, the only source for loans for the poor was a money lender who charged exorbitantly high interest rates ranging from 50% to 200%.

One of the main reasons MFIs have to charge higher interest rates is to cover the high operating costs required to deliver microfinance services to the doors of their rural clients. There are a large number of transactions, in very small amounts, which makes the cost of each transaction very high as a percentage of the transaction amount. As noted earlier, it is encouraging to see that overall industry efficiency is growing, and continued improvements in the cost structure of the MFIs will have a positive impact on interest rates and ultimately create a win-win situation for both the end clients and the MFIs.

➔ Capacity Building

MFIs traditionally evolve from NGOs that were focused on social development. This means that management comes from the social sector and possess limited skills in financial services and business management. Typically they are trained in disciplines such as capacity building, livelihood promotion, and raising donor or grant money from multilateral and government organizations.

As the microfinance industry continues to grow rapidly and becomes more commercialized, the industry will require professional managers and technical staff to manage the MFIs as viable businesses. Microfinance has evolved into its own discipline and it requires specialized skills—a combination of social development, financial services, and business management, which is a rare combination of skills, and there are not enough people in India who are professionally trained in such a diverse set of skills. It is estimated that during the next four years the Indian microfinance industry will require 20,000 professionals with expertise in accounting, financial control, risk management, business planning, financial analysis, new product design, MIS, and social development.

Another major hurdle facing MFIs hoping to attract professional talent and business school graduates is the perception that microfinance is still not a viable business and cannot provide a professional work environment.

There are some ongoing developments toward filling the need for microfinance professionals. The Washington-based Micro Finance Management Institute is collaborating with the top business schools in India to develop courses and training materials for microfinance management. ICICI Bank, in collaboration with the Center for Microfinance and the recruitment consulting firm Mitra, has founded "MFI Careers," which will analyze the requirements for microfinance jobs. They will also create awareness and promotion of the microfinance industry with potential candidates and universities.

➔ Commercial Finance

As discussed earlier, there is an increasing supply of capital from commercial banks and other investors. However, there are still challenges for smaller MFIs and in some cases larger MFIs, to access the capital needed to grow their operations.

➔ Equity Capital

Equity capital is essential for leveraging debt financing and maintaining capital adequacy norms. According to RBI regulations, NGOs, one of the main constituents of financiers, are not allowed to make equity investments in MFIs. The microfinance community in India continues to recommend changing this regulation to increase the amount of available equity capital for MFIs.

According to Sa-Dhan estimates, Indian MFIs require an equity investment of Rs 1 billion ($23.8 million). ICICI Bank is one of the largest commercial financiers, and it is currently working with 30 large MFIs in India that want to rapidly expand their MFI relationships. ICICI provides bulk loans for lending and works with MFIs in a partnership model. ICICI sees the lack of equity capital as one of the main constraints preventing them from extending bulk loans to smaller MFIs[7].

The smaller MFIs are faced with issues such as lack of proper financial control, internal governance mechanisms, and risk management, which are very important for accurate valuation of the firms. Without proper valuation mechanisms, investors are not inclined to make equity investments.

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[7] Center for Microfinance at Institute for Financial Management and Research, Microfinance in India – Current Trends and Challenges, October 2006.

Another important consideration for equity investors is an exit strategy. The Indian microfinance industry is just now taking off, and there are no incidents of MFIs being acquired or issuing an IPO. Equity investors typically look to exit their venture investments within 5 to 10 years, and having no forward-looking view of possible exit makes it harder for them to take ownership in MFIs.

➔ Limited Debt Financing Options

Debt financing is limited to mostly short-term bulk loans at market rates. Only institutions such as SIDBI and NBARD provide long-term loans at rates better than the market. An increasing number of commercial banks are showing interest, but only a handful of large commercial banks in India are actually financing MFIs.

MFIs have not yet been able to access the public bond markets in India, which is another important avenue for accessing funds.

Another option is to create structured finance deals with asset-backed securitization of the loan portfolios similar to the deal undertaken by BRAC in Bangladesh. This means of financing not only helps diversify the funding sources but also significantly lowers the cost of capital.

➔ Policies and Regulations

The government and Ministry of Finance have made many favorable policy changes in the past two decades to promote microfinance activity in India. NABARD as an apex government body for agriculture and rural development in India has done an exceptional job of promoting the SHG-bank linkage program and is largely responsible for increasing

commercial bank lending to MFIs. However, government policies and regulations still hamper the microfinance industry in India, and further policy changes will be needed to promote growth. Other state and federal governments continue to provide subsidized loans, which creates market distortions. Random and *ad hoc* debt relief by government agencies is another impediment to developing a culture of repayment among the poor.

In the earlier chapters, we discussed the advantages for non-profit NGOs registered as societies and trusts to convert to NBFCs. But there are several discouraging factors for smaller MFIs that wish to make this conversion. First, is the minimum capital requirement of Rs 20 million ($465,000), which is well beyond the reach of many smaller MFIs. In Indonesia, by comparison, the minimum capital requirement for commercial MFIs is $58,000—almost 10 times lower than what is required in India.

Another major limitation for NBFCs is the severe restrictions on mobilizing savings. NBFCs can accept deposits only if they achieve an investment-grade rating from an independent rating agency. Even a large profitable MFI like SKS made the decision to stop accepting deposits when it converted to an NBFC. SKS now offers only micro credit and insurance products. Inability to accept deposits denies the NBFCs an important source of low-cost funds for lending, which could lower interest rates for the end clients. Introducing a tiered regulation for NBFCs that includes different levels of minimum capital requirements and easing the restrictions on mobilization of deposits, would allow a large number of NGO MFIs to convert to for-profit entities.

CHAPTER 7

Summary and Conclusions

7.1 Summary of the Study

In this study, I reviewed the current state of microfinance in India. In addition, two representative case studies were conducted as part of the research. The two studies were chosen not only to represent the two differing schools of thought in microfinance (for-profit commercial MFIs and not-for-profit NGOs) but also because they offer good examples of the two dominant microfinance delivery models used in India—the Grameen model and the Self Help Group model.

The study captures evolving legal structures, strategies, financing models, and operating models used by Indian MFIs to rapidly grow their operations in order to fulfill the huge unmet demand for microfinance. I also discussed the legal, financial, and technological challenges facing MFIs, and I recommended remedial measures and policy changes required to support the urgent need to expand microfinance services in India.

7.2 Conclusions

To summarize the findings of this study, the following conclusions can be drawn.

- ➔ Microfinance has become a viable tool for alleviating poverty. With its enormous population of poor people, India has attracted increased attention over the past decade, although microfinance services were actually initiated by NGOs in India 30 years ago.
- ➔ There is a huge gap between demand and supply for microfinance services in India. Less than 10% of the total demand for micro credit is presently met.
- ➔ During the last decade, the microfinance industry in India has evolved in many respects, and it is now entering a new phase of rapid expansion. Some of the larger MFIs are experiencing more than a 100% year-over-year growth.
- ➔ SHG-bank linkages were pioneered and aggressively promoted by NABARD, which was largely responsible for microfinance growth in the 1990s.
- ➔ Commercial MFIs are leading microfinance growth in India. Larger MFIs run as NGOs are converting to for-profit organizations in order to grow their operations and attract investments from commercial banks and other institutional investors.
- ➔ NBFC is the most common legal form adopted by for-profit MFIs. MFIs started as societies and trusts, but after reaching a certain size they are now inclined to convert to NBFCs.
- ➔ The models most widely used by Indian MFIs are the self-help group model and the Grameen model. Clients reached by MFIs using the Grameen model are growing at a faster rate than those reached by MFIs using the SHG model. One reason is that the Grameen model is preferred by commercial MFIs as it enables them to create smaller

groups more quickly. On the other hand, the SHG model requires considerable up-front work and takes much longer to form a group and make it self sufficient.

- MFIs in India offer three primary microfinance products: loans, savings, and insurance, although a majority of MFIs focus on credit services. Most MFIs that adopted the SHG model have a compulsory savings policy.
- There has been a significant increase in the supply of capital for microfinance services due to the strong entry of commercial banks. However, challenges still remain for smaller MFIs that wish to access capital. While traditional lending from commercial banks to MFIs continues to grow, alternative investments forms (e.g., equity, loan purchases, and securitization) in MFIs are still in the early stages of development. There are other innovative methods, such as ICICI Bank's partnership model, that increase the funding available for microfinance.
- MFIs are highly leveraged financial institutions, and equity investments in MFIs are critical for leveraging and raising debt. NGO-run MFIs find it difficult to raise equity capital.
- The Indian government, Reserve Bank of India, and NABARD have made favorable policy changes in the regulatory framework and helped promote microfinance during the past decade. However, further policy changes are required in order to achieve the full potential of microfinance in India. NBFC regulations, including the minimum capitalization requirement of Rs 20million, need to be changed as the current capitalization requirement is too high for most MFIs, and it discourages them from converting to an NBFC. NBFCs also have severe restrictions on accepting deposits, which denies MFIs another less-expensive source of finance.

➔ Interest rates have been declining, but the poor still pay a much higher rate than do credit-worthy middle and upper-income people. The single biggest reason for higher interest rates is the high operating costs involved in providing doorstep service when delivering financial services to the poor. Many larger MFIs have achieved significant reductions in their operating costs by making better use of best practices, technology, and scale. Smaller MFIs continue to struggle with high operating costs. Technologies such as smartcards, kiosks and digital cash, when available in a cost-effective format, will have a significant impact on reducing the operating costs of MFIs.

There is general euphoria that microfinance has the potential to offer a solution for India's massive poverty and to become a major industry serving people at the bottom of the income pyramid. However, India is a large country with very diverse cultures, languages, and religions, and varying levels of development in its many states and regions. The past successes of microfinance have been limited to a few states that are relatively well developed compared to the rest of the country. It is too early to predict whether microfinance will have similar successes in other parts of the country.

Whether microfinance will become a major player depends on the outcomes of the following questions:

- Will Indian MFIs ever scale up sufficiently to meet the huge demand for microfinance?
- Will the global capital markets be willing to provide the huge capital required for the Indian microfinance industry?
- Will the size of MFIs eventually make them more like traditional banks?

- Will MFIs continue to serve those who have finally moved beyond the need for microfinance and can now access higher levels of money?
- Will commercial banks scale down to offer specialized financial services to the poor?
- Where is the fine line between MFIs and traditional banks?
- Will MFIs have the same success in less-developed states in the north and northeast of India?
- As MFIs consciously moving toward commercialization and seek greater profit, will they continue to preserve the core value of microfinance, which is alleviating poverty and doing social good?
- Will MFIs run by NGOs continue their dual role of providing financial services as well as livelihood promotion and capacity building?
- With their vast network and the trust they have engendered among the people, can MFIs become a platform for delivering other non-financial services, such as consumer goods?

Only time will tell – time, and the ongoing need of the poorest of the poor.

Appendix

Operational features of microfinance models in India

Operational Features	SHG Model	Grameen Model
Clients	Primarily women	Primarily women
Targeting	'The poor' – broadly described as the weaker sections or 'BPL'	'The poor' – specifically defined in terms of income, housing, other assets, type of employment
Groups	15 to 20 clients per group	Usually 5 clients per group (organized into 'centers' of 4-6 groups)
Service focus	Savings and credit	Credit – regular cycle Some Savings
Meetings	Monthly	Weekly
Savings deposits	Rs20-100/month	Rs5-25/week
Interest on savings	Bank rate (4.25%) + profit share	0-9%
Initial loan size	Rs5-10,000	Rs1,000-10,000
Effective interest rate (usual range)	24%-28%	28%-38%
Insurance	At a very preliminary stage: usually loan linked Sometimes linked to national companies	
Development services	Some associated programs	A few small social projects

Source: Akula, 2004. Adapted by the author.

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