Financial Inclusion through Micro Finance Lending: An Evaluation of Banks' Initiatives and MFIs in Andhra Pradesh

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Brief Historical Background

To keep pace with growing population and prevent the unemployment rate from rising, the global economy needs to consistently create 1 mn - 2 mn new jobs per year. **Microfinance** is the provision of financial services to low-income clients, including consumers and the self-employed, who traditionally lack access to banking and related services.

More broadly, it is a movement whose object is "a world in which as many poor and near-poor households as possible have permanent access to an appropriate range of high quality financial services, including not just credit but also savings, insurance and fund transfers. Those who promote microfinance generally believe that such access will help poor people out of poverty".

The concept of microfinance originated in the mid-1970s in Bangladesh through a pioneering experiment by Dr Muhammad Yunus, then a Professor of Economics. His aim was to offer poor people:

- financial services
- entrepreneurship opportunities
- an end to mistreatment by money lenders
- a system where they could produce, manage and maintain their own finances

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One of the big goals in microfinance is impact. Poverty is very complex; it's not a simple thing. There are many factors which keep people poor: education, healthcare, community, the water they're drinking, etc. Financial services are only one aspect of that. There have been some positive impact, but to say that microfinance by itself will solely remove poverty is highly pretentious, but nevertheless it is a major beginning and a positive step.

Microfinance in India through its two major channels – **SHG Linkage and MFIs** – has served over 40 million Indians. 4 out of 5 microfinance clients in India are women. Micro-credit portfolio of India Microfinance was more than Rs. 22,000 crore. 75% are accounted for by SHG Linkage, 20% by large MFIs and 5% by medium and small MFIs. SHG Linkage reports over Rs. 3,500 crore savings, only MFI Bank, KBS Bank reports about Rs. 40 crore savings portfolio.

MFIs operate in 209 out of 331 districts of the country, 28% of the new clients are more from urban areas than rural. An important source of detailed data on selected microfinance institutions is the *Micro-Banking Bulletin*. At the end of 2006 it was tracking 704 MFIs that were serving 52 million borrowers ($23.3 billion in outstanding loans) and 56 million savers ($15.4 billion in deposits). Of these clients, 70% were in Asia, 20% in Latin America and the balance in the rest of the world For Micro Finance Institutions (MFIs) there is constant need to work hard not only on providing microfinance, but also collaborating to provide access to healthcare, education, vocational training, and community development for the customers. The impact is going to be more significant when these issues are tackled which affect the lives of the poor along with microfinance.

Challenges of Micro Finance

Through all channels, microfinance reach is only 30-40 million. 250 million people live below poverty line. Rupee One lakh per individual needed for livelihood promotion, hence trillion of Rs needed. Penetration of life insurance services in rural India is <10%. Asset, health, weather and other general insurance services are still nascent. Micro savings and remittance products have huge potential under BC model. There is high Volume of Financial Transaction but value wise very low. Majority of the financial transactions are mostly off-site in nature. There is lack of Geographic spread of operations as well as density of customers. There is further lack of infrastructure facilities like power, broadband etc. There is unsecured lending and no documented financial history are available. Combination of all these factors above has lead to high operating cost.

Seen from a broader perspective, the development of a healthy national financial system has long been viewed as a catalyst for the broader goal of national economic development. However, the efforts of national planners and experts to develop financial services for most people have often failed in developing countries.

Because of domestic difficulties, when poor people borrow they often rely on relatives or a local moneylenders, whose interest rates are very high. An analysis of 28 studies of informal money lending rates in 14 countries in Asia, Latin America and Africa concluded that 76% of moneylender rates exceed 10% per month, including 22% that exceeded 100% per month. It has also been observed that moneylenders usually charge higher rates to poorer borrowers than to less poor ones. While moneylenders are often demonized and accused of usury, their services are convenient and fast, and they can be very flexible when borrowers run into problems. Hopes of quickly putting them out of business have proven unrealistic, even in places where microfinance institutions are active.

Although much progress has been made, the problem has not been solved yet, and the overwhelming majority of people who earn less than $1 a day, especially in the rural areas, continue to have no practical access to formal sector finance. Microfinance has been growing rapidly with $25 billion currently at work in microfinance loans. It is estimated that the industry needs $250 billion to get capital to all the poor people who need it. The industry has been growing rapidly, and concerns have arisen that the rate of capital flowing into microfinance is a potential risk unless managed well.

Some principles that summarize a century and a half of development practice were encapsulated in 2004 by Consultative Group to Assist the Poor (CGAP) and endorsed by the Group of Eight leaders at the G8 Summit on June 10, 2004:

1. Poor people need not just loans but also savings, insurance and money transfer services.

2. Microfinance must be useful to poor households: helping them raise income, build up assets and/or cushion themselves against external shocks.
3. "Microfinance can pay for itself." Subsidies from donors and government are scarce and uncertain, and so to reach large numbers of poor people, microfinance must pay for itself.
4. Microfinance means building permanent local institutions.
5. Microfinance also means integrating the financial needs of poor people into a country's mainstream financial system.
6. "The job of government is to enable financial services, not to provide them."
7. **"Donor funds should complement private capital, not compete with it."**
8. **"The key bottleneck is the shortage of strong institutions and managers." Donors should focus on capacity building.**
9. **Interest rate ceilings hurt poor people by preventing microfinance institutions from covering their costs, which chokes off the supply of credit.**
10. **Microfinance institutions should measure and disclose their performance – both financially and socially.**

Microfinance is clearly distinguishable from charity. Families who are destitute, or so poor they are unlikely to be able to generate the cash flow required to repay a loan, should be recipients of charity. Others are best served by financial institutions.

Commercialization of Microfinance in India

There has been a long-standing debate over the sharpness of the trade-off between 'outreach' (the ability of a microfinance institution to reach poorer and more remote people) and its ‘sustainability’ (its ability to cover its operating costs—and possibly also its costs of serving new clients—from its operating revenues). Although it is generally agreed that microfinance practitioners should seek to balance these goals to some extent, there are a wide variety of strategies, ranging from the minimalist profit-orientation of Bancosol in Bolivia to the highly integrated not-for-profit orientation of BRAC in Bangladesh. This is true not only for individual institutions, but also for governments engaged in developing national microfinance systems.

Private Investors and equity funds are now financing fast growing and nascent MFIs. Some state governments are funding SHG-programmes along with Commercial Banks. Govt. of India has appointed NABARD to manage the Microfinance Development & Equity Fund (MFDEF). Microfinance Bill is still pending in Parliament

Commercial microfinance institutions (MFIs) structure a profitable business model around the functions of conventional financial services, scaled down to “micro” levels. This does not prevent them from being socially responsible, or “pro-poor”. One MFI describes itself as a “commercial bank” with a “social mission”. This form of microfinance is most commonly found in middle income countries, or the urban areas of poorer countries. Though all are microfinance institutions, the actual services offered by each organization vary considerably due to the dissimilar nature of their client base.

Another area in which private investment is playing an increasing role in microfinance is through the wholesale funding of MFI loan books. In recent years, investors have begun to create investment funds for the microfinance sector offering a market rate of return. Large, multinational banks are also now becoming increasingly involved in this area – Citigroup, HSBC and Morgan Stanley all have microfinance divisions providing services such as loan guarantee funds, operational support and commercial wholesale lending to MFIs. In the UK, Morgan Stanley has a well established microfinance department, providing wholesale funding to microfinance institutions. They have even repackaged microfinance debt into structured investments such as Collateralised Debt Obligations (CDOs), which are then sold on to institutional investors.

Microfinancial services are needed everywhere, including the developed world. However, in developed economies intense competition within the financial sector, combined with a diverse mix of different types of financial institutions with different missions, ensures that most people have access to some financial services. Efforts to transfer microfinance innovations such as solidarity lending from developing countries to developed ones have met with little success.

As Marguerite Robinson describes in The Microfinance Revolution, the 1980s demonstrated that "microfinance could provide large-scale outreach profitably," and in the 1990s, "microfinance began to develop as an industry" (2001, p. 54). In the 2000s, the microfinance industry's several issues remain that need to be addressed before the industry will be able to satisfy massive worldwide demand. The obstacles or challenges to building a sound commercial microfinance industry include:

- Inappropriate donor subsidies
- Poor regulation and supervision of deposit-taking MFIs
- Few MFIs that meet the needs for savings, remittances or insurance
- Limited management capacity in MFIs
- Institutional inefficiencies
- Need for more dissemination and adoption of rural, agricultural microfinance methodologies

Microfinance Institutions (MFIs), established primarily to lend small sums to the poor, are trying to make consumers out of them. Going beyond their traditional role, some MFIs are starting to offer schemes to the poor to buy mobile phones and other products by paying in installments—a mode of credit that drives consumer spending in India.

The SKS head office in Hyderabad. SKS is offering loans to buy even mobile phones. The country’s largest MFI, SKS Microfinance Pvt. Ltd, is running pilots in Andhra Pradesh and Karnataka offering loans to the poor for buying mobile phones, solar-powered lights and water purifiers. SKS is also offering schemes to grocery shops to buy merchandise from wholesale retailer Metro Cash and Carry India Pvt. Ltd.

It’s not typically what MFIs do. But as the concept of microcredit evolves, some pioneering MFIs globally have begun pushing their mandate to loosely resemble that of financial institutions. The Reserve Bank of India has warned the heads of top microfinance institutions that the sector could lose its priority sector lending status if corporate governance standards did not improve among MFI’s.

Since then to improve the functioning of the entire sector microfinance institutions have taken the initiative to start a credit bureau for micro loans .This credit bureau would contain information about micro loan borrowers and will be accessible to micro-finance institutions and could help to rein in multiple lending.

Microfinance 'Bubble'

Daniel Rozas' piece in an edition of Microfinance Focus titled "Is there a Microfinance Bubble in South India?" highlighted this point and indicated that the microfinance industry in India; especially Andhra Pradesh; could be on the verge of a bubble. To optimize the benefit for the industry through this engagement with credit bureaus, the NBFC-MFIs have come together to create an association, Micro Finance Institutions Network (MFIN).

Thus, Microfinance Institutions Network – MFIN, the newly created association of NBFC-MFIs, agrees to such a bubble existing since it has been seized with the issue of potential over-lending to borrowers. As Daniel mentioned, the quest for rapid growth could lead a company or industry to not realize the bubble they have been building up during this growth phase.

In order to obtain a better sense of the bubble-vulnerability of the Indian microfinance sector, an analysis of members' loan exposure levels versus their repayment capability needs to be conducted. Information of such granularity is not easy to obtain; and hence Daniel's proxy measure carries value. It points out the level of multiple-borrowing by members, especially in Andhra Pradesh. In fact, it is this precise issue that the MFI sector seeks to address through collaboration among MFIs. Around 30 leading NBFC-MFIs that accounts for around 85% of the Indian market have come together to form Alpha Micro Finance Consultants P Ltd. Alpha will help get the credit bureau services made available to the MFIs in the country.

MFIN has formulated a Code of Conduct; which will require member-MFIs to adopt certain processes and be subject to certain limitations that will limit over-lending to a borrower. This Code of Conduct, in tandem with the enrollment to the Credit Bureaus, will form a strong industry-initiative to pro-actively restrict over lending and associated pains
In addition; Alpha has also had preliminary consultations with the Unique Identity Development Authority of India (UIDAI). Alpha believes it could provide a valuable service to the nation by

serving as a channel for verification and enrollment of millions of lower-income household members in the UIDAI database.

It is expected that such an exercise will also prove beneficial to Alpha since MFIs will be able to identify each of their members individually with their unique ID. This ID will empower MFIs to be completely certain of any borrower's prior exposure to other MFIs.

One believes that these measures will enable the microfinance industry to responsibly serve the microfinance needs of the Indian market; without creating a bubble. Apart from the benefit to clients in terms of sustained availability of micro credit and for MFIs in terms of self-regulation and sustainability of growth, on implementation of these initiatives, a goldmine of information would be available for research and analysis; enabling independent experts to provide a more comprehensive evaluation of the industry – including whether a bubble is around the corner!

Not-for-profits to for-profits: The imperatives for MFIs

There has been a significant shift from the days when microfinance was being discussed as the next big innovation to address the poverty issues in India to being discussed in terms of the next big investment opportunity. The language of microfinance has undergone a fundamental change in the two decades of its evolution. When we look at the past two decades of microfinance, we find three distinct waves of action. The first wave was when people who were working in the development sector discovered the methodology of reaching micro-loans to the poor through a methodology that was mastered by Grameen Bank. The wave II came in when the first generation organizations reached scale and sought methods to morph into for-profit commercial organizations. The wave III is when mainstream commercial institutions like L&T finance, Equitas and the private equity players started looking at microfinance as an interesting business.

For the first time people in the developmental sector were discovering a methodology where they could keep in touch with a large number of poor clients, scale rapidly, and actually count the direct impact of their work. The counting could easily be done by number of clients reached, the portfolio quality, amount loaned and the magic 100% recovery statistic. This was a magic formula discovered and by the time the Microfinance Institutions (MFIs) spent three to four years in operations, they found that there were challenges in keeping pace with the growth opportunities. From 2002 onwards we found these MFIs talking a new language – the language of transformation.

We find numerous imperatives for movement to a for-profit format for MFI and the challenges in "transformation" from not-for-profit to for-profit format. These imperatives stemmed from size – which meant the MFIs were growing much bigger than they should in their original form of not-for-profit incorporation.

This also meant that it would be increasingly difficult for them to explain their form to the commercial world, while the developmental world would stop funding them after a stage, given that the operations were largely profitable. It was also increasingly difficult for them to maintain capital adequacy or attract commercial capital because profits could not be distributed in a not-for-profit format. Therefore there was a need for all these institutions to "transform" or move from a non-profit format to a for-profit format.

RBI officials said that they are yet to take a view on how to treat private equity investments in Microfinance Institutions. For decades microfinance in India was always seen as a not for profit function with a social purpose but this has changed drastically in the last few years with many foreign based private equity funds pouring money into this sector.

The Reserve Bank of India has categorically told the lending public sector and private banks to exercise more corporate governance and to check whether microfinance institutions to which they are lending are lending in a humane manner.

Challenges and issues of moving from public purpose to private profits

Thus, we can see that there was a natural push for microfinance institutions to move into the commercial space. Unfortunately for the operators of microfinance, the move into the commercial space was not going to be simple. The options available in the commercial space to carry out microfinance activities were three:

1. Move the operations to a non-banking finance company [NBFC]

2. Move the operations to a co-operative format

3. Set up a local area bank

Each of these options had their own barriers from the perspective of the wave 1 microfinance organizations. Setting up of a local area bank was a painful and arduous route. The Reserve Bank was careful and miserly in granting licenses for banks, its area of operations were to be restricted to three contiguous districts and the capitalization required was Rs.5 crores, a significantly steep hurdle for the players operating at that time. The regulations also prescribed divestment of the equity stake in a specific time frame and diversification of ownership, with cap on voting rights irrespective of investments. All these did not make the prospect attractive for anybody to pursue.

While several initiatives took off on the co-operative format, the design of co-operatives dictate it to be user-member based and therefore posed a challenge of continuously raising capital from the members, a much more difficult, slow and arduous route.

This actually left the players with only one option of setting up of an NBFC. While BASIX had set up its operations in the for-profit space right from the beginning – through a complex structuring of softer loans obtained from patient investors like Ford Foundation and the Swiss Development Co-operation in a highly leveraged holding company and downstreamed as equity in an operating company, it was not possible for the others to replicate the model. Following a scam in the NBFC space in 1996-97, the Reserve Bank tightened the regulatory environment for NBFCs. The initial capital requirement for new NBFCs was set Rs.2 Crore and licence from RBI was made mandatory.

The wave 1 organizations that were operating under the not-for-profit format were ostensibly not in a position to bring in this capital through their personal resources to morph into wave 2 organizations. Most of the players at that time were from the developmental sector, which had discovered the magic of microfinance. There was a peculiar situation of having generated adequate business and profits within the non-profits, enough funds to promote an NBFC but a clear legal hurdle that these funds could not be invested in for-profit NBFCs because they were not public purpose organizations, but private profit generating organizations.

Internationally this was not much of a problem. BancoSol of Bolivia and Banco Compartamos of Mexico a little later had smooth experiences in moving from non-profits to profits. In the Indian context the law – through the office of the charities commissioner – prohibited equity investments by not-for-profits. The logic followed the spirit of what public purpose organizations ought to do. The public purpose organizations were holding public funds in "trust" and such funds could not be invested in risky ventures irrespective of how proven the idea was, because the funds were in fact meant for larger public good. Therefore the law provided that it is okay to park excess funds in approved safe securities (like government bonds, mutual funds and so on) so that they earn a return while they are waiting to be deployed, but not used as investments in commercial activities.

Discussion of the issues arising

Microfinance sector has emerged out of the development paradigm. Over a period of time microfinance sector has tasted success, because it was addressing a latent need for financial services for a certain market segment that was willing to go through the standardization of delivery of the MFIs and also the discipline. This ensured that there were sufficient rents to be sought **– because of the inelasticity in interest rates at the client end.** The market has been discovered and well catered to.

When we look at the above cases, and look at the data, the fact emerges that the poor are being exploited with usurious interest rates. However, many feel that if there is market at these rates of interests and MFIs can deliver efficient services, they should do so and earn a good profit in order to carry out their business to ensure long term sustainability. This is debatable and experts favouring high interest rates feel that those who are ideologically opposed to the market based models should be free to examine the community based SHG models that may also be pursued. We will examine these arguments in greater details during our survey.

One such argument has been that even if we for a moment assume that the interest rates are usurious, the MFIs still might have a place under the sun. **The MFIs have been variously called white collared moneylenders in several forums.** The reason why they should be welcome to operate, even if the interest rates charged is usurious is because of the fact that they belong to the organized sector. These organizations file their returns and are therefore open to scrutiny. The fact that SKS in Andhra Pradesh has gone public is welcome from a singular point that it was now accountable to a larger number of people and thus would hopefully show a more responsible behavior. If we assume that the MFIs are exploitative, then they could be brought to the table for counseling or brought to book by the regulator. Therefore a MFI – however usurious it is, should be desirable than a faceless moneylender where the terms of exchange never come out and can be discussed.

The argument is basically about the **ethical fabric on which the largest MFIs** are being built. Each one of the promoters possibly came in with a developmental objective – which they indeed wanted to promote institutions that were with the community. The fact that each of them tried to have community share holding and give some parts of the profit back to the community is coming from their developmental background. No commercial outfit would have thought of such a structure. The fact that they had to move to the mainstream was also imperative due to the requirements of capital and the pace of growth. **That might also be the reason for public institutions to pro-actively design products and be a part of this process**. However, in the process of getting the mainstream into the poverty market, somewhere they seem to have lost the vision. Whether they were pushed into a corner because the private equity investors gave offers that they could not resist or thought that their job was done and they have a larger agenda in life is again debatable.

Hence, when we look at the large MFIs in India, we find the there are much larger ethical issues that we will have to discuss, not only from the underlying theory of understanding public purpose and private profits, but also from the apparently legal mechanisms used by the large MFIs. Given that these institutions are hitting the market there would be a heightened public scrutiny of their practices and we will have to examine their conduct in greater details.

1. **BASIX** is a livelihood promotion institution established in 1996, working with over ***a million and a half customers, over 90% being rural poor households and about 10% urban slum dwellers. BASIX works in 16 states*** - Andhra Pradesh, Karnataka, Orissa,

Jharkhand, Maharashtra, Madhya Pradesh, Tamilnadu, Rajasthan, Bihar, Chattisgarh, West Bengal, Delhi, Uttarakhand, Sikkim, Meghalaya and Assam, 205 districts and over 25,300 villages. It has a staff of over 6,260 of which 80 percent are based in small towns and villages. **BASIX mission** is to promote a large number of sustainable livelihoods, including for the rural poor and women, through the provision of financial services and technical assistance in an integrated manner. BASIX will strive to yield a competitive rate of return to its investors so as to be able to access mainstream capital and human resources on a continuous basis. **BASIX** strategy is to provide a comprehensive set of livelihood promotion services which include Financial Inclusion Services (FINS), Agricultural / Business Development Services (Ag/BDS) and Institutional Development Services (IDS) to rural poor households under one umbrella.

2. **APMAS** is a national-level technical and managerial support institution with a vision, **"Sustainable self-help movement in India"**. It works for women's empowerment and poverty alleviation through capacity building, quality assessment, livelihood promotion, communication and research & advocacy on a fee-for-service basis. APMAS is funded by DFID through CARE India, Ford Foundation, Aga Khan Foundation, and InWEnt. APMAS became fully operational in July 2001 and today it has a functional team of 40 professionals providing services to diverse stakeholders across the state and in a limited way to other states. A variety of tools and content have been developed to take up Quality Assessment (rating) and capacity building services. Towards wider dissemination of best practices and for impacting the quality of community based institutions, APMAS publishes a monthly magazine called Mahila Sadhikaratha (Women Empowerment), conducts National Immersion Programmes for all stakeholders, and is establishing a national virtual resource centre for SHG stakeholders (www.shggateway.in). APMAS has developed strong networks with the Department of Women Empowerment & Self Employment, SERP, APRLP, PRIA, NABARD, Andhra Bank and other state level institutions. APMAS has responded to requests for capacity building support from training institutions located in Hyderabad like NIRD, MANAGE, APARD, ICM and other.

3. **SHARE Microfin Limited** (SHARE) is a regulated Non-Banking Financial Company (NBFC) providing financial and support services to the marginalized sections in society, particularly to poor rural and urban women across India. Through its income generating loans and business development services, SHARE reaches out to help these women build productive micro-enterprises, thereby contributing to the development of sustainable communities.
4. **SKS-** Microfinance is an effective tool that can help reduce poverty and spread economic opportunity by giving poor people access to financial services, such as credit and insurance. Their micro-enterprises range from raising cows and goats in order to sell their milk, to opening a village tea stall. SKS uses the group lending model where poor women guarantee each other's loans. Borrowers undergo financial literacy training and must pass a test before they are allowed to take out loans. Weekly meetings with borrowers follow a highly disciplined approach. Re-payment rates on our collateral-free loans are more than 99% because of this systematic process. SKS also offers micro-insurance to the poor as well as financing for other goods and services that can help them combat poverty.
5. **Spandana** is one of the fastest expanding micro finance institutions in the country. It is not only amongst the largest MFIs, but also the most efficient in the country with an operating expense ratio of 5.5% on portfolio. Spandana has achieved this remarkable distinction in a short span of just under a decade since its inception in 1998. This has been possible on account of its highly focused and clearly structured operations.Spandana has continued to successfully manage growth with operations now spanning 8 States Andhra Pradesh, Karnataka, Tamil Nadu, Orissa, Maharashtra, Chhattisgarh, Madhyapradesh and Rajasthan. It now boasts of a client base that constitutes almost 1.5% of the BPL (Below Poverty Line) population of India.