Microfinance in India

A State of the Sector Report, 2006

By

Prabhu Ghate

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The "State of the Sector Report 2006" is a significant effort made by the Microfinance India platform to bring together the sector's progress in its entirety. The pace of growth of the sector in India in the last few years has been phenomenal. Further, the growth of institutional diversity too has been exceptional. For some time, there has been a growing demand for a comprehensive report in both India and abroad (by practitioners, financial institutions, policy makers, regulators, the research community, the media, and the intelligent layman). People in various parts of the sector are curious to know much more about parts of the sector they do not normally deal with, or with parts of the sector they would like to engage with more. Thus the social venture capitalists might like to know more about training and capacity building service providers, the insurance companies about opportunities offered by the self-help group-bank linkage programme (SBLP), bankers about what opportunities lie in money transfers, and so on. Not nearly enough is known about what the donors are still doing, among whom there are some new big boys on the block. Everyone is affected by what the regulators are up to (or not up to!), who in turn would like to more about the sector they are charged with regulating. Bringing out of the State of the Sector Report aligns well with the overall objective of Microfinance India, which is an attempt to bring together the Sector to look at critical issues together, propose solutions and jointly vision for the harmonious growth of the Sector.

While a number of extremely useful annual reports are already being prepared, such as NABARD's on the SBLP, Sa-Dhan's various documents on the sector more generally but with an emphasis on MFIs, and those by M-CRIL, to name just a few, much of the information on the sector is scattered over a wide variety of sources. For instance some of the best information on microinsurance in India is being gathered and disseminated by the STEP programme of the ILO. An increasing number of useful documents are emanating from abroad (such as the recent MIX survey of microfinance in South Asia with a special emphasis on transparency, and several recent case studies by CGAP on microinsurance in India). Indian microfinance is not as under-researched as it used to be, although of course we are just touching the tip of the iceberg in terms of what needs to be known. One of the aims of the State of the Sector report is to synthesize as many as possible of the more important recent studies without trying to duplicate them, but highlighting issues on which continued progress depends, and identifying knowledge gaps calling for further research, statistical efforts, etc. By publicizing these studies it hopes also to stimulate a greater demand for them.

All this is in a sense the task of all annual reports, and a primarily descriptive one, although aiming at being a comprehensive document that records all that has happened during the year is not yet feasible, and will require a much bigger team and more advance planning than was possible this year. This year's report is in a sense a trial run. It will hopefully generate feedback for subsequent years on such issues as the appropriate length, the balance between analysis and description, how much demand there is for data and in what depth and detail, etc. It is intended to be as participatory an effort as possible (draft chapters are being widely circulated for comment), with a different main author, or a different editor and team of chapter authors, each year.

I am glad that through the indefatigable efforts of Dr. Prabhu Ghate, Microfinance India has been able to bring together the first issue of the State of the Sector Report and that it will be ready in time for the annual Microfinance India conference on October 30 and 31 this year. The task was indeed daunting, but Prabhu accepted the challenge, for which the Microfinance India Platform is extremely appreciative. The Report is being overseen by the Microfinance India Advisory Group, on which many of the main players in the sector are represented. Several key resource persons in the Sector have provided valuable inputs, all in the spirit to help it represent the Sector as truly as possible so that it helps a variety of readers catch up on the latest developments, issues, and accomplishments of the sector.

Vipin Sharma
Program Director, CARE India

Preface and Acknowledgements

This report is an attempt to put together a one-stop document that will help a variety of readers catch up on the latest developments, issues, and achievements of the microfinance sector in India. The sector is growing rapidly, both in scale and diversity of actors, and is hopefully sitting on the cusp of regulation. It is therefore in the midst of rapid flux. The report is in a sense a snapshot of the sector taken when it was written, that is in second and third quarters of 2006. To the extent it succeeds in being topical, parts of it can expect to become out of date pretty soon. But at the same time, it hopes to function as a kind of evolving reference document, with something of permanent value retained in each successive annual edition.

While a number of extremely useful periodic reports are already being prepared by some of the main players, much of the information on the sector is scattered over a wide variety of sources, as one would expect in a highly decentralized development and financial movement which has evolved as a result of the combined actions of a large number of creative, dynamic and idealistic individuals in civil society, who were supported initially by donors, and then increasingly, by NABARD and SIDBI, the banks, and government. Fortunately, Indian microfinance is not as under-researched as it used to be, although we are still touching the tip of the iceberg in terms of what needs to be known. One of the aims of the report is to publicize and synthesize the findings of important recent studies each year. This is one justification for the abundant use of footnotes, the other being to include as much important empirical material as possible without losing the attention of readers with less specialized interests.

Due to constraints of time this year several important topics could not be covered, including "empowerment", SHG federations, the cooperative MFI movement, the role of many of the public sector banks including some prominent RRBs and DCCBs in supporting the SHG movement, and community-based microfinance generally, which after all constitutes the bulk of the sector. Hopefully this omission will be rectified in future years. Other topics that could not be covered were urban microfinance and impact assessment (which are themes of this year's Microfinance India conference) or the prospects of new technology applications, or regulation. Of MFI financial services only two of the "younger" ones, microinsurance and money transfers, could be covered briefly, and not innovations in credit or savings. We are grateful to the Centre for Microfinance, Chennai for contributing a chapter on studies initiated there, but there was not enough time to review on-going research in the country generally, which needs to be covered more systematically in the future.

While I attempted to consult as many sector participants as possible, I am conscious that a number of significant approaches, programmes, initiatives, institutions, studies and documents have escaped mention because of the constraints of time and space and my own lack of familiarity with them. In

particular it has not been possible to do justice to the individual building blocks of the MFI model, the MFIs themselves, or to the NGOs promoting the self-help group movement, many of who are setting new standards in good governance, transparency, product development, and successful identification and targeting of the poor. A report like this cannot expect to match their insights or have as nuanced an understanding as they do. I hope the individuals and organizations concerned will understand.

I am grateful to Vipin Sharma of CARE India for having had the vision to launch this effort, for the energy to see it through, and for taking a chance on me! Malcolm Harper was an endless source of good advice and useful comments (some of them very rude!). The other person who went way beyond the call of duty and ploughed through many of the chapters out of sheer interest, although with considerable scepticism and disagreement on many points, was Ajay Tankha.

Rewa Misra prepared Section 8B on donor participation, Annie Duflo and her colleagues at the CMF contributed Chapter 9 on ongoing research, and Sakshi Varma assisted with Chapter 2. Many thanks to all of them. Anjum Khalidi was a great source of support, as were Prabhat Labh and Rekam Jayasurya at CARE India. Others who spared valuable time to comment on draft chapters and share material were Krishan Jindal, Ajit Kanitkar, Vishal Mehta, Rajkamal Mukherjee, D. Narendranath, Jayendra Nayak, Sitaram Rao, Santosh Sharma, Sanjay Sinha, Frances Sinha, Mark Socquet, MS Sriram, and Blaine Stephens,

Those who provided valuable information and pointed me in the right direction through, in some cases, extensive discussion and briefings were Deepak Alok, Mohammad Amin, Caitlin Baron, Rajendra Bhoi, Anjana Borkakati, Mirai Chatterjee, Sandeep Farias, David Gibbons, Amit Gupta, Marie-Loise Haberberger, Brahmanand Hegde, Ashok Jha, Vaman Kamath, Harish Khare, Udaia Kumar, Rajiv Lall, Vijay Mahajan, Brij Mohan, Rakesh Mohan, Nachiket Mor, CS Murthy, K. Narender, Saleela Patkar, Viswanath Prasad, Vineet Rai, Manohara Raj, S Ramachandran, Muralidhara Rao, CS Reddy, Padmaja Reddy, Raja Reddy, Vinatha Reddy, Savita Sarkar, Moumita Sen Sarma, Dr Sethuraman, Uday Shankar, Rashmi Singh, Sukhbir Singh, R Sowmithri, R. Srinivasan, Sudarshan Synghal, Yashwant Thorat, Mathew Titus, Niraj Verma, and MP Vasimalai.

I am extremely grateful also to Viji Das and her team at FWWB; Annie Duflo, Rati Tripathi and other friends at CMF; Punit Gupta, Berenice Rose and Rupalee Ruchismita of the Social Initiatives Group at ICICI; Sneh Lata Kumar and her colleagues at RMK; Vijay Kumar, Navin Mittal and other officials of the AP government in Hyderabad and Krishna district; Jayant Madhab, Amiya Sharma and their colleagues at RGVN; Mathew Titus and his colleagues at Sa-Dhan; JS Tomar and his team at Cashpor; and Graham Wright and Ranjani at MicroSave. Stuart Rutherford, Shashi Rajagopalan and many others were kind enough to give me guidance and share material through e-mail. My apologies to the many others who I have left out. Thank you again, all of you. It goes without saying that the usual absolutions apply.

Prabhu Ghate

Abbreviations

ABC	Activity Based Costing
ADB	Asian Development Bank
BC	Banking Correspondent
BF	Banking Facilitator
CAR	Capital Adequacy Ratio
CAGR	Compounded Annual Growth Rate
CAP	Country Assistance Plan
CB	Capacity Building
CBO	Community based Organisation
CFSF	Credit and Financial Services Fund
CGAP	Consultative Group to Assist the Poor
CIDA	Canadian International Development Agency
CIF	Community Investment Fund
CM	Computer Munshi
CMF	Centre for Micro Finance
CMS	Computer Munshi System
DFID	Department for International Development
DRDA	District Rural Development Authority
DRI	Differential Rate of Interest
FLDG	First Loss Deficiency Guarantee
FWWB	Friends of Women's World Banking
GA	Group Accountant
GLP	Gross Loan Portfolio
GRT	Group Recognition test
IFAD	International Fund for Agricultural Development
IFMR	Institute for Financial Management and Research
IIMB	Indian Institute of Management Bangalore
IRDP	Integrated Rural Development Programme
JLG	Joint Liability Group
JSBY	Jan Shree Bima Yojana
LAB	Local Area Bank
LIC	Life Insurance Corporation of India
LSS	Light and Shades Study

MACS	Mutually Aided Cooperative Society
MCFI	Micro Credit Foundation of India
M-CRIL	Micro Credit Ratings International Limited
MDC	Microfinance Development Council
MFDEF	Microfinance Development & Equity Fund
MFI	Microfinance Institution
MIS	Management Information Systems
MIX	Microfinance Information eXchange
MSDF	Michael and Susan Dell Foundation
MTO	Money Transfer Operators
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Finance Company
NGO	Non Governmental Organization
ODA	Overseas Development Assistance
OSS	Operational Self Sufficiency
PACS	Primary Agricultural Cooperative Societies
PAR	Portfolio At Risk
PKSF	Palli Karma Sahayak Foundation
PLR	Prime Lending Rate
PS	Priority Sector
RBI	Reserve Bank of India
RGVN	Rashtriya Gramin Vikas Nidhi
RMK	Rashtriya Mahila Kosh
RMTS	Regular Monthly Transactions Statement
RoA	Return on Assets
RRB	Regional Rural bank
SBS	Side by Side Study
SBLP	SHG Bank Linkage Program
SDC	Swiss Agency for Development Cooperation
SEWA	Self-Employed Women's Association
SFMC	SIDBI Foundation for Microcredit
SGSY	Swarnajayanti Gram Swarozgar Yojana
SHG	Self Help Group
SHPA	Self Help Promotion Agency
SHPI	Self Help Promoting Institution
SIDBI	Small Industries Development Bank of India
TA	Technical Assistance
TCB	Training and Capacity Building
UNDP	United Nations Development Program
USAID	United States Agency for International Development
VCF	Venture Capital Fund
VO	Village Organization
VWS	Village Welfare Society

NOTE: 1 CRORE = 10 MILLION, 1 LAKH = 10,000, US$1 = RS 45.5 APPROXIMATELY

CHAPTER 1

Overview and Summary of Main Recommendations

The good news (which far outweighs the bad)

Indian microfinance continued growing rapidly towards the main objective of financial inclusion,[1] extending outreach to a growing share of poor households, and to the approximately 80 percent of the population which has yet to be reached directly by the banks.[2] The larger of the two main models, the Self-Help Group (SHG) Bank Linkage Programme (SBLP) covered about 14[3] million poor households in March 2006 and provided indirect access to the banking system to another 14 million, including the "borderline poor". Although firm estimates are lacking, the other, Microfinance Institution (MFI) model served 7.3 million households, of which 3.2 million were poor. Even allowing for a degree of overlap of borrowers from both models, the total number of poor households being reached was roughly a fifth of all poor households[4], as well as a smaller share of the larger number of non-poor households who have yet to be reached by the formal financial sector.[5] Apart from providing financial services to both these segments of the population, there is widespread evidence that much stronger competition provided to the informal sector has significantly improved the terms of credit provided to both segments by the informal sector, which is losing share to both the formal and (semi-formal) MFI sector.

...the sector ...can perhaps afford to sit back a bit and look more closely at issues of quality, such as improving bookkeeping in the SHG model, consumer protection issues in the MFI model, and extending the depth of outreach and evolving products which are more responsive to consumer needs and preferences in both models

Now that the sector[6] can be reasonably confident that it will continue growing rapidly enough for it to make a major dent on financial inclusion within the next 10 years or earlier (subject to success in tackling the main uncertainty facing the MFI model, the difficulties stemming from the lack of public and regulatory awareness of the need to charge cost-recovering interest rates) it can perhaps afford to sit back a bit and look more closely at issues of quality, such as improving bookkeeping in the SHG model, consumer protection issues in the MFI model, extending the depth of outreach and evolving products which are more responsive to consumer needs and preferences in both models. Solving quality issues will in any case contribute to higher growth in the long-term. These issues have become increasingly salient, both because recent studies have given us a better understanding of their nature and extent (in the case of the SHG model), and because the sector is now a big enough player for its mistakes to be noticed and publicized.

This has been an unexpected price of success, but the sector has perhaps always underestimated the age-old image problem that confronts the business of money lending (no matter how exalted its purpose). It remained shell-shocked for a while by the harshness with which some of its practices were brought to public notice during the AP crisis which came to a head in March 2006, but better to be woken up this way than not at all, and the consensus is that the sector will emerge stronger if it reads the lessons the right way, and conjures up the collective will to implement them. The experience has left many observers less sanguine about the sufficiency of self-regulation left to itself, unaided by external regulation, and has highlighted the need for a combination of both. Ironically, it is the sector that wants outside regulation more strongly than the agency likely to be entrusted with the task, NABARD, under the proposed microfinance bill.

Growth under the MFI model has been greatly facilitated by the sharp increase in bank credit to MFIs. A wide range of banks are now financing the sector, the private sector banks lending mostly to MFIs, and the pubic sector banks through their wide network of rural bank branches, mostly the SHGs. The private sector banks are financing MFIs both because they regard it as good business, and because of priority sector obligations. More and more public sector banks are also viewing SHG financing as profitable, and undertaking it less and less because of moral suasion from government and NABARD.

Thus one of the main constraints to expansion under both models, the availability of on-lending funds, has been greatly relaxed in the last couple of years. More recently, a number of new venture capital funds are making a similar contribution with respect to equity capital, which is required not only to (i) meet capital adequacy concerns, and (ii) entry capital requirements to the more formalized parts of the sector, mainly the NBFCs, but also (iii) to provide longer term capital for financing MFI infrastructure, and working capital during the long expansion phase, between 5 to 10 years, when a start-up MFI is running deficits.

One of the most exciting new trends in the sector is the imminent expansion of urban microfinance in India

Aided by increases in sources of equity capital, the sector is heading in the direction of greater formalization, with several former NGO-MFIs and Section 25 companies seeking to transform themselves into NBFCs. Some of them are buying out exisiting NBFCs registered before 1999 when entry capital requirements were much lower, and which have ceased operating and are available for sale. Moreover, an increasing number of start-ups are seeking to enter the sector as NBFCs from the outset. The latter trend has been assisted by the growing number of experienced professionals who are being attracted to the sector, many of them retired bankers or former MFI professionals, who find it easier to the provide the necessary comfort to equity investors and lenders.

One of the most exciting new trends in the sector is the imminent expansion of urban microfinance in India. At least four new and one existing urban MFI (one of the very few in the country), two in Bangalore, and one each in Ahmedabad, Kolkata and Mumbai, are negotiating with equity investors and lenders so as to enable them to expand rapidly as NBFCs. Another new trend is downscaling, with an existing NBFC, an urban finance company, planning to expand lending to micro borrowers, in Delhi. Downscaling has for long been an emphasis of donors and technical assistance providers in Latin America, and is an approach that applies to lending by the banks too.

Further, financial sources for technical assistance for much needed capacity building are becoming more diverse, including the new equity investors who provide it through grants to accompany their capital assistance, some of the larger lenders such as ICICI tying up with capacity building providers to provide assistance to their borrowers, and large grants by foreign foundations as the poverty alleviation benefits of microfinance become better known.

The central government has announced its intention to enact a new microfinance bill in parliament in the near future, which will confer stronger legal standing to the microfinance activities of all participants in the sector, whatever their legal form of registration, and allow them to raise member (not public) savings, subject to certain conditions. The absence of savings in Indian microfinance except through SHGs and MFI cooperatives has been referred to as "walking on one leg" (the two legs being microcredit and microsavings). The absence so far of savings has unfortunately been one of the distinguishing features of Indian microfinance, and prevents it from providing a financial service to the poor which is as valuable to them as microcredit.

A third financial service, microinsurance, is increasingly being offered by MFIs acting as agents of the insurance companies. Life insurance is quite common now among MFI members, with a smaller proportion availing of asset insurance, mainly of loan financed assets. Insurance is less widespread under the SHG model. The form of insurance of greatest relevance to poverty alleviation is health insurance, which a growing number of MFIs along with other civil society organizations such as charitable hospitals are beginning to offer. Efforts are also getting under way to introduce the form of asset insurance of greatest interest to the poor, crop or weather insurance.

Continuing and new challenges

These are all welcome developments. But as with any complex and rapidly evolving sector of activity, microfinance in India, especially the MFI model, continues to face persisting challenges, and at least one major new threat.

This is a time more than any other, with the need to rebuild the public image of the sector, when MFIs need to be experimenting with new products and repayment schedules that pay greater heed to client cash flow compulsions, and to client perspectives generally, as opposed to a single-minded preoccupation with their own need to minimize costs

Creating an awareness of the need to charge cost-recovering interest rates

Perhaps the most important of the continuing challenges facing the MFI model is the need to create much greater awareness of the need for MFIs to charge cost recovering interest rates if they are to survive and grow. Clearly, the level of interest rates, especially for the poor, is a relevant public concern. However interest rate ceilings are not the best way to control them.[7] Very few even otherwise well informed persons realize that MFIs deliver and collect unsecured small loans virtually at the doorstep, and collect them once a week, 50 times a year. In India, in addition, they do not benefit from lower cost funds collected as savings, as a result of which their financial cost ratio (cost of funds as a ratio of portfolio outstanding) is amongst the highest in the world (Chapter 3). Despite this, their interest rates are amongst the lowest in the world, because of high repayment rates and high productivity of field staff.[8]

For small start-up MFIs, unit transactions costs are particularly high. Again, very few persons outside the sector recognize that any transactions costs guidelines that may be laid down will have to recognize and provide for this. Third, if there is one clear lesson from the AP crisis (discussed in Chapter 4), it is that attempts to achieve 100 percent recovery rates (or "zero tolerance" for default) is a recipe for excesses in collection practices in the long run, leading to adverse publicity, and loss of borrower support and public confidence. Only documented experience with policies of conscious acceptance of higher loan loss rates will indicate where the optimal trade-off lies between maintaining financial viability on the one hand and public support on the other, but many persons would guess it lies between 2 and 3 percent. This component, the risk premium, adds further to the cost-recovering interest rate (although much less than the cost of funds and transactions costs).

This is a time more than any other, with the need to rebuild the public image of the sector, when MFIs need to be experimenting with new products and repayment schedules that pay greater heed to client cash flow compulsions, and to client perspectives generally, as opposed to a single-minded preoccupation with their own need to minimize costs. As has often been pointed out, there have been no major innovations in credit delivery systems since the original break-through came in the form of group lending 30 years ago. What is referred to as Grameen II is reported to be developing interesting new approaches in Bangladesh, and these need to be studied.[9] Moreover potential technological innovations, alluded to in Chapter 7A, offer the promise of substantial reductions on transactions costs, but they are still around the corner. For the present, MFIs need to feel they can afford to incur the risks of experimentation, and make a few mistakes. Pressures to squeeze interest rates further are not conducive to such a frame of mind.

Finally, there is the need to build up reserves to leverage loans in the case of all MFIs, and in the case of those seeking to transform to for-profit status, to accumulate the initial entry capital requirement of Rs 2 crores. While the latter can now be sought from the new venture capital funds or NABARD's Micro Finance Development and Equity Fund (MFDEF) (the corpus of which was doubled by government in the 2005 budget) equity capital still has to be serviced with dividends, albeit modest ones. The new microfinance act proposes to reduce the entry capital requirement for microfinance organizations with a portfolio above Rs 1 crore, to Rs 25 lakhs (as against eight times this amount to register an NBFC). This will certainly help. However until it happens, MFIs are faced with yet another in a whole host of pressures to maintain interest rates that appear high to the uninitiated, and certainly to politicians.

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At least a couple of studies have been conducted recently on MFI transactions costs (one of them described in Chapter 9, which describes some of the ongoing research in the sector).[10] While their findings need to be given widespread publicity, the somewhat arcane topic of transactions costs does not make very exciting copy for the media, upon whose shoulders falls the task of enlightening public opinion. What would seem required is a massive public education campaign, using public relations firms, and full page ads in the papers, as well as much greater media contact by the sector. Certainly, more than seminars for the already converted are called for. The sector should capitalize on the Nobel prize for peace awarded in 2006 to Professor Yunus and the Grameen Bank, perhaps by inviting him to India for a lecture tour.[11]

Side by side with attempts by the sector to instill a greater awareness of the need to allow MFIs full freedom and flexibility in setting interest rates, it would help if the sector could set up a self-regulatory mechanism to monitor MFI interest rates itself, so that it can rap the knuckles of any member charging unusually high interest rates, either because of inefficiency and an attempt to push excessive costs on to the borrower, or in order to grow at an unsustainably high rate in terms of borrower relations and public and political acceptability. If this were to happen, there is surely a case for the RBI or the new Microfinance Development Council proposed under the microfinance bill to enunciate the principle of reasonable, cost recovering interest rates, loud and clear. While the sector must indeed fight its own battles, it is entitled to some help from the regulator in this respect.

The importance for the MFI sector of building long-term and healthy relationships with government and other stakeholders

As the AP crisis and one of the studies reported in Chapter 9 remind us, the question of building communication strategies to combat the MFI image problem, and build (or rebuild) public support, is a much broader one than that of interest rates. Indeed the AP crisis was not about interest rates at all, but stemmed from the fact that MFIs and the government are now increasingly occupying the same space. This is the new threat facing the sector and requires MFIs to become much moré adept at building communication strategies that entail more than publicizing their good work (essential though that is), but more importantly, long-term healthy relationships with government and other stakeholders at local and higher levels. Even before the massive expansion of state government involvement in the SBLP (much of it through projects sponsored by multilateral agencies such as IFAD and WB)[12] resentment and suspicion was often reported from the field on the part of DRDAs who felt that the self-help promoting institutions (SHPIs) were "hiding" their groups from them, to save them from being poached and getting corrupted by the culture of subsidized credit of SGSY and similar programmes (although some SHPIs claimed that they had succeeded in "co-opting SGSY).

Today the competition is much more severe, especially in certain pockets of the country, and it is the MFIs who are being accused of doing the poaching. As both models grow, the potential for conflict will increase, and the need to evolve a harmonious modus vivendi will become increasingly urgent. MFIs will have to show greater sensitivity to the need not to affect credit discipline in SHGs. It would not seem unreasonable to expect an MFI to satisfy itself before lending to an existing SHG member that she will be in a position to repay not only the MFI loan, but also any outstandings she might have to the SHG. At the same time, DRDAs should respect the right of borrowers to exercise choice. There are many borrowers who genuinely need the kind of larger and more timely loan MFIs have a comparative advantage in offering (see Box 1.1) There can not be a blanket prohibition on MFIs extending their activities to existing SHG areas, although MFIs would be adding more value by expanding operations to areas underserved by both models (as many of them are doing).

Greater information sharing and much closer contact will have to be part of the solution. Some of the issues are discussed further in Chapter 4. It is essential though, that no matter how closely a state government is associated with the SBLP, it remembers it is not only a player, but has the duty to play the role of neutral umpire between the two models in the event of conflict. It should respect the fact that as financial institutions MFIs are crucially dependent on public confidence, which is very hard to restore once damaged, and any action against erring MFIs should be taken by the proper authority according to law. The sector should be prepared to challenge the legality of the actions such as that taken by the AP government in Krishna district in March 2006 in the courts if necessary.[13] It needs, of course, also to put its own house in order.

It is essential though, that no matter how closely a state government is associated with the SBLP, it remembers it is not only a player, but has the duty to play the role of neutral umpire between the two models in the event of conflict. It should respect the fact that as financial institutions MFIs are crucially dependent on public confidence, which is very hard to restore once damaged

...and of putting its own house in order

Discussions of transparency in the MFI sector have tended to focus on issues such as the need for more detailed, accurate and timely disclosure in financial statements and annual reports, or in other words on issues of financial transparency.[14] Sa-Dhan, the association of MFIs, is finalizing with the Institute of Chartered Accountants of India a standardized set of reporting formats compatible with both MFI requirements, and Indian accounting conventions and law. However, the AP crisis has highlighted the importance of another aspect of transparency – transparency in dealings with borrowers, or "consumer protection" issues. Some of these are discussed in Chapter 4. Here too Sa-Dhan is working on a more detailed code of conduct" (which will replace those framed in a hurry after the AP crisis, in Box 4.1). There is considerable variance in the extent to which MFIs have been sensitive to both aspects of transparency. Hopefully there will be considerable progress on both fronts, which will greatly strengthen the MFI sector's moral position in dealings with other stakeholders.

Growing seeds and saplings: the importance of maintaining diversity

As noted earlier, a trend that has picked up pace in the last couple of years has been that towards formalization, as NGO-MFIs increasingly seek to transform themselves from unregulated, not-for-profit institutions into for-profit NBFCs, a form of incorporation much better suited to financial operations.[15] The AP crisis is likely to encourage this migration, having made NGO-MFIs feel more vulnerable to the interest rate predilections of state governments.[16] While there are clear benefits to formalization and commercialization, and NGO-MFIs tend to have weaker governance and systems, they enable easier entry into the sector, being much easier to set up, and serve to broad-base participation in it. Indeed they do not even have to be set up afresh since many of them take up microfinance as an add-on to existing social sector activities. This can also be a drawback, since it may be easier to inculcate microfinance professionalism in a new rather than existing NGO (the oft-mentioned NGO "mindset" problem touched upon in Chapter 6). In many cases however, they provide an important outlet to the creative energies of talented new comers to the sector, many of who emerge later as sector leaders. Thus NGO-MFIs play an important role as a seed bed from which saplings emerge to grow into trees.

Second, being much smaller, they are much more likely to be found in underserved areas and therefore lend themselves more easily to the rectifying regional skew. Third, being easier to set up, they can more easily be promoted by public and private apex financing institutions such as the FWWB and RMK, although the attrition rate is high, and many of them fall by the wayside (Chapter 8A). Being closer to the ground, they serve as an important source of innovations. The MFI cooperatives sector has served as a trenchant source of critiques of the SHG movement which it attempts to improve on.[17] Last but not least, because many NGO-MFIs have continuing activities in skill development, promoting marketing linkages, and other aspects of livelihood promotion, they lend themselves potentially to "microfinance plus" activities. For all these reasons it would seem a loss if the sector were to become increasingly homogenized in the pursuit of commercialization. The proposed microfinance act recognizes the need to promote and protect diversity, by requiring formalization only above a certain size.

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Improving statistics and information on the sector

One of the strengths of the sector is that it has grown and evolved as a result of the combined actions of a large number of creative, dynamic and idealistic individuals from diverse backgrounds, including trade unionists, graduates of management schools who wanted to apply professional management skills to development, promoters and employees of NGOs from other sectors, retired bankers, chartered accountants, social workers, and many others. Between them they manage about a dozen NBFCs and S 25 companies, about 400-500 NGOs and trusts, and 300-400 cooperatives. The microfinance sector remains very much a civil society movement, although state governments have become active partners in the SBLP. Bankers, academics, consultants, trainers, credit raters, regulators, policy makers and donor representatives have become partners in the sector generally, in an arrangement that has been characterized, in a different context, as "co-production". However, as a result, the sector as a whole is highly decentralized, with no single agency responsible for its development.

This is hopefully about to change with the setting up of the proposed microfinance development council. Hopefully one of its tasks will be to coordinate and strengthen data and information gathering and dissemination in the sector. While some useful information resources already exists,[18] it would be useful if it could be supplemented by an annual statistical yearbook on Indian microfinance which would include information contained in the existing reports but also on areas such as bank lending to the MFI sector, investments by the venture capital funds, information on the new products, life and non-life, of the insurance companies, and their uptake by the sector, the activities of the apex financial institutions such as SIDBI, FWWB and RMK (which are contained in their annual reports but could usefully be consolidated). Also it would be useful to commission state level reports which would be the most appropriate level to do a complete census of NGOs in the states conducting microfinance above a certain scale.[19] At present there are no firm estimates of the total number of NGO-MFIs in the country (the potential seeds and saplings) including multi-activity NGOs conducting microfinance above a certain scale.

Other issues highlighted in the chapters

Chapter 2 shows that the SBLP is growing at a rate which is running ahead of the capacity of SHPAs to ensure its quality. This could have serious implications for the programme in the long run. The first priority should be consolidation, even if it means accepting a lower growth rate for the next few years. Targets should be strictly eschewed, and the programme should be allowed to grow organically, although special promotional efforts are called for in the underserved states. Groups formed by government agencies tend to be the weakest, and reducing their share relative to those promoted by NGOs and even the banks would enhance overall programme quality.

Improvements in book-keeping capacity at the group, cluster and federation level are key to a whole range of variables such as (i) equity, (ii) longevity (i.e how long the group survives), and (iii) the drop out rate (all of which recent studies show to be reassuringly satisfactory), (iv) increasing the proportion of the poor in the groups (presently about half the membership) and (v) enabling the banks to better appraise and monitor loan portfolios on which their repayment rate depends in the long run. A massive programme of action research is required to standardize and simplify accounts and devise the best means of enhancing SHPA capacity to undertake the requisite training. Higher funding than present levels will be required, but could easily be met by reducing funds spent on credit subsidies under the SGSY and similar programmes, which reach only a small subset of groups and have much lower quality.

A massive programme of action research is required to standardize and simplify accounts and devise the best means of enhancing SHPA capacity to undertake the requisite training

Chapter 3 describes how the MFI model is growing rapidly, has good portfolio quality, and is highly efficient. Although, on average, Indian MFI interest rates are among the lowest in the world, large as well as many medium MFIs have attained operational sustainability, and a large number of small MFIs are progressing towards it as they grow. As in neighbouring Bangladesh, the bulk of borrowers and loans outstanding are concentrated in a few larger MFIs. The size gradient drops sharply after the top few MFIs, and as much as 95 percent of loans outstanding may be concentrated in the top 20 MFIs. Existing MFI membership and growth of outreach are both heavily concentrated in the South, although growth has been almost as rapid in the East in recent years, from a much smaller base.

Expansion to areas other than the South will come from a combination of existing MFIs expanding operations to other areas (a process which has been expedited by the AP crisis), the inception of start-ups, especially in the urban areas, and the growth of small and medium of MFIs. New lending, investment and capacity building all have a role to play in regional diversification, as could, potentially, apex financing institutions for small MFIs such as FWWB and RMK and RGVN, which could play an important role in nurturing and grow small MFIs in the underserved regions.

Indian MFIs are unique in the extent to which they leverage borrowed funds.[20] This situation is partly the outcome of the regulatory environment which only allows mutual, or member-owned institutions such as cooperatives to collect savings. Savings fund a large share of lending in other countries, providing a valuable service to borrowers and an important source of funds to reduce costs for MFIs.

Chapter 4 describes the lessons from the AP crisis for the MFI model and its likely implications for the future, many of which have already been referred to. Chapter 5A describes the new set of incentives for the insurance industry to reach the poor, and the considerable innovation in new product design and service delivery taking place. It reviews some lessons learnt from experience so far, and flags the issue raised by SEWA and others of the desirability of lower entry capital requirements for mutual organizations such as cooperatives that specialize in catering to the insurance requirements for the poor, similar to those that exist in other countries.

Chapter 5B reviews the experience of another of the "younger" microfinancial services, money transfers within the country. Huge flows of migrants criss-cross the country in search of a better life for themselves and their families, who mostly stay behind in their villages. Internal labour migration is increasing with differential rates of growth in different states, and pockets within states. The section discusses the need for a fast, low cost, convenient, safe, and widely accessible money transfer service and points out that at present options available to a poor migrant are limited.[21] One requirement for an MFI to meet the need for a money transfer service is a critical minimum number of migrants in the place of migration destination from a particular place of origin, which will almost invariably be a rural area. At least a dozen larger cities in India meet this condition, each of them for several groups of migrants from different parts of the country. It discusses how an MFI from the originating area can establish a base in the city or area of migration destination, or can tie up with an existing MFI or bank (under the Business Correspondent model).

A second constraint is crucial regulatory anomalies which constrain more widespread adoption of the partnership model, and uptake of the recently introduced Banking Correspondent models. The most important of these is the cap on small loans to the poor at the PLR. RBI needs to conjure up the necessary "political" will to lift this ceiling

With the relaxation of constraints on the availability of on-lending and investment funds in the last couple of years, human resource development has become perhaps the most important challenge facing the sector. However the state of development of the training and capacity building sector is embryonic in relation to needs. Perhaps the most important need is to integrate class-room based training not only with continuing on-site mentoring and hand-holding over a period, but also with pre-training needs assessment. Chapter 6 - on Training and Capacity Building - discusses these and other issues.

Chapter 7 reviews the availability and issues in commercial financing, both lending and investment. Section 7A describes the massive increase in commercial bank lending for the MFI model that has taken place though bulk lending and the partnership model. It also briefly describes innovative new financing mechanisms such as portfolio buy-outs and securitization. While lending growth is expected to continue, the rate of growth is constrained by the fact that MFIs with adequate capacity and systems have already largely been covered (although these are being joined by start-ups with huge borrowing requirements). There is thus a great need for strengthened training and capacity building services and institutions as discussed in Chapter 6. A second constraint is crucial regulatory anomalies which constrain more widespread adoption of the partnership model, and uptake of the recently introduced Banking Correspondent models. The most important of these is the cap on small loans to the poor at the prime lending rate (PLR). RBI needs to conjure up the necessary "political" will to lift this ceiling, if not altogether, to a much higher level that takes into account the transactions costs of efficient MFIs.

Chapter 7B describes the new venture capital funds, including their special emphases in the choice of partners and actual as well as prospective investments. Since they all have social as well as financial goals, backed by considerable resources to provide grant funded technical assistance to investees, they are in a position to promote both, and the potential conflict between the two is much less acute in India than it may be abroad. The chapter discusses the demand for equity capital and the value that the new public sector investor, the MFDEF can bring to the sector in making smaller investments than are presently permitted to the foreign registered funds, and in investing in the not-for-profit segment of MFIs through forms of quasi-equity such as subordinated long term low interest loans. Finally, it proposes a modification in the existing foreign investment regulations for NBFCs, at least for microfinance-specific NBFCs, since MFIs do not always need equity injections in the minimum quantities laid down presently, which entail an inefficient use of equity funds. A modification of the regulations would enable smaller quantities of equity to be provided when needed.

Chapter 8 is on "development" financing as opposed to commercial financing. Chapter 8A discusses apex financing institutions such as Friends of Women's World Banking (FWWB) and the Rashtriya Mahila Kosh (RMK), two organizations charged with growing the "seeds and saplings of the sector", and preparing them for commercial financing by the banks. FWWB is a private NGO, and RMK an NGO funded and controlled by the Department of Women and Child Development of the central government. Unfortunately this difference in ownership and control seems to have affected RMK's performance. It showed great promise in its early days when there was a dearth of funding for SHPIs and some of today's large SHPIs and MFIs, including the largest in the country, SHARE, were its partners. Unfortunately the documentation or ongoing monitoring does not exist to enable an evaluation of how successful RMK continues to be in nurturing small nascent MFIs. Its goal should be to incubate small organizations provided they are willing to take up microfinance "professionally" (target the truly poor, equip themselves with the necessary skills and systems, and set themselves the goal of achieving sustainability for the microfinance activity). In order to do so, RMK's will have to greatly strengthen its own capacity to identify, appraise, monitor, and mentor such organizations, through third-party service providers if necessary. A thorough review of RMKs structure, operations and future strategy needs to be carried out since this is a publicly funded institution, with an important role to play.

The kind of research that appears to be most needed is careful field research of the type economic anthropologists do, which is very often the only way of collecting useful microeconmic data on the savings and credit behaviour of poor households and their enterprises

Chapter 8B reviews the important role that donors have played in the development of the sector, their diminishing role as a provider of funds, and their emerging priorities in filling the remaining gaps in the sector, including capacity building. Another gap, that of knowledge, is being filled by greatly stepped up research activity in the sector in the last few years. Chapter 9, describes some ongoing research in the sector, at the Centre for Microfinance, Institute of Financial Management and Research, Chennai, and has been written by researchers there. The CMF works with principal researchers at home and abroad, and provides support in terms of identification of sites, organization of data and execution of studies. While it represents one of the largest concentrations of research in the sector, and is collaborating with a number of MFIs in various action research projects, there was unfortunately not enough time to systematically review research ongoing elsewhere, much of which is scattered. However the findings of a number of useful studies have been discussed in the other chapters. The kind of research that appears to be most needed is careful field research of the type economic anthropologists do, which is very often the only way of collecting useful microeconmic data on the savings and credit behaviour of poor households and their enterprises. This requires time, but in the long run produces insights and understanding faster than the shorter studies that have typically been produced so far.[22]

Box 1.1 The SHG and MFI models

Self Help Groups (SHGs) are informal associations of up to 20 women (their average size is 14) who meet regularly, usually once a month, to save small amounts (typically Rs 10 to 50) a month. While they are formed with the encouragement of NGOs and other self-help promoting agencies (SHPAs) such as government agencies and the banks, they are expected to select their own members, and are therefore sometimes called affinity groups. After saving regularly for a minimum of six months, and using the funds to lend small amounts to each other for interest, which is ploughed back into group funds, and satisfactorily maintaining prescribed records and accounts, they become eligible to be "linked" by the local bank branch under a NABARD-sponsored programme called the SHG Bank Linkage Programme (SBLP). Norms are laid down for the maximum size of the initial and successive bank loans as an increasing ratio of the group's own-funds. SHGs and the SBLP are discussed extensively in Chapter 2. On-time loan repayment to the banks has been very high, above 90 percent, and there have been no defaults so far. The programme has grown rapidly, and the savings component in particular has been a success, with an increasing number of groups having reached loan absorption limits based on the existing menu of activities open to them, mostly animal husbandry and trading, given limitations in support services and infrastructure. Thus the SBLP may be running into a second generation problem, whose solution depends on the ability of rural development programmes generally to increase opportunities for productive investment, and thereby increase loan demand. However, large parts of the country are still underserved. Record keeping in the groups is another challenge.

The SBLP is a home-grown model and unique to India, at least on the scale at which it is carried out. It differs from the Microfinance Institution (MFI model) found worldwide in which the MFI acts as an intermediary, much as the SHG does, but borrows in much larger amounts from the banks (in India mostly the private banks who do not have rural branches to conduct SHG lending) for a much larger number of members (going up to one million in the case of the largest MFI in India). These members are also organized into groups (whether the classic five-member Grameen Bank-type group, or larger "joint liability" (JLG) groups, or even SHGs).

Lending to groups, whatever they are called, entails the joint and several liability of all members, which is more moral than legally enforceable, and exercised through peer group pressure and the prospect of being denied future loans. The essential difference is that in the case of SHGs the loan is a single loan to the group as a whole, which decides how to allocate it to its members, while in the case of other groups the MFI records and tracks loans in the name of individual lenders, although the task of disbursement and collection is made easier and cheaper by the group mechanism. Thus interest rates charged by MFIs to SHGs are usually lower than on loans to members in other types of groups. Moreover, MFIs also make a few larger, individual loans to "graduating" members. Loan repayments to MFIs are in the upper 90s.

The major advantage of the SHG model is the empowerment and participation it has engendered in millions of rural women (currently 31 million) of which half are below the poverty line. It also has the advantage that it can spread much faster, taking advantage of India's huge network of bank branches, and potentially, of PACS. Ironically, in view of what has been said above about credit absorption limits, the main disadvantage is that average loan size goes up much more slowly than in the MFI model, because it is tied to savings performance, and because loan cycles are much longer (the average tenor of bank loans to SHGs is 2.5 years as opposed to the usual 1 year under the MFI model) so that every member has to wait till the last member has repaid her loan to the group, so that the group can repay its loan to the bank. Turn-around time among the bank branches also varies, and can often take six

Box 1.1 Continued

months depending on the manager's perception of the credit-worthiness of the group for a repeat loan, and of the profitability of the programme at existing lending rates. Despite this, as Chapter 2 discusses, the proportion of repeat loans is increasing, and the average size of repeat loans is beginning to approach the average size of MFI first loans.

Conversely, MFIs have the advantage that they can borrow huge amounts from the banks and increase loan size according to demand. By enabling prepayment of existing loans, they enable borrowers to access the next loan before the existing loan has run its full one year cycle, although at a penalty for prepayment. The higher average loan size this enables allows borrowers to invest a higher proportion of loans in income generating as opposed to consumption activities (essential though they may be).

Neither model is exclusively focused on those below the poverty line (although some individual SHPAs and MFIs are). However, the SBLP seems to do slightly better in this respect, even though there is no poverty targeting under the SBLP, and a large number of poor women can not afford even the small regular savings and repayment obligations, given the uncertainties and seasonality of their incomes, and prefer to exclude themselves. The SHPAs have not been able to introduce the flexibility that would improve inclusion of the poor above about 51 percent of the total membership, according to the most recent large-scale survey of SHG borrowers (EDA and APMAS (2006)). The last large-scale survey of MFI borrowers (EDA (2005)) found that on average only 43 percent of the borrowers of a sample of 20 MFIs were below the poverty line, despite the fact that many MFIs lending to Grameen groups tend to be particular about lending only to BPL women, using in one well-known case an easy to administer housing index test, and that the more time consuming procedures of MFIs such as weekly instead of monthly meetings, encourage self-targeting,

A disadvantage of the MFI model (unless the MFI is a cooperative) is that it does not provide for savings, but this is purely a function of the regulatory environment in India (savings are allowed and indeed encouraged as an essential service for the poor in most other countries). The biggest disadvantage of the MFI model however is that it is less participatory and empowering, since the "banking" functions and procedures are taken care of entirely by field staff of the MFI, who disburse and collect loans. In the SHG model million of poor women deal with the banks and do their own accounting and cash handling. However, some MFIs argue that this is actually a disadvantage of the SHG programme (because most women do not want to get involved in the banking function), and that it is more efficient to focus on achieving one objective effectively, which in the case of "minimalist MFIs" (the vast majority) is delivering financial services. Also they point out that given the millions of poor women in SHGs who have to be trained in book keeping and accounting, the training requirements of the MFI model are a little less daunting. Finally, they point out that MFIs lend to SHGs too, and in fact have more members in SHGs than in the other types of groups, thereby sharing in the empowerment benefits of SHGs.

Endnotes

1 *The main objective is often regarded as poverty alleviation, but financial inclusion subsumes this objective as long as reaching the poor (or maximizing depth of outreach) is given equal attention in product design, delivery systems and monitoring. A few microfinance institutions (MFIs) do lend only to the poor through careful targeting, but microfinance proponents need to be realistic about the limits to which microfinance can reach the bottom decile of the population, whose poverty is more the result of factors such as old age, ill-health and disablement, which are more efficiently tackled through income transfer or social security programmes. There is however scope for closer linkages between social security and microfinance programmes for the poorest and destitute (Sinha and Rasmussen (Forthcoming)). For some of the other limitations of microfinance as a stand-alone means of reaching the poor, and respects in which it has to be complemented by other inputs and services, see Vijay Mahajan (2005).*

2 *The World Bank-NCAER Rural Financial Access Survey for AP and UP found that only 21 percent of rural households have access to formal sector credit, although as many as 41 percent had a deposit account in a formal institution (Basu and Srivastava 2005))*

3 *See Chapter 2 for support for the following data and assumptions: 2.23 million groups minus an estimated 10 percent of groups no longer functioning, with 14 members each, of which 51 percent are poor. This estimate includes all groups still functioning, even though they may not be currently linked (borrowing from the banks).*

4 *7.3 million was the outreach of all Sa-Dhan members in March 2006, and is assumed to constitute 95 percent of all MFI borrowers (see Chapter 3). Of MFI borrowers, the proportion below the poverty line is assumed to be 43 percent (see EDA (2005) and Box 1.1), and the total number of poor households is assumed to be 75 million. Within the average of 43 percent MFIs lending to 5-member Grameen groups tend to have higher poverty coverage than those lending to SHGs or making individual loans (EDA (2005))*

5 *The proportion of the credit requirements of both these segments that is actually met, especially of the un-banked non-poor, is much lower than their share of persons reached (i.e. served at all). A useful back of the envelope estimate of the demand for credit is contained in Mahajan and Romola (2003).*

6 *The word "sector" is used in this report to refer to the development and financial movement that constitutes microfinance, rather than "industry", just as "member" is generally used in preference to "client".*

7 *If anything they are counter-productive, and reduce the amount of formal and MFI credit available to the poor, while raising interest rates in the informal sector. It is true that a number of activities are just not viable at the interest rates charged by MFIs, but many others have extremely high returns because these are returns not just to capital but also to labour which has zero to low opportunity cost for the otherwise unemployed. As more wage labour and more productive self-employment opportunities become available in the economy, these activities gradually wither away as as "inferior" activities. They are in the nature of livelihood activities rather than growth oriented microenterprises.*

8 *Unfortunately, the efficiency of Indian MFIs, whether measured in cost per borrower, or cost per unit loan outstanding, is based partly on low remuneration levels by international standards. Average salary levels are about three times per capita income, as against 13 times in regions such as Africa (Chapter 3). There would seem to be a case for bonuses geared to profits in the case of those MFIs who make them.*

9 *See Rutherford et al (2006) and Rutherford (2006)*

10 *Shankar (2006). EDA is also doing a transactions cost study sponsored by SIDBI.*

11 *India has the highest outreach of Grameen-replicant MFIs outside Bangladesh.*

12 *Typically, the project provides the resources required to form, train and nurture groups to maturity, the insufficiency of which are a major lacuna in the regular programme as Chapter 2 discusses, while onlending funds are provided by the banks.*

13 *The severity of the Krishna action (raiding the MFI branches at night and sealing them) was justified by the district authorities on law and order grounds. While the courts have traditionally allowed a wide latitude to the district authorities in matters of law and order, they would not hesitate to intervene if they suspected this was just a pretext. A further incident was reported from Karnataka recently, when some field workers of an MFI headquartered in Bangalore were detained for a few days, reportedly on the grounds that as a trust the MFI was not allowed to carry out the lending activities.*

14 *See for instance the Microfinance Information and eXchange (MIX) report (MIX 2006), which deals extensively with the transparency environment in India. As it points out, Sa-Dhan has been working on promoting standards and improving financial reporting norms, but low penetration rates suggest these are still in the advocacy and dissemination stage.*

15 *One would like to say "financial intermediation" in the sense of direct intermediation between savers and borrowers with all its recognized allocative efficiency advantages, but unfortunately eligibility conditions for being allowed to accept savings are so stringent that not a single NBFC has succeeded yet in obtaining permission, even to accept the savings of its own members who are mostly net-borrowers and in whose case the standard prudential concerns do not apply.*

16 *As financial institutions licensed under the RBI Act, NBFCs have the freedom to set their interest rates, whereas NGOs and trusts registered under state acts come under the purview of state moneylender acts, which although intended for professional moneylenders of earlier, colonial times, can be used by state governments to impose interest rate caps, as Tamil Nadu attempted to do in 2003 through the Tamil Nadu State Prohibition of Charging Exorbitant Rate of Interest Act which capped interest rates at 12 percent for unsecured loans. Fortuitously, the ordinance was stayed by the by the Chennai High Court who were moved by the private lenders fraternity. AP is reported to be preparing a similar act (see Chapter 4).*

17 *See for instance Shashi Rajagopalan (2004).*

18 *NABARD's annual reports on the SBLP are very useful, and quite comprehensive in some respects. However, there are a number of aspects of the programme on which they are silent, partly because of difficulties in obtaining timely data from the large number of partner banks. There is an understandable reluctance to increase bank costs thorough increased reporting requirements, but information on some aspects of programme would appear to justify these. Areas in which programme data is missing are discussed in Chapter 2. On the MFI model Sa-Dhan's Side by Side reports and directory of members are a useful beginning, but not yet comprehensive enough, largely because of the capacity constraints members face in submitting timely data in a form useful for microfinancial analysis (as opposed to audit reports, which in any case for NGO-MFIs are often delayed). M-CRIL plays a valuable role in analyzing the performance of its rated MFIs, which account for a large share of the sector, through its periodic MCRIL Reviews. The recent MIX report, MIX (2006) relied on extensively in Chapter 4 contains extremely useful analyses not just of the MFI model in India, but of Indian microfinance in a comparative context.*

19 *Such as the extremely useful "vision" document for Orissa commissioned by CARE recently.*

20 *As Chapter 3 discusses the average capital asset ratio in India is less than 11 percent, only half the average for South Asia, which is itself only two-thirds to half the level in the other three main microfinance regions in the world (East Asia, Latin America and Africa). Because of the access Indian MFIs enjoy from the banks (primarily, and increasingly, the private banks) and apex financial institutions such as SIDBI and FWWB, eight out of 25 of the most highly leveraged MFIs in the MIX's global data set (of 518 MFIs) are Indian. Loans are used not only for on-lending, but increasingly to bridge operational losses during the initial years as economies of scale are being built up, a function usually served by equity received from donors in other countries.*

21 *The postal money order charge of 5 percent means parting with a full day's wages about once a month to send one's meager savings home.*

22 *As the adage goes, there is never time to do things well, but always time to do them again!*

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CHAPTER 2

Progress under the SHG Bank Linkage Programme

Of the two major models of microfinance in India, the SHG Bank Linkage Programme (SBLP) is by far the dominant model in terms of number of borrowers and loans outstanding.[1] The cumulative number of SHGs linked has grown almost tenfold in the last five years, to achieve an outreach of about 31 million families through women's membership in about 2.2 million SHGs by March 2006 (Table 2.1)[2]. Not all SHGs are currently "linked" in the sense of having loans outstanding to the banks or federations, and only an estimated half of their members are poor.[3] However, this still means about 14 million poor households have been reached so far[4]. Moreover the entire membership is saving regularly, and has access to a ready source of small emergency and consumption loans in the form of loans extended out of the group's own funds.

Of the non-poor members, about half have yet to be reached by the banking system, and the programme gives them indirect access to it. When one considers the non-financial (and unquantifiable) benefits of the programme commonly grouped under the rubric of empowerment …the programme is a remarkable achievement

Of the non-poor members, about half have yet to be reached by the banking system, and the programme gives them indirect access to it. When one considers the non-financial (and unquantifiable) benefits of the programme commonly grouped under the rubric of empowerment (the increased sense of self-worth within the family and self-confidence in dealings with the outside world, including the banks, and in participation in panchayat elections, accessing other government programmes, and in some cases launching joint actions against social injustice)[5] the programme is a remarkable achievement, especially in the context of the large poverty lending programmes which have been costly failures in the past.

Recent trends in the growth of the SBLP

Is growth levelling off?

While the size of the programme continued growing in 2005-06, the rate of growth of loans to new groups declined sharply (to 15 percent). The rate of growth of repeat loans also declined, although by not as much as that for new loans (repeat loans grew by 34 percent in 2006 as against 50 percent in 2005).[6] Thus the proportion of repeat loans in total loans, and repeat lending in total lending, increased to 36 and 48 percent respectively. Also, average loan size of both kinds of loans increased to Rs 37,574 and Rs 62,960 respectively. This translates to average loan size of Rs 2,684 for first loans and Rs 4,497 for repeat loans per group member, given average group size of 14 members.[7]

Table 2.1: Growth trends in the SBLP

		2001	2002	2003	2004	2005	2006
1	No. of new SHGs provided with bank loans (cumulative)	263,825	461,478	717,360	1,079,091	1,618,456	2,238,565
1a	Of which in Southern region (cumulative)					938,941	1,214,431
1b	Percent in Southern region (%)					58	54
2	No. of new SHGs financed during the year	149,650	197,653	255,882	361,731	539,365	620,109
2a	Of which in Southern region						275,490
2b	Percent in Southern region						44
2c	Rate of growth of loans to new SHGs (%)		32	29	41	49	15
3	No. of SHGs receiving repeat loans	21,630	41,413	102,391	171,669	258,092	344,502
3a	Rate of growth of repeat loans (%)		91	147	68	50	34
3b	Proportion of repeat loans in total loans (%)		17	29	40	32	36
3c	SHGs taking repeat loans as a percentage of cumulative SHGs that stood linked between 2 and 3 years ago				47	44	38
4	Bank loan disbursed cumulative (Rs crore)	481	1,026	2,049	3,904	6,896	11,398
4a	Bank loan disbursed during year (Rs crore)	NA	545	1,023	1,855	2,994	4,499
4b	Of which, disbursed to new groups (Rs crore)	290	453	691	1,158	1,727	2,330
4c	Of which, disbursed as repeat loans (Rs crore)	NA	92	332	698	1,268	2,169
4d	Proportion of repeat loans in total disbursed (%)		17	33	38	42	48
5a	Average loan sizes - new (Rs)	19,379	22,919	27,005	32,013	32,019	37,574
5b	Repeat (Rs)		22,215	32,425	40,660	49,130	62,960

Source: NABARD annual reports, and data sheet for 2005-06

Since the original target announced for the programme, of linking 1 million groups by March 2007 had already been almost doubled, the annual target for 2006 was set in the finance minster's budget speech at only 3.5 lakh groups. The modesty of this target was a welcome development from the point of view of ensuring the quality of the programme, as discussed below. In the event, growth was much higher. It would be ideal if it were to stay at the level of about half a million new linkages in the next few years so that the programme can consolidate quality as discussed below, accompanied by an acceleration in the underserved states.

Inter-state imbalances are gradually being rectified

Athough the programme is still heavily skewed in favour of the three southern states (AP, Tamil Nadu and Karnataka) the share of new loans for the four southern states came down from 49 percent in 2005 to 44 percent in 2006, and of cumulative loans from 58 to 54 percent. The number or new loans actually came down in AP, from 107,351 in 2005 to 94,311 in 2006. However, the number of repeat loans increased from 153,903 to 200,030.[8]

In 2005, NABARD identified 13 priority states accounting for 70 percent of India's poor for special efforts and location-specific strategies. Table 2.2 shows that the number of groups linked in these states increased by 68 percent in 2005 and 51 percent in 2006 As against an increase of 49 percent in the number of new SHGs linked country-wide in 2005 (Table 2.1) the number went up by 54 percent in the Northeast, 45 percent in the West, and 44 percent in the East. Growth in the central, northern and southern regions ranged from 15 to 20 percent. Of these three regions, acceleration of growth in the central region deserves the highest priority.[9]

In 2005, NABARD identified 13 priority states accounting for 70 percent of India's poor for special efforts and location-specific strategies

Growth in these states was achieved partly by diversifying the use of partners. Partners receive grant assistance for the formation, training and nurturing of SHGs under Model II of the programme under which groups are promoted by formal agencies other than banks.[10] NGOs, in addition, participate under Model III as credit intermediaries, although the share of Model III had declined further to 7 percent by March 2006 from 11 percent in 2001.[11] Model I in which groups are both formed and financed by the banks has been growing at the expense of the other two models and stood at 21 percent in 2006.[12]

Table 2.2: Growth of SHGs linked in 13 Priority States

State	2003	2004	2005	2006
Assam	3,477	10,706	31,234	56,449
Bihar	8,161	16,246	28,015	46,221
Chhattisgarh	6,763	9,796	18,569	31,291
Gujarat	13,875	15,974	24,712	34,160
Himachal Pradesh	8,875	13,228	17,798	22,920
Jharkhand	7,765	12,647	21,531	30,819
Maharashtra	28,065	38,535	71,146	131,470
Madhya Pradesh	15,271	27,095	45,105	57,125
Orissa	42,272	77,588	123,256	180,896
Rajasthan	22,742	33,846	60,006	98,171
Uttar Pradesh	53,696	79,210	119,648	161,911
Uttaranchal	5,853	10,908	14,043	17,588
West Bengal	32,647	51,685	92,698	136,251
Total	249,462	397,464	667,761	1,005,272
Percent increase		59	68	51

Source: NABARD annual reports

The Light and Shades Study

A major breakthrough in our understanding of the SHG bank linking model came with the release in 2006 of the study "Self Help Groups in India: The Lights and Shades of SHGs" by EDA in association with APMAS (EDA and APMAS (2006)) referred to hereafter as LSS. The study combined survey research with a search for "stories", which give us a rich feel for the qualifications and nuances attached to the numbers. Before this study much of the information on the programme had been largely anecdotal (with a few prominent exceptions) and without data on how representative the success and horror stories were. As a result what went on inside an SHG remained largely a black box to non-field workers.

The study was carried out in four states, two southern (AP and Karnataka) and two northern (Orissa and Rajasthan). In all, 214 SHGs in 108 villages in 9 districts selected purposively to reflect different agro-climatic and socio-economic conditions (three in AP, and 2 each in the rest) were visited by three teams of researchers during October 2004 to May 2005. The villages were selected purposively as those most likely to have groups that had had bank savings accounts for at least four years, with some external borrowing, and that would yield a mix of three types of SHPAs (NGO, government and bank) in roughly the proportions that prevailed in the nationwide programme at the time. Accordingly, the majority of groups chosen in the sample were formed by NGOs, and 60 percent of them belonged to cluster networks or federations.[13] Given the sampling criteria adopted, Table 2.3 shows the profile of the typical SHG in the study.

The study has provided welcome reassurance on a number of issues that have been raised in discussions of SHG bank linking programme. These relate to the equity of loan distribution within the groups, the longevity or stability over time of the groups, and the incidence of dropouts among members

As already noted, 51 percent of members were poor, and 55 percent belonged to the SC/ST. Sixty-six percent of SHGs were single-caste SHGs (in other words SHGs tend to be homogenous in caste, but less so in terms of wealth). However a good third had mixed-caste membership which contributes over time to bridging caste divisions through the experience of working together in monthly meetings. 72 percent of the membership had had no schooling at all. In only 51 percent of the groups did more than half the members have a primary school education. It is this characteristic of the membership that renders bookkeeping and accounting so challenging, as discussed below. Sample SHGs covered 29 percent of all households in their villages.

Average monthly savings were Rs 45, and cumulative member savings Rs 2,400. The modal rate of interest charged on loans to members was 2 percent per month. Seventy-seven percent of the groups had borrowed from banks or federations at least once, for an average of 2.5 times. Their cumulative borrowings had been Rs 102,300 each and current outstandings (for those groups who had them) were an average of Rs 58,600 per group. The average size of the group fund (savings and surpluses on lending to members) was Rs 33,700. For a subset of the sample with available/usable balance sheets the ratio of external borrowings outstanding to internal capital was 1.43[14]

The study has provided welcome reassurance on a number of issues that have been raised in discussions of the SHG bank linking programme. These relate to the equity of loan distribution within the groups, the longevity or stability over time of the groups, and the incidence of dropouts among members. Loans are relatively *well distributed* among members, with low variance around the mean both in respect of number of loans and loan amount.[15] Moreover, the proportion of non-borrowers is only 7 percent. As regards *longevity*,[16] it found that the proportion of defunct and broken groups was only 7 percent, which is low considering that average group age was 6 years.[17] While SHG longevity is not an end in itself, it is important that members are able to save and borrow in the group mode for as long as it is useful for them to do so, and that they can graduate to more attractive alternatives such as savings and borrowing through the banks without causing groups to break up. New rather than restructured groups are "inefficient" in a global sense, since they increase promotion costs, and they entail having to start afresh in building credit-worthiness, impeding the flow of linkage credit. There is a need for SHPAs to conduct the action research to evolve more flexible mechanisms to allow new members to replace existing members, which would not only allow members to graduate without breaking their groups, but also, more challengingly, include among the replacements those hitherto excluded, by waiving the usual requirement that new members bring into the groups the same amount as the accumulated savings of existing members. Flexibility in this and other respects will place an even greater burden on book keeping skills, but would have a high pay off.

Finally, on the "light" side, less than 10 percent of members had dropped out, over a third of them for reasons of migration, death or illness. *The dropout rate* was only marginally higher among the very poor, and just 10 percent of dropouts were in default.

On the "shades" side however several of the findings are not so reassuring. While the number of dropouts is low, only a fifth of them were paid their full share of interest and other income on group operations when they exited, partly because the state of group accounts did not allow for a clear apportionment of surpluses over and above over accumulated savings. Clear guidelines and greater effort is needed on the part of SHPAs to ensure that dropouts receive not only their accumulated savings but also share of profits or surpluses so as not to discourage longer term memberships.[18]

Issues of concern on the financial side include the state of group records, and overdues within groups

Of greater concern perhaps is *the phenomenon of exclusion*, which keeps the depth of outreach to 51 percent. Self-exclusion as well as exclusion by existing group members and SHPAs is practiced for much the same set of reasons - (i) anticipated difficulty in meeting savings obligations, and in keeping up with loan repayments, as well as (ii) lack of understanding and confidence in group processes, (iii) having to go outside the village for daily work which makes it difficult to attend weekly meetings, and (iv) caste and personality related antipathies. The study found no examples of SHPAs addressing the most important of these reasons -- the inability to save regularly by households with variable and uncertain incomes -- by introducing lower and more flexible savings requirements in keeping with varying cash flows.

Issues of concern on the financial side include the state of group records, and overdues within groups (unfortunately, overdues from the groups to the banks were excluded from the terms of reference). The *quality of group records* would appear to be crucial to accountability and transparency within groups and (therefore to their longevity) and to providing the banks with the necessary comfort levels in loan appraisal and monitoring.[19] However record quality was assessed as being "good" in only 15 percent of the groups, "moderate" in 39 percent, and "weak" in 40 percent (they were unavailable in the remaining 6 percent of groups). Passbooks however were up-to-date in 72 percent of the groups, although in the possession of the members themselves as opposed to group leaders or account keepers, which is important for transparency, in only 79 percent of the groups. The government promoted groups had the highest proportion of weak records (over half), and were half as likely as NGO or bank promoted groups to have good or moderate records. This is not surprising, since 77 percent of government promoted groups receive low inputs of any kind, microfinance or development, or field worker supervision, as compared with the average proportion for all groups, of 37 percent.[20]

The level of overdues within groups has prudential implications not only for members' own savings, but is likely to be correlated with overdues from the groups to the banks, although this may have been masked so far because the relatively small size of the first couple of loans has enabled most groups to make bullet repayments at the end of the loan period. While this has the advantage of reducing transactions costs and may be more compatible with seasonality of cash flows, it could prove increasingly problematic as loan size increases. Although the norm is regular weekly or monthly payments, at least of interest, and often also of principal, in practice most SHPAs do not consider a loan to be overdue until repayment is 90 days overdue. On this definition 24 percent of current borrowers had overdues (and 5 percent of them were overdue by more than 12 months). Overdues were the highest for very poor borrowers, followed by those for the non-poor.[21]

An extremely useful finding is that it costs the equivalent of $115 to launch a group and another $145 to continue training and monitoring it, for a total of $259 per group. This figure is about the modal cost of about Rs 10,000 per group reported across a number of studies, and imparts a sense of realism about the financial magnitude of the task ahead, which however is affordable as discussed below

Another measure of portfolio quality is portfolio at risk (PAR), which for the 45 percent of groups that had PARs of 365 days was 17 percent.[22] Overdues do not necessarily lead to default, and largely reflect considerable variance in practice with the stated norm of regular monthly or quarterly repayments, but default was found to be the most important reason for groups breaking up or ceasing to function (small though their number is), and overdues reduce the availability of funds for relending within the group and timely repayments to the banks. They also reduce profitability.[23] The study also found indications of an increasing number of groups reaching the limits of their credit absorption capacity, or the emergence of a sort of Peter's Principle, with groups rising to a level of loan size which they find difficult to absorb or repay, and of older groups being more likely to default. Viewed in this context, the impatience sometimes expressed with the rate and progression in size of repeat loans by the banks may be misplaced. In fact the evidence points to the need for consolidation of quality in its many aspects, and considerably diluting if not abandoning the present focus on targets.

Value for Money

Another 2005 study "Do Self-Help Groups provide value for money?" by LB Prakash and Others (Forthcoming), of 150 SHGs, 30 in each of 5 states, in each of which they were promoted by an SHPA of different institutional type, comes out with a similarly mixed verdict, and remarkably similar findings on (i) equity in loan distribution within groups (ii) dropouts (15 percent of members for the sample groups with had an average age of 5 years, but who were replaced by new members to the extent of 9 percent) (iii) longevity (lower for government promoted groups), and (iv) deteriorating portfolio quality with age (but better than in LSS with the 365 day PAR being 11 percent). It found evidence also of a correlation between PARs within groups and in relation to loans outstanding to the banks.[24]

Like many other studies it noted empowerment benefits, and increases in income (but for only 25 percent of the members), and the decline of moneylenders who either "disappeared" or reduced their rates. Interestingly it did not find evidence of the NGOs in its sample having better portfolio quality, deeper outreach or greater profitability. An extremely useful finding is that it costs the equivalent of $115 to launch a group and another $145 to continue training and monitoring it, for a total of $259 per group. This figure is about the modal cost of about Rs 10,000 per group reported across a number of studies,[25] and imparts a sense of realism about the financial magnitude of the task ahead, which however is affordable as discussed below.

Using these "promoters" costs as worked out for each institution, and providing for loan loss reserves based on APMAS norms, it estimated that average return on assets (RoA) drops from 13 percent unadjusted (with a range of 18 to 7 percent) to 9 percent after adjusting for losses (range 16 to 1 percent) and to nil after adjusting for promotion costs (range 7 to -9 percent)[26]

The APMAS Study

Older is not wiser

A third study extremely rich in detail and insights, but focusing on a single state, AP, was brought out by APMAS in 2005, summing up the experience of several studies conducted by it from early 2003 onwards. It covers 400 groups in 8 districts, with a weighted average age of 4 years, but with 5 percent of the sample going up to over 9 years. It provides interesting information on the *dynamics of aging*. Thus the percentage of dropouts increases to 28 percent after 9 years. As the study points out "Membership change is usually the sign of a well developed organization having a life quite apart from its members. In the case of SHGs, however, their small size makes them vulnerable to upheavals in membership. Further, members need continued support from their organization, over lengths of time, if they are to benefit in a sustainable manner."

Grading the groups into A, B, and C quality groups based on NABARD's suggested Critical Rating Index tool,[27] the study detected evidence that the overall quality of groups tends to deteriorate after a couple of years, recovering again in years 7- 8, and thereafter perhaps undergoing a second cycle of deterioration, although shallower than the first one. Nevertheless the share of A graded groups ends up at 66 percent in year 9 after starting from 74 percent in years 1-2.[28] The study notices a similar cycle in cumulative savings.[29] In contrast with the inverse relationship of group quality with age, group quality tends to improve with successive repeat loans.[30]

The study contains interesting descriptive information on the costs of securing a "linkage", time taken for loan sanction and release,[31] procedures, and the problems faced by groups[32] and by bankers[33], with each other, and with other players, greatly enhancing our understanding of the whole linkage process. While default had not yet manifested itself as a serious problem,[34] the study points out that practices such as deducting overdues from new loans, or from amounts lying in group savings accounts were common practices hiding the true picture, and that "real default is probably a much bigger problem than is acknowledged."

Implications for policy

An issue often raised is the financial sustainability of the programme as a whole, and of its various components, i.e. (i) the profitability of groups after accounting for loan losses, (ii) their profitability after accounting for both loan losses and the promoting SHPA's costs (iii) the sustainability of SHPAs in being able to recover their costs on group promotion, (iv) the sustainability of federations in providing continuing support, and (v) the sustainabiliity (profitability) of the banks in undertaking SHG lending. We have already considered the evidence of our studies on (i) and (ii). Regarding (v), the jury is still out on the profitabilility of the banks at the current level of interest rates being charged.[35] The evidence on sustainability of federations has been discussed by Nair (2005). For the programme as a whole, the sustainability of relevance is not financial but social and economic (in the cost-benefit sense). There is little doubt in the mind of well-informed observers who have field experience that the programme is vastly profitable in a social sense, even after including the cost of promotion that will have to be met by subsidies. Proving this is another matter given the unquantifiable nature of many of the benefits such as empowerment, and equity in access to finance. A third benefit, the reduction of income poverty is measurable, but much more rigorous studies than have been done so far will be necessary before it can be measured.[36]

Regarding (iii), the modal estimate of SHG formation, training, and hand-holding costs over a period of time is about Rs 10,000, as noted earlier. One of the criticisms of the programme is that the level of support it provides to SHPAs is well below this, and insufficient in amount and time to build the capacity, primarily book-keeping systems and skills, required to (i) achieve the flexibility that would allow greater inclusion and depth of outreach, apart from (ii) greater transparency and accountability, both of which contribute to the social and financial objectives of equity, longevity, and portfolio quality (and therefore profitability).

One of the criticisms of the programme is that the level of support it provides to SHPAs is well below this, and insufficient in amount and time to build the capacity, primarily bookkeeping systems and skills, required

However NABARD takes the view that grant assistance to NGOs for SHG promotion is not intended to meet the full costs of successful group promotion, but is only an add-on, which the NGO is expected to supplement from other sources including donors, and cross-subsidization from funding available for the other activities they often promote. In April 2005, NABARD increased the amount of grant assistance it pays an NGO for successful group promotion from Rs 2,000 to Rs 3,000 per group, and by 50 percent for all other SHPAs, including Regional Rural Banks (RRBs) which now receive Rs 1,000. The higher amount to NGOs is now released over 3 instead of 2 years, with a higher proportion of the amount "back-ended", and made conditional on maintenance of books of accounts, which have been audited by the NGO.[37]

Had the problem been entirely one of funding it would have been relatively tractable. It should be possible for the government to come up with the funds to pay for the full costs of SHG promotion. Assuming the programme expands organically at half a million new groups a year at a promotional cost of Rs 10,000 over the life of the groups, this translates to Rs 500 crore, which is not very much more than the average of about Rs 400 crore a year as subsidies that were spent by the central government alone on the SGSY programme during the 10th Plan, on a small sub-set of the total number of groups that were included in the SGSY programme, largely ineffectively and wastefully. Since the states are expected to match the central government contribution with a matching 25 percent, the actual expenditure on credit linked subsidies was higher than Rs 500 crores.[38] The corpus of NABARD's Micro Finance Development and Equity Fund (MFDEF) was doubled to Rs 200 crores in 2005, and amounts spent out of this on a pilot programme to find out what (and how long) it takes to create high quality groups that fulfill the criteria of an "ideal SHG" should be high priority. For the problem is as much one of the lack of a model or models, of the best way to go about equipping groups with the relevant skills and capacity, as discussed below.

The evidence of our studies is that an issue deserving as much concern perhaps as financial sustainablilty is that of institutional sustainablilty. Fears expressed in the early days of the programme of groups disappearing after a couple of years have proved largely unfounded as discussed above. However as we have seen, overdues and portfolio at risk within groups are more serious problems than is widely appreciated, and may be reaching the critical level at which they could affect group cohesion in a much larger proportion of groups, affecting repayment to the banks. Several studies (including those discussed above) of both groups and federations, indicate that overdues increase with time and loan size, and this could affect the programme as it ages.

The situation is particularly serious in respect of groups promoted by field staff of government departments[39] in response to targets. Government promoted groups may already constitute the largest single number and their proportion appears to be increasing under a variety of programmes, many of them state governments'. As LSS notes, government promoted groups contain the highest proportion of "low" input groups in terms of continuing hand-holding, training, and monitoring after the group has been formed. Direct subsidies (matching grants, revolving fund assistance, interest rate subsidies) further distort the programme.[40]

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Deteriorating portfolio quality over time, as well as exclusion, another challenge facing the programme, are both closely related to the need for greater flexibility and variability in loan repayment schedules, and in savings amounts and frequencies. The former have to be made more compatible to the different cash flows of the various activities being financed, and the second to the income levels of the poor and fluctuations therein. Clearly, greater flexibility will place an even greater burden on loan administration skills within the group, and on limited book-keeping skills. Simplification of book-keeping is another priority. There is an urgent need for action research in both these areas and in organizing the logistical aspects of book-keeping generally. Ekgaon Technologies with the Covenant Center for Development in Tamil Nadu, Ibtada in Rajasthan and Pradan in Jharkhand are doing valuable work in this respect, which is being documented under the GTZ-NABARD collaboration. Box 2.1, based on Kanitkar and Meissner (2006), describes Pradan's "Computer Munshi" project. However there is need for many more similar efforts all over the country.[41]

Based on the results of the action research, the critical area in which training and continuing assistance to the groups is needed is book-keeping. As LSS says "Even with social objectives, "Self-Help" has a financial base (depositing and managing savings, lending and borrowing) and the base has to be right, with effective and transparent management and the guidance to do this. Clear guidelines and systematic record-keeping for microfinance transactions are essential, whatever, the SHPA orientation… This has to be part of the initial focus and guidance, over a period of 2-3 years. It is a case of getting the basics right."

Recommendations

The need to slow down

A clear conclusion that emerges is the need to slow down and emphasize quality rather than quantity. Global targets for the programme should be strictly eschewed, and only indicative targets for the underserved states and regions within them, or for the share of particular SHPAs being encouraged, should be used for internal planning purposes. The goal should be allow the programme to grow organically, in response to needs and capabilities. As we have seen, the rate of growth of the programme did indeed slow down in 2005-06, and hopefully will continue to do so until there is greater confidence that quality issues are under control, accompanied by higher growth in the underserved states.

Good books make for good groups

As noted above, book-keeping is perhaps the single most important area for greater action research on how to create and organize systems to impart the necessary training, devise viable incentives to participants in the system, and provide continuing support over time.

A periodic quality assurance survey

In order to stengthen the focus on quality, and to monitor progress in increasing it, the SHG movement needs to devise an annual or biannual sample survey, representative at the national level, designed to assess changing (and hopefully improving) SHG quality. At the very least we need a continuing series of high quality studies of the kind that have recently been conducted.

As noted above, book-keeping is perhaps the single most important area for greater action research on how to create and organize systems to impart the necessary training, devise viable incentives to participants in the system, and provide continuing support over time

Better statistics

On the quantitative aspects of the programme too, we need better statistics. The annual NABARD publication has a wealth of useful information on growth trends in different states and in the contribution of different partners and SHPAs, broken down to the district level. However lending figures are reported in cumulative terms, which is of interest, but overstates current loans outstanding, since a number of groups stop borrowing for various reasons, or are temporarily between loans. Lending Information is received from the banks and they should be able to provide year-end loan outstanding (stock) information in addition to flow information. This is essential for a true estimate of the size and annual growth of the model, and therefore of the microfinance sector in the country as a whole, and for comparison with other models. In the absence of global data, one is forced to rely on surveys, which indicate that outstandings are about 70 percent of cumulative lending.[42]

Second, no break-up is provided of repeat loans, whether second, third or subsequent loans, in the absence of which it not possible to monitor the respective proportions of groups in each group, or of loan size progression. Third, it would be useful to have information on bank portfolio quality (PARs, defaults). Fourth, and equally useful, would be information on group savings and the credit-deposit ratio under the linkage programme. As noted above, APMAS (2005) found that loans outstanding in AP were only 74 percent of members' thrift deposited with the banks. As it says "SHPIs need to ensure that bank linkage is not just about SHG funds being lent to SHGs".

Box 2.1 Pradan's Computer Munshi System (CMS)

In keeping with its mission to "impart rural livelihoods to enable communities" Pradan promotes SHGs in 7 states as community institutions designed to offer mutual help, financial intermediation, empowerment and livelihood promotion. It sees high quality book-keeping as crucial to the transparency, equity and longevity of its groups. Since it would like its groups to be on their own within one and a half to two years of inception, with Pradan assisting thereafter only with annual audit (carried out within a week of the end of the financial year), this means the groups must be self-sufficient participants within 3 to 5 months in an innovative system of accounts and bookkeeping called the Computer Munshi system. The system is built around a Group Accountant with basic financial literacy selected from among group members, or from the village, who is acceptable to the group, and is trained on-the-job for 3 months, supported by a Computer Munshi, equipped with a computer and printer in a central location with electricity supply, who has at least a high school degree, and the necessary interactive and social skills to be acceptable to a large enough number of groups to make a living, and the entrepreneurial ability to supplement it, if need be, by offering similar book-keeping and training services to the banks, DRDAs and other SHPIs.

After each weekly meeting the GA completes, apart from the books of accounts, a Regular Monthly Transactions Statement (the RMTS I) recording the week's savings and credit transactions, and balances, including any items of expenditure and income, memberwise, in the local language. It is collected by a messenger from a drop-box according to a fixed schedule, and is delivered to the CM, who enters the accounts in his computer, and remits back to the group a corrected statement, the RMTS II, in time to form the accounting basis for the next weekly meeting of the group, and for the group to correct its accounts against if necessary. The system is designed to be self-correcting, since the GA is warned each week of any discrepancy between the balances in the RMTS and the balance in the cash box, and can correct any errors as they arise. Likewise the CM is warned of any remaining discrepancies each week, and is also in a position to prepare a monthly trial balance for the group, which is discussed at a monthly meeting of village level clusters consisting of about 25 groups each, which are attended by the group representatives, the CM and Pradan staff.

The groups are expected to pay an honorarium to the GA from the outset, and a fee to the CM after the first year, during which it is paid by Pradan. It should be possible for a CM to serve up to 300 groups, which at Rs 2 per RMTS per week should earn him a viable income. By March 2005, 48 CMs were serving about 2,000 groups and the system was functioning with minimal supervision in about half the locations, with some CMs making up to Rs 1,800 a month and being occupied for about half their time. However not all groups were convinced enough yet about the usefulness of the system to be willing to pay, especially for the CM who is located further away than the GA. Some of the difficulties faced are the CMs not being able to read the handwriting of the GAs, the GAs not being able to interpret the RMTSs correctly, and errors arising from a lack of understanding on the part of the CMs of all the different loan products of the groups. Some of the challenges facing the system are the need for further improvements in the software (it is already capable of accommodating electronic data entry at the group level, which will minimize human errors), improving the back-up system for the hardware in conditions of frequent power failures, and logistical difficulties in the messenger system in view of the remoteness of some of the groups. One of its features is a heavy commitment of time, and cost information is not yet available on the overall system to estimate how much other SHPIs would have to be compensated to take it up (PRADAN has received grants from NABARD, SIDBI, and initially from the DFID funded CASHE project of CARE, under its innovations window)[43]

Based on Ajit Kanitkar and Jan Meissner, 2006.

Table 2.3 Profile of sample SHGs in Light and Shades Study

	Indicator	South		North		Overall
		AP	Karnataka	Orissa	Rajasthan	
1.0	**SAMPLE**					
1.1	Sample villages	28	16	31	33	108
1.2	Sample SHGs	60	51	50	53	214
1.3	SHGs >/= 4 years old	54	47	42	50	193
	Average age of SHGs (yrs)	5.8	5.7	5.1	6.9	5.9
1.4	SHGs promoted by: NGO	23	27	42	45	137
	Government	31	2	8	8	49
	Bank	6	22			28
1.5	Average members/SHG	12	14	14	15	14
1.6	Average distance from bank (km)	6.2	2.8	2.1	2.2	3.5
1.7	SHGs in federation or cluster	97%	29%	56%	53%	60%
1.8	SHGs provided mF+	90%	57%	46%	51%	62%
2.0	**OUTREACH**					
2.1	Village household coverage in SHGs	43%	23%	35%	21%	29%
2.1a	SC/ST household coverage (North)	-	-	53%	24%	
2.2	Single caste SHGs	63%	69%	74%	60%	66%
2.3	Functionally literate SHGs	72%	45%	50%	36%	51%
2.4	% SHG members: poor	53%	61%	58%	34%	51%
2.5	SC	7%	45%	41%	27%	30%
2.6	ST	13%	10%	35%	41%	25%
2.7	women heads of households	13%	16%	14%	3%	11%
2.8	completed primary school or above	20%	8%	8%	2%	10%
2.9	casual labour as main activity	22%	45%	45%	39%	38%
2.10	SHGs with dropouts	43%	47%	56%	66%	52%
2.11	Rate of dropout	7%	10.5%	9.5%	12.2%	9.8%
2.12	Rate of dropout among the poor	9.0%	9.9%	8.0%	17.3%	10.1%
3.0	**SOCIAL ROLE**					
	POLITICS *(panchayat)*					
3.1	SHGs with members elected	23%	18%	14%	19%	19%
	Elected women representatives - n	14	12	7	11	44
3.2a	- proxy	7	8	1	3	43%
3.2b	- engaged/active	7	4	6	8	57%
	SOCIAL & COMMUNITY ACTION					
3.3	SHGs acted on social justice issues	25%	-	10%	11%	12%
3.4	SHGs engaged in community activities	42%	20%	22%	36%	30%
3.5	SHGs involved in group enterprises	20%	16%	28%	23%	21%
4.0	***SUSTAINABILITY/FINANCIAL ROLE***					
	GROUP RECORDS					
4.1	Good/adequate quality records	45%	60%	65%	62%	54%
4.2	Weak recordsa	52%	37%	34%	36%	40%
4.3	Book keeping by: - SHG office bearer	65%	22%	14%	19%	31%
	- SHPA staff	7%	6%	64%	38%	28%
	- other (paid/unpaid)	28%	73%	22%	43%	41%
4.4	Up-to-date passbooks (within 6 months)	59%	83%	70%	76%	72%
	FINANCIAL TRANSACTIONS					
	[n=sample groups applicable or with data]					
4.5	Average monthly savings/member (Rs)	36	74	29	43	45
4.6	Average group fund - incl profit (Rs)	28,900	45,900	17,100	43,000	33,700
4.7	Average member savings (Rs)	2,400	3,300	1,200	2,800	2,400
4.8	SHGs that have had external loans	60	51	42	37	190
	SHGs with external loans outstanding	40	32	38	22	132
4.9	Average external loans (Rs):					
	- cumulative [n=164]	105,500	105,700	72,000	127,100	102.300
	- outstanding [n=121]	60,500	89,000	29,800	61,400	58,600
4.10	Internal lending: outstanding/SHG (Rs)					
	[n=190] - mean	70,900	98,500	27,400	76,000	69,100
	- median	49,000	74,100	19,000	67,500	48,000
4.11	Charging =/>24% annual interest	83%	92%	86%	78%	83%
4.12	Borrowers/total members [n=189] [b]	96%	93%	93%	91%	
4.13	Average loan/borrowing member [b] (Rs)	6,700	13,000	5,600	13,400	
	Std deviation	3,180	7,360	3,150	7,070	
4.14	SHGs lending to non-members	23%	14%	22%	11%	18%
	FINANCIAL VALUE					
4.15	SHGs with a current profit	53%	47%	45%	52%	50%
	For SHGs with a current profit [n=106]					
	Current return: -on total assets	6.2%	7.2%	2.9%	7.8%	6.5%
	-on member equity (own savings)	12.6%	15.5%	5.1%	9.1%	11.0%
4.16	Overdues at group level >/= 1 year [n=155]					
	% SHGs	66%	46%	41%	12%	45%
	% 'portfolio at risk' (PAR)	35%	12%	9%	2%	17%
	[n=91] Average 'PAR' (Rs)	34,300	24,700	5,400	11,400	24,200
	DEFUNCT/BROKEN GROUPS					
4.17	Inactive SHGs (% total formed) in sample villages	7.9%	1.7%	9.9%	10.9%	7.0%

Note: (a) Records not accessible in 6% of sample groups. (b) there are different time periods for the regional samples, with higher levels of borrowing in the south: the south sample covers the previous one year; the north sample covers time since group formation - northern sample.

By SHPA

	Indicator	NGO	Government	Bank	Overall
1.0	**SAMPLE**				
1.1	Sample SHGs	137	49	28	214
1.2	SHGs >/= 4 years old	126	41	26	193
	Average age of SHGs (yrs)	6.3	5.2	5.0	5.9
1.3	SHGs in:				
	AP	23	31	6	60
	Karnataka	27	2	22	51
	Orissa	42	8		50
	Rajasthan	45	8		53
1.4	Average members/SHG	14	13	13	14
1.5	Average distance from bank (km)	3.4	3.5	3.7	3.5
1.6	SHGs in federation or cluster	41%	17%	2%	60%
1.7	SHGs provided mF+	73%	67%		62%
2.0	**OUTREACH**				
2.1	Single caste SHGs	61%	69%	86%	66%
2.2	Functionally literate SHGs	47%	65%	50%	51%
2.3	% SHG members poor	48%	55%	61%	51%
2.4	SC	28%	21%	54%	30%
2.5	ST	35%	7%	4%	25%
2.6	women heads of households	10%	14%	12%	11%
2.7	completed primary school or above	7.5%	14.6%	11.8%	9.5%
2.8	casual labour as main activity	39%	22%	58%	38%
2.9	% SHGs with dropouts	57%	49%	32%	52%
2.10	Rate of dropout	10.7%	7.8%	8.2%	9.8%
2.11	Rate of dropout among the poor	12.0%	7.0%	8.3%	10.1%
3.0	**SOCIAL ROLE**				
	POLITICS (*panchayat*)				
3.1	SHGs with members elected	20%	14%	16%	19%
3.2	Elected women representatives - n	31	8	5	44
3.2a	- proxy	32%	4	5	43%
3.2b	- engaged/active	68%	4		57%
	SOCIAL & COMMUNITY ACTION				
3.3	SHGs acted on social justice issues	11%	18%	7%	12%
3.4	SHGs engaged in community activities	37%	14%	25%	30%
3.4	SHGs involved in group enterprises	25%	16%	14%	21%
4.	**SUSTAINABILITY/FINANCIAL ROLE**				
	GROUP RECORDS				
4.1	Good/adequate quality records	61%	32%	61%	54%
4.2	Weak records [a]	36%	53%	36%	40%
4.3	Book keeping by: - SHG office bearer	25%	41%	46%	31%
	- SHPA staff	35%	20%	4%	28%
	- other (paid/unpaid)	40%	39%	50%	41%
4.4	Up-to-date passbooks (within 6 months)	72%	66%	80%	72%
	FINANCIAL TRANSACTIONS				
	[n = sample applicable or with data]				
4.5	Average monthly savings/member (Rs)	42	40	69	45
4.6	Average group fund -incl profit (Rs)	35,200	27,900	34,500	33,700
4.7	Average member savings (Rs)	2,500	2,100	2,700	2,400
4.8	SHGs that have had external loans	119	43	28	190
4.9	Average external loans (Rs):				
	- cumulative [n=164]	101,800	91,900	120,700	102,300
	- outstanding [n=121]	53,500	48,900	88,500	58,600
4.10	Internal lending: outstanding/SHG (Rs) [n=190]				
	- mean	72,200	58,500	80,400	69,100
	- median	51,120	48,000	45,410	48,000
4.11	Charging =/> 24% pa interest	82%	89%	79%	83%
	South sample for previous year [n=102]:				
4.12	Borrowers/total members	94%	98%	93%	95%
4.13	Average borrowed/borrowing member (Rs)	12,445	7,220	10,050	10,370
	Std deviation	11,455	5,260	8,590	9,630
4.14	SHGs lending to non-members	17%	24%	11%	18%
	FINANCIAL VALUE				
4.15	SHGs with a current year's profit	50%	55%	39%	50%
	For SHGs with a current profit [n=106]				
	Current return: -on total assets	6.0%	7.9%	7.0%	6.5%
	-on member equity (own savings)	9.5%	15.6%	13.5%	11.0%

Note: Records not accessible in 6% of sample groups. Source: EDA Rural Systems and APMAS, 2006, "Self Help Groups in India: The Light and Shades of SHGs", for CRS, USAID, CARE and GTZ/NABARD, CARE India.

Endnotes

1 *It is very hard to compare the size of the two main models by portfolio outstanding, because it has not been reported yet for the SBLP (although it is understood that it will be reported for the first time in the forthcoming NABARD annual report). However, according to an estimate communicated by officials in MCID/NABARD, based on data for March 2005, the outstandings to cumulative disbursement ratio is about 70 percent, reflecting the rapid expansion of disbursements in the last few years. Since the average tenor of loans is about 2. 5 years, the ratio should decline in subsequent years, once the rate of growth of disbursements stabilizes. Using this ratio for March 2006, the SBLP had a portfolio outstanding of about Rs 8,000 crores, as against about 1,600 for the MFIs.*

2 *For the latest statistics on the programme, see the most recent of NABARD's annual reports "Progress of SHG - Bank Linkage in India, 2004-2005" (the report for 2005-06 is still awaited) and for good descriptions of the programme and of SHGs, Harper 2002a, comparing SHGs with Grameen Bank groups, and Harper 2002b on the respective strengths of different SHPAs, written for a NABARD conference in 2002, the other studies presented at the same conference (especially Puhazhendi and Badatya 2002 and Seibel and Dave 2002), Fisher and Sriram 2002, and Harper and Arora 2005, among many others.*

3 *The important recent study "Self Help Groups in India: The Light and Shades of SHGs" (EDA and APMAS (2006)) discussed below and referred to henceforth as LSS, found that 51 percent of members in the sample were poor in terms of the first two of four wealth ranking categories defined by the study (the "very poor" constituted 15 percent, the "poor" 36 percent, the "borderline poor" 32 percent and the "non poor" 17 percent). At 55 percent, the proportion of SCs/STs in the sample is higher than for the country as a whole, and that of widows 10 percent, about the same as the All India figure.*

The finding that the poor constitute about half of total SHG membership is in keeping with findings from other studies. The first two categories above correspond with common (head-count) definition of the poverty population as the share of the population which falls below a household expenditure on minimum calories-based poverty line. We need to remember though that that the borderline poor are also vulnerable to income shocks which can drag them below the poverty line, often permanently, through illness and disability, or even death of the main breadwinner, and microfinance (including microinsurance - see Chapter 5A - can both protect from, and help to overcome, such shocks. Secondly, microfinance suffers from inherent limitations in reaching the very poorest of the poor, many of who need to be, and can more efficiently be reached though social security programmes (or income transfer programmes, sometimes referred to as social consumption). Microfinance is best suited to reach the economically active poor, which may exclude some in the lowest decile or two of the population that suffer from old age, ill health, or disability.

4 *See footnote 3, Chapter 1*

5 *For a discussion of each of these see LSS, and Burra et al (2005).*

6 *Despite this lower decrease in the rate of growth of repeat loans than that of loans to new groups, the ratio of groups who received repeat loans to the average of the cumulative number of groups that existed two and three years ago also declined, and is now 38 percent. This is because the decline in the rate of growth of new groups only started this year. It will take another couple of years before this ratio starts going up again. The base for purposes of this comparison is the average of 2 and 3 years ago because this is approximately the average tenure of loans under the programme.*

7 *The repeat loan figures are averages for an unreported mix of first, second and subsequent repeat loans, a gap in the published statistics that needs to be filled as discussed later. Two of the most important factors keeping average repeat loan size from rising faster are growing accumulated savings within groups and lack of loan demand, pointing to the need for more emphasis on increasing loan absorption capacity through general development programmes, or even "microfinance plus". Yet, lower average loan size than in the MFI model is also a disadvantage of the SHG model for those borrowers who need larger loans, and was a factor in the AP crisis as discussed in Chapter 4.*

8 *The numbers stayed roughly steady in Tamil Nadu and Karnataka.*

9 *Because coverage is at almost saturation levels in some districts of the South and poverty is relatively low in the North, with the exception of Rajasthan.*

10 *NGOs had by 2005 formed 43 percent of the cumulative number of groups promoted (but not necessarily linked) (Statement IX of the 2005 report). However 51 percent had been formed by government agencies, such as DRDAs, who are expected to raise funds for promotion out of their own resources, and 1 percent by IRVs (Individual Rural Volunteers).*

11 *Model III includes loans made to federations, and to bulk lenders like FWWB and RGVN, as well as to NGO MFIs. The intermediaries receive funds at 6.5 to 7 percent currently.*

12 *Promotional grant assistance is received by RRBs and DCCBs under Model I. The best account of the respective strengths and weaknesses of Self-Help Promoting Agencies (SHPAs) and appropriate policies towards them is Harper 2002b. He notes that the DCCBs in particular have an advantage among the banks because of their grassroots presence through PACS. (The term SHPAs includes government agencies, and functionaries such as anganwadi workers, whereas the term SHPIs is used to refer to all other promoting institutions, but excluding government and its functionaries).*

13 *This can be taken as a useful estimate of the proportion of groups with federation membership, nationwide (there are few other estimates). Also, it has the implication that it makes the findings discussed below on SHG bookkeeping quality even more serious, since one of the important expectations from federations is that they improve bookkeeping quality. Unfortunately due to limitations of time it was not possible to review the growing experience with federations (see for instance APMAS (2006), Nair (2005), and Rajagopalan (2003) and (2004)).*

14 *Since the declared policy is to allow the banks to lend up to 4 times the internal capital of the groups, there is considerable headroom for an expansion of lending. APMAS (2005) found that for the state of AP the debt-equity ratio was even lower. In fact loans outstanding were only 74 percent of "thrift", or members' savings deposited in the banks. Since it also found that part of internal capital was lying idle*

as cash with the groups, the true ratio would be lower still. A possible explanation is the high grant contribution to SHGs for revolving funds in AP.

15 *Leaders had higher access by about 25-30 percent, in both frequency and amount, although in AP, APMAS (2005) found that on average leaders had received twice as much. However according to LSS this was not an issue with other members, who recognized that leaders put in time and effort on behalf of the group to access external loans.*

16 *On the analogy with ROSCAS (Rotating Savings and Credit Associations, or what are known as chit funds in India) the study argues that longevity of a group is not necessarily a virtue, pointing out that ROSCAS are short-lived, usually breaking up and forming again after each round. However it is mistaken in stating that SHGs evolved out of ROSCAS - in India they were the result of a very deliberate policy initiative by NABARD in the early 1990s, based on pilot project experimentation by GTZ in Indonesia and the Philippines and MYRADA in India, and supported by the far reaching innovation by the RBI in allowing banks to lend to totally informal (unregistered) women's groups without collateral. ROSCAS in any case do not attempt to accumulate savings, unlike ASCAS (Alternating Savings and Credit Associations), which do often last last longer than a year, and unlike SHGs, which save both as an end in itself, and as collateral against which to borrow from the banks.*

17 *It should be noted thought that in three of the states the proportion ranges from 8 to 11 percent, the average being brought down by Karnataka where it is below 2 percent, explained by more sustained promotion by SHPAs, easier and more regular access to loans by bank promoted groups, and the lowest involvement by government agencies, which among SHPAs show the highest proportion of defunct groups.*

18 *APMAS (2005), discussed below, found that in 27 of the groups surveyed some dropouts owed more to the group as loans outstanding than the value of their savings. This was factored in however, in LSS.*

19 *"Would appear", because interestingly, the study found no evidence of lack of trust or unhappiness with group leaders or record keepers even in groups with weak accounts. Also, it found many banks appear not to rely on group records but to maintain their own. At the group level there were in some cases incomplete records of recoveries and interest payments, and at the bank level a tendency to credit all repayments into the savings account and make only annual appropriations to the loan account which increases the interest liability on SHGs. Reliance on their own records is largely forced on the banks by the state of group accounts - the study found that only 28 percent of groups maintained balance sheets or profit and loss accounts.*

20 *Overall, about one-third of the groups had their records maintained by a group office bearer, usually paid for her services, and another third by an outside, locally recruited, para-accountant. SHPA staff undertook the task in 28 percent of the cases, and an unpaid non-member, usually a relative or other well-wisher, in the remaining 9 percent. SHPA staff are likely to maintain the best records, unpaid non-members the worst. The quality of records is likely to be better in the case of SHPAs that focus on the financial aspects of performance (as opposed to non-financial), although not invariably so, given the variability in the quality of SHPAs and their staff The few SHPAs that have started computerization of records and have introduced external (as opposed to internal) audit are beginning to experience a difference. The state of records tends to be better in groups that have some schooling.*

21 *This would seem to suggest a higher proportion of willful cases of overdues from non-poor borrowers than poor or borderline. However leaders had lower overdues than members. As with the quality of*

records, overdues were the highest for groups that received low inputs of any kind, or mainly development inputs.

22 Or an average of Rs 24,260 per SHG, representing one fifth of the portfolio in the southern sample and 5 percent in the northern. The proportion of groups with overdues ranged from 66 percent in AP (PAR 35 percent) to 12 percent in Rajasthan (PAR 2 percent). Both the proportion of groups with overdues, and average PAR per group, were substantially lower for bank promoted groups than for government or NGO promoted groups.

23 The picture that emerges on profitability is mixed. Around half the sample groups are operating on a profit with a good return on assets of 65 percent, and a return on internal capital (savings plus accumulated interest) of 11 percent. Around 20 percent of the sample groups are running at a loss, and for the rest the data is lacking.

24 The two institutions (one of them an RRB) which had the highest 360 day PARs within the groups (19 and 13 percent) also had the highest in loans outstanding to the bank (13 and 9 percent respectively) Like the other studies it did not examine loan default rates, except to note that they are low, but could eventually pose a problem.

25 See Tankha (2002), and for a tabulation of other studies, Christen and Ivatury (2005).

26 Sakhi Samiti, a two-tier federation in Rajasthan promoted by PRADAN, which came second in the first two "rounds", came out on top after both adjustments, while PRADAN itself (for its operations in Lohardaga district in Jharkhand) which was on top in the first two rounds dropped to fourth position (with an RoA of -1 percent) perhaps as a result of the high costs incurred on its Computer Munshi scheme discussed below. It would be an instructive but much more difficult to undertake the exercise after standardizing for SHG quality (or rather some definition it). The RRB came third with an RoA of 1, despite having the lowest promotion costs of the five institutions at $ 50 per group, which raises the question of the adequacy of bank of interest rates under the programme. While banks are in practice free to set their own rates, in practice they feel it would be impolitic to exceed the current average of 9 to 10 percent (with some banks such as SBI charging less, and the cooperative banks and PACS charging more, about 12 to 13 percent), The evidence of bank profitability at these rates is discussed in footnote 33 below. It will become one of more than academic importance once the pressure of targets is removed, as is suggested below, and profitability is the major criterion.

27 The proportion of A grade groups was 66 percent, B groups 26 percent, and C groups 8 percent. The study reports that the banks do not use the CRI because they feel it takes too long, and use their own assessment procedures instead. It makes the point that grading should not just be an externally led and externally assimilated exercise, but that SHPAs need to invest in engaging the groups in the grading process so that they learn to appreciate the elements of good financial performance and governance.

28 The same dynamics have been observed by APMAS (2006) in connection with AP federations.

29 In this case the study suggests the explanation is likely to be benign, and due to one or more of the following: dropouts, a reorganization of membership, the possibility of some of the older groups distributing part at least of their savings back to their members, or adjusting it against loans outstanding.

30 Of the 48 percent of loans received by the groups that were repeat loans, 32 percent were "2nd *linkages", 11 percent 3rd, and 5 percent 4th and above. The proportion of A groups increased to 91 percent in groups that had received 3 loans, from 57 percent in groups which had received only one loan.*

31 *2.8 and 1.4 months respectively, despite which, somewhat surprisingly, 85 percent of groups felt that loans were "timely". 47 percent, however felt they were inadequate in size, a reflection perhaps of the much lower CD ratio reported for AP than in LSS (see footnote 13)*

32 *These included number of visits (an average of 4), frequent transfers of bank managers adding to delay, staff behaviour, inadequate loan size, the need for NOCs from other banks in the service area, loan drawing procedures such as SHG transactions being allowed only on certain days, and the presence of all members required by some banks, to sign the inter-se agreement to prevent cases of default arising out of leaders faking resolutions and signatures to withdraw funds for misuse. Signatures are required instead of thumb impressions, and since most members are illiterate they practice their signatures for the occasion, which do not always tally on later occasions, leading to difficulties in subsequent transactions. Data on the frequency of these difficulties is not included.*

33 *These include targets, their own lack of understanding of the SHG concept and guidelines, and perhaps most importantly, lack of adequate staff time. In view of the AP crisis that occurred the next year, it is interesting that the study mentions as a difficulty "In some parts of the state where the MFIs have been working towards attracting clients towards them, they highlighted the weaknesses in the SHG programme … such as small loan size, higher operational cost, long wait for loans, many visits to the bank and MDOs for necessary certificates, meetings, etc"*

34 *Only 12 percent of groups had overdues of at least a month, the percentage increasing slightly with age until years 5-6 and decreasing thereafter. C grade groups had relatively high overdues. This finding is at variance with data on the 365 day PAR from LSS, which includes AP, in footnote 20 above, presumably because of different samples.*

35 *Christen and Ivatury (Forthcoming) in comparing the overall system cost of four SHG systems (two MFI based, two based on direct branch linkage) found that only one, a commercial bank belonging to the latter category, a branch of the Overseas Commercial Bank, showed a positive return on assets. Seibel and Dave 2002 report that on the basis of both average and marginal cost analysis linkage banking in 7 branches of 3 banks was profitable. By far the most detailed and rigorous study, albeit of a single branch of an RRB in Rajasthan, appears to be that of Meissner (2006), who found that linkage banking is a viable business once a certain amount of loan per SHG has been reached. However the finding depends crucially on the provisioning requirements for SHG loans being treated as agricultural rather than non-agricultural loans, which leads to an underestimation of the actual overdues on SHG loans. This is an aspect of the programme which deserves further analysis. Sinha (2003) on the other hand found that it costs RRBs between 22 to 28 percent to do SHG lending. ICICI found the existing branch linkage programme of the Bank of Madura when it took it over to be unprofitable and switched to the partnership model with an MFI it promoted which handled servicing costs for a fee. The public sector banks are not as concerned with the profitability of their SHG portfolios as private banks, since these are so small in relation to their size that they can easily be cross-subsized. The problem becomes more acute with the RRBs and DCCBs some of which have taken enthusiastically to SHG banking, accounting for a significant share of their portfolios.*

36 *Thus measures such as the subsidy-dependence index are not relevant here. If the programme is socially viable as a whole, then the question becomes one of ensuring the individual profitability of components*

in the programme chain running down from apexes, to branch banks, to SHPA's and federations to SHGs and finally to individual members, by reallocating costs and benefits between them so that they each have an incentive to participate. The problem is particularly acute for SHPAs and federations since most of them are not in a position to cross-subsidize their operations unlike the commercial banks. It may well be true as Christen and Peck suggest that the programme is presently "subsidizing SHG capital accounts by magnifying the interest margin between external borrowing, rather than ensuring that this margin is appropriate to ensure capital accumulation as well as payment for the services required to maintain those financial services for the long run". However this can not be taken as a criticism of the viability of the programme as a whole, but merely of the share of total benefits being cornered by one participant. More important is the need for government to recognize the need to spend enough on promotion to maintain SHG quality and the viability of the programme as a whole.

37 *Previously only 10 percent of the grant assistance was withheld for 3 months after credit linkage. This has been increased to 30 percent, of which 15 percent is released a year after, upon certification of proper maintenance of books that have been audited by the NGO. Promotional grants sanctioned to 257 NGOs for promotion and credit linkage of 25,087 SHGs during 2005-06 was Rs 6.27 crore. In addition, NABARD has also sanctioned 31 grant assistance proposals to RRBs, IRVs and DCCBs to the tune of Rs 1.85 crore.*

38 *This was in addition to the promotional grant to DRDAs which is fixed at a realistic level by the central department of rural development at Rs 10,000 per group.*

39 *The quality achieved by state level women's development corporations is usually better initially, but also gets diluted with increasing targets.*

40 *A comprehensive study on the incidence and effect of subsidies needs to be carried out, perhaps as part of the Eleventh Plan formulation exercise, since the relevant information is scattered over a number of sources.*

41 *Ibtada is simplifying accounts through the use of color coded formats (Kumar and Parikh (2006)). Ibtada, an SHPA in Rajasthan is promoting the Munshi system under which youths with a school leaving degree from one of the nearby (but as a matter of policy, not the same) village are trained to maintain the accounts of 20 to 25 SHGs each for a small fee, which increases each year, and which provides a viable income (Kanitkar (2006)). If any exercises are ongoing to introduce flexibility in savings and repayment schedules, similar to the experimental projects CMF is undertaking on the MFI side with a KAS in Orissa and VWS in TN (see Chapter 9), there is little information available on them.*

42 *According to which subset of the LSS sample is chosen, the number of groups with outstandings was 70 or 74 percent of all groups that had ever borrowed. For one of these sample subsets, for which data is available, the ratio of outstandings to the cumulative amount borrowed was 57 percent (70 percent for the southern sample and 46 percent for the northern). This is lower than the global estimate of 70 percent communicated by MCID officials (see footnote 1). APMAS 2005 also found that only 74 percent of the groups had loans outstanding.*

43 *Out of 25 innovative projects chosen CMs and Adhikar's remittances project (see chapter 5B) were the most successful.*

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CHAPTER 3

Progress Under the MFI Model

The MFI model is growing rapidly in India,[1] has good portfolio quality, and is highly efficient. Although on average Indian MFI interest rates are slightly higher than the average for the South Asian countries, the South Asian region has the lowest average rates among all regions in the world. Large MFIs have attained operational sustainability, many medium MFIs are close to attaining it, and a number of small MFIs are progressing towards it rapidly as they grow. Major challenges before the MFI model are the need to improve financial transparency through higher standards and better performance on disclosure and reporting, and to improve transparency in dealings with borrowers (the subject of the next chapter).

The MFI model in India is characterized by a diversity of institutional and legal forms. The first well known MFI, SEWA, was incorporated as an urban cooperative bank in 1974, and paved the way for microfinance in India by showing that the poor were bankable. In the 1980s, a number of registered societies and trusts commenced group based savings and credit activities on the basis of grant funds from donors. Others towards the end of the decade began replicating the Grameen model, based initially on donor funding but increasingly on funding from domestic apex financial institutions such as SIDBI, FWWB and RMK. As the profitability of microfinance got established, the incentive to accumulate equity capital with which to leverage the funds increasingly becoming available from the banking system grew stronger, and this led to the transformation in the 1990s of several of the larger and medium MFIs into NBFCs and S 25 companies, and one LAB, all of which enable the MFI to attract investments as share holder equity. The passage of the MACS acts in several states in the mid-1990s led to an increase in the number of cooperatives registered under the new act, and to an increasing number of SHG federations registered as MACS.[2]

The MFI model is growing rapidly in India, has good portfolio quality, and is highly efficient. Although on average Indian MFI interest rates are slightly higher than the average for the South Asian countries, the South Asian region has the lowest average rates among all regions in the world

Partly because of the diversity of registering authorities there is no reliable estimate of the number of MFIs in India, The most frequently used estimate is that it is likely to around 800.[3] By March 2006, Sa-Dhan's membership had grown to 162 MFIs, of which 140 had active credit prorgrammes. They had an estimated portfolio outstanding of Rs 1,600 crore.

As in neighbouring Bangladesh, the bulk of borrowers and loans outstanding are concentrated in a few larger MFIs. The size gradient drops sharply after the top few MFIs and as much as 95 percent of loans outstanding may be concentrated in the top 20 MFIs.[4]

While South Asia leads other regions in the scale of credit delivery, savings services are a relatively undeveloped because of the regulatory environment.[5] An increasing number of MFIs

While South Asia leads other regions in the scale of credit delivery, savings services are a relatively undeveloped because of the regulatory environment

offer insurance to their members, mostly as agents of insurance companies in the partner-agent model (Chapter 5A).

Side-by-Side: A Slice of Microfinance Operations

Sa-Dhan's efforts to establish and disseminate performance standards and promote transparency by publishing financial information on MFIs in the three core areas of sustainability, asset quality and efficiency bore further fruit with the publication of the 3rd Side by Side report in September 2005 (Sa-Dhan 2005). Coverage expanded from 42 MFIs in the 2nd (2004) report to 74 MFIs submitting financial information on the basis of audited balance sheets for the year end March 2005. Progress is reflected in Table 3.1

Table 3.1 Financial performance of sample MFIs in FY 2004 and FY 2005

		Sustainability		Asset Quality	Efficiency		
Number of MFIs in sample	**Year**	**OSS**	**PAR**	**CRR**	**OCR**	**TCR**	**Client per credit officer**
42	2004	72.8	4.5	90.4	20.0	34.9	164
74	2005	110.3	2.2	97.7	15.4	24.9	405
Sa-Dhan recommended standards		100%	<10%	>90%	<20%	<30%	between 250 and 350

Source: Tables 1 and 9 of Side-by-Side (Sa-Dhan 2005). OSS: Operational Self-Sufficiency (defined as Operating Income from Loans and Investments/Operating Costs + Loan Loss Provision + Financing Cost); PAR: Portfolio At Risk (defined as Unpaid Principal Balance of Loans Overdue by > 60 Days); CRR: Current Repayment Rate (Principal Amount Collected - Prepayments/Principal Due); OCR: Operating Cost Ratio (Total Operating Costs/ Average Outstanding Portfolio); TCR: Total Cost Ratio (Total Costs/Average Outstanding Portfolio).

As will be noted, this sample of MFIs (representing the bulk of the sector) has achieved operational sustainability, has excellent portfolio quality, and has exceeded the three efficiency norms. Each of these is discussed further below.

The share of the gross loan portfolio (GLP) outstanding that is funded by borrowings is uniformly high

The 74 MFIs covered all *legal forms*[6]. They operate mainly through group based models (SHGs, smaller Grameen groups of 5 members, and Joint Liability Groups or JLGs[7]) although cooperatives, and some of the larger MFIs also make individual loans[8] Many MFIs use more than one model. Nine of them were credit only MFIs, 6 provided credit and insurance, and the remaining 59 provided savings as well as credit and insurance services. Savings services were increasingly being facilitated through the banks, rather than being offered directly. Forty-eight MFIs for which data was available offered insurance to 0.35 million clients.

Although MFIs of all legal forms have *own funds or equity*, built up mainly from (i) donor grants in the case of societies and trusts, (ii) equity investments and promoters capital in the case of companies, (iii) shareholdings in the case of cooperatives, as well as (iv) retained earnings in the case of all three categories, the main source of funds is debt, borrowed from the banks and apex financial institutions. The share of the gross loan portfolio (GLP) outstanding that is funded by borrowings is uniformly high for large, medium and small MFIs (82, 86 and 78 percent respectively). Large MFIs are more efficient users of funds, with 81 percent of total assets held as loans, as against 75 percent in the case of medium and small MFIs.

Table 3.2 Region-wise growth in outreach in 2003-04 and 2004-05

MFIs by regional distribution	No. of MFIs	Outreach - FY 2005	Annual Growth (%) in outreach FY 2005	Annual Growth (%) in outreach FY 2004
East	18	332,476	61.12	32.68
West	2	6,738	31.40	42.15
North	3	91,317	11.34	19.50
South	45	1,710,323	67.50	51.73
Total	**68**	**2,140,854**	**62.86**	**45.94**

Source: Table 3 of Side-by-Side (Sa-Dhan 2005).

Table 3.2 which is based on outreach data from 68 MFIs for which three year data was available from 2002-03 to 2004-05 (Table 3 of SBS) shows that the sample of 68 MFIs is growing fast, at 63 percent overall in terms of outreach in 2004-05, up from 46 percent in 2003-04. Growth is concentrated in 2 regions, the South and East, which already accounted for about 95 percent of membership as Table 3.2 shows. The growth rate was 31 percent in the West, on an extremely small base, and only 11 percent in the North, on a higher base.[9] However like the SBLP, the MFI model is trying to rectify regional skew, and the latest data will probably show a higher rate of growth in the West and central India, coming partly from expansion of existing MFIs from the South.

Second, there is a *broad inverse relationship between growth and size*, with young MFIs growing faster than mature MFIs. According to the MIX report discussed below (MIX 2006), young institutions grew the fastest, by 160 percent over the same two years, followed by new institutions at 60 percent, and mature institutions by 53 percent.[10]

Growth is concentrated in 2 regions, the south and east, which already accounted for about 95 percent of membership

SBS contains some interesting information on the *dynamics of financial performance as MFIs age and grow*. It takes 5 to 10 years for an MFI to attain operational sustainability.[11] As for the relationship of financial performance with size, Tables 3.3 provides a break up of performance by size in terms of outreach, and GLP, separately. It will be seen that only when MFIs become large with an outreach of 50,000 and GLP of Rs 20 crores do they become sustainable and manage to bring delinquency under control. However, using the same size classification in terms of GLP, but a smaller sample, the MIX report discussed below (MIX 2006) finds that even medium MFIs are sustainable, and have positive returns on assets and on equity (Figure 5, page 51, of the MIX report).

Interestingly, it appears from Table 3.3 that small MFIs are more efficient, with lower unit cost ratios than medium sized MFIs, perhaps because they have higher productivity in terms of number of active borrowers per credit office (small MFIs in terms of GLP have 88 percent more

Table 3.3 Financial performance of MFIs classified by client outreach and loan portfolio

Categories	No. of MFIs	Sustainability OSS	Asset Quality PAR	Asset Quality CRR	Efficiency OCR	Efficiency TCR	Efficiency Client per credit officer
MFIs categorised by credit client outreach							
Small (<10,000)	44	73.6	4.3	92.2	15.0	23.5	485
Medium (10,000-50,000)	23	84.2	4.2	93.8	20.4	30.5	438
Large (>50,000)	7	123.3	1.5	99.3	14.2	23.7	372
Aggregate	74	110.3	2.2	97.7	15.4	25.0	405
MFIs categorised by loan portfolio							
Small (< 5 crore)	53	66.6	3.6	93.3	12.4	21.2	561
Medium (5-20 crore)	14	90	4.9	94.3	25.9	36.2	298
Large (>20 crore)	7	125.8	1.3	99.2	13.0	22.3	389
Aggregate	**74**	**110.3**	**2.2**	**97.7**	**15.4**	**25.0**	**405**
Sa-dhan recommended standards		100%	< 10%	>90%	<20%	<30%	between 250 and 350

***Source:* Tables 13 and 14 of Side-by-Side (Sa-Dhan 2005).**

borrowers per credit officer than medium MFIs). The most likely explanation is that as small MFIs grow rapidly in the initial years they run into delinquency problems, to which they respond by increasing supervisory staff, and the back office staff required to improve systems and procedures. They also step up investment in infrastructure such as IT, vehicles and in some cases training. Thus as they grow to medium size, their unit costs go up as they improve portfolio quality and bring delinquency under control. Finally when they graduate to becoming large MFIs, their unit costs decrease again.[12]

The MIX report

SBS contains some interesting information on the dynamics of financial performance as MFIs age and grow. It takes 5 to 10 years for an MFI to attain operational sustainability

Another major contribution to increasing our understanding of the financial aspects of the MFI sector came in the from of the MIX report, "Performance and Transparency: A survey of microfinance in South Asia" It does so partly by comparison with other South Asian countries and of the South Asian region with the rest of world, based on data in Table 3.4. However it uses a smaller sample than SBS of only 28 MFIs, who are all part of the SBS sample, but for whom the data was judged to be consistent and reliable enough to be used.

As the MIX report points out, Indian MFIs are unique in the extent to which they leverage borrowed funds. As will be seen from Table 3.4 the average capital asset ratio in India is less than 11 percent, only half the average for South Asia, which is itself only two thirds to half the level in the other three main microfinance regions in the world (East Asia, Latin America and Africa). Because of the access Indian MFIs enjoy from the banks (primarily, and increasingly, the private banks) and apex financial institutions such as SIDBI and FWWB (a private wholesaler which also provides capacity building support) 8 out of 25 of the most highly leveraged MFIs in the report's global data set (of 518 MFIs) are Indian. Loans are used not only for onlending, but increasingly serve to bridge operational losses during the initial years as economies of scale are being built up,[13] a function usually served by equity received from donors in other countries. This situation is the outcome of the regulatory environment as discussed later, and

Table 3.4 Comparative performance indicators for MFIs in India, South Asia, and other regions of the world

Indicators	Africa	EAP	ECA	LAC	MENA	S. Asia	Afghanistan	Bangladesh	India	Nepal	Pakistan	Sri Lanka
Scale and Outreach												
Number of Active Borrowers	14,968	97,905	6,162	24,162	19,165	107,875	15,489	221,099	44,031	19,766	24,179	43,347
Gross Loan Portfolio	3,960,419	48,220,723	10,395,162	19,829,124	5,360,530	9,467,381	1,543,763	15,872,904	5,647,202	2,148,174	3,490,386	7,370,274
Percent of Women Borrowers	62.1%	76.5%	53.4%	58.0%	65.6%	83.3%	67.0%	94.0%	90.4%	90.5%	47.8%	65.8%
Average Balance per Borrower	509	291	1,902	788	512	113	216	66	134	131	175	124
Average Balance per Borrower/ GNI per capita	113.4%	38.6%	187.0%	53.3%	28.3%	22.2%	26.9%	15.3%	21.6%	50.4%	33.1%	12.8%
Number of Savers	40,140	814,176	9,980	12,826	225	32,791	-	56,685	4,056	22,784	5,084	106,168
Voluntary Savings	3,995,671	86,210,649	9,061,083	14,049,333	-	2,962,383	-	5,682,724	236,530	607,200	303,747	5,682,913
Average Savings Balance per Saver	127	164	1,328	2,424	n/a	64	n/a	15	121	47	146	33
Average Savings Balance per Saver/ GNI per capita	43.8%	34.3%	78.3%	140.0%	n/a	13.7%	n/a	3.7%	19.6%	18.1%	31.0%	3.4%
Financial Structure												
Capital / Asset Ratio	37.3%	37.6%	60.0%	32.8%	71.5%	21.3%	41.1%	23.5%	10.6%	9.2%	32.9%	28.1%
Debt / Equity Ratio	4.2	3.0	2.9	5.8	1.1	29.8	3.0	(1.5)	122.8	12.3	(19.7)	4.2
Deposits to Loans	122.0%	37.6%	20.5%	26.2%	0.0%	14.0%	0.0%	3.0%	8.4%	37.4%	24.6%	61.7%
Deposits to Assets	31.2%	24.7%	11.8%	19.7%	0.0%	7.1%	0.0%	2.2%	7.1%	21.3%	1.7%	34.4%
Gross Loan Portfolio / Assets	64.2%	70.5%	78.1%	79.9%	69.5%	73.6%	66.1%	75.8%	83.0%	52.3%	65.2%	67.5%
Profitability and Sustainability												
Return on Assets	-5.7%	0.9%	5.3%	2.9%	3.6%	-2.3%	-66.7%	3.6%	-1.5%	1.0%	-8.2%	-0.1%
Return on Equity	-37.6%	5.9%	14.6%	8.1%	5.0%	-6.6%	-226.8%	17.2%	-10.2%	12.1%	-32.3%	3.5%
Operational Self-Sufficiency	97.7%	117.5%	128.9%	115.8%	117.2%	105.5%	33.2%	125.7%	98.5%	110.0%	73.6%	101.3%
Revenue												
Financial Revenue Ratio	25.2%	28.6%	30.4%	31.2%	22.7%	18.5%	21.2%	19.8%	20.7%	13.3%	13.2%	15.5%
Profit Margin	-37.3%	1.9%	6.2%	8.4%	-13.6%	-19.6%	-319.2%	15.3%	-7.8%	7.9%	-90.7%	-15.8%
Expense												
Total Expense Ratio	30.7%	27.2%	24.3%	27.6%	19.0%	20.7%	87.9%	16.1%	22.0%	12.0%	21.4%	15.1%
Financial Expense Ratio	2.8%	5.0%	2.4%	6.3%	1.0%	5.1%	4.2%	3.4%	8.5%	5.1%	4.3%	4.3%
Loan Loss Provision Expense Ratio	2.2%	1.2%	1.1%	2.2%	-0.1%	1.2%	2.0%	0.8%	1.3%	1.2%	2.3%	0.5%
Operating Expense Ratio	25.7%	21.0%	20.7%	19.1%	18.2%	14.4%	81.7%	11.9%	12.3%	5.7%	14.8%	10.4%
Efficiency												
Operating Expense / Loan Portfolio	60.6%	32.1%	28.4%	26.5%	35.1%	22.0%	126.7%	15.8%	15.5%	11.5%	34.6%	19.3%
Cost per Borrower (USD)	232	58	326	155	130	25	152	10	14	14	67	16
Productivity												
Borrowers per Staff Member	149	139	72	139	120	219	54	131	439	152	171	175
Savers per Staff Member	206	179	27	95	-	81	-	12	115	186	28	369
Portfolio Quality												
PAR>30 Ratio	7.9%	5.6%	2.1%	4.8%	2.9%	7.6%	0.4%	5.8%	4.4%	6.2%	20.5%	11.1%
Loan Loss Reserve Ratio	6.9%	3.7%	2.0%	5.0%	3.4%	4.2%	2.6%	3.9%	1.6%	4.7%	9.6%	5.4%
Risk Coverage Ratio	139.5%	5660.8%	413.4%	255.5%	155.8%	315.5%	585.4%	277.5%	482.6%	89.5%	180.6%	116.3%
Write Off Ratio	3.5%	2.5%	1.2%	1.8%	2.2%	0.5%	0.1%	0.3%	0.5%	0.5%	1.0%	0.4%

Source: Copyright Microfinance Information eXchange, Inc. Performance Indicators by Region and Country. First published in: Performance and Transparency. A survey of microfinance in South Asia. Edited by Hind Tazi. Microfinance Information eXchange, Inc., Washington, DC. January 2006. p. 93. Reprinted with permission.

the profitability of lending to MFIs, which have almost perfect repayment rates. Large MFIs are the most highly capitalized, at 21 percent.

A second feature of the Indian MFI sector is that it funds only 8.4 percent of loans from voluntary deposits (the deposit to loan ratio in Table 3.4). This is a feature it shares with Bangladesh (but not with other South Asian countries) where this ratio is even lower, at 3 percent, and has led observers to characterize the sector in these countries as "walking on one leg", because microfinance really offers only microcredit, and not the other main financial service of vital importance to the poor, which is savings. This characteristic too is a function of the regulatory environment, which only allows mutual, or member owned institutions such as cooperatives to collect savings.[14]

As the MIX report points out, Indian MFIs are unique in the extent to which they leverage borrowed funds. As will be seen from Table 3.4 the average capital asset ratio in India is less than 11 percent, only half the average for South Asia, which is itself only two thirds to half the level in the other three main microfinance regions in the world (East Asia, Latin America and Africa)

However it should be noted that the consequences are very different in India and Bangladesh. In both countries MFIs, whether registered as societies or trusts, or in addition in India as NBFCs which many Grameen type lenders are transforming into, do raise compulsory savings through a variety of arrangements (such as small weekly contributions added on to the loan repayment installment, membership fees at the time of joining, or a percentage of the loan amount or a lump-sum deducted at the time of each loan disbursement). In India, the savings are often retained and controlled by group members themselves for emergency loan assistance to members, or they are usually placed in local banks under group or individual accounts, as with savings in the case of SHGs. However, in Bangladesh, and most other countries, because of regulatory forbearance, MFIs are allowed to use such compulsory savings to fund lending,[15] and they constitute as much as 30 percent of the funding base (loans account for 46 percent and capital for the rest.)[16] Deposits, although small as a proportion of loans India, are more important than in Bangladesh because of the higher presence of cooperatives in India, both as primary lenders and SHG federations registered as MACS playing the MFI role in securing bulk funds.[17]

Third, Table 3.4 provides further evidence of the depth of outreach in India, as in South Asia generally, compared to other regions, as measured by average loan balances as a proportion on income,[18] and the percentage of women borrowers (90 percent in India, ranging from 94 percent in small MFIs to 85 percent in large MFIs. As large MFIs grow and diversify product offerings, they tend to attract men through larger, individual loans).[19]

Fourth, India along with its South Asian neighbours has very high staff productivity. Indeed India's productivity is the highest in the world and is twice as the South Asian regional average. This is due to the prevalence in India of group lending through SHGs which are usually 2 to 3 times as large as the standard Grameen group of 5, as well as due to the low proportion of individual loans. Eight out of 10 of the most productive MFIs in South Asia are Indian, with a range of 2,873 to 469 borrowers per staff member, (way above the 250 to 350 recommended in the Sa-Dhan performance standards, about which SBS expresses concern).

Fifth, *high productivity, coupled with low staff costs*[20] makes South Asian MFIs the most efficient in the world whether measured in terms of cost per borrower, or cost per unit loan outstanding. On the latter measure, at 12 percent, India's operational cost ratio is about the same as Bangladesh's and the regional average, but at a level only half to two-thirds of the rest of the world (Table 3.4). It needs to be borne in mind though, that India's performance on efficiency is partly the product of aggressive growth, based almost entirely on group mechanisms, and on little product diversity. With growth likely to slow down at least in the short term (see Chapter 4), greater use of individual lending, and progress on product diversity, efficiency performance may go down.

It needs to be borne in mind though, that India's performance on efficiency is partly the product of aggressive growth, based almost entirely on group mechanisms, and on little product diversity. With growth likely to slow down at least in the short term, greater use of individual lending, and with progress on product diversity, efficiency performance may go down

Profitability depends however also on non-operational or financial costs, as well as financial income. Another unique feature of the Indian MFI sector is that its *financial expense ratio* as shown in Table 3.4 is also the highest in the world. At 8.5 percent it is almost three times as high as in neighbouring Bangladesh. This is a function of India's low capital asset ratio noted above (or what comes to the same thing high debt equity ratio, of 122 percent, also the highest in the world) and the high proportion of commercial borrowings in India's debt. Bangladesh as we have seen can rely on lower cost compulsory savings, and a large share of the borrowings of Bangladeshi MFIs are at concessional rates from PKSF. As a result, as Table 3.4 shows, India's total expense ratio at 22 percent, while still significantly lower than that in most other regions of the world, but is 6 percentage points higher than Bangladesh's.

Since interest rates (the financial revenue ratio in Table 3.4) in India are only 20.7 percent, they are insufficient to cover the *total expense ratio*. As result the MFIs in the MIX sample have on average negative profitability as measured by return on assets (-1.5 percent), return on equity (-10.2 percent), and operational sustainability marginally below the break-even level of 100 percent.[21] In contrast, in Bangladesh the average return on assets is 3.5 percent. The most profitable MFI in the Indian sample, Spandana, has 6 Bangladeshi MFIs and 1 Sri Lankan MFI above it in the list of the ten most profitable MFIs in South Asia.[22] As noted earlier, while Indian MFIs have interest rates slightly higher than the South Asian average, these are lower than in any of the other regions of the world.

Finally, as also found by SBS, India's MFIs have good *portfolio quality*, with outstanding balance due for more than 30 days slightly below levels in other parts of the world. Moreover, the risk coverage ratio is also high, higher than in all except one region of the world. However, as a reminder of the importance of improving accounting and reporting standards, and transparency generally, it should be borne in mind that a large number of medium and small MFIs do not age overdues so as to be able to report PAR (portfolio at risk) in accordance with internationally accepted reporting standards, and performance on this measure, as possibly on some others, may be overstated. As pointed out in Chapter 1, Sa-Dhan is working with the ICAI on formulating and implementing reporting and disclosure standards more appropriate to microfinance.

Endnotes

1 *Sa-Dhan's 162 members, of which 140 have active credit programmes, had loans outstanding of about 1,600 crore in March 2006. In March 2005 Sa-Dhan had a total of 139 members, with portfolio outstanding of about Rs 1,095 crore. If it is assumed that about Rs 50 crore of growth is attributable to new members, the portfolio outstanding in March 2006 represented a growth of 42 percent, as against an increase of 50 percent in loans disbursed under the SHG model (see Table 2.1). Unfortunately, as noted in Chapter 2, the SBLP does not track loans outstanding, but if it is assumed that the relationship between loans outstanding and loans disbursed remains constant each year, the SBLP grew faster than the MFI model in terms of portfolio outstanding. Adjusting for the estimate that Sa-Dhan membership accounts for about 95 percent of the total portfolio outstanding under the MFI model, the MFI model is still about one-fifth the size of outstanding under the SBLP model on the basis of the assumption that outstandings under the SBLP are about 70 percent of cumulative disbursements (see footnote 1, Chapter 2).*

Regarding growth of outreach Sa-Dhan's members' outreach grew from 6.2 in March 2005 to 7.3 million in March 2006, or by about 16 percent. This is very similar to the 15 percent growth reported during 2005-06 by the SBLP of new groups (and hence borrowers) linked. In 2004-06 both models seemed to have expanded outreach much faster. Thus the the sample of 68 MFIs in Table 3.3 grew by 63 percent, while the SBLP expanded coverage by 49 percent last year (Table 2.1). As noted in Chapter 2, the SBLP is focusing increasingly on repeat loans to existing groups, which is raising average loan size per borrower closer to that under the MFI model.

Intellecap 2005 estimates that the CAGR of Sa-Dhan members' portfolio outstanding was 76 percent over the five years from 2001 (Intellicap 2005). At this rate of growth it estimates that by 2010 the MFI model should account for almost half of total loans outstanding of about Rs 28,000 under both models.

2 *For a description of these and other institutional forms see Sa-Dhan (2006). Federations in a sense straddle both models - they provide services to their members enabling them to link up directly with the banks, while supplementing their funds from bulk borrowing they access as MFIs. But they do not represent "convergence" as is sometimes claimed.*

3 *A recent estimate is 400-500 MFIs registered as societies and trusts, 300-400 as cooperatives, mostly under the state MACS acts, and the remaining as S 25 companies and NBFCs (Sa-Dhan (2006)). It would be useful to get a firmer estimate of the universe of MFIs now operating in India since this is the seed-bed out of which future saplings will emerge, some of them to grow into trees. The question is of more than academic interest since it has implications for training and financing requirements, whether by the banks or apex financing institutions catering to small, nascent MFIs, such as FWWB, RMK, and RGVN, and it could lead to a study of the problems of start-up MFIs.*

4 *However the share of the top four is lower in India. According to the MIX report discussed below (MIX 2006), 3 MFIs (Grameen Bank, BRAC and ASA) with 8.5 million borrowers served over 80 percent of the total borrowers in the MIX sample of Bangladesh of 48 MFIs representing 90 percent of the market. (Proshika, the fourth largest, was not included in the sample). In India the share of the top three in March 2005 was 55 percent (Table 10.1 of Sa-Dhan 2005). The largest Indian MFI, SHARE, with about 1 million members in September 2006, is less than half the size of any Bangladesh's top 3.*

However Bangladesh may have a longer "tail" defined as all MFIs smaller than the top 20, reported to constitute 13 percent of all active borrowers in 2000 (ADB 2002). If this is indeed the case, the reason has to do with the PKSF, an apex financing institution which has received funding from the World Bank and is in a position to make concessional loans to partners. Data in the same source indicate that concentration in Bangladesh seems to have increased since 2000 when the share of the top three NGO-MFIs (BRAC, ASA and Proshika) was 51 percent of the total number of active borrowers (excluding members of government programmes) and that of Grameen Bank another 21 percent. The remaining 15 percent was accounted for by medium sized NGOs (defined as the rest of the top 20).To sum up, India may have a larger middle, but smaller head and tail than Bangladesh.

5 *As MIX 2006 points out, both sub-Saharan Africa and East Asia focus on voluntary savings services. A single institution, Bank Rakyat Indonesia and its Unit Desa system manage more deposit accounts than the total number of microloans offered by all South Asian MFIs.*

6 *These are Societies (34), Cooperatives (18),Trusts (7), Section 25 Companies (7), NBFCs (7) and one LAB.*

7 *The use of the term JLG is slightly misleading because all three types of groups bear joint liability, although in the case of SHGs it is more moral and implicit, unlike in Grameen groups, in whose case it is legally explicit, because all 5 members sign the loan document, although hardly enforceable in the courts. The term JLG is used in India usually to refer to groups larger than Grameen groups of five (sometimes as many as 15, which is larger than the average-sized SHG of 14 members). However the only real distinction in group lending is between lending to SHGs in which the lender is not concerned with the identity of the individuals to whom the loan is distributed by the group, and lending to other groups (whether Grameen or "JLG" groups) groups where loans are recorded in the names of individual borrowers. The lowering of transactions costs in the former case allows MFIs to lend at lower rates to SHGs. EDA (2005) estimated that the SAG model predominates even for MFIs, accounting for 65 percent of all members in their sample of 20 MFIs.*

8 *The share of individual lending is however very low, according to the latest M-CRIL Review for 2005 (M-CRIL 2006), which unfortunately was not available in time to be discussed in this chapter.*

9 *However of the 3 MFIs in the North the bulk of growth came from one in eastern UP, CASHPOR.*

10 *Thus the relationship is discontinuous, with a break in the middle, and according to the report a disproportionate share of total growth came from large institutions (in terms of gross loan portfolio) which were young. Intellecap (2005) which makes projections on the likely growth of the sector over the next 5 years, assumes a steady inverse relationship with start up and Tier 3 institutions (defined as MFIs with a GLP of below Rs 2 crore) growing the fastest, followed by Tier 2 institutions (GLP between Rs 2 and Rs 30 crores), followed by mature institutions (Tier 3, GLP above Rs 30 crores).*

11 *See Table 10 of SBS, which shows that the average operational sustainability figure of 110 is made up, on an average, of 83 percent for new MFIs (less than 5 years old), 102 percent for those aged 5 to 10 years, and 172 percent for those older than 10 years.*

12 *However, this needs to be examined further, since using approximately the same size classification of small (GLP below US$ 1 million), medium (US$ 1-5 million) and large (above US$ 5 million) but based on a smaller sample the MIX report discussed below finds the opposite in respect of productivity, i.e. that medium sized MFIs are the most productive, with the highest number of borrowers per staff member, because large MFIs have a larger proportion of individual clients who require more staff time to serve. Since individual loans tend to be larger however, they still have the lowest unit operational costs.*

13 *Or as "working capital".*

14 *Most medium and small MFIs are registered as societies and trusts which are not allowed by the RBI to mobilize savings, while the larger MFIs registered as NBFC have yet to qualify for approval to raise public deposits.*

15 *In the Phillipines for instance compulsory deductions at the time of loan disbursement are referred to as "CBU" (capital build up). Both these uses of compulsory contributions should be distinguished from a third common use, that is to build up a "risk fund", to make temporary repayments on behalf of members with genuine problems, or even to cover permanent default.*

16 *The MIX report does not include compulsory savings in the category of deposits, since they are lacking in liquidity, judged to be an essential feature of savings if they are to be used in emergencies. Leverage is defined as lending funded not only by debt and capital, but importantly in the case of Bangladesh, also compulsory savings*

17 *Pushtikar, a cooperative in Jodhpur, is reported to fund 70 percent of its loans through deposits. Another possible explanation for the higher deposits to loan ratio reported for India (compared to Bangladesh) is that it includes the security deposits deducted by many MFIs at the time of loan disbursement. However, while these are refundable on full repayment of the loan, they are not liquid. Such deposits (see Chapter 4) are not regarded as savings by the RBI, but are regarded as being akin to the deposits taken by the banks as cash collateral. They add up to a significant amount, and are used to fund loans.*

18 *According to Figure 5, page 8 of the MIX report, 7 out of 10 of South Asia's MFIs with the smallest loan balances are Indian (with balances per borrower as a proportion of GNI ranging from 1.7 to 5 percent).*

19 *SBS reports a higher proportion of woman borrowers, 95 percent.*

20 *According to the report, average salary levels for qualified personnel in South Asia are about three times per capita income as against as much as 13 times in regions such as Africa.*

21 *The slightly different sample presumably explains why this is different from the 110 percent found by SBS.*

22 *Figure 11, page 11 of the MIX report..*

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CHAPTER 4

MFIs: Learning from the AP Crisis[1]

In March 2006 the action by the Andhra Pradesh (AP) government in raiding and temporarily closing down nearly all the branches of MFIs functioning in Krishna district came as a rude shock to the sector. It led to widespread negative publicity in the press, and did much to reverse the slowly growing awareness and appreciation of the good work being done by MFIs among the educated public. It is important for the sector to attempt to fully understand the causes and nature of the crisis and attempt to put it to good use as an important learning experience. Most observers believe that if it can successfully do so the sector will come out stronger.

Events and responses

Unfortunately there is still no detailed objective account of what actually happened, and why. It is important that such a study be undertaken by an independent group with access to all parties as soon as possible, before it becomes harder to get at the facts with the passage of time. However the bare facts are that on the night of March 8, 2006, the Collector (district officer) of Krishna district seized the records and closed about 57 branches of Spandana and SHARE in the district, the two largest MFIs in the country, as well those of a few smaller MFIs.[2] Borrowers were given the impression that they need not repay MFI loans since the MFIs had violated a number of laws, including criminal laws. About 300 cases are reported to have been filed by the revenue authorities during the next few weeks. While many of the branches were soon reopened, field staff were reluctant to continue operations in view of the hostile atmosphere created by a frenzy of negative stories in the press. Repayments went down to about 10 to 20 per cent for some months after the crisis. It is widely reported that borrowers were informally told by government staff that they need not repay since their loans would be taken over by the government or other banks at the rate of interest charged by Velugu (see below).

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Although the severity of the state government's reaction came as a surprise, the crisis had clearly been brewing for some time.[3] During a visit of the Chief Minister to neighbouring Guntur district in April 2005, complaints by MFI borrowers were brought to his notice by local politicians and DRDA officials, the agency at the district level responsible for implementing Velugu. In August 2005 after its annual national conference held that year in Hyderabad, Sa-Dhan board members and MFI members from AP and TN met with the Principal Secretary, Rural Development who emphasized the need for preventing "conflict situations arising out of a lack of understanding", and suggested a broader debate on the activities and operations of

MFIs, and the need for MFIs to plough back some of their profits for development activities. Suggestions were made to set up coordination committees at various levels, and it was agreed that a delegation would meet the Chief Minister to apprise him of the need to exempt MFIs from the purview of a proposed amendment to the state Moneylender's Act providing for an interest rate ceiling.

There were a series of further news reports during the year. Finally, in response to a demonstration involving stone-throwing by a group of irate borrowers led by a local politician outside a SHARE branch in Krishna district, demanding the return of house title deeds which had been retained as security for housing loans SHARE was making, the Collector of Krishna district moved on the branches that night.

The move received widespread publicity, especially in the local Telegu press, expressing support through wildly partisan news reports and editorials. Many of the accounts even in the national press were based on basic misunderstanding of MFI procedures, exaggerations, and verbatim reproductions of official notes leaked to the press. The press did not speak up for the MFIs - issues like transactions costs do not make exciting copy

The move received widespread publicity, especially in the local Telegu press, expressing support through wildly partisan news reports and editorials. Many of the accounts even in the national press were based on basic misunderstanding of MFI procedures, exaggerations, and verbatim reproductions of official notes leaked to the press. The press did not speak up for the MFIs - issues like transactions costs do not make exciting copy. A quick factual "white-paper" put out by the sector explaining MFI procedures and costs would have been invaluable. However, on March 20, Sa-Dhan issued a voluntary code of conduct to be followed by members, which were publicised through a press-conference (See Box 4.1).

The RBI expressed its concern to the state government that the action it had taken could have wider repercussions by vitiating the MFI repayment culture in other parts of the state, jeopardizing about Rs 680 crore outstanding on loans made by the banks to MFIs in AP. It set up a Co-ordination Forum to discuss issues of concern to stakeholders and resolve them as soon as possible. At a meeting of the forum held on April 20 it was claimed that the MFI movement was "eating into the SHG movement", MFI practices were "barbaric" and posed a serious law and order problem, and that even the lower interest rates suggested in the March 20 code of conduct of 21-24 per cent were usurious and illegal. Spandana and SHARE announced a reduction in their interest rates, including those on current loans outstanding, to 15 per cent on a declining balance basis. It was left to a respected MFI leader to state that this rate was unacceptable to other Sa-Dhan members because it was not sustainable, and pointed out that the state government had no business to stipulate rates for NBFCs regulated by RBI. SIDBI stated that it would not increase its exposure in the state, and was commissioning a study into MFI transactions costs.

To resolve outstanding issues, discussions continued between Sa-Dhan and a High Level Committee of the state government. However the state government maintained its position that interest rates should be reduced further, especially as low interest rates for the poor were a major policy initiative of the state government. A series of highly publicized visits to Krishna district by the Financial Commissioner and the state Human Rights Commission took place, and their findings leaked to the press. There had been no formal outcome of the discussions in the High Level Committee at the time of writing and an air of ambivalence continues to prevail about the state government's final position on interest rates. News reports say that it is reviving the Moneylender's Act, with interest rate ceilings to be revised by a committee from time to time. In May, RBI came out with guidelines for NBFCs to abide by a fair practices code, including giving the terms of a loan to the borrower in writing. Meanwhile Sa-Dhan is working on a more detailed Code of Conduct.

However there were news reports in early October that the major lender ICICI Bank had offered to break the stalemate by resuming management of its portfolio in 46 villages that had been identified by the district authorities as being particularly distressed, where it would reschedule loans and collect them though the Village Organizations (VOs -- the second tier of the Velugu structure of institutions) at the lower rate of interest already agreed to by the MFIs. The arrangement was widely seen as a "compromise", with the MFIs and lenders conceding to the long-standing demand of the government that they should lend through the VOs, at a much lower interest, and the government allowing normal operations to resume in the rest of the district. The on-time repayment rate has recovered to 40 to 50 per cent.[4]

The causes of the crisis: enabling

While it is somewhat arbitrary to divide the causes of the AP crisis into the categories of enabling and underlying, it is a useful analytical device. In the absence of more definitive empirical data, the numbers in the following discussion are taken mostly (from two quick small sample surveys carried out by APMAS, and is subject to revision as further studies take place. The first of these surveys was carried out to provide an objective assessment of the complaints made to the Chief Minister during his visit to Guntur in April 2005, and sampled 40 Spandana borrowers (the Guntur survey, APMAS 2005). After the crisis, a year later, APMAS conducted a second survey in Krishna district of 130 borrowers who had borrowed from either SHGs, or MFIs, or from both (the Krishna survey, APMAS 2006).

The most important enabling (or contextual) cause was the near-saturation of coastal Andhra with microfinance

The most important enabling (or contextual) cause was the near-saturation of coastal Andhra with microfinance. AP as a whole has covered a very large proportion of poor families under the SHG programme, which in AP is assisted by the World Bank and popularly referred to as Velugu.[5] Ninety-two per cent of poor households in AP had already been covered by March 2005 according to the annual report of the AP rural development department, and the project aimed to cover the rest by end-2005, (Government of AP 2005). For the MFIs, the high proportion of poor landless or near-landless agricultural labour families in the coastal districts and the high population density generally, provided strong demand conditions, and important operational cost saving advantages. Spandana actually started life in Guntur district, next door to Krishna district. Given the high coverage of both Velugu and the MFIs in coastal Andhra, the Guntur survey found that dual membership was as high as 67 per cent, and that multiple membership in Velugu, Spandana and SHARE was 32 per cent. The proportion of dual membership in a second quick survey of 130 borrowers from any of the three sources undertaken in Krishna district just after the crisis was even higher, at 82 per cent. Further, despite the presence in the area of two large MFIs (the two largest in the country) both expanding rapidly, reportedly with considerable rivalry, new local MFIs were still springing up and joining them.[6]

Despite all this competition, the Krishna survey reported the widespread presence of informal lenders, referred to locally as "girigiri" bankers,[7] indicating that demand was still not satiated. 18 per cent of borrowers had taken loans at some time from moneylenders to pay for MFI instalments. However, despite the much publicised "comeback" of moneylenders, 80 per cent of respondents said dependence on moneylenders had decreased. It is interesting that while increasing loan size is the most prominently reported means of competition in the literature,[8] and both MFIs were increasingly making individual loans above a size of about Rs 10,000, Spandana reports that in view of difficulties being experienced by borrowers, its average loan size had actually come down during the year ending with the crisis.[9] Another interesting consequence of intense competition for clients pointed out by the Krishna study was a "softening" of practices, such as fines for late arrival.

The second enabling cause was the rapid expansion of bank lending to MFIs that took place after 2003 with the introduction of ICICI's partnership model (discussed in Chapter 7A). With the financial constraint on expansion lifted, the MFIs were free to grow as rapidly as they could recruit and lend to new borrowers, or existing borrowers of Velugu or other MFIs.

While extending the depth and breadth of outreach is clearly central to microfinance's mission of making an impact on poverty through financial inclusion, and while sustainability is essential if MFIs are to attract lenders and investors in order to grow, the crisis serves as a useful reminder that there are other just as important client-centred consumer protection objectives such as transparency in dealings with borrowers and being careful not to saddle them with more debt than they can handle

The third enabling or contextual cause was the political investment the state government had made in cheap credit for the poor as an important part of its election platform, through the "Pavla Vaddi" or literally "quarter interest" rate scheme which derives its name from the fact that the state government stands committed to subsidise whatever excess of interest over 3 per cent the SHGs have to pay to the banks for linkage loans (currently about 12 per cent). The subsidy is transparent, since it is financed out of the budget (and is not a cross-subsidy like many other previous schemes such as the DRI which were borne by larger bank borrowers) and is "collective", in the sense that it is deposited into the group's bank and that too after completion of timely repayment (which is made a condition), although of course group funds belong to members individually in proportion to their savings. Politically it must be jarring to see MFI microfinance not only flourishing but growing rapidly in the state at much higher cost-recovering interest rates. Fourth, there was and still is widespread lack of public awareness of features of MFI microfinance such as doorstep disbursement and collection in weekly installments which lead to the seemingly usurious interest rates they have to charge. This lack of understanding is shared equally by the bureaucracy,[10] politicians and the media and was clear on display in the exaggerations, misinformation, and screaming headlines[11] that followed the crisis. Thus there was a massive external or public relations failure on the part of the sector, and one of the major challenges before it is a public education programme.

Causes: underlying

The rush to grow at all cost

One of the longer term causes was clearly the "quest for numbers" relating to outreach and profitability that is the main motivation of many MFIs. While extending the depth and breadth of outreach is clearly central to microfinance's mission of making an impact on poverty through financial inclusion, and while sustainability is essential if MFIs are to attract lenders and investors in order to grow, the crisis serves as a useful reminder that there are other just as important client-centred consumer protection objectives such as transparency in dealings with borrowers and being careful not to saddle them with more debt than they can handle. These are goals that apply equally to minimalist as well as more holistic microfinance. We are all responsible for building up a climate of expectations (including perhaps the preceding chapter!) that celebrates the interrelated achievements of rate of growth of outreach, efficiency, field worker productivity, etc. without always remembering that they can (i) lead to short-cuts in client selection and training, field worker training and sensitisation, and loan size determination, (ii) be used as the only criteria for incentive payments to field workers and (iii) put a degree of pressure on them that leaves no time for issues affecting client satisfaction, other than loan turn-around time, and progression in loan size etc.[12]

MFIs have a social as well as financial mission. Unfortunately social performance is not as easy to measure as financial performance, although a welcome development is that new social rating tools are being developed by M-CRIL and others to measure social performance as the "effective translation of mission into practice, in line with accepted social values"[13]. These may involve surveys to obtain feedback on client protection issues, client satisfaction, reasons for dropping out, and other variables. Interestingly, mission drift in the literature usually refers to moving up-market to increase breadth of outreach at the cost of depth of outreach. This has not been an issue at all in the present crisis, and it is generally accepted that MFIs have a poorer clientele than SHGs. Rather, the mission drift here was to ignore the rest of the social mission at the expense of the financial mission.

MFI practices

Interest rates

A second underlying cause clearly relates to the operational practices of the MFIs concerned, some of which were the outcome of the rush to grow and be profitiable. These practices were probably no worse than those of many other (although by no means all) MFIs growing rapidly in other areas, but since they received extensive publicity there is more information on them, allowing us to use them to discuss the issues arising that apply to the sector as a whole. While they were not the real reason for the state government's action, "usurious interest rates and hidden costs", or what are referred to as "deceptive" interest rates in the literature (CGAP 2004) were given prominence in the early days after the closure, before many state government officials realized that NBFCs are free to set their own rates. Indeed they do not seem to have been aware that the state moneylenders act was no longer valid[14] so that non-NBFCs were likewise legally free to do so.

While they were not the real reason for the state government's action, "usurious interest rates and hidden costs", or what are referred to as "deceptive" interest rates in the literature (CGAP 2004) were given prominence in the early days after the closure, before many state government officials realized that NBFCs are free to set their own rates

Spandana's and SHARE's effective interest rates before the crisis are reported to have been 31 and 28 per cent respectively from 2002-03 to 2005-06, when they were reduced to 28 and 24 per cent. These rates are not very different from the modal rate of 2 per cent a month rate charged by SHGs, and below half that of the informal sector (for girigiri bankers 6.7 per cent a month). They include the loan processing fee, but not a one-time membership fee. The MFIs also required borrowers to make a security deposit as cash collateral.[15] Third, Spandana deducted 1 per cent of the loan amount or Rs 50 towards a life insurance premium in which the borrower's spouse received the loan amount, less the outstanding balance if she died, on which Spandana made a surplus (see Roth et al 2005). However this too does not increase the effective interest rate, whether one agrees or not with the widespread presumption that the surplus from the scheme should have been distributed to borrowers. It is true though that borrowers lacked a clear understanding of their entitlements under the scheme, which is unfortunately generally the case with insurance products (see Chapter 5A) and indeed of the effective interest rate.

A practice that has raised some eyebrows was charging borrowers who wanted to prepay their current loan in order to avail of a larger one, interest on the entire period remaining on the current loan. This can be a rather high penalty, depending on the period in case. As with many other questionable practices the MFIs were accused of, there is no data on how frequently it was resorted to. The MFIs, like most others in India and Bangladesh, were also using flat rates. Transparency demands MFIs should prominently disclose the effective rate of interest as an

The point at which peer group pressure becomes coercive is an extremely difficult one and along with other No Easy Answer questions is discussed in Box 4.2. However one clear lesson of the crisis is that the policy of 100-per cent repayment and zero tolerance for default carried a very high cost in terms of client dissatisfaction, and provided ample material to be exploited by interested parties

APR. This could place new, start-up, MFIs at a disadvantage compared to established large ones, because the higher rate they need to charge to recover higher initial transactions costs will become more "visible". The remedy would be to lay down a slab system of suggested interest rates instead of the uniform rate laid down in the code of conduct at present, assuming, that is, it is felt it is "politically" necessary to have suggested rates at all.[18]

Coercive collection practices

The set of accusations that received the most prominence however related to coercive collection practices, leading to borrowers having to "abscond", or migrate out of the village, and even in some cases, allegedly, commit suicide.[19] The Krishna survey respondents felt that (i) joint liability (the group paying on behalf of the defaulter), (ii) compulsory attendance, (iii) fines and (iv) keeping all members waiting until repayments are made are the chief means (in that order of importance) of ensuring a "cent per cent recovery" rate. Means that would generally be regarded as "abusive"[20] or at least questionable were mentioned by respondents in the following order of frequency[21] (i) adjusting overdues against the security deposit, (ii) holding the weekly meeting in front of the defaulter's house, (iii) MFI staff sitting in front of a defaulters door (iv) offensive language used by group leaders or staff (v) putting up a loan overdue notice in front of a defaulters house.[22]

The point at which peer group pressure becomes coercive is an extremely difficult one and along with other No Easy Answer questions is discussed in Box 4.2. However one clear lesson of the crisis is that the policy of 100-per cent repayment and zero tolerance for default carried a very high cost in terms of client dissatisfaction, and provided ample material to be exploited by interested parties. Clearly there is a need for flexibility to accommodate cases of extreme distress in which a borrower is unable to pay because of critical illness, hospitalization etc. A second lesson is that there is a great need for action research to provide answers to the question how flexible MFIs can afford to be even in cases of lesser distress (such as failure of a business) in rescheduling loans, without affecting repayment discipline generally, and how much operational costs would go up to introduce such flexibility.[23] Third, an additional response should clearly be much wider use of emergency loans and risk funds.[24]

There was no doubt some overlending but we need detailed case studies of how some borrowers got into repayment difficulties. This is the kind of research still neglected in India as elsewhere, and needs economic anthropologists willing to live in villages for prolonged periods and to use participant observation and other methods to get over the limitations of survey-based research and "quick and dirty" studies

Overlending

The third set of accusations was that MFIs were "dumping money on borrowers" who were finding it difficult to repay and having to borrow from moneylenders at a higher cost in order to stay in good standing with the MFI. This is an extremely complicated issue calling for much further field research and is discussed very briefly in Box 4.2. While the banks are in a position to lend to salaried borrowers whose total income is relatively easy to assess, MFIs lend almost entirely to the self-employed whose, relevant income is that of the household as a whole. There was no doubt some overlending but we need detailed case studies of how some borrowers got into repayment difficulties. This is the kind of research still neglected in India as elsewhere, and needs economic anthropologists willing to live in villages for prolonged periods and to use participant observation and other methods to get over the limitations of survey-based research and "quick and dirty" studies.[25]

Unattractive features of the SHG model for borrowers

A third underlying cause of the crisis lay in certain features of the main alternative model of microfinance available to borrowers, the SHG programme. These features made Velugu less attractive to many borrowers as a source of microcredit (although they may have continued to value many of the other services provided through Velugu), and led them to borrow also from the MFIs. Most of these features are inherent disadvantages of the SHG model itself, although the disadvantages are dominated by the advantages (see Box 1.1). In the Guntur survey of Spandana borrowers, two-thirds of whom were also SHG members, inadequate loan size was the most frequently cited problem in borrowing from SHGs, followed by the long waiting period for loans. In contrast, timeliness of loans was cited most frequently as an advantage of borrowing from MFIs. In the second, the Krishna district survey, cumulative borrowing from SHGs was about 40 per cent of that from the two MFIs (standardised for number of loans), although there was less difference in loans outstanding given the longer tenor of SHG loans. MFIs deliver loans of larger average size in a more timely fashion because they borrow in bulk from the banks for relending, whereas SHGs have to wait for the last member in the group to repay her loan to the group before the group can repay its loan to the bank, and secondly when they do get a loan, its size is tied to group savings and depends on the whims of the local bank manager. (Chapter 2 alludes to some of the difficulties encountered by groups under SBLP).

A third underlying cause of the crisis lay in certain features of the main alternative model of microfinance available to borrowers, the SHG programme. These features made Velugu less attractive to many borrowers as a source of microcredit (although they may have continued to value many of the other services provided through Velugu), and led them to borrow also from the MFIs

Interestingly, the Krishna district survey ranked the availability of individual loans as the most frequent response among reasons for enrolling in MFIs, ahead of timeliness and large loans.[26] Interestingly, again, the most frequent response (90 per cent) for problems with MFI procedures was weekly installments, just ahead of the high rate of interest, and well ahead of "rigidity even in genuine cases" (19 per cent). "More pressure and mental tension" on account of weekly repayment was an important drawback also reported in the first survey.[27]

On balance, given these advantages and disadvantages, only 10 per cent of Guntur district borrowers said they would discontinue MFI membership after repaying their current loan, a proportion that increased to 21 per cent in the Krishna survey. However as the survey report explains, many members who intend to leave, end up "prolonging" their membership because a member who leaves either has to wait for another drop-out in her original group who she can replace, or organize a new group. In addition she loses her seniority and is on a par with new members in respect of loan size. So the incentives are structured so as to keep membership alive.

Likewise despite dissatisfaction with SHG membership as a credit institution, very few members actually quit and "defect". This is because SHG membership too confers many advantages, with access to a large number of development programmes, services and benefits being contingent on membership.[28] Thus there was no "poaching" as such, because both models were restricting competition by making it costly for borrowers to switch. The impact of competition is more on regularity of loan repayments and monthly savings in the SHGs. The Krishna survey found overdues amounting to almost half of outstanding in the SHGs that members belonged to. The proximate cause of the state government action was the increasing frustration being experienced by Velugu managers over the effect MFI lending to SHG borrowers was having on Velugu performance as shown in indicators such as the recovery rate within groups, and of groups to the banks, and to the Community Investment Fund (CIF).[29]

The lack of contact and communication with other players in the political economy

A final underlying cause was the MFIs, in their self-absorption with growth at the cost of other objectives, underestimated the degree to which they were antagonising several powerful players in the local political economy

A final underlying cause was the MFIs, in their self-absorption with growth at the cost of other objectives, underestimated the degree to which they were antagonising several powerful players in the local political economy. Among these were informal lenders such as chit fund organisers[30] and local girigiri bankers, politicians who were embarrassed by the fact that the MFIs were disbursing much more money in their constituencies than they could lay their hands on themselves through their constituency funds, some bureaucrats who felt uncomfortable about anything major happening, even if it is good, without their "blessings", or at least their knowledge. Even retail traders of consumer durables are said to have felt threatened by the fact that Spandana had earlier set up a consumer store so as to be able to purchase goods in bulk and enable borrowers to benefit from lower prices using vouchers they had the option to accept instead of cash loans.[31] And finally of course there were a number of discontented borrowers, as we have seen above, some of who were championed by local politicians. This powerful combination of interests may explain the lack of public support when the crisis hit.

Implications for the MFI model, short and medium term, and lessons

One short-term impact of the crisis was a heightened perception of political risk among banks, who both increased interest rates, and reduced new lending to MFIs in AP, especially SHARE and Spandana, in the first few months of the current year. It is too early to say what overall lending growth in the country as a whole will be during the year. At least one of the medium-sized lenders (see Table 7.1) has plans to more than double lending this year, but a great deal depends on ICICI, since it has the lion's share of total lending to MFIs. SHARE and Spandana both had to make higher provisions in 2005-06, as well as write-off loans. However they were not the only ones affected. Other AP MFIs had to make higher provisions too.

Another impact has been a sharp diminution in the rate of growth of the MFI model in AP

Another impact has been a sharp diminution in the rate of growth of the MFI model in AP. SHARE's portfolio actually shrunk by about 10 percent during the first six months of the year, while Spandana's has climbed back to a level only slightly higher than in March. Although Spandana may have been the larger lender in Krishna district, with Rs 74 crore outstanding in March, it has a larger share of borrowers in the urban and semi-urban areas, and is shifting its rural lending to the Telengana and Rayalseema areas of the state, apart from expanding in Hyderabad, and opening branches in Karnataka. SHARE has not opened any new branches in the state since the crisis, but has added 15, all outside the state, to its 300 in March. It now has 100 branches in four neighbouring states - Karnataka, Maharashtra, Madhya Pradesh and Chhattisgarh and has plans to open branches also in Rajasthan, Orissa and UP. SKS is also expanding rapidly outside the state. Thus while the crisis is a short-term loss to the poor families of AP, this will be partly offset by acceleration of growth in other states, many of them badly underserved.

Hopefully, risk perceptions will improve as things return to normalcy. The AP crisis was caused essentially by a combination of four factors, (i) the fact that the state itself was an active promoter of microfinance through a politically-attractive and high visibility programme, Velegu, (ii) competition between this programme and MFIs (iii) the fact that this competition was damaging Velugu, and (iv) that the state government intervened to protect the model it was promoting, or in other words let its promotional role dominate the role of neutral umpire between models. Even if the first condition comes to apply elsewhere, the last may not, especially if MFIs ensure that the second and third conditions do not arise, at least in the acute form it did in coastal Andhra. One of the challenges before the sector is to evolve a harmonious relationship with the SBLP, as geographic separation is not possible in the long run, with both models expanding. Nor is it desirable if the different segments of the un-banked and the poor are to be offered a choice of models.

One of the challenges before the sector is to evolve a harmonious relationship with the SBLP, as geographic separation is not possible in the long run, with both models expanding. Nor is it desirable if the different segments of the un-banked and the poor are to be offered a choice of models

Among positive effects, many of the lessons of the crisis for MFI practices have been recognized and reiterated in Box 4.1, and self-regulation mechanisms will hopefully be strengthened to enforce them. However many difficult questions remain, some of them discussed in Box 4.2, on which much soul searching and hard thinking remains. Lower acceptable interest rates could spur the introduction of technology as a means of lowering transactions costs. With a lower rate of growth, MFIs are likely to be able to devote more attention to good governance, transparency and client perspectives. They are likely to become more sensitive to social performance generally, and the use of social ratings is likely to increase. Other likely impacts are that incentives to transform will get strengthened as NGO-MFIs seek to insulate themselves from the uncertainties of interest rate populism, as NBFCs. The crisis will hopefully also expedite action on the proposed microfinance bill.

Among positive effects, many of the lessons of the crisis for MFI practices have been recognized. However many difficult questions remain, some of them discussed in Box 4.2, on which much soul searching and hard thinking remains

Another medium term impact is likely to be downward pressure on interest rates from a desire to conform to public, political and regulatory perceptions of what a "reasonable rate" is. Several MFIs around the country have already reduced their rates. While large MFIs are in a position to reduce rates with a lower impact on their growth,[34] the growth of the sector as whole is likely to slow down at least for the next year or two. The high growth rates of some of the larger and some medium MFIs witnessed in the last few years are certainly likely to become a thing of the past.[35] The challenge will be to grow steadily even at modest rates, especially for small start-up MFIs.

Box 4.1 Sa-Dhan's Voluntary Mutual Code of Conduct for Micro Finance Institutions, March 21, 2006

In view of the various issues about MFIs pointed out by AP government officials and the media, the following code of conduct was adopted in a meeting in Hyderabad on March 20, 2006.

Complementing credit delivery by SHGs:

1. MFIs will ensure that they complement the credit provided to poor households under the SHG-Bank linkage programme, and especially extend services to those not served adequately by banks.
2. MFIs will avoid over-financing of the same household by different MFIs, by informal information sharing on operations among themselves and with banks doing SHG lending.

Interest rates and Savings:

3. MFIs will charge reasonable interest rates, which are based on schedule attached below. MFIs will indicate interest rates, including loan processing and other charges, on an annual percentage rate basis (effective rate on declining balance basis).

Box 4.1 Continued

4. MFIs will collect savings from members/customers only when explicitly allowed by RBI or a state legislation to do so.

Recovery of loans:

5. MFIs will not take original land titles, house pattas, ration cards, etc as collateral security for loans but can take copies of these for fulfilling "know your customer" norms of RBI.
6. MFIs will strictly instruct staff members not to use abusive language or intimidation tactics while collecting repayment and will dismiss those staff members who do so.
7. MFIs will ensure that all borrowers are provided with life and other insurance which covers the loan outstanding and some additional amount, in conformity with IRDA guidelines.
8. In case of death of the borrower, a family member or of livestock or any other major adversity in the borrower's household, the MFIs will offer ways and means to reduce the shock for the family.

Governance and Transparency:

9. MFIs will adopt a high standard of corporate governance, with eminent independent board members and fully involving them in policy related decision.
10. MFI leaders will declare their salary and benefits on an annual basis in the financial statements.
11. MFIs will ensure ethical and disciplined behaviour by their staff; take action against those who do not conform; and declare the names of those staff members who have been dismissed.
12. MFIs will stay in touch with government authorities, banks and the media on a regular basis.

General:

Any complaints against MFIs can be sent to Sa-Dhan, the national association of MFIs, which will refer it to its Ethics Committee for action.

Interest rate schedule for MFIs:

Item of cost	Basis of Cost	Percentage of
Cost of Funds	SBI Prime Lending Rate	9%
Cost of delivery of credit	Money order charges by government Post Office	5%
Cost of collection of repayment	Money order charges by government Post Office	5%
Cost of provisioning for bad debts	As per RBI norms, based on extent of bad debts	1-3%
Profit margins	Minimum required to maintain capital adequacy as per RBI norms	1-2%
Total		21-24%

Box 4.2 Some Not Easy to Answer (NEA) questions calling for further research and consensus building

What constitutes abusive collection methods?

Group lending is built on the foundation of joint and several liability (also referred to as social collateral, or a collateral substitute) This applies equally to SHGs, where the lender is not concerned with the identity of the individuals to whom the loan is distributed by the group, and to smaller Grameen-type groups where loans are recorded in the names of individual borrowers. Joint liability, although theoretically enforceable in the latter case through the courts (because other group members sign the necessary documents), is in practice enforceable only morally through peer group pressure.

The strictly moral component of peer group is the sense of obligation that group members feel to repay their loans. In India, as in Bangladesh and perhaps elsewhere, poor village women take the oath they are administered when becoming members extremely seriously. The other more opportunistic component of peer group pressure derives from the incentive to repay as the condition for receiving larger loans or continuing to receive credit at all.

The NEA question is, can MFIs rely on these two components alone, and if not what other methods are ethical? There was much talk during the AP crisis of MFIs keeping borrowers standing in the sun waiting for the last member of the centre to turn up with her loan payment. A field worker from a rival MFI felt this was unacceptable (as most people would). But when asked "how about keeping them waiting sitting down, in the shade?" she replied: "Well perhaps, for a while ...." In the memorable words of an IIMB professor "you don't recover loans by smiling at people". However at what point does embarrassing a borrower for keeping everyone waiting by coming late to a meeting with her repayment, become unacceptable humiliation?

What constitutes over-lending?

It is not easy to define the tipping point beyond which a borrower over-borrows. Clearly when borrowers default involuntarily they have over-borrowed, but not all over-borrowing leads to default, as when a borrower sells a valuable asset, or cuts back on educational expenses, or is forced to work when ill in order to meet the next weekly instalment. Group lending leaves it to the good sense of group leaders to take a call on whether to chip in for a "deserving" defaulter. But what are the ethical considerations when they are not prepared to put up for a willful defaulter who then migrates out of the village or worse. Instances of excessive peer group are not the monopoly of MFIs. There are documented cases of SHG members contemplating suicide, and it is standard practice in the bishis or informal credit unions of Maharashtra for the entire membership of perhaps 50 to a 100 people to visit and embarrass a defaulter in her house, perhaps even restraining her inside temporarily.

When does healthy competition become unhealthy?

What constitutes poaching, merely lending to a borrower when she has a loan outstanding to an existing lender? A libertarian in these matters would advocate respecting her freedom of choice to avail of a larger or more timely loan. Is there an obligation on the new lender not to lend to her until she has fully repaid her existing lender? Or is the lender only obliged to ensure that she will be able to pay back both loans? Is it necessarily irrational to borrow from a higher cost moneylender for a few days to repay an MFI? "Double dipping" is said to be widely practiced in Bangladesh. What have been the effects?

Endnotes

1 *There will be many disagreements with this chapter, not all stemming from respective biases. It attempts to present the facts fairly, although the facts themselves were very hard to establish in the short time available. It will have served its purpose if it provokes discussion and increases awareness. I am grateful to a number of officials of the AP government for sparing time to meet and discuss with me, and to the MFI leaders concerned. I am particularly grateful to Dr CS Reddy and Dr Raja Reddy of APMAS who generously shared their time and the studies relied on in this chapter, and Padmaja Reddy of Spandana for always being available to present her perspective. As she points out, Spandana has never tried to hide its profits (which were much lauded before the crisis, and resulted from Spandana's equally lauded efficiency) and has always opened its doors to researchers, two of whom are cited in this chapter, enabling closer understanding of issues generic to the sector. It needs to be remembered that it is very easy to be wise after the event, and that both MFIs have brought valued financial services to almost 2 million poor borrowers.*

2 *SHARE had 927,290 members in March 2006, with Rs 366 crore in loans outstanding, while Spandana had 784,323 members, and loans outstanding of Rs 305 crore. According to a report in the Economic Times (August 30, 2006), 10 MFIs had operations in Krishna district with 1 lakh borrowers and loans outstanding of Rs 130 crore. In the 10 districts of coastal Andhra they had about Rs 1,400 crore outstanding to 1 million borrowers.*

3 *For prescient observations on the need for Spandana to address political risk, see Sriram (2005).*

4 *See Times of India, September 25, 2006. The villages selected were presumably those where overdues to the MFIs were the highest. Loans above Rs 25,000 were to be rescheduled over two years. As discussed in Chapter 7A, under the partnership model, the loans remain on the books of the lender, and by handing over their servicing to the VOs in those villages the MFIs were presumably released from their FLDG obligations for that part of the portfolio. Thus the VOs will in effect be used as partners under the partnership or BC models (see Chapter 7A) for at least the second part of the credit transaction, loan collections, for an undisclosed share of the 15 per cent interest rate. The arrangement is a characteristically creative response on the part of the lender. It will be interesting to see whether the experiment results in a wider relationship of the lender with VOs generally.*

5 *The current government changed the name of the programme to Indira Kranti Patham.*

6 *Two of them, an NGO and the other a MACS, had borrowed from FWWB.*

7 *They provide loans of Rs 500 repayable in 12 weekly instalments of Rs 50 each, after deducting Rs 10 for a pass-book.*

8 *As in Bolivia, on the basis of which Rhyne (2002) goes so far as to claim that competition between MFIs is inherently unstable.*

9 *The average size of loans outstanding for all members was Rs 4,233 in March 2006.*

10 *For instance a DRDA official in Krishna district showed the author as evidence of bad faith a loan agreement document signed by ICICI bank with individual borrowers which mentioned 8.5 per cent as the interest rate. The official did not understand that under the partnership system this is only the loan cost component of the composite interest rate which includes the MFIs servicing charges and which is entered in the pass book.*

11 *Such as "Blood Money!"*

12 *Ironically, Spandana was widely lauded by the MFI community for being a highly profitable MFI, and for having unusually high efficiency with extremely low operational costs. It was not clear to most observers at the time that these were being minimised at the expense of repercussions on client satisfaction. On the other hand Spandana's profitability had attracted adverse political attention well before the crisis, in response to which Spandana had indeed started reducing interest rates.*

13 *See M-CRIL flyer "M-CRIL is offering a Social Rating product: A new service to help meet the double bottom line in microfinance". It conducted 7 social ratings in India and Bangladesh during 2005-06.*

14 *Reportedly an attempt to revive it failed to reach the President's assent, a necessary step also for state acts. As reported above, action is under way to revive it again.*

15 *Spandana had reduced the amount of the deposit from 10 to 5 per cent of the loan amount, or Rs 500, whichever was higher, in 2005-06, and SHARE introduced a security deposit of 5 per cent for the first time in 2005-06 after it discontinued and refunded savings mobilised through a parallel cooperative structure of its members. Since such deposits are refundable, although without interest, they raise the effective rate of interest not by the full amount of the deduction, as would be the case of an advance repayment instalment, but on the interest forgone on the deposit.*

16 *As Roth et al point out, because the scheme was generating too much surplus Spandana added (i) hut insurance up to Rs 1,000 (ii) coverage of spouses (without the age limit of 55 that applied to women borrowers, which led to adverse selection and a high spouse claims rate) and (iii) a rather expensive-to- administer scholarship scheme. The alternative would have been to (i) reduce the premium (even with the additional benefits it yielded a net income of 20 per cent of premiums) or (ii) use the surplus as a reserve - which would have been prudent in the absence of re-insurance (this was an in-house scheme, from being a partnership with LIC earlier). One of the benefits of switching to an in-house scheme was a massive in improvement in settling claims (73 per cent within 7 days).*

17 *Not even MFI field workers know what the EIR is, let alone the mathematical formula according to which it is calculated. However it serves the essential purpose of comparability.*

18 *The code of conduct contains a table which explains how the rate of 21-24 per cent is derived. Ten percentage points are accounted for by what is claimed to be the post office money order delivery charge. The charge is actually 5 per cent. Rather than use the money order charge as a proxy, the sector in its public education programme should use the result of well-publicised studies on actual transactions costs as a function of scale.*

19 The base suicide rate in AP is 14 per 100,000. There would be cause for concern only if the rate among the borrowers of an MFI were significantly above this. None of the allegations in the press and from government seemed aware of this, apart from the fact it is very hard to determine the cause of a suicide. This is not to imply that suicides are not tragic whatever the reasons.

20 This is the term used in the literature (e.g. CGAP 2004). In India abusive is also commonly used to refer to verbal abuse, another practice field workers were accused of, as noted below, but it should be remembered that what is considered abusive in the latter sense is culturally specific.

21 Frequency of mention, not necessarily use.

22 Only as a "last resort" were mostly larger, individual, loans, recovered by encashing signed blank cheques, or taking legal action to enforcing blank promissory notes. Use of blank documents is of course clearly an abuse, and lay behind the cheating cases registered. Two respondents mentioned physical force, exercised presumably by centre and group leaders, since a lone field worker would risk retaliation (one was in fact murdered soon after the crisis).

23 The CMF in collaboration with KAS Foundation is experimenting with the impact of introducing flexible repayments schedules, such as allowing the client to skip up to two principal installments through a coupon payment system which simplifies the accounting for both MFI and borrower, or allowing the client to pay double the principal installments during the first six months of a milch animal loan when the animal is productive (see Chapter 9).

24 There is an interesting discussion of emergency loans in the annual report for CASHPOR for 2005-06.

25 But not "long and dirty" ones, which is too often the alternative.

26 Spandana has introduced what it calls a small business loan product, mostly in the urban areas where about half its borrowers reside, to members who have established a track record through the regular group lending programme, or to their spouses, with a maximum loan size of Rs 1 lakh (compared to the earlier ceiling of Rs 15,000, but with average loan size presently of about Rs 25,000) and customised tenor which could extend to 4 years. These loans are expected to constitute as much as 15 to 20 per cent of the portfolio this year.

27 This is contrary to the widespread advantage claimed for weekly repayment that it makes repayment easier, and to what some women told this author during a visit to a village in Krishna district where repayments stood suspended after the crisis, that they regretted the fact that they were working less because they no longer needed to raise money for the wages to meet the next repayment.

28 The previous government was also acutely conscious of the political importance of Velugu and offered members incentives, especially before election time, such as easier access to gas connections. It could be argued though that competition through bribery is preferable to attacking the other model.

29 The CIF is a component of Velugu, under which funds are passed down through the two upper-tiers of the three-tier structure, Mandal Samakhya's and Village Organisations, to the SHGs, with the intention to make each tier self-sufficient in the long run through an interest differential added on each stage. The World Bank's original intention was for CIF to finance small collective projects started by Common Interest Groups of the poor, prepared with their participation under micro-plans, but in view of the poor recovery rate (of 45 per cent in 2003-04) is now used mostly for individual loans by the SHGs,

with the recovery rate expected to increase to 60 per cent in 2004-05 according to AP (2005). CIF continues to finance some collective projects implemented by the higher tiers, such as marketing of agricultural commodities, and food security interventions.

30 *Much was made of the fact that the group that ran one of the leading Telegu dailies, also owned a prominent chit fund company. However it is not clear how an MFI borrower could ever join a registered chit fund with large monthly contributions. Only small local informal chit funds would be affected.*

31 *On the other hand, except when loans are tied to purchases in particular outlets connected with the MFI, one would expect there to be a strong complementarity of interest between MFIs making large individual loans and the retail trading community generally. Spandana discontinued the business when it transformed to an NBFC (see Sriram 2005).*

32 *Spandana wrote off Rs 18 crore in 2005-06, while still reporting profits. It is likely to have to make further loan write-offs in the current year, since it expects to recover only 70 to 75 per cent of its loans in Krishna district. SHARE wrote off Rs 6 crore, and made a similar provision for further loan losses.*

33 *It expects its portfolio in AP to come down from about 80 percent currently to 50 percent in the next few years.*

34 *SHARE's rates in AP are 15 percent, and 19 percent in other states.*

35 *Both SHARE and Spandana have been roughly doubling their size in the last few years.*

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CHAPTER 5

Diversifying Microfinancial Services

A. Microinsurance

This chapter deals with two non-traditional financial services that the microfinance sector is beginning to offer in India. The first, microinsurance, is in rapid flux with the recent arrival on the scene of a number of private insurance companies, who are required to do a certain proportion of their business in the rural and social sectors. Thus there is a new set of incentives for the insurance industry to reach the poor. A great deal of innovation in new product development and service delivery is taking place in partnership with MFIs and others, and the early pioneers such as SEWA and DHAN Foundation have been joined by a host of more recent entrants to the microinsurance sector. However, these are early days yet, and the sector is likely to continue evolving rapidly, especially with growing interest in the broader political environment in improving India's social security record, which like other parts of the social sector has been relatively neglected until recently.

Thus there is a new set of incentives for the insurance industry to reach the poor. A great deal of innovation in new product development and service delivery is taking place in partnership with MFIs and others

There are strong synergies between microinsurance, microcredit and microsavings. Insurance offers protection to assets created under credit programmes, and protects savings from being wiped out by shocks arising out of sickness, death, accidents or asset loss caused by fire, drought, floods, and riots. While both savings and insurance provide protection against such shocks, insurance offers a higher degree of protection, especially when savings have just commenced and are still being built up to provide an adequate cushion on their own. Insurance provides protection not just against one-off losses and calamities, but as important, reduces the on-going uncertainty induced by vulnerability to such shocks, with its debilitating affect on investment in new assets or working capital.

Given these synergies it is gratifying that an increasing number of MFIs are offering insurance.[1] However many of them are still feeling their way in moving beyond the traditional offerings of life insurance (which was provided through group insurance schemes by the former public sector monopoly provider, LIC, for a couple of decades) and loan-financed asset insurance. A great deal depends on the vision and mission of the MFI, and specifically on the degree to which it is minimalist in the sense of focusing primarily on the growth of outreach and sustainability through credit services, or is concerned equally with borrower risk mitigation (as opposed to its own) and livelihood growth as ends in themselves. More than half of the 83 MFIs that responded to the Side-by-Side study (Sa-Dhan 2005) offer insurance, with life insurance being more widespread than non-life insurance. The impact evaluation study of 20 SFMC partners, "The Maturing of Indian Microfinance" (EDA 2005) found that 14 of them offered an insurance product. 11 of these offered life insurance, covering 48 percent of their membership, and 8 of them offered asset insurance, restricted usually to loan-financed assets (such as cattle and houses), and covering 32 percent of their membership who had asset loans. Coverage was more than twice as high for Grameen replicants than for MFIs using the SHG model.[2] Unfortunately, data is not available on how widespread insurance is under the SBLP programme.[3]

It is estimated that more than 90 percent of the Indian population does not enjoy social protection[4] of any kind, a higher proportion even than those who are unserved by the banks in respect of savings and credit. Both government[5] and civil society actors[6] have tried to make a dent on this huge deficit in recent years. The movement was greatly strengthened by the social obligation placed on the existing public and new private insurance companies to intervene in the sector through the IRDA of 1999, which opened the insurance market to the private sector. Regulations issued under the act in 2002 required private insurance companies to issue 16 percent of their total life insurance policies to the rural sector within five years, and build up to at least five percent of their gross premium income from non-life policies within three years.[7] Competition within the sector suddenly increased, and resulted in a sharp increase in the number of players (currently about 30) and number and variety of insurance products aimed at the poor.[8]

It is estimated that more than 90 percent of the Indian population does not enjoy social protection of any kind, a higher proportion even than those who are unserved by the banks in respect of savings and credit

The extent of microinsurance in India

The subregional office for South Asia of the STEP programme of the ILO has provided a very useful service to the sector by building up virtually from scratch the beginnings of the statistical foundations of the microinsurance sector though a series of recent studies on microinsurance products, the institutions offering them and case studies. An inventory prepared in 2003-04, ILO 2005(1), identified 83 products listed by insurance companies, evenly divided between life and non-life, three-fourths of which were accounted for by the private insurance companies. Of the non-life products the most important were accident related risks - accidental death, disability, and accident expenses.[9]

Another inventory, also prepared in 2003-04, ILO 2005(2), of institutions engaged in microinsurance, managed to gather information on 51 organizations already offering microinsurance schemes, and another 9 with plans to commence operations in the near future. A third of the organizations were engaged primarily in microfinance, and 31 percent were NGOs supporting a wide range of development activities at the grassroots level (including microfinance). Of the rest, 23 percent were community based or organizations (CBOs), and another 12 percent health care providers. Given the strong presence of existing microfinance providers it is no coincidence that 52 percent of the organizations were located in AP, Tamil Nadu and Karnataka.[10]

Health insurance

While the number of organizations offering health insurance had been only 29 in the 2003-2004 inventory of institutions, it had jumped to 54 organizations offering 61 schemes in a 2006 update (ILO (2006)) The institutions are listed in Appendix Table 2,

The total number of individuals covered was at least 5.1 million. While 35 of the schemes were under the partner-agent model, with the agent collecting premia and disbursing claims in the capacity of an intermediary, and financial ownership, management and risk being borne by the company, 25 of them consisted of in-house schemes, a higher proportion than for other products, life and non-life, given the synergies of health insurance with health care provision (discussed below).[11]

Of the many risks the poor face, sickness occurs the most frequently, accounting for the largest expenditures and greatest loss of daily income, necessitating often the sale of assets (decapitalization) and higher indebtedness, and leading to greater poverty. A large number of studies identify health shocks as the most important of the multiple risks the poor face that push them back into poverty, although in a largely agricultural country like India, crop failure, and weather and disease-related loss of cattle wealth are also very important. Unfortunately all three are also the most difficult of provide insurance against given the easier possibilities they hold out for adverse selection and moral hazard . (It is not as easy to fake death, old-age, maternity, accidents and a number of other "insurable perils"). Box 5.1 illustrates some of these problems encountered in cattle insurance by SHEPHERD.

Of the many risks the poor face, sickness occurs the most frequently, accounting for the largest expenditures and greatest loss of daily income, necessitating often the sale of assets (decapitalization) and higher indebtedness, and leading to greater poverty

Synergies with microfinance

It is precisely these features of all forms insurance (not just microinsurance) that gives community based organizations (CBO) and NGOs an advantage over insurance offered through the traditional individual agent for life and other non-life insurance products. NGOs, SHGs and MFIs have now been formally recognized as "micro-insurance agents" for purposes of acting as intermediaries between the insurance companies and beneficiaries.[15] MFIs are in a better position to overcome information asymmetries through information acquired on potential clients through credit and savings services. The economies of scope provided by the provision of these other financial services also puts them in a position to reduce costs by such devices as deducting premia while extending loans, or adding a small monthly contribution towards premia in periodic loan repayment installments, or paying premia out of accumulated group funds (savings and profits) of SHGs once these funds have grown to a minimum size, (as commonly practiced in DHAN Foundation federations) or agreeing with clients to deduct their premia out of their savings accounts.

MFIs are in a better position to overcome information asymmetries through information acquired on potential clients through credit and savings services

SEWA offers members the option to open fixed deposits in an amount sufficient to yield the interest required to pay premia directly, saving both SEWA and members the transactions costs of collecting and paying annual premia separately.[16] Third, the flexibility available in various modes of premia collection allows microfinance organizations to allow for the uncertain and irregular incomes of the poor. Fourth, the need to make premia payments may itself serve as an inducement to save more. Fifth, there are obvious benefits to the MFI too, such as being able to recover the balance of an unpaid loan if a client dies,[17] additional income from commissions in the partner-agent model[18] or from the excess of premium income over payouts in the in-house model (see below).[19] Sixth and last, CBOs such as SEWA and DHAN have the additional advantage of the greater sense of ownership and control over fraud and adverse selection that derives from members also being share-holders and managers of the scheme, although it is clearly not strong enough to eliminate fraud completely.[20]

Third, the flexibility available in various modes of premia collection allows microfinance organizations to allow for the uncertain and irregular incomes of the poor

The in-house or provider model

Before social obligations were placed on the new private companies and greatly increased the menu of choice available to MFIs in terms of products and combinations of products, MFIs

The advantage of the provider model is that there is a close synergy between health insurance, health care and health education. It is only in the context of availability of the last two that micro health insurance is likely to be viable

mostly used the alternative, in-house, model rather than the partner-agent model.[21] A special case of the in-house model is the so called provider model, which is particularly common in health insurance such as when a health care provider or a hospital run by an NGO or trade union develops a microinsurance scheme. The advantage of the provider model is that there is a close synergy between health insurance, health care and health education.[22] It is only in the context of availability of the last two that micro health insurance is likely to be viable (see Box 5.2 for the example of VimoSEWA) and in most cases not even then. As will be seen from Table 5.1 non-MFI provider organizations including NGOs, trade unions, and hospital trusts such as Students Health Home, Yeshashvini Trust, Family Plan Health Limited, Voluntary Health Services and RAHA account for the bulk of micro health insurance policies.

However, it is to be noted that the tie up with health care and health education can be achieved by MFIs too, through arrangements entered into with third party hospitals, government, private or charitable, as SEWA and DHAN Foundation have others have done in their in-house schemes.[23]

The main advantage of an in-house scheme in the pre-2002 situation of limited choice of insurers and mostly inappropriate products, even for non-health products, was that it allowed for much greater flexibility in putting together the most appropriate insurance package for poor clients, and by-passed the procedural difficulties and paper-work that stood in the way of speedy settlement of claims, which were an important factor in low renewal rates. Often, MFIs would try out a product offered by an insurer but then revert back to an in-house scheme based on experience gained. However as the microinsurance market suddenly changed from being a sellers' to a buyers' market the MFI would then end up trying out an improved product offered by the same or another public sector insurer. Thus ASA, an FWWB affiliated partner, experimented with 7 packages with both in-house and agency components before settling on its present package, which is now exclusively under the partner-agent model[24]. SEWA went through a similar process.[25]

Apart from the fact that competition greatly strengthened the negotiating position of MFIs vis-à-vis insurers, MFIs became increasingly aware of the risks and disadvantages of running in-house schemes. Insurance is a risky business, especially in the case of products with large "covariate" risk affecting whole regions simultaneously (eg crop failure, cattle epidemics)

Apart from the fact that competition greatly strengthened the negotiating position of MFIs vis-à-vis insurers, MFIs became increasingly aware of the risks and disadvantages of running in-house schemes. Insurance is a risky business, especially in the case of products with large "covariate" risk affecting whole regions simultaneously (eg crop failure, cattle epidemics) as against products in which risks are more "idiosyncratic", affecting individuals at random (e.g. natural death, accidents). SEWA was affected by drought, communal riots and floods in three successive years, which affected its asset insurance claims rate in particular.[26] For a small local MFI, a widespread human epidemic could affect the claims ratio also for natural death. The scale on which insurance has to be provided both in terms of number of beneficiaries and diversity of areas covered is therefore greater than is the case with other financial services.[27]

Most MFIs are themselves taking advantage of the "buyers market" that exists in the microinsurance segment of the insurance industry. The experience of the Dhan Foundation is instructive. As of June 2004, 1.09 lakh Kalanjium (SHG) members (including 0.24 lakh spouses) had volunteered to be covered by insurance out of a total of 2.16 lakh members distributed over 61 federations. While 8 out of these had originally offered life insurance through self-run programmes, only one, the Kadamalai federation, continued to do so. The higher benefits and support for the education of children under LIC's subsidized JSBY (Jan Shree Bima Yogana-see below) was the main reason for the shifting to LIC. Health insurance with hospitalisation benefits was initiated by 5 federations, of which only one, again the Kadamalai federation, continued to offer it, the others having first transferred to the nationalized companies before withdrawing the product altogether because of the higher percentage of claims and a higher rejection rate by the companies. "The Kadamalai federation is able to manage successfully due to its well designed scheme and exclusions followed by close monitoring and community health support through local village health workers and its own hospital" (DHAN Foundation 2004).

Special regulations for mutual schemes for the poor?

SEWA has argued that the regulations need to be amended to differentiate between commercial organizations that cater to the well-to-do on the one hand, and mutual organizations such as cooperatives that specialize in catering to the poor on the other hand, as is the case in some other countries. It feels on the basis of its actuarial experience, claims ratios, benefits package and business plans that Rs 35 crore would be an adequate initial entry capital requirement to meet all possible contingencies and prudential concerns, rather than the Rs 100 crore prescribed for all types of institutions at present.

SEWA has argued that the regulations need to be amended to differentiate between commercial organizations that cater to the well-to-do on the one hand, and mutual organizations such as cooperatives that specialize in catering to the poor on the other hand

The role of government

Another issue is the role of the government in the microinsurance sector, apart of course, from regulation. A National Seminar sponsored by IRDA, SEWA and FWWB in 2003 recommended that the government and IRDA should assist microinsurance organizations to obtain access to investment funds rather than give them subsidies (SEWA and FWWB 2003). Even if lower capital requirements are laid down for microinsurance organizations, or even for mutual microinsurance organizations, there will be need for equity investments in them from both the private and public sectors.

The main subsidy in the insurance sector is the contribution made to the Social Security Fund administered by the LIC, which enables it to pay half of the Rs 200 premium for the flagship product for the poor, the JSBY, which covers natural and accidental death and disability, and an education grant for children in the 9th to 12th standards.[28] Presumably the recommendation above implicitly excludes subsidies such as these which make insurance much more widely affordable. The Seminar also recommended that government assist with capacity building of microinsurance entities, product development and R&D, technical assistance (e.g. for actuarial services), risk funds and re-insurance. Assistance should be provided through a one-window mechanism.

It has been proposed that one way of rendering it would be through a separate authority to be constituted to regulate microinsurance schemes, with representation of sector representatives including NGOs, CBOs (including the SHG movement) trade unions, cooperatives etc. Such an authority would be better informed and more sensitive to the needs of the microinsurance sector, while ensuring higher transparency and accountability in in-house schemes. Subsidies to the sector should be routed, it has been suggested, through this authority to the approved schemes of CBOs and NGOs since it would be in a better position to judge the appropriateness of products to the needs of the poor (George (Forthcoming)).

Some lessons learnt from experience so far

Clearer communication about the terms and conditions of the insurance they have bought, speedy clearance of claims, and introducing products that carry maturity benefits would all serve to increase the proportion of members who avail of insurance

While a growing number of MFIs are offering microinsurance, an important issue is the extent to which the products offered are meeting client needs preferences. It takes time for many MFI members to get used to the idea of paying an annual insurance premium and getting back nothing in return, although with time, as claims are made and paid out, many of them do become convinced and willing to join the scheme. MFIs on the other hand have an obvious immediate interest in protecting their loans, as well building up economies of scale by expanding outreach as soon as possible, and many of them make insurance compulsory, at least initially. EDA (2005) discusses the balancing act that MFIs have to face between what is practical and sustainable for them as service providers with what is responsive to members' needs. It points out that clearer communication about the terms and conditions of the insurance they have bought,[30] speedy clearance of claims, and introducing products that carry maturity benefits would all serve to increase the proportion of members who avail of insurance.

Examples of products with such maturity benefits are return of life insurance premium if policy holder survives[31], or of sum insured[32] or payments of periodic lumps sums, or of pension. One of the best known pension products was LIC's Krishi Shramik Samajik Suraksha Yojna under which a premium of Rs 365 per annum or Rs 1 a day paid for life and disability insurance as well as lump sum survival or pension benefits after the age of 60.[33]

A summary of the valuable lessons to be gleaned from the experience of three MFIs, ASA, SHEPHERD, Spandana, who have offered insurance for some years is contained in Box 5.3.

Box 5.1 Issues in Livestock Insurance: SHEPHERD's Experience

For some time SHEPHERD had been running a livestock insurance scheme with UIIC. Unlike ASA's livestock insurance, which is compulsory for its milch animal loans, SHEPHERD's coverage is voluntary and some members even continue their coverage after they have repaid their loan. In roughly half of the cases of persons taking out a loan for livestock, they also buy in to the insurance. According to field staff, some of the reasons why clients choose not subscribe to the insurance scheme include:

- **Cost:** The premium is a one time payment of 4% of the animal's initial value (as determined by a veterinarian and also serves as the sum assured), which typically amounts to Rs 400 ($9);
- **Money down the drain:** If the animal does not die, it is much harder to justify "losing" the large premium than the smaller ones for life and health insurance;
- **Term:** The current policy is for one-year of coverage, but some members want the flexibility to sell the animal during the course of the year;
- **Extra formalities:** The availability of the vet to prepare the paperwork and assess the health and value of the animal is an additional complication that may also deter potential policyholders; and

Box 5.1 Continued

- **Claims problems:** The claims process also discourages demand, again, because the vet is not immediately available–people do not like keeping dead animals around their houses.

As shown in Table 5.1, SHEPHERD has experienced a sharp drop in livestock insurance. According to field staff, fewer people are buying cows due to the drought.

Table 6. SHEPHERD Cattle Insurance

Product Feature	Comment
Group or individual product	Group
Term	1 Year
Eligibility requirements	Veterinarian certificate of health, immunization and valuation
Delivery model	Partner-agent with UIIC
Voluntary or compulsory	Voluntary
Product coverage (benefits)	Value of animal as determined by a vet (usually around Rs 10,000 ($222)) upon natural or accidental death
Key exclusions	Intentional death caused by owner
Pricing	Member pays 4 percent of the animal's value; 2.25 percent goes to the insurance partner
Number of policyholders	350 in 2001 302 in 2002 85 in 2003 134 in 2004

SHEPHERD runs cattle care camps, funded through a surcharge on each insurance policy, to promote the proper maintenance of animals and to provide free immunization and de-worming. These camps are for the general public, not just members, and they are not just for cows either–all animals are welcome. Besides preventing claims, the camps also serve as a recruitment or marketing vehicles. The veterinarian suggests to people that they should insure their animals, particularly those that are yielding a lot of milk.

To control for adverse selection, the vet must assess the health of the animal before the ear is tagged, which shows that the animal is insured. All of the policies are for one-year terms, which help to control for moral hazard, so it is unlikely that the animal's market value will drop significantly below the sum assured during that period. Moral hazard is also controlled by having the vet determine the cause of death to ensure that it was not due to neglect or abuse…."

Excerpted from Roth et al 2005

Box 5.2 VimoSEWA: Synergies between health insurance, health care, and health education

The health service provided by SEWA to members is a particularly important resource for VimoSEWA's health insurance. SEWA Health has worked to improve the skills of midwives and health workers, which has had a direct impact on reducing maternal and infant mortality. In some districts, a pharmacy service provides low-cost, generic drugs to members. Attempting health insurance without knowledge of diseases, health facilities and risk mitigation strategies will likely doom a scheme to failure. VimoSEWA has benefited from the experience of SEWA Health by better detecting fraud by members and providers, directing members away from inappropriate and expensive treatments, and by providing health promotion activities and information to insured members.

Excerpted from Garand 2005

Box 5.3 Lessons from the insurance experience of ASA, Spandana and SHEPHERD

Lessons: Mission, Vision and Outcomes

- MFIs cannot provide all services; and clients cannot afford to buy numerous insurance products. The challenge for the MFI and its clients is to figure out the most cost-effective solutions to their clients' primary problems.
- These cases demonstrate that the MFIs' mission and vision significantly influenced which products were selected and how they chose to sell and service them.
- There appears to be a trade-off between reaching many people with a simple (mandatory) product and reaching fewer people with more complex, varied, and voluntary insurance.
- MFIs should examine who is likely to receive a life insurance benefit. By ensuring that children, especially girls, can receive the benefit, the product could be more attractive to women.
- For women to really benefit from life insurance, the coverage should be on the lives of their husbands. As the cases will show, however, this is easier said than done because of adverse selection problems that can emerge when coverage was extended to husbands without screening or age restrictions.
- While an MFI might undertake prevention strategies to fulfill its social mission, these interventions could have the additional advantage of reducing claims.
- It makes sense for MFIs to start with a simple life policy to learn about insurance. However, once MFIs know how to manage insurance risks, then it makes sense for them to move on and provide coverage that better meets clients' needs.

Lessons: Delivery Mechanisms

- There are many problems with the partner-agent model, but they can be fixed.
- In India, where insurers are legally compelled to sell insurance to low-income clients, it is difficult to see the advantages of an MFI selling insurance in-house.

Box 5.3 Continued

- MFIs do not have to be wedded to one insurance partner forever. If the insurer is not performing, the MFI can get a new partner. Yet if an MFI changes insurance partners too frequently, it can cause confusion among clients and staff.
- The alternative to changing partners is to get existing partners to improve. SHEPHERD has adopted this approach by inviting insurers to the field so they better understand the target market and begin to recognize the difference between insurance and microinsurance.
- To get good products and processes from insurers at a decent price, MFIs need to know what they want and they have to take the driver's seat in the negotiations. The larger they are, the more demanding they can be.
- An efficient claims processing system is one of the most important points for negotiation. MFIs should insist that they pay the claims, and then be reimbursed from the insurer, based on documentation that is appropriate for their clients.
- A review committee, with representatives from the MFI, insurer and clients, could be a way of improving claims processes.
- MFIs should also persuade insurers to drop as many exclusions as possible, even if they have to pay a higher price.

Lessons: Product Design

- Efficiency depends less on the delivery model than on the simplicity of the product or product menu.
- Simple products work best because they are easier to administer and easier for clients to understand. Adding riders is fraught with difficulties. Even small riders may have large consequences.
- The link between insurance and a loan can improve efficiencies, but it also has significant limitations. Of the three, only SHEPHERD has concluded that insurance should not be linked to microcredit since risks can happen when people do not have a loan.
- The target market is heterogeneous, so it is wise to offer a couple of different product options as long as they do not overly complicate the marketing message.
- MFIs should only include benefits that clients can claim without difficulty.
- If MFIs sell microinsurance to non-members, the organizations (or their insurance partners) are vulnerable to adverse selection risks. To control this risk, insurance should only be offered to persons who have joined a group for purposes other than accessing insurance.
- Without actuarial calculations, premiums are likely to be set too high–which means that clients are getting poor value for money–or too low, which can place the entire scheme in jeopardy.
- MFIs need to conduct a costing analysis to determine how much they need to earn in commission to cover their administrative expenses.
- MFIs cannot afford to lose money on an in-house insurance scheme, so they have to price conservatively and hence overcharge their customers.

Excerpted from Roth et al 2005

Table 5.1 Main Feature of Health Micro-Insurance Schemes

NO	Designation	Start. Year	Initiator	State	Area of Int.	Sch. Type	Sch.	Risks covered	Total Ben.	Memb. Type
1	Anisha Microfin Association	2002	MFI	Tamil Nadu	Rural	Partn-Agent	S. I	Health Care	3,744	Voluntary
2	Kagad Kach Patra Kashtkari Panchayat	1998	TU	Maharashtra	Urban	Partn-Agent	S. I	Health Care	4,210	Voluntary
3	Gandhi Samaraka Grama Seva Kendrum	2002	NGO	Kerala	Rural	In-House	S. I	Health Care	3,567	Voluntary
4	Raigarh Ambikapur Health Association (RAHA)	1980	HP	Chattisgarh	Rural	In-House	S. I	Health Care, Maternity Prot.	58,334	Voluntary
5	Mayapur Trust/Sri Mayapur Vikas Sangha	2003	NGO	West Bengal	Rural	Partn-Agent	S. I	Health Care	1,022	Vol/Comp.
6	Kasturba Hospital	1978	HP	Maharashtra	Rural	In-House	S. I	Health Care, Maternity Prot.	14,390	Voluntary
7	Voluntary Health Services (VHS)	1961	HP	Tamil Nadu	Riral/Urban	In-House	S. I	Health Care, Maternity Prot.	124,715	Voluntary
8	Mathadi Hospital Trust	1982	CBO	Maharashtra	Urban	In-House	S. I	Health Care	110,000	Compulsory
9	Students Health Home (SHH)	1952	GOV	West Bengal	Rural/Urban	In-House	S. I	Health Care	1,587,890	Voluntary
10	Health Programme of Aga Khan Health Services	1995	CBO	Gujarat Gujarat	Rural Rural	In-House In-House	S. I S. II	Health Care, Maternity Prot. Health Care, Maternity Prot.	5,635 9,185	Vol/Comp. Vol/Comp.
11	Mallur Health Cooperative	1973	CBO	Karnataka	Rural	In-House	S. I	Health Care, Maternity Prot.	20,000	Voluntary
12	Goalpara	1994	NGO	West Bengal	Rural	In-House	S. I	Health Care	1,247	Voluntary
13	Seba Cooperative Health Society	-	HP	West Bengal	Urban	In-House	S. I	Health Care	800	Voluntary
14	Self-Employed Women's Association (SEWA)	1992	NGO	Gujarat	Rural/Urban	Partn-Agent	S. I	Health Care, Life, Accidental Death, Assets, Maternity Prot	164,346	Voluntary
				Gujarat	Rural/Urban	Partn-Agent	S. II	Health Care, Life, Accidental Death, Assets, Maternity Prot	9,658	Voluntary
15	Nidan	2000	NGO	Bihar	Rural/Urban	Partn-Agent	S. I	Health Care, Life, Disability, Housing, Assets	10,203	Voluntary
16	League for Education and Development (LEAD)	2000	NGO	Tamil Nadu	Rural	Partn-Agent	S. I	Health Care, Life	4,320	Vol/Comp.
17	Association for Sarwa Sewa Farmers (ASSEFA)	-	NGO	Tamil Nadu	Rural/Urban	Partn-Agent	S. I	Health Care	20,000	Voluntary
18	Working Women's Forum (WWF)	1983	NGO	Tamil Nadu, Andhra Pradesh, Karnataka	Rural/Urban	Partn-Agent	S. I	Health Care	3,649	Voluntary
19	Society for the Provision of Area Resources (SPARC)	1997	NGO	Maharashtra	Urban	Partn-Agent	S. I	Health Care, Accidental Death, Disability, Assets	2,000	Voluntary
20	Organization for the Development of People (ODP)	1993	NGO	Karnataka	Rural	Partn-Agent	S. I	Health Care, Life, Disability	1,137	Voluntary
21	Activists for Social Alternatives (ASA)	2003	MFI	Tamil Nadu	Rural/Urban	Partn-Agent	S. I	Health Care	217	Voluntary
22	Development of Humane Action Foundation (DHAN)	1997	CBO	Tamil Nadu	Rural/Urban	In-house	S. I	Health Care, Maternity Prot.	13,685	Voluntary
23	Self-Help Promotion for Health and Rural Development (SHEPERD)	1999	MFI	Tamil Nadu	Rural	Partn-Agent	S. I	Health Care	8,540	Voluntary
24	Action for Community Organization, Development and Rehabilitation (ACCORD)	1990	NGO	Tamil Nadu	Rural	Partn-Agent	S. I	Health Care, Life, Disability, Housing, Assets	12,500	Voluntary

Table 5.1 Continued

NO	Designation	Start. Year	Initiator	State	Area of Int.	Sch. Type	Sch.	Risks covered	Total Ben.	Memb. Type
25	People's Rural Education Movement (PREM)	2003	NGO	Orissa	Rural	In-House	S. I	Health Care	108,000	Voluntary
26	Casp Plan International	2003	MFI	Maharashtra	Rural	In-House	S. I	Health Care	25,000	Compulsory
27	Yeshasvini Trust	2002	HP	Karnataka	Rural	In-House	S. I	Health Care	1,473,576	Voluntary
28	Karuna Trust	2002	NGO	Karnataka	Rural/Urban	Partn-Agent	S. I	Health Care, Loss of Income	118,808	Voluntary
29	Arthik Samatha Mandal (ASM)	2003	NGO	Andhra Pradesh	Rural	In-House	S. I	Health Care	31,627	Voluntary
30	Emmanuel Hospital Association (EHA)	2004	HP	Uttaranchal	Rural	Partn-Agent	S. I	Health Care, Accidental Death, Disability, Daughter's Marriage	600	Voluntary
31	Self Help Association for Development and Empowerment (SHADE)	1993	NGO	Kerala	Rural/Urban	Partn-Agent	S. I	Health Care	75	Voluntary
				Kerala	Rural/Urban	Partn-Agent	S. II	Health Care	4,200	Voluntary
				Kerala	Rural/Urban	Partn-Agent	S. III	Health Care	6,665	Voluntary
				Kerala	Rural/Urban	Partn-Agent	S. IV	Health Care	4,325	Voluntary
32	Indian Association for Savings and Credit (IASC)	2002	MFI	Tamil Nadu,	Rural/Urban	Partn-Agent	S. I	Health Care	12,911	Voluntary
				Kerala	Rural/Urban	Partn-Agent	S. II	Health Care	1,200	Voluntary
33	Family Plan Health Limited (FHPL)	2003	TPA	Andhra Pradesh	Rural/Urban	In-House	S. I	Health Care	350,000	Voluntary
				J&Kashmir	Urban	In-House	S. II	Health Care	200,000	Voluntary
34	Healing Fields Foundation (HFF)	2004	NGO	Andhra Pradesh	Rural/Urban	Partn-Agent	S. I	Health Care, Accidental Death, Disability	15,900	Voluntary
35	New Life	1995	NGO	Tamil Nadu	Rural/Urban	Partn-Agent	S. I	Health Care, Accidental Death, Disability	17,860	Vol/Comp.
36	Sri Kshestra Dharamsthala Rural Development Project	2004	NGO	Karnataka	Rural	Partn-Agent	S. I	Health Care	186,000	Voluntary
37	Arogya Raksha Yojana Trust	2004	NGO	Karnataka	Rural/Urban	Partn-Agent	S. I	Health Care	56,411	Voluntary
38	Youth for Action (YFA)	2004	NGO	Andhra Pradesh	Rural	Partn-Agent	S. I	Health Care, Accidental Death, Disability	2,715	Compulsory
39	Uplift Mutual Fund	2004	NGO	Maharashtra	RuralUrban	In-House	S. I	Health Care	16,062	Voluntary
40	Manipal Health System	2005	HP	Karnataka	Rural/Urban	Partn-Agent	S. I	Health Care	62,500	Voluntary
41	MD India Healthcare Services	2003	TPA	Madhya Pradesh	Urban	Part-Agent	S. I	Health Care	49,419	Voluntary
42	Naandi Foundation	2004	NGO	Andhra Pradesh	Urban	In-House	S. I	Health Care	49,000	Voluntary
43	Halo Medical Foundation	2004	NGO	Maharashtra	Rural	Partn-Agent	S. I	Health Care	3,424	Voluntary
44	BAIF	2002	NGO	Maharashtra	Rural	In-House	S. I	Health Care	1,500	Voluntary
45	Praghati Grameen Bank Chitr.	2004	MFI	Karnataka	Rural	Partn-Agent	S. I	Health Care	11,320	Voluntary
46	Seva Mandir	2004	NGO	Rajasthan	Rural	In-House	S. I	Health Care	401	Voluntary
47	CYSD	2005	NGO	Orissa	Rural	In-House	S. I	Health Care	15,468	Compulsory
48	Samskar - Plan International (India) Nizamabad Project	2005	NGO	Andhra Pradesh	Rural	In-House	S. I	Health Care	5,303	Voluntary
49	Myrada	2005	NGO	Karnataka	Rural	In-House	S. I	Health Care	3,831	Voluntary
50	Bihar Federation of Milk Cooperatives	2004	CBO	Bihar	Rural	Partn-Agent	S. I	Health care, Accidental death, Disability	55,000	Voluntary

Source: Reproduced from ILO (206) courtesy, ILO/STEP, New Delhi

Endnotes

1 *While the microinsurance sector was until recently relatively undocumented, CGAP's "Good and Bad Practices in Microinsurance" project has produced several useful case studies, including one on VimoSEWA (Garand (2005)), another on ASA, SHEPHERD and SPANDANA (Roth et al (2005)) some lessons from which are contained in Box 5.3, and a third on an insurer, Tata-AIG (Roth and Athreye 2005). A good book on SEWA is ILO 2001. See also the ILO reports discussed below.*

2 *See Kanitakar (2005) for an excellent case study of lessons to be learnt out of Chitradurga Grameen Bank's experiences with two insurance schemes for their SHGs, and why one was more popular than the other. However, neither scheme enabled the bank or the Community Managed Resource Centre promoted by MYRADA supporting the SHGs under one of the schemes to recover its costs from processing fees (commission).*

3 *However it is not uncommon, and a variety of insurance products exist for SHG members.*

4 *See ILO 2001. Following the ILO, the term social protection is understood to include not only social security schemes (defined as public measures to provide against various contingencies such as sickness, maternity, old age and death of the breadwinner, as well as health care and benefits for families with children) but also private schemes, formal and informal. Social security includes social insurance, i.e. contributory schemes, social assistance, defined as tax-financed benefits provided only to those with low incomes, and universal benefits provided without reference to income or means testing. If the proposed Social Security for Organized Workers Bill, 2006, is enacted, coverage will be universal with (i) health insurance for self, spouse and children, covering hospitalization expenses up to Rs 15,000, and sickness and maternity benefits, (ii) life insurance covering natural and accidental death, and (iii) old age pensions for BPL workers above the age of 60, and provident fund cum unemployment insurance benefits to all other workers. The premium of Rs 3 a day will be shared between workers, employers and central and state governments (with the state paying the share of BPL persons).*

5 *Although the bulk of coverage under social security schemes is of employees in the organized sector (through the ESI, EPF etc) about 40 million informal sector workers are estimated to be covered under social assistance schemes such as the National Social Assistance Programme (started in 1995 to provide old age pensions to BPL persons over 65, and maternity and survivor benefits) and various subsidized group insurance schemes for different occupational groups run by the LIC and GIC.*

6 *Including trade unions, charitable hospitals, NGOs and CBOs.*

7 *The regulations are due to be revised shortly and there is talk of these obligations going up to 25 and 8 percent respectively. For the social sector, for both life and non-life insurers, a schedule was laid down according to which they had to cover up to 20,000 persons within five years. This is a meaninglessly low number since the "social sector" is defined to include the overlapping categories of unorganized sector, informal sector (including agricultural labour) and economically vulnerable or backward classes, which between them constitute a large part of the rural population, which is already covered under the rural sector targets.*

8 *In the public sector while life insurance remained the monopoly of the LIC, the four subsidiaries of the public non-life company, the GIC, were de-linked from the parent company as independent companies, with reinsurance remaining the responsibility of the GIC. In addition a new Agricultural Insurance Company of India was set up. In the private sector 12 life and 8 non-life insurers entered the field and started offering a variety of new products.*

9 *Of the 42 life products, 24 were addressed to individuals, and the rest to groups or to both. 23 were pure risk products, the other 19 offering various types of maturity benefits which in some cases could be combined with regular withdrawal arrangements in accordance with savings plans. There were only 14 health insurance products, mostly restricted to groups, and most of which excluded deliveries and pregnancy-related illnesses, but 9 of them included hospitalization. The inventory is currently being updated.*

10 *Life and health insurance were offered by 61 percent and 57 percent of the organizations respectively, followed by insurance against disability (25 percent) loss of assets (25 percent) loss of livestock (20 percent) accidental death (10 percent) and loss of amounts borrowed as loans (10 percent). 48 percent of the organizations offered insurance against a single specific risk, and the rest offered packages providing protection against multiple risks (22 percent more than three specific risks, 16 percent 3 risks, and 17 percent two risks). Most of organizations offered schemes with voluntary contributions, the rest made them compulsory or a combination of the two (differentiating for instance between the member and her spouse). While most of the partnerships were with private companies, 15 involved more than one company, and 7 of them with both public and private companies.*

11 *23 schemes had either a rural-urban or entirely urban coverage. 11 schemes offered multi-risk health care products, and with a few exceptions all were voluntary.*

12 *FWWB has initiated talks with the Agriculture Insurance Corporation of India to underwrite a weather insurance product for 5 of its partner organizations in Vidharba, based on a field survey of their requirements by Cardinal Edge Management Services.*

13 *The tendency for high risk individuals to enroll in insurance plans covering the particular risks (only) they know they face (the latter being an example of "asymmetrical information", another term originating in the insurance industry, but now widely used in economics, especially in connection with credit programmes)*

14 *Dishonest behaviour that increases the risk to the insurer.*

15 *Through IRDAs recent microinsurance regulations of Novermber 2005. The way these institutions have been defined shows some lack familiarity with them and will no doubt be revised (thus not many SHGs have documented "memoranda of association, rules, bye-laws or regulations", although of course their federations usually do).*

16 A little less than a fifth of the 1.78 lakh members of VimoSEWAs integrated insurance scheme in January 2006 paid through this method. Renewal rates are almost 100 percent for FD members as against only 41 percent in 2005 for annual payment members, resulting in an average renewal rate of 59 percent overall. Raising this rate is one of the crucial challenges facing membership growth and eventual viability. As against these advantages of the FD method, one of the disadvantages is that it is hard to persuade members to increase the FD amount when the premium has to be increased or interest rates go down. Also, BPL members find it hard to amass the requisite amount. In order to enable them to do so an interest free from SEWA Bank was introduced in 2004 with funding from a Canadian donor.

17 It may do so either through loan insurance under which the beneficiary gets back only the loan amount less the unpaid balance, or through regular life insurance in which the beneficiary is persuaded to repay the balance to the MFI.

18 Maximum commissions laid down by IRDA are 20 percent for life insurance and 12 percent for non-life.

19 There are not many analyses of the financial results of microinsurance schemes in India yet. One of the most best is contained in Garand's study of SEWA (Garand 2005). ILO 2005(2) contains information for some organizations on premia income and claims expenses. Roth et al 2005, a case study of lessons to be learnt from the experiences so far of ASA, SHEPHERD and Spandana, contains an income statement for Spandana which shows it was making a profit on its in-house life insurance scheme (see also endnote 16, Chapter 4). ASA's surplus as an agent was modest, although one of the three companies providing life insurance to ASA's clients, Bajaj Allianz, was to its credit forthcoming enough on its financial results to show that it was making a profit over and above the expected profit assumption (of 15.5 percent). Generally however private insurers indicate that they just aim to break even with their rural and social policies. Achieving viability is likely to be particularly difficult in in-house micro health insurance schemes. SEWA will have to double the premium it currently charges and for enrollment to increase to about 5 lakh to become viable in about 6 more years (Conversation with Mirai Chatterjee). In the May 2006 report of the National Commission on the Unorganized Sector a claims ratio of no more than 70 percent is assumed to cover expenses for health and maternity cover proposed in the social security bill (see endnote 4) and there is discussion of the possibility of the state paying for the excess and the insurance companies offering a discount for shortfalls below this ratio.

20 As DHAN Foundation 2004 puts in relation to the self managed Kadamalai federation (see also endnote 23) "Over the years the capacities of the leaders and staff, who are part of the insurance management committees has been enhanced in the process of learning by doing. They are involved in verifying claims, making recommendations and disbursal of claims etc. This has led to the adding of credibility to the decisions taken regarding the admissibility of claims. Even when claims are rejected by the committee, they have been taken in the proper perspective by the other members, which would not be the case had the programme been managed by outsiders". (Dhan Foundation 2004)

21 In 2003, 75 percent of the insurance extended by or through FWWB partners was extended under in-house schemes and only 25 percent through insurance companies. (Presentation at National Workshop on Microinsurance for the Poor, September 2003). Under its social security scheme sponsored by GTZ, FWWB had by February 2006 extended life insurance to 0.51 million women members and 0.58 million spouses in 9 partner organizations by assisting in negotiations with the insurance companies and providing initial operational support. 3 of these organizations also offered health insurance to 0.37 million members, as well as pension and crop insurance

22 The same rationale applies to in-house schemes for cattle insurance, or for crop insurance by farmers' cooperatives.

23 In order to monitor the quality of treatment, standardize expenses and verify the genuineness of claims the Kadamalai federation promoted by DHAN Foundation has entered into a tie up with the local hospital under which Kalanjiam members get admitted without payment of an advance and receive a 20 percent discount. Later, a pool of six larger hospitals were identified to which members could be referred by the partner hospital, and the federation also built a hospital annex in their own building to cater to minor treatments. Premia are shared between members and their Kalanjiam group funds in proportions depending on the age of the group. (DHAN Foundation 2004). VimoSEWA is experimenting with a cashless service under which it screens public, charitable trust and private hospitals for quality of service and fee structure, and signs MOUs which include understanding on rational treatments and medicines for various deseases according to globally accepted protocols. VimoSEWA' front line staff or "aagewans"function as a team of "grass roots third party administrators". They are responsible for enrolling members, collecting premiums and submitting claims. They are equipped with mobile phones and rush to a hospital when a member gets admitted, and make 80 percent of the payment on the spot. (Conversation with Mirai Chatterjee).

24 This offers insurance against natural and accidental death of Rs 20,000 each as an agent to two private insurance companies Allianz Bajaj and AMP Sanmar, and cattle insurance as an agent of UIIC. Like many other MFIs it also runs an in-house emergency fund available to members unable to repay their loans on time due to external factors, which is funded out of deductions of 1 percent of the loan amount. However this is an emergency fund, not an insurance scheme. See Roth et al 2005 and the documentation study on ASA brought out by FWWB as part of a series of case studies on several partners (FWWB undated).

25 VimoSEWA's scheme is now almost entirely under the partner-agent model. The only risks it assumes are (i) for claims it has already paid through an imprest account, but which are later rejected by its partner companies (AVIVA Life for life and ICICI-Lombard for non-life) as being non-contractual. (The imprest account was set up through an arrangement with the insurers as a device to expedite the settlement of claims) and (ii) for the extra benefits provided to members paying through fixed deposits (relating to maternity, dentures and hearing aids). The problem of devising an appropriate package was made even more challenging in having to negotiate separately with two or more insurance companies, who were each allowed to offer only life or non-life products. This difficulty has been removed by IRDA's November 2005 regulation, which allows tie-ups between life and non-life insurers.

26 It also affected the renewal rate on account of dissatisfaction with delays in dealing with the claims because of the increase in the workload.

27 IRDA's latest regulations of November 2005 strongly encourage the partner-agent model, in preference to the in-house model which is left unregulated.

28 The scheme is open to workers in approved vocation/occupations organized in groups of at least 25 persons between the age of 18 and 60. The insured amounts are Rs 20,000 for natural death, Rs 50,000 for death or total permanent disability resulting from an accident, and an educational grant of Rs 100 a month for a maximum of 2 children for 3 years. Commencing with the budget of 2003-04 the government also subsidizes health insurance through the four public sector general insurance companies, but the claims ratio so far has been extremely low, with only 34,000 families reached by January 2005.

29 *The rationale for transfer programmes (subsidies) in social security is well recognized and indeed may be the only way of reaching the lowest one or two deciles of the income distribution, although more through social assistance programmes than social insurance. A high proportion of the poorest of the poor are too old, ill or infirm to benefit from microcredit which can assist only the economically active poor.*

30 *Several sources point out that members are often not clear about their entitlements, or receive documentation about it. Many so called "life" insurance schemes instead of offering beneficiaries a fixed sum in the event of death, pay out an amount equal to the loan received with the unpaid balance being deducted.*

31 *For example Tata AIG's Karuna Yojana life (natural and accidental death) insurance scheme especially designed for SHGs, with monthly payment of premium or Rs 25, and with provision for total premium paid along with 25 percent interest to be returned after expiry of the term of 15 years.*

32 *Such as ICICI Prudential's Salam Zindagi and Mitra policies.*

33 *ILO 2005 (2) reports that in the latest version of the scheme some of the DHAN Foundation federations participate in there is a also a contribution of 200 percent (Rs 730 per year) by the government towards the premium, and that a money back scheme has been incorporated into the product under which lump sum amounts are paid back to the policy holder every ten years. However, it is learnt that the scheme has since been withdrawn. The pension benefit was not strictly a pension since it was lacking an intergenerational component, but really a provident fund.*

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B. Money Transfer Services

If microinsurance is a young albeit rapidly growing microfinancial service in India, domestic money transfer services are still in their infancy, in India as elsewhere. However they would appear to have tremendous scope. The focus of the growing attention on money transfer services as a potential opportunity for MFIs has been on cross-border remittances.[1] However, in many large countries the number of domestic migrants far outnumbers those who migrate abroad.[2] In India, huge flows of migrants criss-cross the country in search of a better life for themselves and their families, who mostly stay behind in their villages. Internal labour migration has a long history in India, and is probably increasing with differential rates of growth in different states and pockets within states. Except for short distance or short term migrants, migrants need a fast, low cost, convenient, safe, and widely accessible money transfer service to send their earnings back to their families and dependents for vital consumption needs, including lean season support and sudden medical emergencies, as well as for important investment requirements.

At present options available to a poor migrant are limited. The postal money order charge of 5 percent means parting with a full day's wages about once a month to send one's meagre savings home. This is unacceptable in this day of modern electronic communications. A second option is bank drafts, which are cheaper, but most recipients do not have access to the banks to encash drafts easily. A third option is sending money in cash through returning friends and relatives, but this means waiting till someone who can be trusted enough is returning home, and even then there is the risk of theft. The fourth option is through informal money transmitters, who are fast, and provide good service in those urban areas in which there is enough competition between them, as in Surat (see Box 5.4)

One requirement for an MFI to meet the need for a money transfer or remittance service is a critical minimum number of migrants in the place of destination from a particular place of origin, which will almost invariably be a rural area. At least a dozen larger cities in India are likely to meet this condition, each of them for several groups of migrants from different parts of the country. Like Adhikar, described in Box 5.4, an MFI from the originating area can establish a base in the city or area of migration destination, or it can tie up with an existing MFI or bank or money transfer company there. The same arrangements are possible in reverse.[3]

The second requirement for an MFI to provide money transfer services viably is that it should be willing to charge a cost-recovering service charge The service charge is likely to be higher than that charged by the banks which enjoy greater economies of scale and scope. However, until the banks become a real alternative to most remitters there is appears to be enough headroom for MFIs to charge a service fee that achieves viability.[4]

Issues and priorities for action research

A major issue is how competitive MFIs are with informal private operators in large centres like Surat. There are very few reported cases of fraud against informal operators who depend on reputation to maximize business and profits. Moreover in Surat, their service is superior for the same cost, in the case of remittances in a certain size bracket, although the charge is slightly higher for the slightly smaller, average-sized remittance. On the other hand, Surat may be exceptional in the degree of competition that prevails between operators. Second, Adhikar has the potential advantage that it offers loans to members, both in Gujarat and in Orissa, as well as insurance.[5] Thus it enjoys the advantage of economies of scope over informal competitors. It is in the process of expanding operations in Orissa to new blocks, and also to neighbouring Ganjam district, and has plans to recruit more agents in Surat.

A second issue has to do with the scope for MFIs to enter remittances as an area of operations in the country at large. There is a need to identify major inter-state migration corridors in the country so as to identify other large concentrations of migrants from particular originating areas.[6] Although there are not many MFIs that have a presence in both originating and destination areas like Adhikar, there is scope, as noted above, for tie ups between MFIs in different sets of origin-destination pairs, or between MFIs and banks in either the originating and destination areas. Approval for such tie-ups between banks and MFIs already exists in the Business Correspondent model (see Chapter 7A) and there is a need to study what has kept the banks out of them so far.[7] With the several new and potentially large urban MFIs being set up, the scope for such tie-ups should increase further.

Second, many of the larger MFIs are now establishing multi-state operations.[8] Third, there is substantial migration within states, and large state-wide MFIs might become interested in providing a remittance service to borrowers in different locations. In Assam for instance, RGVN (see Chapter 8A), is planning to introduce remittances as a service to its approximately 35,000 Credit and Savings Programme members spread over 10 districts of the state. Remittances will be delvered initially only to other members, either using email or telephone, for a proposed fee of 1.5 percent. Delivery is expected to be completed within 24 hours.

The third issue is that of *regulation*. In the case of lending it is the MFI that incurs the risk, whereas in the case of remittances, as with savings, the risk is incurred by the client. However, as with MFI savings, the client is usually not only also a borrower, but one whose outstanding loan often exceeds the remittance amount. Thus he is a net borrower. This greatly reduces the prudential concern. In Adhikar's case remitters are often borrowers at both ends (through their dependent families at the destination end). In order to encourage ease of entry and competition among international money transfer operators (MTOs) so as to lower the cost of remittances (which have been found to be price elastic, and which amount to more than the value of development assistance received by developing countries) the UK regulators make a clear distinction between remittances and savings by excluding the former from the definition of the latter as long as they are not held for less than 3 days. (World Bank 2006). Also, UK regulations do not lay down any net worth requirements for MTOs. These should be examined by the framers of the proposed Microfinance Act.

Migrants have a vast range of problems, including lack of employment and physical insecurity, separation from families and children, lack of housing and sanitation and educational opportunities in the home language. Given the existence of the money order system, expensive though it is, and informal channels, remittances are not likely to be the most important of their needs. But they do provide an entry point for new MFIs, and an opportunity to existing MFIs, to broaden their portfolio of services, and to do so profitably, in the process increasing access, decreasing the cost of remittances considerably in relation to Money Orders (MOs), and removing the sense of uncertainty migrants experience about whether remittances have reached their destination.

Box 5.4 Serving migrants through remittance services: The case of Adhikar

Adhikar, a Bhubaneshwar-based MFI registered as a cooperative, extended operations to Gandhidham, in Gujarat, in 2003, to serve the approximately 10,000 Oriya migrants working in nearby Kandla port, hosiery units in an SEZ, and local plywood and salt-making units, with a remittance and other financial services. In early 2005 it opened another branch office in Surat, which has a much larger Oriya population from Adhikar's three districts in Orissa, estimated to number about 70,000. Membership of Adhikar has grown much faster in Surat, to 913 in June 2006, as compared to only 220 members in Gandhidham at the same age.

There are estimated to be over 5 lakhs Oriyas working in Surat, the largest single number from Ganjam district, followed by those from Adhikar's three-district area. Most of them are workers in the powerloom factories, and average earnings may be a little higher than in Gandhidham, as is the average size of remittance (about Rs 3,500). The total volume of monthly remittances from Surat to Orissa by all channels is estimated variously at Rs 10 to 50 crore.

A large part of this is handled by informal money transfer operators of which there are estimated to be 30 to 40, and of which the largest 5 are reported to have monthly remittances above Rs 1 crore, and the next 15 above Rs 50 lakh. They charge 4 percent for amounts below Rs 5,000, 3 percent for the next slab up to Rs 20,000 and 2 percent above that. They remit instructions to a partner by fax, who makes payments at the doorstep out of funds with him in Orissa, faxing back the signed receipt along with signatures of witnesses, reportedly within 24 hours.[9]

Adhikar's service fees for remittances are 3 percent for amounts up to Rs 10,000 and 2.5 percent thereafter. Thus for remittances of between Rs 5,000 to Rs 10,000 the service fee is the same for both channels. However for the mean remittance size in Surat of about Rs 3,500, Adhikar's service fee is one percentage point cheaper. As against this, the service is available only thrice a week, and it usually takes at least 1 day more than the private operators. Also, receipts signed by the remittee are sent back by the partners by mail.

According to Adhikar, about 60 percent of total costs are incurred on account of collections and 40 percent on distribution. To reduce collection costs Adhikar has appointed 4 collection agents in Surat, who collect remittances door to door, and receive a share of 1 percentage point of the service fee. Apart from this, in view of the size of the market, (Adhikar expects to add 500 remitters a quarter in Surat) it now has two branches (with plans to open more) as against the single branch in Gandhidham.

Only a study of overall operations at both ends would indicate the prospect of achieving sustainability (estimated to be about 40 percent at present).

Endnotes

1 *See for instance CGAP (2005).*

2 *Moreover outgoing cross-border migrants, from India at least, tend to come from better off families with bank accounts or from locations which have banks and post offices. The cross-border remittances they receive can therefore be remitted formally by banks and money transfer companies (MTCs) with tie- ups with post-offices. With domestic migrants this is not usually the case. They come from the poorest income groups, and disproportionately from areas which have not been penetrated by the banks and where there is a special need for poverty oriented MFIs.*

3 *Since the destination area will usually be rural, where remittees are likely to be more spread out than in an urban area, and distributing remittances more expensive, an MFI without a presence in both areas but with existing operations in a rural area, will have even more to offer in a tie-up arrangement.*

4 *Adhikar is clearly competitive with India Post that charges 5 percent for money orders, and also with bank drafts in terms of access, convenience and speed, although not cost. However, it should be noted that the post office assumes a universal service obligation (it undertakes to deliver an MO to any person in the country). For a detailed comparison between the four channels, see a case study on Adhikar's operations in Gandhidham in Ghate (2005), a shorter version of which is Ghate (2006a). Data in the case study is as of December 2003, when Adhikar had 280 members. The story has been brought up to date in Ghate (2006b). Adhikar in based in Bhubhaneshwar, and undertook the remittance activity under the innovations fund of the CASHE project financed by DFID.*

5 *Although registered as a cooperative, it is now following the Grameen model, and has received financing from FWWB and ICICI Bank.*

6 *Concentrations develop over time partly because migrants from a particular originating area tend to specialize in a particular destination area to minimize search costs.*

7 *The reason may have to do with the fact that the bank has a relatively very minor role to play in a door to door remittance transaction, compared to the task of collection and distribution that the MFI performs at each end. The bank can merely offer a means of electronic transmission which any account holder of a bank can use for a small fee anyway. If the bank were to attempt to charge more from the MFI agent, it would be rational for the agent to conduct the entire transaction itself.*

8 *Such as BASIX, SHARE, Asmitha, SKS, and KAS Foundation.*

9 *Also, apparently, some of the traditional tappawalas/dabbawalas are still operating, although instead of carrying cash back (in dabbas) they now carry bank drafts!*

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CHAPTER 6

Training and Capacity Building

With the relaxation of constraints on the availability of on-lending and investment funds in the last couple of years, human resource development has become perhaps the most important challenge facing the sector.[1] There has been an increase in the number of and variety of institutions offering training courses and other capacity building (CB) activities, and the number and variety of courses themselves have multiplied, but the state of development of the training and capacity building (TCB) sector is embryonic in relation to needs.

Like other support services for the sector (rating, consulting, auditing, research and statistical), training and capacity building (TCB) institutions and organizations have developed organically in response to perceived needs on the demand side, and in accordance with the particular orientations and priorities of providers on the supply side. However effective TCB demand (as expressed willingness to pay) has been weak, for a combination or reasons, including (i) the understandable tendency "not to know what one doesn't know" (i.e. a lack of appreciation of the crucial importance of training) and the consequent unwillingness on the part of promoters and senior management to spend money on TCB, especially in the case of new NGO entrants to the sector with existing social services activities, who need TCB in new financial skills the most, (ii) genuine affordability issues, (iii) the tendency to regard training as a free good and (iv) perceptions about the mixed quality of the offerings available, and the sense, no doubt correct for some skills and types of training, that one can do a better job in-house, through learning-by-doing. The growth of TCB has thus been in large part supply driven, with donors and apexes such as NABARD, SIDBI, and FWWB financing much of it in the early years. They are now increasingly being replaced by banks like ICICI, which has a comprehensive vision and plan to grow the sector, with an important place in it for support services including TCB.

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Main TCB institution types

Over the years there has been a slow but steady increase in the number and variety of institutions offering TCB. While it is not possible to survey the field here, a few words on the main types of institutions and trainings offered follow.

Most of the early entrants to the sector were the NGOs who pioneered the SHG model such as MYRADA, PRADAN, and DHAN who were funded largely by NABARD, and donors, as the SBLP grew. Some of them spun off training activities to separate wings which later evolved into standalone institutions (e.g. the Tata-Dhan Academy) They were joined by a number of NGOs such as Chaitanya who soon became specialized resource NGOs with SHG training as their major activity, and sources of funding increased to include the state women' s development corporations, themselves funded by multilaterals such as IFAD and the WB.

As the MFI model grew, *EDA Rural Systems* entered the training arena in 1999 as the first institution to fully recover its costs on a commercial basis, although many of the trainees themselves were funded by donors or apex financial institutions. EDA now offers a full range of skills training courses including (i) CGAP modules (such as Financial Analysis for MFIs) (ii) adaptations to Indian conditions of CGAP modules (e.g. Business Planning for MFIs) and (iii) courses designed by EDA itself (e.g. Internal Audit, Social Performance Management). EDA was originally a franchisee of CGAP for the South Asian region, but CGAP courses are now open access courses available to anyone on their website. EDA has the advantage of being a sister institution of M-CRIL which is a rating institution. Thus many of its trainers have hands-on experience of MFI financial and managerial performance. Moreover, as a consultancy EDA has done a great deal of capacity building. It is now in the process of forging tie-ups with smaller regional training providers around the country, initially in the Northeast with the assistance of FWWB, but eventually in other parts of the country too. [2] Over the years EDA has grown in respect of number of courses, trainees, and geographies covered. It has sent teams to 9 countries, mostly in Asia, and has had nearly 500 foreign trainees attending its courses in Gurgaon, Haryana.

As the state governments have become more actively involved in the SBLP several of them have felt the need to promote resource institutions to provide support to the programme

As the state governments have become more actively involved in the SBLP several of them have felt the need to promote resource institutions to provide support to the programme. The first and best known of these is *APMAS*, designed to provide TCB, evaluation, and other research support. APMAS has developed particular expertise in the SHG Federation movement which is an integral part of AP's state SBLP (IKP, formerly Velugu, funded by the World Bank). It has developed a rating tool for federations in collaboration with EDA, and since federations function partly as MFIs requiring the same set of skills as MFIs, it has branched also into skills training, including the use of CGAP modules in Telegu. Other states have also encouraged the setting up of resource institutions such as CMF in Rajasthan, and MLRC in MP. [3] In the four states (AP, Orissa, WB and MP) in which the DFID-funded CASHE project has been functioning, CARE has helped set up a number of capacity building institutions, designed primarily to serve the SBL programme.[4]

FWWB, apart from regular field visits to its ID (Institutional Development) partners, and organizing customized training for them through EDA and more recently MicroSave, also conducts training and workshops for its partners directly. In 2003 FWWB, along with SEWA and the Coady International Institute, set up *the Indian School of Microfinance for Women (ISMW)* with core funding from Citigroup International, in Ahmedabad. It is focusing at present mainly on financial literacy training for the women leadership of CBFIs, with support from SEWA Bank (which has a separate financial literacy department) but also offers skills training courses. Courses range in duration from one week to a six-month's diploma course. Like EDA, it is building links with regional training NGOs.

SIDBI, the largest apex for MFIs, has always devoted a share of its resources to TCB for its partners, including sponsorship of their staff to training at *management institutes* such as IIMA, IIMB, IRMA, XIMB, and IIFM. Some of these institutions are developing graduate education in microfinance management along three tracks: electives, specializations and certificate courses for microfinance professionals. .IIMA offers microfinance as an elective in its regular agribusiness programme. Faculty and students are also engaged in preparing case studies for use in teaching. IRMA seems to offer the largest number of short-term courses. The MFMI funded "Microfinance in MBA Programs" has funded a Chair at IRMA and has enabled IIMB to set up a Microfinance Group and offer a course in Social Entrepreneurship which has a substantial section on microfinance. Responding to the need for handholding start-ups, IIMB started a *Microfinance Incubator* in June 2005, funded by SIDBI, which is described in Box 6.1.

Likewise *NABARD*, the apex for the SBLP, has funded a huge programme of training not only through the resource NGOs mentioned above, but through specialized public sector training institutions for bankers such as BIRD, NIBM, CAB, and the staff colleges of banks. [5] Of these, BIRD is sponsored and financed by NABARD as a premier training institution with extensive facilities including a library and hostel geared to providing a range of training requirements in rural credit (not just microfinance) primarily to bankers. In the Northeast the IIBM, financed by the RBI, has an extensive new campus in Guwahati, and is developing courses for the microfinance sector under both models. Much of the training offered through these institutions is geared to introducing participants to the SBL model, and tends to be more introductory and conceptual than skills oriented or even attitudinal. However, it is the NGO resource institutions closer to the ground that are better equipped to providing comprehensive training to SHPIs, especially in the crucial skills identified in Chapter 2, including bookkeeping and accounting.

MicroSave is a strong believer in combining class-room based learning with on-site follow-up technical assistance

A major recent entrant to the training field is *MicroSave*, which has considerable experience of training, action research, and toolkit development in Africa. It conducted a comprehensive assessment of training needs in India (Wright 2005) and has opened two offices, one in the South (Chennai) and the other in the North (Lucknow) each of which has identified an action research partner (IASC and Nirman Bharti respectively) MicroSave is a strong believer in combining class-room based learning with on-site follow-up technical assistance (see Box 6.2). Among its more popular offerings are strategic business planning and process mapping, and it is developing a series of toolkits specific to Indian conditions on topics like market research, governance, and delinquency management. Thus it is equipping itself to deliver both managerial and skills training, and hopes eventually to train and work through about 60 "low-cost but high capacity" consultants, either individuals, or grouped in mostly young and new consultancy firms. The consultants will be trained in the use of rapid institutional assessments after which they will provide both class-room training and long-term mentoring to assisted institutions. A scheme is under discussion with ICICI to assure them a minimum income, under which ICICI will pay them a monthly retainer for assisting a certain number of ICICI borrowers each, with MicroSave providing continuing back-up support.

Another recent entrant (and distinct model) is "*ACCESS Development Services*" which has been registered by CARE as a S 25 company, and as a successor institution to the capacity building component of the CASHE project, which is due to end in December 2006. Access will have the same emphasis on community-based institutions as CASHE, such as SHG federations and SHPIs, and hopes to incubate 100 currently un-banked partners over the next five years. Incubation will be the responsibility of separate regional responsibility centres such as the MLRC (Microfinance and Livelihood Resource Centre) being set up in MP. Access has received grant money to support operational expenses of nascent partners, although at a much lower level than in the CASHE project. It will also provide livelihood development, microinsurance, and research services, and has received funding from ICICI and FWWB to incubate potential partners.[6]

Finally, *Reach India*, is an important recent initiative in SHG training for the East and Northeast, taken by Freedom from Hunger (FFH), USA, which seeks to strengthen the capacity of a large number of self-help promoting institutions (SHPIs), to provide CB services to SHGs, sustainably. Reach India will consist of a network of low-cost service centers, managed and supported by a Capacity Center in Kolkata. It is registered as a trust but has also applied for a S 25 company license. It has already identified six social entrepreneurs to operate the first field-based service centers in Orissa, Jharkhand and Bihar and has developed an orientation and training curriculum to equip them to operate effective "social franchises". A comprehensive needs assessment and mapping of SHPIs across the region undertaken by Reach identified more than 1,200 SHPIs working in the region: 301 in Orissa, 215 in West Bengal, 208 in Bihar, 205 in Jharkhand, 131 in Chattishgarh, and 142 in the northeast serving 30 lakh poor women and their families.

The courses include those which are (i) relatively broad and general introductions to the field or a specific topic and are primarily conceptual, (ii) seek to sensitize, motivate, and bring about attitudinal and behavioral change (iii) enhance managerial skills (iv) impart microfinance-related specific skills

These SHPIs are willing and able to pay for training in the provision of CB services. Reach India has also started a dialogue with organizations like NABARD, Ford Foundation, SDTT and others for partnership building to take this initiative forward.

Apart from institutions geared primarily to microfinance training under the two models, several institutions offer training in the set of skills relevant to livelihoods generally (of which finance is just one component). The most recent of these is the Indian *School of Livelihood Promotion* set up in 2004 by Indian Grameen Services, which is part of the BASIX group, with funding from the Ford Foundation and the Sir Dorabjee Tata Trust. Programmes have been conducted in different parts of India and regional centres have been set up in Indore (for western and central India), Ranchi (for eastern India) and Bangalore (for the South). A Livelihood Promotion Resource Book is used extensively, and has been translated into Telegu by APMAS. ISLP works both through in-house and "extended" faculty who are practitioners close to the ground. Other institutions imparting the skills necessary for enterprise and livelihood development are the Entrepreneurial Development Institute, Ahmedabad, AFPRO which promotes mostly technical skills in agriculture, livestock, soil and water conservation, and BAIF (livestock).

Along with institutions, the number and variety of courses themselves have multiplied. The training calendar put out by Sa-Dhan for its members in 2006 lists 65 courses, and this excludes courses offered by non-respondents, non-member institutions such as DHAN, and the public sector training institutions, as well as 10 courses proposed for which the dates have not been finalized. In addition it lists 58 courses offered by 5 institutions [7] which are "demand based" i.e. will be held if there are enough takers for them. The courses include those which are (i) relatively broad and general introductions to the field or a specific topic and are primarily conceptual, (ii) seek to sensitize, motivate, and bring about attitudinal and behavioral change (iii) enhance managerial skills (iv) impart microfinance-related specific skills.

Offerings in relation to needs

Despite what at first sight appears to be an abundance of riches TCB offerings are a drop in the bucket in relation to the needs of the sector. [8] It is useful to look at needs in relation to the two major models, and to the four levels of governance, senior management, middle management, and field staff, within each of them.

The MFI model

With respect to the MFI model, many observers would agree with a professor of management with considerable experience of the sector who recently characterized Indian microfinance as having excellent field staff, but inadequate management, and "atrocious" governance. Taking the last of these first, while one can only admire the dynamism, talents and flair of the promoters of the some of the largest MFIs [9] the AP crisis brought to light a few unsustainable practices that good systems of governance would not have countenanced had they been in place. On the other hand, other MFIs, which are growing as rapidly, have always had a much better image for transparency, accountability, and client and employee satisfaction. Differences such as these arise not so much out of the lack of skills or capacities of the promoters, but have more to do with that intangible called "values" and the ethos promoters instill in their organizations. To that extent they are not amenable only to "training" in governance in a narrow sense. However, much greater awareness of good governance practices and structures is needed and this is one of the tasks of training. Governance improvement is also a major need in many small and medium NGO-MFIs which are often one-man shows.

The next rung, of "managerial" and skills related training, for senior and middle management, is where standard classroom training followed by on-site mentoring can contribute the most to the healthy growth of the MFI model

The next rung, of "managerial" and skills related training, for senior and middle management, is where standard classroom training followed by on-site mentoring can contribute the most to the healthy growth of the MFI model. On managerial training the management institutes would appear to have a distinct comparative advantage over specialized, microfinance-specific training institutions. This is because the relevant management principles in "visioning", strategic planning, and human resource development, and so on, are generic to a wide variety of financial and service industries. Examples of the kind of issues involved are doing something about the observation that only a handful of MFIs are "fun places" to work, or the COO can not take off for a month because of insufficient delegation, and so on. [10] However, while the managerial principles themselves are generic, faculty of management institutes are still in the process of equipping themselves with a greater understanding of the context in which they are to be applied, through action research, case-studies, consultancy assignments and familiarization with international experience. All of these are time-consuming, and a critical minimum number of faculty has yet to be developed in any of the institutions.

While primarily managerial training can be supplemented with a modicum of skills training as the incubator experiment is doing by drawing on other faculty members who are specialists in banking, MIS, IT etc, and some management institutions such as IRMA do offer more skills training than the IIMs, it is more cost effective in most cases for skills training to be delivered by specialized microfinance-specific skills training institutes.[11] A couple of issues with skills-related training that is often raised by EDA and others are, first, the need for the CEO herself to be sensitized to the new skills her staff have acquired in classroom training so that they are encouraged to apply them on their return, and second, the need for not just one or two but a critical minimum of key individuals within the MFI to be trained so that they can back-stop and synergize each other's efforts.[12] Finally recent events serve as a reminder that MFI skills-related training is required also by the lenders, so as to better appraise MFIs and make good lending decisions.

While microfinance has broader social and developmental objectives, the means is essentially finance, and the microfinancial skills entailed in the MFI model (and in federations in the SHG model) are every bit as sophisticated as any other kind of banking. However there continues to remain a huge gap in the availability of skills. The CGAP modules used by EDA are the most carefully prepared and comprehensive set of modules available for training purposes. Yet because EDA uses high quality trainers who have to be paid the going market rate if they are to be attracted and retained, affordability has been a problem for many smaller MFIs.[13] Hopefully now that EDA is planning to identify regional partners, the quantum of skills training will increase without a dilution in quality.[14]

Perhaps the most important need however is to integrate class-room based training not only with continuing on-site mentoring and hand-holding over a period but also with pre-training needs assessment. An example of a TCB institution that has made this concept central to its business model is MicroSave, as Box 6.2 describes. The issue here however is partly financing, since few institutions can afford to pay the full cost of all three stages. The other issue is the availability of the hand-holders.

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SIDBI, and now the banks, and even the new crop of equity investors, are trying to address both needs simultaneously. SIDBI has for some years now had a scheme to develop a team of certified mentors to assist their partners out of the grant funding they package with their loans. ICICI, as noted above, is in discussions with MicroSave, BASIX, and CARE-CASHE to adopt this model. The private equity firms such as UNITUS, Lok Capital, Bellwether and MSDF (see Chapter 8B) all have schemes to package equity with TA. Thus UNITUS has a tie-up with ACCION to depute to some of its partners full time "resident advisors" for CB.[15] Finally, yet another hopeful new development is the incipient emergence of relatively low cost private microfinance consulting firms as hand-holders.[16]

Training for field staff in the MFI model is undertaken almost entirely by the MFIs themselves, mostly through on the job training under the supervision of field staff. The numbers entailed are much larger at this level and it is by now well recognized that for some MFIs expanding the fastest, the rate at which they can identify the right persons, train them, and then retain them (once the new recruits find out how challenging the work is) is more of a constraint on the rate of expansion than financing. [17] In addition, MFIs using the Grameen model have the additional training task of training borrowers, administering the GRT, and so on. Some MFIs such as SKS are hiring fresh recruits also for the branch manager level for their "horizontal" expansion plans to new states, and training them in the same manner, rather than through the usual, much slower, promotion process.

The SHG model

Using the same framework to analyze training needs under the the SHG model, the promoter, CEO and senior managerial level in this case consist of senior NABARD and commercial bank manager staff. Training needs here much greater awareness and sensitivity to the policy and operational issues identified in Chapter 2. [18] Required too is what can be best described as attitudinal training, in terms of the four-fold classification above.[19] The need for skills related training such as that entailed in the MFI model is greatly minimized by the fact that bank branches are already equipped with all the requisite skills as going financial concerns. The main technical skills bankers need is in SHG appraisal and rating, although they need to be sensitized also to the "softer" areas of SHG group dynamics, leadership development, credit needs, etc.

The real TCB challenge in the SBLP however lies is training SHPIs in developing bookkeeping and accounting capabilities at the SHG level. One of the most misleading perceptions about the accounting challenge is that it is relatively tractable because it is "not rocket science". However for the 70 percent of totally illiterate group members and at least the one half of the groups in which more than half the membership is illiterate, it is rocket science, as it is for the majority even of the much smaller number of group leaders, group accountants, and SHPI workers. As emphasized earlier SHG accountability, equity, longevity and the repayment rate of the groups to the banks all depend on cracking the bookkeeping and accounting challenge.

This is not purely a training problem however, since there are important organizational and logistical components to all the possible approaches and models being experimented with, whether Computer Munshis, or federations, or fee-charging village based accountants, and the priority is to firm up and operationalize these models on a large enough scale through action research, although there may be need also to simplify, pictorialize etc the accounts themselves. This is the most important task facing the SBLP, the dominant model of Indian microfinance.

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Box 6.1 The Microfinance Incubator

The Microfinance Incubator Programme consists of a month-long Foundation Programme in management of an MFI followed by a year of handholding at the incubatees' locations; it is therefore a virtual incubator. The Incubator is also model-neutral. The Incubator does not provide training to field staff as it is not IIMB's core competency. ...IIMB received fourteen applications from a variety of agencies who we believe had had been knocking on doors to find some support for their microfinance activities.... We considered the energy of the promoters, their integrity, their demonstrated interest in starting microfinance activities and (unfairly) their likelihood to succeed to select the incubatees. We assumed that a couple of MFIs would grow even without IIMB's inputs, while a couple of them would face better chances and there could even be a failure.

All the five incubatees work in regions of India underserved by banking and microfinance, i.e. the North, East, and Northeast of India, and northern Karnataka in the South. They follow different methodologies - two follow the Grameen methodology, two work with self-help groups and one is an asset lending model.

The SIDBI grant enabled IIMB to charge very nominal fees for the programme. Each participating MFI was expected to send in the equivalent of a COO and CFO for the training in IIMB and IIMB would provide a year-long mentoring for a sum of Rs. 35,000 (about 10% of IIMB's costs) per organisation.

We held a month-long Foundation Programme at IIMB between November and December 2006 attended by nine participants from the incubatee organisations and four from established MFIs. The army bootcamp style programme began with yoga in the morning and ended late with tutorials on Excel. Classroom sessions took up 8 hours of each day and dealt with various modules in management (see Box 1). The Microfinance Workout (see Box 2) was used to bring

Box 6.1 Continued

in experts and to contextualise the management learning to the specific issues in microfinance.

We are currently in the handholding phase and have made several visits to the Incubatees at their field sites. The inputs have been tailor made to suit individual MFIs and the resource persons include consultants. The handholding has included a training of trainers for field operations, organisational diagnostics for human resources development and MIS and IT. The Incubatees have sent various concept notes, business plans and draft agreements with lenders, so that IIMB can vet them and provide feedback and suggestions.

The environment for microfinance in India has undergone significant change in 2006. The industry underwent a crisis in the state of Andhra Pradesh with opposition to the high interest rates charged to clients, staff behaviour towards clients and ethical practices of some MFIs; some of the issues relate to the high growth rates experienced by these agencies. The political economy that governs microfinance practice in India is complex. The challenge for the Microfinance Group has been to design our programme and advisory to enable the Incubatees to appreciate this environment, and develop strategies to function clearly within the law and pursue growth strategies that truly reflect the ability of the organisation and its finances rather than supply side pressures.

Box 1: Modules in the Foundation Programme

- Accounting and Finance
- Banking and Finance
- Human Resource Management
- The Start-up Model
- Governance
- Visioning
- Strategy
- Rural Marketing
- Data Analysis
- Venture Capital Funding
- Microfinance Workout

Box 2: Content of the Microfinance Workout

- Understanding MFIs as organisations
- Scaling up of MFIs
- Financial Analysis and Financial Planning in MFIs
- Managing Partners
- Valuation of an MFI/SHG
- Economics of Microfinance
- Legal issues and Transformation
- MF for men, urban areas and agriculture
- MF and Development
- Operations and Field Force management
- Crisis Management
- Understanding Client Cashflows
- Transformation issues for MFIs and the experience from India
- International experience in MF
- Insurance
- Funding and Capacity Building
- Learning Needs Assessments of Incubatees and Trainees
- Tutorials in using spreadsheets (Excel)

Future plans of the Incubator include taking incubatee organisations on field visits to other mature MFIs, developing some cases and case studies on their experiences, support for IT and MIS development and learning from the first cycle of the programme. Our learning from this cycle of incubation should let us know if we could attempt another cycle of incubation with a new set of organisations.

From "A Note on the IIMB Microfinance Incubator", IIM, Bangalore

Box 6.2 Some key findings and recommendations from "Catalysing Capacity Development: Assessing the Need for Training"[20]

...Selecting Training Courses

The large-scale and diversity of courses required by the MFIs will necessitate the development of a system to assist MFI to diagnose their key issues and thus to assess and prioritise their needs. Using participatory methods to identify training needs will increase buy-in and understanding of the role that capacity building can play in the overall development of the organisation. This should reduce the number of participants sent to courses as a reward, and increase the expectations of the MFI for those trained to apply the skills they have learned. In addition, it will be important to look at methods for sequencing the courses - so that MFIs first take and implement the more basic courses that necessarily underpin subsequent (more sophisticated) ones. This will also relate closely to the state of evolution of the MFIs seeking the courses.

...Use Classroom plus On-Site Follow-up Technical Assistance

The study highlighted the need for post-training assistance to implement what has been learnt in the classroom. Worldwide there has been a move toward training that combines classroom-based learning with on-site, follow-up technical assistance, under which the participants work with the trainers/consultants to implement and institutionalise the training/ changes within their MFIs. Thus, for example, after three days working on portfolio management (ideally using their own data), participants return to their MFIs with a trainer or a consultant to work on institutionalising portfolio management systems and skills within their MFI.

This approach is much more resource and labour intensive, and requires a special quality of trainer (one that can put the classroom theory into practice in a variety of institutions). However, this approach has been demonstrated to lead to far more effective change and improvement within MFIs participating in the training programmes. The approach also means that the use of training courses as a reward system for staff members will probably be reduced since the MFIs will know that the participants will be expected to work with the trainers/ consultants to implement the training. This approach also offers a better business model for trainers/consultants in that the revenue stream generated is for 3 days training, plus 5-8 follow-up, on-site assignments of a week or more - rather than simply a 3 day classroom based training.

...Develop Comprehensive, Easy-To-Use Training Packages

Given the huge market in India, it will be essential to engage and empower as many trainers as possible to use the courses in an Integrated Curriculum for Microfinance in India setup. Several training institutions and independent consultants expressed the need for training materials they could adapt and offer to the industry. Some of the expanding and mature MFIs expressed the desire to conduct some of the training "in-house" tailored for their specific institutional systems and needs. It will be important to develop and disseminate training materials that can be adapted and translated for local needs and delivery through as many channels as possible.

Exerpted from Wright et al (2005) Microsave Briefing Note No 46

Endnotes

1 *In a sense it always was, but financing constraints were as binding. Training and capacity building are considered together since they are properly regarded as a continuum as discussed below. One of the most comprehensive recent training needs assessments was conducted by MicroSave, Wright (2005), some key recommendations from which are summarized in Box 6.2. A workshop conducted at IRMA last year on the managerial and operational problems of MFIs in India also identified a number of training priorities (Shylendra et al 2005).*

2 *Prospective organizations are Margdarshak in UP, RASS in AP, Chaitanya in Maharashtra, CYSD in Orissa, RGVN in Guwahati, and ARAVALI in Jaipur.*

3 *Like CMF some of them have representatives on their boards of local social science research institutes, and like APMAS some of them have received support from CARE India.*

4 *For an evaluation, based on client satisfaction of surveys, of some of these CBIs in AP (APMAS and RASS) and in West Bengal (RDC, SPADE, and DRCSC) see BIRD (2006) Along the lines of the APMAS model, the institutions are expected to become progressively self-supporting through fees. An evaluation of TCB which would compare subsequent performance with a control group, is waiting to be done.*

5 *According to the SBLP annual report for 2005 (NABARD 2005) it trained 43,000 bankers, 33,000 government officials, 638,000 SHG members and leaders, 25,000 NGO participants, as well as others such as PRI representatives, during the year (Statement XI), through a set of training modules for bankers, NGO-SHPIs, NGO-MFIs, trainers, government officials, SHG members and leaders and others (described in detail on pages 19-22).*

6 *Thus ICICI has put up Rs 1.34 crores for Access to incubate 10 partners in MP in two years. Nine nascent partners serving 1,776 SHGs have already been identified. Output goals have been defined in terms of the total outreach of the 10 partners (100,000 clients), operational sustainability, PAR, and systems developed to the level where ICICI can lend to them.*

7 *These are ARAVALI, AFPRO, SPADE, DRCSC and RDC.*

8 *Symptoms of the sector being "under-trained" are widespread and include inadequate systems and processes for MIS, unsatisfactory accounting systems, weak internal controls, ageing of overdues, and so on (see Sa-Dhan 2006). It needs to be borne in mind that many of the TCB providers are themselves young, and are still building up their own capacity.*

9 *As Sitaram Rao says "these are unique people, not like you and me".*

10 *IIM Ahmedabad was proposing to hold an annual 5-day course for the "number twos" of MFIs in an attempt to respond to the oft-observed problem that when the chief executive is out of town decisions tend to get held up (a reflection perhaps as much of organizational culture as of competencies, which got IIMA interested also in offering human resource related courses to do with staff incentives, participation etc). IIM was also interested in getting into structure, design, and "world-view" related issues (often loosely referred to as "Boulder-type" training). The courses could not be held for various reasons, the most important being other priorities, but also because of the dearth of case materials. SIDBI has sponsored case study preparation through faculty at IRMA and other institutions, and the Sir Ratan Tata Trust Fund for Research Collaboration in Microfinance through IIMA, and several cases have been prepared over the years, two of them being Pathak and Sriram (2004) and Sriram (2005). However the dearth continues. SIDBI has also subsidized the fees for MFI leaders to attend IIMA's well-known three tier programme for top, senior, and middle management, designed for all industries, but after the first year response from MFIs dropped off..*

11 *As Box 6.1 points out the incubator experiment recovers only 10 percent of the cost from participating MFIs.*

12 *EDA has also noted the tendency for people too junior to apply the skill in question to be sent for training, presumably on the basis of grant money, and for CEO and COOs to consider it "infra-dig" to attend courses along with their subordinates (another cultural problem). A related issue is the failure of senior personnel from the apexes to "get trained" themselves by attending courses. A recent evaluation indicated that the type of participants who benefit the most are middle management, and MFI leaders who have had at least a little experience. Working level staff tend not to benefit as much, partly because they are concerned in their jobs only with one limited aspect of operations and therefore lack the motivation to develop a broader understanding of inter-related aspects, and/or have language problems in absorbing the training.*

13 *One solution would have been for EDA to have trained faculty in several public sector training institutions where salary costs are lower, or which are aided by government, who would then in turn have trained MFIs around the country. For various reasons this did not happen.*

14 *And that more of it will be offered in regional languages, with translation where appropriate of CGAP and other modules. An issue that is becoming increasingly salient is the impact on institutions attempting to recover their costs, of the large amount of grant money becoming available for the sector for training (which in itself is a good thing). Incentives for quality control are much weaker when an institution can depend on subsidies. A possible solution is use of the voucher system under which institutions would cost their offerings at full cost, and the subsidy (a voucher) would go to those seeking the training so that they can choose the best offerings from among eligible institutions.*

15 *The ACCION resident advisers will enjoy back-up support from specialists in the US. One such adviser has already been posted to a UNITUS grantee, where he will have executive line responsibilities. ACCION also expects to work with Lok Capital's partners. ACCION's emphasis is on urban microfinance, and on downscaling, and would like to partner with commercial banks and finance companies on this. It hopes also to promote the CAMEL rating methodology it has developed.*

16 *Examples are Margdarshak in Lucknow and "M2i" in Gurgaon. The latter presently consists of two partners, but hopes to grow as it inducts others after certifying them. Each partner will be expected to develop his own business, but contribute a share of earnings to the firm to pay for use of overhead facilities and brand image.*

17 *CASHPOR has usefully described its training programme in recent annual reports.*

18 *A useful beginning could be made by building a short course around the Light and Shades Study as a required text.*

19 *Examples of some banker attitudes that need changing are contained in Section 5.7 of Harper (2000b).*

20 *The full briefing note and study on which it is based are available on the MicroSave website www.MicroSave.org.*

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CHAPTER 7

Financing: Commercial

A. Lending to MFIs by the Commercial Banks

MFI managers used to devote most of their energies to dealing with the uncertainty of where the next loan for on-lending funds would come from. Except for the smaller MFIs this is no longer the case. The rapid expansion of the MFI model in the last few years has been driven by the private commercial banks. The extent of dependence on borrowing sets Indian microfinance apart from most other countries. As Chapter 3 discusses, Indian MFIs are the most highly leveraged in the world, and because their borrowings come at commercial rates from the banks, their financial cost ratio is also among the highest in the world.

FWWB from 1993 and SIDBI from 1999 pioneered bulk lending to MFIs, which along with their capacity building activities (see Chapters 6 and 8A) prepared the MFIs to be followed soon by the private commercial banks, who are now being joined by the public sector banks. The private sector banks were motivated initially by priority sector obligations (since they did not have the rural branch networks of the public sector banks, who were meeting priority sector obligations through SHG lending) but now increasingly see lending to MFIs as a profitable activity given almost perfect repayment rates.

The private sector banks were motivated initially by priority sector obligations (since they did not have the rural branch networks of the public sector banks, who were meeting priority sector obligations through SHG lending) but now increasingly see lending to MFIs as a profitable activity given almost perfect repayment rates

An attempt was made to obtain data on the exposure of the commercial banks to MFIs as of March 2006. Unfortunately not all banks responded, and Table 7.1 shows outstandings at the end of March 2006 only for those that did. ICICI Bank's figure represents their entire microfinance lending, including SHG lending and jewel loans. About 60 per cent of their microfinance lending consists of loans to MFIs under the partnership model, but they also make bulk loans to MFIs. Even after allowing for non-response by other banks it will be seen that they are by far the largest lenders to the sector.[1] Commercial bank lending for the sector is likely to have doubled every year for the last three years. It is too early to say yet whether this will happen again this year. Overall lending to MFIs in AP, a large share of total lending, slowed down in the first half of the year, and it may take some time before AP MFIs can develop the systems and train the staff to expand operations in other states.[2]

Bulk lending

Bank lending to MFIs take the form of both term loans and cash credit. Security accepted is usually the hypothecation of book debts, but where the MFI lacks a track record or the bank is the majority lender, personal guarantees or pledged deposits are also taken. Tenor (which can range from 3 months to 5 years, with scheduling depending on the MFI's cash flows), and pricing, are individually determined based on risk assessments. Rates are currently in the

Table 7:1 Commercial bank exposure to microfinance of selected banks, March 2006

S.No.	Bank	No of MFIs supported	Outstanding as of 31-03-2006 (Rs crore)
1.	ICICI Bank	100	2,350*
2.	HDFC Bank		250
3.	UTI Bank	40	103
4.	ABN AMRO Bank	19	87
5.	ING Vysya Bank	19	61
6.	Standard Chartered Bank	12	50
7.	HSBC	8	15
8.	Rishikulya Grameen Bank, Ganjam	3	6
9.	State Bank of India	1	5
10	UCO Bank	4	2
11.	United Bank of India	1	2
12.	Indian Bank	2	0.4
Adjusted total (only for reporting banks)			1,991**

Source: Responses to a questionnaire or telephonic follow-up, and interviews. *Figure for ICICI includes all microfinance lending. **Includes only partnership lending component for ICICI Bank (assumed to be 60 percent of total microfinance lending).

range of 8.5 to 11 per cent. They have come down on the "premium names" in the sector during the last year, but have remained stable for most MFIs despite the hardening of rates generally. Most of the banks have dedicated microfinance units. Lending has been concentrated in the South, but since the AP crisis most banks are expediting their efforts to expand to other "geographies".

The "partnership model"

As noted above, about 60 per cent[3] of ICICI Bank's total exposure of Rs 2,350 crore represents lending under the "partnership model" that it pioneered as a way of getting around the discomfort it felt with the lack of equity MFIs had to support high and increasing levels of leverage under the bulk lending model, in which the MFI borrows on its own risk and then on-lends to the final borrower. Under the partnership model on the other hand the loans remain on the books of the bank, with the MFI providing loan origination, monitoring and collection services, for a fee. As Ananth (2004) and Tara Nair, M S Sriram and Viswanatha Prasad (2005), and others have described extensively elsewhere, the MFI performs the role of social intermediary, which it is best equipped to perform, while credit risk is borne by the bank.

As noted above, about 60 per cent of ICICI Bank's total exposure of Rs 2,350 crore represents lending under the "partnership model" that it pioneered as a way of getting around the discomfort it felt with the lack of equity MFIs had to support high and increasing levels of leverage under the bulk lending model

While the partnership model greatly eases the equity constraint, it does not remove it entirely, because the MFI partner is expected to share the risk of default in the form of a first-loss deficiency guarantee (FLDG), which is typically around 10 per cent, depending on the bank's risk assessment of the MFI concerned. In other words, the MFI has to provide a "credit enhancement" by bearing the risk of default up to the specified FLDG level.[4] It can furnish the FLDG in the form of (i) an FD placed with the bank, or (ii) a bank guarantee(or a combination of both),[5] or (iii) the "excess spread" on the portfolio trapped in a separate account[6]. Where the MFI is unable or unwilling to provide any of these, ICICI makes things easier by furnishing the MFI with an overdraft in the amount of the FLDG, on which the commitment charge is typically 10 per cent (but which attracts penal rates if drawn upon) thereby effectively transferring "mezzanine capital" to the MFI at a rate lower than that at which equity would have to be serviced commercially. The arrangement has worked well, and has supported a massive expansion of lending in the last couple of years.[7] It was put to the test for the first time in the AP crisis, but it is too early to assess how well it will protect the interests of the parties concerned.

The use of portfolio buy-outs in India, which is a third means of delivering credit. When followed with securitization of the bought-out assets, it also offers the prospects of reducing rates to the ultimate borrower

Portfolio buy-outs and securitization

Apart from the partnership model, ICICI has pioneered the use of portfolio buy-outs in India, which is a third means of delivering credit. When followed with securitization of the bought-out assets, it also offers the prospects of reducing rates to the ultimate borrower. Under deals with SHARE and Basix, ICICI has bought-out chunks of their portfolio, for amounts on which it charged 9 per cent, which was 3-4 per cent lower than the previous cost of funds (Tara Nair et al 2005), and which enabled the MFIs to expand lending by the same amount.[8] The FLDGs in these cases varied from 8 to 15 per cent because of differences in the percentage of risky assets in the portfolio, the maturity of the loans and the perceived risks of collection. Once it acquires a sufficient pool of such assets ICICI has the option of securitizing them, i.e. packaging them (pooling them with other assets), getting them rated, and selling them in the capital markets where there is expected to be a demand for such assets from banks that are falling short on their priority sector obligations (the RBI has made such assets eligible for fulfilling PS obligations, as it has the initial buy-out loans).[9] It should be noted that securitization by the lender is possible also under the partnership model, but not in the case of bulk loans, although in the latter case it is quite possible in the future that large credit-worthy MFIs could issue bonds themselves, assisted perhaps by guarantees provided by institutions such as Grameen Capital India (see Chapter 7B).

Over and above the benefits technology offers to the MFI partners of banks, it offers the banks the prospect of easing constraints imposed by the lack of an extensive branch network and the unsuitability of typical branch hours of operation, processes and costs, to serving poor customers, through low-cost ATMs, mobile phone banking, internet kiosks and other devices that help automate cash transactions in the field

Commercial bank activities in promoting new technology applications

Because ICICI's microfinance portfolio is just a small part of its total rural finance portfolio of about Rs 16,000 crore currently, it has taken an active interest in developing what it calls "missing markets", complementary infrastructure, and technology.[10] Over and above the benefits technology offers to the MFI partners of banks, it offers the banks the prospect of easing constraints imposed by the lack of an extensive branch network and the unsuitability of typical branch hours of operation, processes and costs, to serving poor customers, through low-cost ATMs, mobile phone banking, internet kiosks and other devices that help automate cash transactions in the field.

ICICI's technology initiatives fall under two categories: (i) front-end technology investments such as smart cards with unique identifiers for each client that help track service usage on a real time basis as well as enable the sharing of credit information across the branch network

The main constraints to the expansion of commercial bank lending for the MFI model, including geographical diversification of lending, are (i) the availability of MFIs with the requisite capacity and (ii) regulatory anomalies

and (ii) back-end technology investments in creating better core banking systems among its partner institutions enabling more efficient data capture and sharing, and reducing the margin of error on transactions. ICICI has collaborated with FINO, a company that seeks to provide (i) front-end technology (smart cards, point-of-sale terminals), (ii) back-end technology (banking software, MIS systems) and (iii) information services (a credit bureau) to its partners. It is now looking to partnering with others, including NABARD, SBI and the Credit Information Bureau of India (CIBIL) to try to see if FINO could provide these services on a system-wide basis, particularly to cooperatives and NBFCs and other institutions undertaking small and micro-lending and savings mobilization.[11] Other banks have also assisted with technology solutions, such as ABN Amro's hand-held locally developed computer (the "Simputer") for use in the field.

Constraints to the expansion of commercial bank lending: capacity

The main constraints to the expansion of commercial bank lending for the MFI model, including geographical diversification of lending, are (i) the availability of MFIs with the requisite capacity and (ii) regulatory anomalies. Several banks are playing an active role in enhancing capacity. Thus as discussed in Chapter 6, CITI Bank has provided core funding for the Indian School of Microfinance, which is part of the SEWA family of institutions in Ahmedabad, and ICICI bank is supporting training and incubation initiatives by Basix, CASHE-CARE,[12] and MicroSave. In a related inititative, ABN-Amro has been supporting the annual Micro Process Excellence Awards in partnership with PlaNet Finance. Several banks have supported industry forums and conferences critical for the exchange of information in the sector, such as the recent Standard Chartered Bank conference on FCRA regulations.

Unfortunately, the prohibition on the banks from charging more than the PLR (of 11-13 per cent) on loans of less than Rs 2 lakh, and indeed from adding any charges or commissions (over the PLR) for loans of less than Rs 25,000, has made the BC model unworkable for the provision of credit, although not necessarily for the mobilization of savings13, or for the provision of other services such as insurance, which is already using the "partner-agent"model or for money transfers

The other constraint: regulatory anomalies

In 2004, RBI appointed an internal group to examine ways of increasing financial inclusion, and came out with a report in July 2005 (the Khan Committee Report). Pursuant to its recommendations, RBI issued a circular in January 2006 providing for the use of specified agencies including MFIs as intermediaries in the provision of banking and financial services. The intermediaries were to be of two kinds, Business Facilitators and Business Correspondents, with the functions summarized in Table 7.1

Unfortunately, the prohibition on the banks from charging more than the PLR (of 11-13 per cent) on loans of less than Rs 2 lakh, and indeed from adding any charges or commissions (over the PLR) for loans of less than Rs 25,000, has made the BC model unworkable for the provision of credit, although not necessarily for the mobilization of savings[13], or for the provision of other services such as insurance, which is already using the "partner-agent"model (Chapter 5A) or for money transfers (Chapter 5B). Even if the bank were willing to pass on to the BC the entire difference between the bank's cost of funds and the PLR (which in any case would make no business sense) it is highly unlikely that this margin would enable the MFI to cover its costs of originating, monitoring and collecting loans. Second, the "end of day" requirement is also a problem, especially for MFIs who do not yet have IT connectivity (the vast majority, because of the cost[14]) to enable them to credit collections to the banks by the end of the day. At present it would take 2-3 days to complete the transaction. Third, pending

Table 7.2 Guidelines for the Business Facilitator and Business Correspondent models

CRITERIA	BUSINESS FACILITATOR MODEL (BFM)	BUSINESS CORRESPONDENT MODEL (BCM)
Eligible Entities	Intermediaries such as • NGOs / Farmers' Club, • Cooperatives, • Community Based Organisations (CBOs), • IT enabled rural outlets of corporate entities, • Post offices, • Insurance agents, and • Well functioning Panchayats, Village Knowledge Centres, Agri Clinics / Agri Business Centres, Krishi Vigyan Kendras and KVIC / KVIB units	• NGOs / MFIs set up under Societies / Trust Acts, • Societies registered under Mutually Aided Cooperative Societies Acts or the Cooperative Societies Acts of States, • Section 25 companies • Post offices Banks may conduct thorough due diligence on such entities. In engaging such intermediaries as Business Correspondents, banks should ensure that they are well established, enjoying good reputation and having the confidence of the local people.
Scope of Activities	• Identification of borrowers and fitment of activities • Collection and preliminary processing of loan applications including verification or primary information/data • Creating awareness about savings and other products and education and advice on managing money and debt counseling • Processing and submission of applications to banks • Promotion and nurturing Self Help Groups / Joint Liability Groups / Credit Groups / others, and • Follow-up for recovery	In addition to the activities of BFM, BCM includes: • Disbursal of small value credit • Recovery of principal / collection of interest • Collection of small value deposits • Sale of micro insurance / mutual fund products / pension products / other third party products, and • Receipt and delivery of small value remittances / other payment instruments
Restrictions	As these services are not intended to involve the conduct of banking business by BFs, no approval is required from RBI for using the above intermediaries for facilitation of services indicated above.	The activities to be undertaken by the BCs would be within the normal course of the bank's banking business, but *conducted through the entities indicated above at places other than the bank premises.*
	BUSINESS FACILITATOR MODEL (BFM)	**BUSINESS CORRESPONDENT MODEL (BCM)**
Payment	• Banks may pay reasonable commission / fee to the BFs / BCs, the rate and quantum of which may be reviewed periodically. • ***The agreement with the BFs / BCs should specifically prohibit them from charging any fee to the customers directly rendered by them on behalf of the bank.***	
Other Terms and Conditions	As the engagement of intermediaries as BF/BC involves significant reputational, legal and operational risks, due consideration should be given by banks to those risks. They should also endeavour to adopt technology-based solutions for managing the risk, besides increasing the outreach in a cost effective manner. The arrangements with the BFs / BCs shall specify: • Suitable limits on cash holding by intermediaries as also limits on individual customer payments and receipts, • The requirements that the transactions are accounted for and reflected in the bank's books by end of day or next working day, and • **All agreements / contracts with the customer shall clearly specify that the bank is responsible to the customer for acts of omission and commission of the BF / BC.**	
Redressal of Grievances	Banks should constitute Grievance Redressal Machinery within the bank for redressing complaints about services rendered by BFs/BCs and give it wide publicity through electronic and print media.	
Compliance with KYC	Compliance with KYC norms will continue to be the responsibility of banks. Since the objective is to extend savings and loan facilities to the underprivileged and unbanked populations, banks may adopt a flexible approach within the parameters of guidelines issued on KYC from time to time.	

Source: Ajay Tankha (2006) based on RBI (2005)

further review, RBI has modified the original circular on BCs/BFs to exclude NBFCs from its purview, when NBFCs are the only MFIs prudentially regulated. Not surprisingly therefore the BC model has remained a dead letter as far as lending is concerned.[15]

It is conceivable of course that an intermediary such as a farmers club would be willing to become a BC by internalizing its costs through donations of time and effort, much as SHG members do, or that an SHPI would be willing to cross-subsidize its costs from other sources (as many of them do, see Chapter 2) to promote SHGs. In the latter case the private commercial banks would be able to conduct SHG lending without a rural branch network.[16] However, such arrangements are no substitute for the massive use of MFIs to provide "last mile" financial connectivity to the unbanked and the poor.

For all these reasons, one of the single most important changes required in the regulatory environment is to remove the PLR ceiling on small loans, which would allow the banks to enter direct microfinance and use the partnership and BC models

The PLR restriction is also the reason why the other banks (except HDFC Bank) have not followed ICICI in using the partnership model. While ICICI covenants directly with the borrower under the partnership model (the loan agreement is signed between the borrower and the bank, and mentions only the interest rate being charged by the bank, which is below the PLR)[17] the amount recovered from the borrower by the partner is a composite amount (shown in the borrower' pass book) which includes the partner's own fee and is above the PLR.

Last but not least, the PLR restriction has kept the banks, both private and public, out of direct individual lending to the poor, or what is referred to as "downscaling". Many observers feel that if the banks could make small loans many existing MFI borrowers would switch to the banks for the convenience and other advantages of individual loans.[18]

For all these reasons, one of the single most important changes required in the regulatory environment is to remove the PLR ceiling on small loans, which would allow the banks to enter direct microfinance and use the partnership and BC models.

Endnotes

1 *For purposes of comparison, if only 60 per cent of ICICI lending is taken as lending for the MFI model, the total amount for all reporting banks, Rs 1,991, is of roughly the same broad order of magnitude as Sa-Dhan's estimate of the total outstanding of their members of Rs 1,600 crore. While reported data on outstandings under the SBLP are not available, they are understood to be roughly 70 per cent of cumulative disbursements under the SBLP (see footnote 1, chapter 2), or Rs 8,000 crore.*

2 *Intellecap (2005) estimates that to achieve outstandings of Rs 12, 800 crore by 2010, the expected level based on present trends, MFIs will require Rs 11,700 crore in the five years (2006 to 2010) for on-lending funds, and a further Rs 1,100 crore as senior long-term debt to supplement equity in meeting infrastructure requirements.*

3 *The other 40 per cent consists of bulk lending, SHG lending, and jewel loans, the last mostly through the rural branches it acquired through its merger with the former Bank of Madura. The bulk of partnership model lending is concentrated in a few large partners.*

4 *In this respect an FLDG is different from a guarantee mechanism under which the guarantor shares say 50 per cent of the overall losses. It is also different from a risk premium charged to all borrowers under most forms of lending (including that to individual borrowers and bulk lending to MFIs) which functions as a form of insurance, through which the lender recovers losses from other borrowers. In this case losses are more likely to be of an all (or at least above the FLDG level) or nothing nature, since any default below 10 per cent will be borne by the MFI , whereas losses could well be above the FLDG level in the case of "catastrophic" events such as a flood, or even a political crisis such as that that occurred in AP. Fortunately, in the latter case, the two main MFIs concerned are very large, and in a position to absorb possible loan losses in the location concerned through a large portfolio, an overwhelming part of which derives from a large unaffected area. This is unlikely to be always the case.*

5 *Thus SHARE has availed of a guarantee, amounting to 93 per cent of the FLDG, from Grameen Foundation, USA.*

6 *The spread is the difference between the interest rate to the borrower and the bank's interest rate, and is paid to the MFI upon the maturity of the portfolio, after adjusting for losses, if any.*

7 *The OD facility amounts in effect to giving back with the right hand what is taken from the left.*

8 *In two transactions with SHARE, ICICI securitized the receivables of SHARE loans amounting to Rs 21 crore. The 9 per cent was the discount rate used to discount the receivables over their maturity. The FLDG was 8 per cent, 93 per cent of which was furnished by Grameen Foundation USA though a guarantee.*

9 *Thus ICICI has sold some of its bought-out assets to Development Credit Bank which enabled it to meet priority sector targets. There could develop a demand for such assets in the future from institutions such as mutual funds if they receive high ratings in view of the safety of the underlying assets.*

10 *For a description see Ananth et al 2004 and Mor and Ruchismita (undated, mimeo). ICICI is reported to be considering making greater use of portfolio buyouts in the future, at the expense of partnership lending.*

11 *Much of this paragraph relies on Mor and Ananth (2006). For a comprehensive survey of the status, challenges and opportunities of extending technology applications in Indian microfinance see Intellecap (2006). Both Intellecap (2006) and Sinha and Rasmussen (Forthcoming) contain forceful reminders that most MFIs are still putting in place basic Information Systems to track lending operations and automate accounting and management reporting. For MFIs, this first stage of technology application is the foundation for more advanced technology applications such as POS (point of sale) devices which promise to reduce costs and improve accuracy in the field. A shared technology platform with connectivity to MFIs and their branches such as that being proposed by FINO could reduce the hardware costs of such IS systems while preserving confidentiality by ensuing data separation for the various users (including cooperative and rural banks).*

12 *CASHE has incubated 35 MFIs in Madhya Pradesh, Orissa and West Bengal (as well as AP) with grants for operational expenditures and capacity building, along with revolving fund assistance, and has prepared some of them for transformation. For ICICI's tie-up with CASHE/ACCESS for incubating new partners in MP see Chapter 6.*

13 *ICICI is experimenting with using MFIs such as KAS and Grameen Koota as BCs for opening and administering savings accounts. The BCs help fill in the account opening form and satisfy KYC requirements (e.g. checking identity cards and proof of address) some of which are cost-raising irritants. An e-passbook is issued to the account holder and all transactions are done only on an authentication device. Four free savings and withdrawal transactions are allowed a month. The challenge is to reduce costs below those of mobilizing much larger savings from regular bank customers.*

14 *The cost of a basic hand-held device is still Rs 10,000 to 15,000.*

15 *Another problem that has been pointed out is that the Khan Committee Report recommends that while BF/BCs can have relationships with different banks in different areas, only one contractual relationship is permissible with one bank in a defined geographical area. This modality of exclusion would require (i) the areas to be defined and (ii) monitoring to maintain geographical exclusions, therefore indicating the involvement of a regulator. Credit information on borrowers would be shared by the banks through the proposed National Microfinance Information Bureau (NMIB). The NMIB is a body proposed to be established under NABARD to collect and store data on clients.*

16 *HDFC Bank was reported to be considering this option.*

17 *This interest has generally been the PLR less 0.5 per cent.*

18 *See Sanjay Sinha, in "Debate: Cap the interest rate on microfinance", Economic Times, March 21, 2006, who anticipates a massive expansion of bank lending to the poor if the banks were allowed to recover their costs of 18-21 per cent of making small loans directly to the poor.*

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B. Equity Investments by the Venture Capital Funds

One of the more encouraging developments in the sector in the last couple of years has been the arrival on the scene of several venture capital funds, one of them registered in India and several others offshore. Between them they have greatly eased the immediate equity constraint facing start-ups and emerging MFIs, and indeed have created temporarily almost a "buyer's market", with MFIs now being in a position to shop around for the best deals. However this situation is unlikely to last

One of the more encouraging developments in the sector in the last couple of years has been the arrival on the scene of several venture capital funds, one of them registered in India and several others offshore. Between them they have greatly eased the immediate equity constraint facing start-ups and emerging MFIs, and indeed have created temporarily almost a "buyer's market", with MFIs now being in a position to shop around for the best deals. However this situation is unlikely to last, as the medium and longer term equity requirements of the sector are considerable. While M-CRIL (2006) estimates the current equity deficit of sample MFIs is only Rs 23 crore, their total equity fund requirement will grow to about Rs 1,100 crore by 2010, based on their growth rate of 146 per cent from April 2003 to March 2005.[1]

The new generation of equity investors

While equity investments in the handful of larger better known MFIs have been taking place for some time,[2] there were no specialized on-shore venture capital funds, or offshore venture capital funds dedicated to Indian MFIs, until the arrival of the present crop of VCFs. Equity investments were part of the charter of SIDBI Foundation for Micro Credit (SFMC), but this component of its activities met with far less success than some others, such as capacity building. Bellwether was the first fund to commence activities with an Indian registration, in 2005, and was followed by two other offshore funds, Lok Capital and Unitus Equity Fund. Taken together the size of their funds is presently $31 million. A fourth fund, Aavishkar-Goodwell, is in the process of raising capital. The Bangalore-based Michael and Susan Dell Foundation (MSDF) is not a fund but has already made one equity investment in partnership with Bellwether, and has provided donated equity to a non-profit Section 25 company. Grameen Capital India, was recently set up to provide investment and advisory services, including equity and quasi-equity investment products.[3]

In the public sector, finally, the corpus of NABARD's MFDEF (Microfinance Development & Equity Fund) was increased in the Budget for 2005-06 from Rs 100 to Rs 200 crore, and equity was added to its charter. Finally, one of the largest investors has in fact been an individual, a high net worth US-based Indian, Mr Vinod Khosla[4]. Table 7.3 describes the main features of the three funds that are already operational as well as MSDF.

Bellwether has been quick to take advantage of the first mover advantage. The diagram shows how Bellwether sees the contribution of its products to different segments of the market.

Table 7.3 Salient features of the main equity investors

	Bellwether	Lok Capital	Unitus	Michael and Susan Dell Foundation
Indian/Offshore	Indian	Offshore	Offshore	Offshore
Size at first closing	$10 million (could grow to $20 million)	$12 million	$12 million	A foundation, with an endowment of more than $1 billion, which also makes equity investments
Life of fund	15 years	10 years, extendable to 14	7 years	NA
Main investors	Individual and institutional (Hivos Triodos and Gray Ghost)	Institutional (IFC, KfW, CDC, FMO)	Mixed	NA
Investees so far (in India)	7 of which equity (3), convertible debt (2) and debt (2)	Fund closed in June 2006	2 equity and 5 capacity building partners	1 equity investment, 1 grant of donated equity to an S 25 MFI
Pipeline	3 existing NGO-MFIs, 2 start-ups Expects 10 equity partners by Sept 2007	5 existing MFIs, 3 start-ups. Expects 3-4 equity partners by Q2 of 2007	By end of 2007, 15 partnership of which 5-6 equity. Goal of Unitus-ACCION Alliance for India, coverage of 15 million clients within 10 years	4 or 5 partnerships this year, of which about half non-profits
Coverage goals	By year 5, aims to successfully transform 7 MFIs, of which at least 3 will be start-ups. Expects 40 per cent of investments to be outside southern states, and a rural-urban balance.	20 investments in all, in partners of different types and stages of growth, through various instruments	Provides capacity building support and branches	Same as above every year
Arrangements for TA	Will access grants for partners from other sources	Lok Foundation, the promoter, raising $2-3 million for long-term TA grants to investee MFIs	Partners must offer clear prospects of rapid growth of client outreach	As a foundation has considerable grant money
Emphases and special features	Apart from social returns, investees must offer clear prospects of attractive returns on equity.	As with Bellwether, but prefers longer-term investments in MFIs of 6-8 years, and use of off-balance sheets models such as the Service Company model		Focuses exclusively on urban microfinance. Regards both financial and social performance goals as best achieved through partners with aggressive growth plans, and willing to assist non-profits to make them attractive candidates for other investors

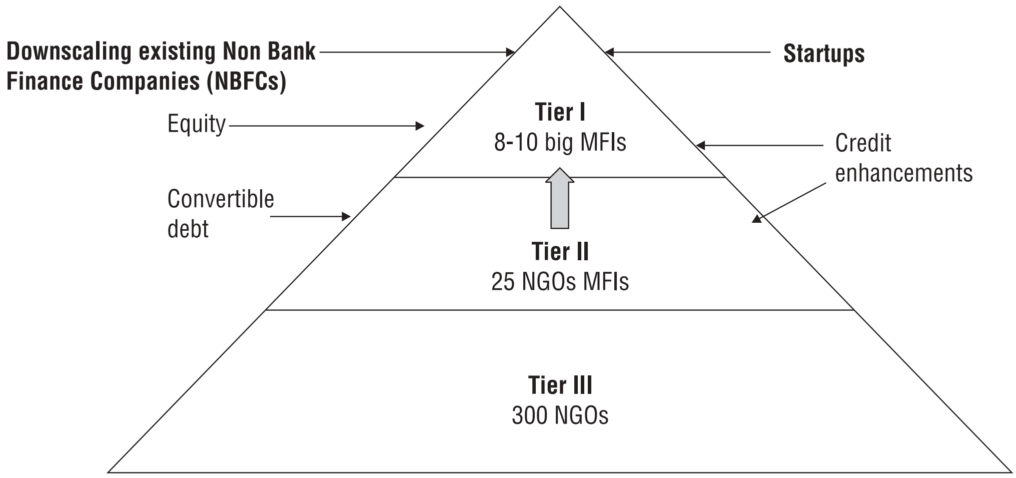

Figure : The Bellwether triangle

Equity is designed for both start-ups and established MFIs (Tier I in the diagram) and is expected to account for 50 per cent of portfolio.[5] Convertible debt is destined either for Tier II NGO-MFIs with high potential for scaling up and transformation, or to well-managed existing NBFCs that want to do down-market.[6] Debt is extended where there is potential for equity later, and loans have been made to two existing NBFCs who want to go down market. As an Indian fund Bellwether is not constrained by regulations governing the minimum size of investments and loans that foreign institutions must make, and thus has the advantage of being in a position to make smaller investments and loans more flexibly.

Lok Capital is a proponent of the service company model as an appropriate legal vehicle for start-up MFIs and Lok's investments

Like Bellwether, Lok Capital has well defined expectations regarding returns. It prefers to get in at an early stage and provide relatively long-term support to its investees, both through its investments (with an average expected duration of 6 to 8 years) and through TA. In works closely with Bellwether and other investors and is proposing to partner them in some investments in the pipeline.

Secondly, Lok Capital is a proponent of the service company model as an appropriate legal vehicle for start-up MFIs and Lok's investments. The service company model was developed in Latin America[7], and is essentially the same as the partnership or business correspondent models in the division of responsibilities between the MFI and the bank. Since a service company can be registered as a private limited company rather than an NBFC, it offers the advantage of (i) reducing the entry capital requirement,[8] (ii) avoiding the pre-emption of scarce managerial time and energy in dealing with the complexities and frequently long waiting period of registering as an NBFC, while leaving open the option to transform into an NBFC later, and (iii) not attracting the regulations on the minimum size of foreign investments in NBFCs, which would enable the investor to make investments of much smaller and more appropriate sizes in accordance with the requirements of the investee as it grows (see Box 7.1) (iv) eliminating an unnecessary layer of equity at the NBFC level. For investees that are already registered as NBFCs it envisages a "hybrid model", i.e. with the NBFC continuing to lend on its own books, as well as off the balance sheet in the role of a service company for one or more banks.

Unitus states its primary goal as extending outreach as quickly as possible since it regards this as the best way to serve the social objective of financial inclusion. The Unitus Equity

Fund invests equity in MFIs around the world. Unitus Inc. provides capacity building support and grant money. In its partners therefore it has shown a distinct preference for MFIs that offer the prospect of rapid growth. It is well-endowed with grant money for TA for CB. However it is flexible about the period in which its TA partners should transform into NBFCs as potential candidates for its equity investments. In September 2005 it announced an alliance with ACCION for Indian operations and the two organizations have set up offices in the same building in Bangalore (see also Chapter 6). However neither organization will limit its operations to joint-partnerships since they define their primary goals differently. Unitus has made two investments in India so far.[9]

MSDF is not a VCF, but a Foundation, dedicated to improving the lives of children around the world. In India it sees an opportunity to do so by promoting urban microfinance, primarily in the slums of the six largest cities, in which an estimated seven million children live

MSDF is not a VCF, but a Foundation, dedicated to improving the lives of children around the world. In India it sees an opportunity to do so by promoting urban microfinance, primarily in the slums of the six largest cities, in which an estimated seven million children live, and where little or no microfinance services exist so far. Microfinance is expected to help families develop the economic security to provide for and educate their children.

MSDF hopes to achieve this vision by catalyzing the development of scalable and sustainable start-ups through direct investments, targeted capacity building, and attracting top quality new leaders to the sector who "combine world-class management skills with the vision for massive social impact". Moreover, as a Foundation, it is in a particularly good position to add value to the market by providing grants to non-profits, not just for CB but for working capital to bring them to the point where they can attract equity investments, either from MSDF itself, or the other players. Thus MSDF has made a grant of the equivalent of $600,000 to Swaadhar, an urban start-up in Mumbai to carry them to break-even in about 3 years.[10] It expects half of its partners to be non-profits each year. However it expects them to aim at attaining exactly the same standards of governance and data driven management as its for-profit partners. It places particular emphasis on integrating social performance measurement into MFIs from the beginning, and to stimulate the creation of new kinds of lending for education, health, infrastructure and market-based services for micro-entrepreneurs.

Issues

Catering to the equity requirements of small MFIs: a task for MFDEF

While the equity requirements of the for-profits and of non-profits with the intention to transform are being catered to by the new VCFs, the segment that is still neglected is the not-for profit segment of MFIs registered as NGOs who are not in a position to transform, or indeed who may not want to transform

While the equity requirements of the for-profits and of non-profits with the intention to transform are being catered to by the new VCFs, the segment that is still neglected is the not-for-profit segment of MFIs registered as NGOs who are not in a position to transform, or indeed who may not want to transform. As discussed earlier there is need and scope for diversity in Indian microfinance and small not-for-profit institutions have a strong role to play in decentralizing coverage to underserved regions. While their main need is for credit funding rather than equity, all segments of the sector are highly leveraged and many of them find it hard to raise the next loan. In the M-CRIL sample 31 per cent of the total equity requirement for growth came from small MFIs with a portfolio size of less than Rs 1 crore, and another 33 per cent from medium MFIs, mostly NGOs, with portfolios of between Rs 1 and 10 crore. Moreover the growth equity requirement from those MFIs in these two categories with negative or inadequate CARs was 39 per cent of the total. Thus there is a both scope and need for equity financing for these segments from MFDEF.

Interestingly, and reassuringly, an earlier M-CRIL study based on nearly 250 MFIs rated since June 2005, found that extremely small MFIs with portfolios of less than 50 lakh had the highest CARs of all size classes - usually on account of accumulated donor grants (M-CRIL 2005). Unfortunately these were being eroded by operating losses, a useful reminder that the main priority in assisting small and indeed most medium MFIs should be capacity building. However the fact that they have positive net worth makes the challenge of investing in them easier, accompanied by heavy doses of CB.

Despite the weaknesses the public sector often displays as an equity investor (excessive caution and sometimes red-tape), these are not inherent, and are more often than not offset by the ability to bear higher risk

Despite the weaknesses the public sector often displays as an equity investor (excessive caution and sometimes red-tape), these are not inherent and are more often than not offset by the ability to bear higher risk. It is true that at a time when the availability of equity financing was more of a constraint than it is now, SFMC did not find many takers for its equity offering, which took the form of cumulative redeemable preferable shares, and which were really quasi-equity or Tier II capital, of insufficient interest to most of the partners it was offered to. On the other hand its long term transformation loan, also a form of quasi-equity as subordinated debt, helped many partners in their transformation plans.[11]

MFDEF has shown similar risk-aversion (or at least bureaucratic delay) in formulating its guidelines (these are still interim) but has now started receiving and considering applications (of which is has received three). Appropriately, it is planning to limit the amount of investment per partner to Rs 2 crore for NBFCs, and Rs 1 crore for others, and to give preference mostly to MFIs in underserved states. For NGO-MFIs, whose structure does not provide for shareholder equity, MFDEF is planning to extend quasi-equity in the form of nine-year loans at 1 per cent, with a moratorium of two years.

The "double-bottom line"

The situation in India is a little more encouraging. Whatever their place on the commercial-social continuum, there is strong demand for the services of all the existing VCFs whether they focus primarily on investments with attractive returns or not

A recent worldwide survey of foreign investment funds concluded that the average fund was too constrained in its ability to take risk[12] to add much value to the market, which was overcrowded. Very few of the funds were prepared "to finance less well-established MFIs, accept higher risk, spend greater amounts on pre-investment research and deliver funding in smaller packages" (CGAP 2005). The situation in India is a little more encouraging. Whatever their place on the commercial-social continuum, there is strong demand for the services of all the existing VCFs whether they focus primarily on investments with attractive returns or not. This is because they all have in addition social goals (and therefore a "double bottom line"), and offer valuable CB inputs, whether through their own resources or by arrangement with institutions that have access to grant funding. Interestingly, in India, unlike the situation worldwide, most of the VC funding comes from private rather than public sources[13] and it is individuals and not public institutional investors who are behind the funds with the largest endowments of socially-motivated capital. Also, all the VCFs bear the foreign exchange risk themselves rather than pushing it on to the investee. Finally they are investing despite the lack of clear exit options.[14]

The demand for equity

The longer-term demand for equity has been discussed above. The strong current demand for equity comes from the spurt in NBFC start-ups, and from buy-outs of old pre-1999 NBFCs, especially in the urban areas. It also comes from a number of existing pre-1999 NBFCs,[15] mostly urban, who want to downscale to include microfinance in their portfolios. Third, many of these MFIs are increasingly being promoted by persons with management experience in banks or other MFIs, and their capacity to add to demand is high. Fourth, there is no reason why this trend should not extend to primarily rural pre-1999 NBFCs.

The longer-term demand for equity has been discussed above. The strong current demand for equity comes from the spurt in NBFC start-ups, and from buy-outs of old pre-1999 NBFCs, especially in the urban areas. It also comes from a number of existing pre-1999 NBFCs, mostly urban, who want to downscale to include microfinance in their portfolios

The sector as a whole is highly leveraged, and although ICICI's partnership model has theoretically softened the capital adequacy constraint by bringing loans on to its own books, in practice recent developments point to the risks of over-lending under the partnership model without concurrent improvements in capacity and management. Also, the partnership model still requires equity to satisfy FLDG requirements, although the demand for equity this creates is much lower (about a 10th) than that which would be required to satisfy standard capital adequacy norms.[16] Further, other banks have not adopted the partnership model, and pending review of eligibility criteria for NBFCs as Business Correspondents, a March 2006 RBI circular has advised banks to defer the selection of NBFCs also as Banking Correspondents (see Chapter 7A).

Perhaps most importantly, the draft microfinance bill proposes broad-basing the initial entry capital requirement to Rs 25 lakh to all NGO-MFIs with a portfolio of more than Rs 1 crore. This too will add considerably to the demand for equity, although only the public sector and private Indian funds will be able to invest in amounts smaller than $0.5 million, which is another reason for considering reducing the minimum foreign investment permissible in NBFCs.

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Foreign investment regulations for microfinance VCFs

The existing foreign investment regulations for NBFCs, which are not microfinance specific, often entail an inefficient use of funds, since MFIs do not always need equity injections in the minimum quantities laid down. A modification of the regulations would enable smaller quantities of equity to be provided when needed. The subject and a proposal is discussed in Box 7.1

The existing foreign investment regulations for NBFCs, which are not microfinance specific, often entail an inefficient use of funds, since MFIs do not always need equity injections in the minimum quantities laid down

Box 7.1 Foreign equity investment

Existing regulations

NBFCs can receive foreign equity investments which have to be in certain minimum amounts depending on the level of foreign ownership in the company. For equity stakes between 0-51 per cent, the minimum capital requirement for any FDI is $500,000. This amount can include any number of foreign shareholders as long as the total upfront foreign investment exceeds $500,000.[17] As shown in the table below, the capital requirements increase sharply as the foreign ownership stake increases beyond 51 per cent.

Modifying the 0-51 per cent minimum capital requirement

There is considerable concern that existing FDI capital and ownership requirements pose serious obstacles to foreign equity interest in the sector. For example, before an NBFC can receive any FDI, it must first raise $500,000 in matching domestic equity to avoid eclipsing the 51 per cent foreign ownership limitation. Otherwise, the foreign capital requirement would ratchet up to $5 million. However, domestic equity in microcredit is in short supply. Therefore, restrictions on domestic equity investment in NBFC-MFIs curb both domestic and

Box 7.1 Continued

foreign sources of equity capital.

It is also important to note that existing FDI regulations skew foreign equity funds away from start-up MFIs which lack the scale to attract individual equity investments of this size. While many foreign investors may be willing to make smaller investments in one or more well-run institutions, few are willing to invest $500,000 in a single NBFC-MFI. Additionally, different MFIs require different amounts of capital. One MFI may require $250,000 in capital while another may require $700,000. Enforcing a $500,000 minimum capital requirement prevents

Minimum Capitalization requirements for foreign equity investment in NBFCs

Percent Ownership	Minimum Capital Requirement	Other Stipulations
0-51%	$500,000	Entire amount must be contributed up front
51-75%	$5,000,000	Entire amount must be contributed up front
76-100%	$50,000,000	$7.5 million must be contributed up front. The balance must be provided within 24 months.

Source : **www.rbi.org.in** ***RBI Circular on Foreign Direct Investment (7/01/2006). Annex-2, Sector-2 (NBFCs)-Sector Cap on Investments by Persons Resident Outside India.***

NBFCs from receiving optimum levels of foreign investment.

Thus, the most onerous NBFC-FDI restriction is clearly the $500,000 minimum capital requirement. We propose reducing this initial requirement to $100,000. This will still discourage non-serious investors from investing in the sector, but will also create more breathing room to

Proposed Alternative: Minimum capitalization requirements for FDI in NBFC-MFIs

Percent Ownership	Minimum Capital Requirement	Other Stipulations
0-25%	$50,000	Entire amount must be contributed up front
26-50%	$100,000	Entire amount must be contributed up front
51-75%	$500,000	Entire amount must be contributed up front
75-100%	$1,000,000	Entire amount must be contributed up front

Box 7.1 Continued

optimize the size of equity investment as well as attracting a greater pool of foreign investors.

Modifying the majority ownership requirement

Equity investors typically prefer having minority stakes in NBFCs. This leaves more space to craft high-powered equity-based incentive packages for local managers. The RBI also prefers local ownership of NBFCs because it eases its monitoring task. Thus, there is a case for having a substantial step-up in the FDI required to achieve a majority stake in an NBFC. However, there is also real concern that the 10x increase in capital requirements accompanying the jump from 50 per cent to 51 per cent ownership is too sharp. One alternative is a slightly more gradual FDI capital/ownership requirement scale rather than the three-tier structure outlined above. As a possible benchmark, we've presented a micro credit-only NBFC-FDI regulatory structure alternative below, incorporating far lower capital/ownership hurdles and a slightly more gradual scale.

Most of India's poor still lack even basic financial services. If foreign investors want to help India alleviate this pressing problem, their investments should be welcomed, subject to minor controls. We feel a structure of the kind presented above would open up the sector to many more potential foreign investors while still encouraging local NBFC-MFI ownership.

Excerpted from Rati Tripathi and Daniel Radcliffe, Forthcoming.

Endnotes

1 *At this point they will cover about 18 million households, about 25 per cent of the estimated 75 million poor households in India. M-CRIL 2006 also provides lower estimates of coverage based on lower growth rates. The sample consists of 87 rated MFIs, covering about 90 per cent of all clients in India, and assumes a capital adequacy ratio of 12 per cent (a debt-equity ratio of about 7:1) and internal accruals at the historical rate. The average capital adequacy of MFIs is presently a relatively prudent 13 per cent, but about 30 per cent of the sample MFIs have either negative or only marginally positive net worth. To support its growth projections in the most likely scenario Intellecap (2005) estimates an equity capital requirement of Rs 1,900 crore over the five years 2006 to 2010.*

2 *Thus Basix has attracted equity investments from IFC, HDFC, and ICICI Bank, among others.*

3 *GCI is a partnership between Grameen Foundation USA, ICICI Bank and Citigroup India.*

4 *He has invested $250,000 in CASHPOR, $2 million in SHARE Microfin, as well as in SKS*

5 *Bellwether has taken a 25 per cent stake in Ujjivan, promoted by professional bankers, to provide urban microfinance services, initially in Bangalore, and a majority stake in another urban start-up, Uttaran, promoted by a senior microfinance professional, who was formerly with BASIX, which will start operations in Kolkata before expanding to other parts of eastern India. The third investment (a 49 per cent stake) is in Biswa, a large transforming NGO in Orissa, which is also being assisted through a TA on legal transformation to an NBFC. One of the equity investments in the pipeline is a majority stake in Sun Microfinance, an existing NBFC in Allahabad, eastern UP, which has been acquired by two microfinance professionals formerly with CASHPOR.*

6 *Under this segment Bellwether has provided a credit enhancement to an urban NGO (a guarantee to a bank), and a loan to a rural MACS, both in AP, with the option to take a 26 per cent stake in them on transformation.*

7 *See ACCION (2003)*

8 *The registration fee for a private limited company is Rs 1 lakh, as against Rs 2 crore for an NBFC.*

9 *These have been the equivalent of $290,000 in Ujjivan (in which it has co-invested with Bellwether and MSDF) and $470,000 in SKS.*

10 *Its equity investment is for the equivalent of $165,000 in Ujjivan, as a co-investor with Unitus.*

11 These were 7-year loans at 1 per cent interest which gave SFMC the option to convert the loan into equity.

12 On account primarily of the risk/return expectations of its promoters, although the bulk of funding came from the investment arms of the IFIs.

13 Lok Capital being fully, and Bellwether partly, the exceptions.

14 Most MFIs are extremely small and listings may not be possible in the near future. ICICI has made an interesting offer to enter into agreements with the VCFs to provide long term subordinated loans to the MFI to provide liquidity for buying back the stake of the VC with pre-agreed returns, automatically, on the MFI securing a minimal CRISIL or M-CRIL rating.

15 Until 1999, entry capital requirements were Rs 25 lakh.

16 An interesting question is whether the standard norm capital adequacy of 12 per cent which has been formulated for banking institutions which accept deposits, is applicable to Indian MFIs which do not. This consideration may somewhat dilute the concern often expressed about the high leverage of Indian MFIs.

17 For example, in November 2005, Vinod Khosla and Grameen Foundation-USA each invested $250,000 in Cashpor Financial and Technical Services. This coordinated investment combined to meet exactly the $500,000 minimum capital requirement for equity stakes between 0-51 per cent.

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CHAPTER 8

Financing: Developmental

A. Apex Financing Institutions: Growing the Seeds and Saplings

The broad division of labour that has emerged among the apexes is that NABARD lends to MFIs (under its Model II) only in areas where bank branches are sparse on the ground and therefore unable to extend linkage loans to SHGs. Also, such lending is provided only to MFIs financing SHGs. As noted in Chapter 2, the share of NABARD lending under Model II is rapidly declining, in view of increases in bank lending, and its role will therefore not be dealt with further in this chapter.[1]

This chapter will deal with wholesale lending to MFIs by the (i) SIDBI Foundation for Micro Credit (SFMC), (ii) the Friends of Women's World Banking (FWWB), (iii) the Rashtriya Mahila Kosh (RMK), and (iv) the Rashtriya Gramin Vikas Nidhi (RGVN). SIDBI/SFMC is described very briefly, since it lends only to large and medium MFIs, as is RGVN which is a relatively small regional apex for the North and East.[2] The bulk of the chapter is devoted to FWWB and RMK since the concern here is with growing small nascent MFIs, the so called "seeds and saplings." Among the four AFIs, FWWB is the only non-public sector bulk lender. The respective size of loans outstanding to MFIs of the four institutions in March 2006, along with that of the banks, is shown in Table 8.1

Table 8.1 MFI loans outstanding to the apex funding institutions and banks (Rs crores)

Apex financing institutions and comercial banks	Outstanding loans to partners in March 2005*	Outstanding loans to partners in March 2006
SIDBI		329
FWWB		67
RMK	37	
RGVN	6	
Commercial banks		2,000 (approximately)

Source: Annual reports for AFIs. Broad order of magnitude figure for commercial banks based on Table 7.1, included for purposes of comparison. *RMK and RGVN figures available only for March 2005.

SIDBI Foundation for Micro Credit (SFMC)

SFMC, set up with assistance from IFAD and DFID (see Chapter 8B), started operations in January 1999. Apart from providing loans grants and equity to MFIs, SFMC's mission includes a strong capacity building component (discussed in Chapter 6), the development of a network of service providers, advocacy of appropriate policies and regulations, and promoting the exchange of information across the sector.[3] Partner institutions comprise large and medium scale MFIs with an anticipated minimum borrowing requirement of Rs 1 million a year, and an outreach of at least 3,000 poor members (or the prospect of reaching this scale within a year), and a clear and credible path to operational and financial self-sufficiency.

Prospective partners are first rated by an independent rating agency. In order to encourage new NBFCs to enter the field, the usual requirement of a minimum track record of three years can be relaxed if the partner has been rated AA (or the equivalent). Grant support is provided as technical assistance to strengthen systems, and also as operational support to enable MFIs to meet a part of their operational deficits during the initial, expansion phase. The Transformation Loan is a quasi-equity product providing for conversion into equity after a specified period of time, subject to the MFI attaining certain structural, operational and financial benchmarks. In 2005-06 SFMC disbursed Rs 253 crores of term loans to 62 partners, Rs 4 crores of Transformation Loans to five partners, sanctioned Rs 9 crores as capacity building grants, and made one equity investment of Rs 1 crore.[4]

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The Rashtriya Gramin Vikas Nidhi (RGVN)

RGVN, headquartered in Guwahati, was set up in the mid-1990s by a consortium of public financial institutions to wholesale to small start-up NGOs in the Northeast and East, much as RMK does for the whole country. As a bulk lender through its NGO Support Programme, RGVN followed a policy until recently of not assisting its partners with revolving fund loan assistance more than twice (apart from providing capacity building assistance and a modicum of grant funding) but seeking instead to graduate them to other lenders. Thus it lent an average of only 2 lakh to about 100 partners in 2004-05. However it has now decided to lend larger amounts to about 10 to 20 out of its 400 partners who have been judged on the basis of a grading exercise to have built-up enough capacity to absorb loans of about Rs 5 lakh each initially. Since the bulk of its funds come from borrowings (from SIDBI, ICICI, and others) it has to charge a higher interest rate than RMK (12 as against 8 percent) and for this reason some of its fledgling partners could also be picked up by RMK, which has appointed two nodal agencies (see below) in Assam. RGVN started a retail programme only for Assam, the Credit and Savings Programme, more recently, which has grown rapidly to equal if not exceed the bulk lending programme in size.[5]

Friends of Women's World Banking (FWWB)

FWWB, India, is part of the SEWA family of institutions and one of about 40 global affiliates of WWB, New York. It is headquartered in Ahmedabad, and has an office in Chennai. It continues to remain a registered society. It has received grants and loans from a number of funding partners, and its business model is to leverage its corpus by borrowing from the banks and onlending to its MFI partners. Its largest lender in March 2006 was SIDBI (with 36 percent of total borrowings outstanding), so in a sense FWWB is a "Tier 2" apex or wholesaler.

Table 8.2 Financial performance of FWWB and RMK (Rs crores)

	FWWB		RMK	
	March 2005	March 2006	March 2004	March 2005
Number of states	11	12	20	20
Number of partners (cumulative)	272	292	1113	1153
Number of partners (active)	79	79	NA	NA
Number of partners assisted	57	70	112	118
Loans outstanding to partners	58.3	67.0	27.6	36.5
Disbursements	61.5	70.6	14.5	18.9
Disbursement per partner assisted	1.1	1.0	0.13	0.16
Number of borrowers (active, current)	1.86 lakhs	2.17 lakhs	NA	NA
Average loans size of borrowers	Rs 4974	Rs 5008	NA	About Rs 3000
Corpus	9.6	10.6	54.1	54.1
Reserves and surpluses	5.6	8.6	19.1	21.7
Share of southern states in LO/disbursements*	81 percent	75 percent	56 percent	52 percent
Cash and bank balances	20.5	20.8	37.00	33.00
PAR of partners, percent	2	0.4	NA	NA
Interest from loans to partners	8.1	9.3	1.61	1.96
Income from bank balances	0.55	0.66	1.95	2.81

***Sources:* Annual Reports and interviews. NA= not available, *LO for FWWB and disbursements for RMK. Figures are for the last two years for which published annual reports are available from each organization.**

FWWB sees its core role as institutional development (ID) and the availability of grant funding, especially from USAID for this purpose, enables it to play a strong capacity building role through a system of a minimum of two technical assistance visits a year by its own staff. These entail face-to-face interactions at both the management and operations level to establish strong systems in respect of accounting, financial management, governance and MIS. FWWB feels that it has an advantage of being able to provide TCB assistance more effectively than TCB providers who provide it as a stand-alone input. Partners are graded into three categories in terms of outreach and loan portfolio into Big Partners (of which there were 6 in March 2006), Institutional Development Partners (20) who are in turn graded into A, B, and C

FWWB sees its core role as institutional development and the availability of grant funding, especially from USAID for this purpose, enables it to play a strong capacity building role

categories, depending on the amount of capacity building they require, and General Partners (GP) (64)[6]. C category ID partners receive the maximum of amount of CB assistance, or as many as four visits a year[7]. In the second year, partners are eligible to receive infrastructure grants for computers, vehicles, etc.

In view of the increasing availability of loans from the commercial banks FWWB follows a conscious policy of graduating partners through the three categories. Progress is monitored and documented in the annual reports. The aim is to graduate about four or five ID partners to Big Partner level every year and a similar number of General Partners to ID partners. About 30 out of the current 79 partners have received loans from the banks and financial institutions such as SIDBI. The aim is to limit the share of BPs in the total portfolio to 50 percent and of ID partners to 35 percent.[8]

FWWB's lending to the non-southern states increased from 19 to 25 percent in 2005-06. Norms for minimum membership, portfolio outstanding, and accumulated savings are lower for non-Southern states, although a minimum of two years of existence as an organization (although not necessarily doing savings and credit) is insisted upon for all potential partners, as evidenced by an audited balance sheet. In states like Jharkhand and in the Northeast these norms have been relaxed further in some cases to go down to as few as 200-500 borrowers for new partners. In fact FWWB prefers relatively fresh organizations to those with a longer life (usually conducting non-savings and credit activities) since it feels they are more responsive to the adoption of new micro-finance specific systems and management practices. Likewise, among its partners generally, it finds organizations with an exclusive focus on microfinance do better than multi-activity partners.

In view of the increasing availability of loans from the commercial banks FWWB follows a conscious policy of graduating partners through the three categories. Progress is monitored and documented in the annual reports

First loans to new GPs are usually not for more than 100-200 borrowers with an average loan size of Rs 2,000-5,000 each. The rate of interest is currently 10.5 percent, with a 0.5 rebate for timely payment. Since the operational cost ratio is only 1 percent, this leaves 1.5 percent for loan loss write-offs. An organization like FWWB that sets out to nurture small and nascent MFIs must be prepared to absorb a certain degree of loan losses and there is a candid and useful analysis in the annual report for 2004-05 of the reasons for why 52 GPs dropped out during the previous three years. 22 of these organizations were not delinquent, since they returned their loans, but they were judged unlikely to be able to absorb further support, and only a quarter of the drop-outs represented cases of wilful default.[9] FWWBs capacity building contribution is further enhanced by insistence on minimum additions to staff capacity as conditions for qualifying for second loans, with the incremental capacity addition requirement depending on the size of the second loan.[10]

Rashtriya Mahila Kosh (RMK)

RMK was set up with great fanfare[11] as a bulk lender to NGOs and government intermediary organizations by the central government in 1993, the same year FWWB commenced operations, to promote lending to women under the SHG programme, which in those days was still in a nascent stage, and before anyone had anticipated that linkage lending from the banks would grow to the extent it has. The RMK is a registered society with a governing body of not more than 16 members including the ex-officio chairperson who is the minister in charge of the Department of Women and Child Development, and the executive director, who is usually an

IAS officer on deputation. Seven members of the governing body are nominated by the government as representatives of NGOs active in the field of micro-credit.

RMK initiated its activities on the basis of an initial corpus received from government of Rs 31 crores, which has since grown to Rs 54 crores on the basis of surpluses generated by the lending operation, and the investment proceeds of its reserve funds of about Rs 21 crores currently. While its Memorandum of Association allows it to borrow from the banks, it has not felt the need to do so yet, and has been sanctioned a further addition to its corpus of Rs 10 crores in this year's budget. The latest published annual report which is available, that for 2004-05, contains a cumulative state-wise list of 1,153 partner NGOs (which has since grown to about 1,250) but does not mention how many of them are active, with loans outstanding currently. Only 112 partners were disbursed loans in 2003-04 and 118 in 2004-05. The cumulative list includes presumably a large number of partners who have repaid their loans and graduated to the banks or SIDBI, and of others who defaulted.[12]

Thus RMK is lending out much less than FWWB on the basis of a much larger corpus, albeit at a lower interest rate of 8 percent as against FWWB's current rate of 10.5 percent

Disbursements (of Rs 18.8 crores in 2004-05) provide a better indication of the scale of activities than loans outstanding, since the latter figure includes Rs 9 crores of cumulative bad and doubtful loans. Writing some of them off will shrink the balance sheet commensurately.[13] Thus RMK is lending out much less than FWWB on the basis of a much larger corpus, albeit at a lower interest rate of 8 percent as against FWWB's current rate of 10.5 percent.[14]

Cumulative overdues constitute 7 percent of total disbursements of 126.8 crores since inception. This may still be an acceptable figure depending on the quality of partners that were sought to be assisted, the extent to which default was beyond their control, and the offsetting success in growing other partners. The social justification for the public sector financial institutions is overcoming market failures by being able to accept higher risk. However, clearly, greater capacity needs to be built up in appraising and monitoring partners.

The true test is how effectively it has helped its partners to grow. Unfortunately the documentation or ongoing monitoring oes not exist to enable such an evaluation. RMK certainly showed great promise in its early days when there was a dearth of funding from other sources

RMK does however make much smaller loans (average disbursements per partner were Rs 16 lakhs in 2004-05 as against Rs 1 crores by FWWB), and it has reached a much larger number of nascent NGOs. Moreover it is much better represented in the non-southern states. The true test is how effectively it has helped its partners to grow. Unfortunately the documentation or ongoing monitoring does not exist to enable such an evaluation. RMK certainly showed great promise in its early days when there was a dearth of funding from other sources, despite the fact that an earlier, unrealistic, interest rate cap on the rate at which a partner could on-lend along with certain procedures greatly decreased its attractiveness.[15] Several of today's well-known MFIs were partners of RMK in their early days, including the largest in the country SHARE. SIDBI was appreciative of the candidates it threw up for SIDBI financing, and others shifted to FWWB.

It is likely that many of RMK's partners are too small or inexperienced to be lent to by the banks, and that assisting them to grow is still a vital need. However more important than funding, even more so in this, is capacity building assistance, which RMK is not in a position to provide in-house, and without radical changes in structure (see below) is not likely to be. With the increase in TCB providers (see Chapter 6) it should be possible to outsource this input, but even this would require a great deal of coordination and monitoring, which is not to say it may not be well worthwhile, provided RMK redefines its role, as discussed below.[16]

The distribution of total disbursements of Rs 18.8 crores in 2004-05 was 46 percent under the Main Loan scheme, 24 percent under the Gold Credit Card scheme, 12 percent under the Franchisee scheme, 11 percent under the Revolving Fund scheme and 4 and 3 percent under the Housing Loan and Loan Promotion schemes, respectively. The last of these schemes is specifically designed for young organizations which have as little as six months experience of thrift and credit management. Under it, 23 partners were disbursed as little as 1.49 lakhs each in 2004-05. Otherwise a minimum of three years experience of savings and credit is expected.

Partners are expected to onlend at less than 18 percent, which now gives them a comfortable margin. Loans are of three years duration, repayable in quarterly instalments after a grace period of six months, except under the Gold Credit Pass Book scheme (now called the Bulk Lending scheme) which allows credit limits of up to 5 crores for medium and large NGOs, and is extended initially for three years. Disbursements under it were however only an average of Rs 65 lakhs to seven partners. Under the Franchisee scheme, small NGOs can borrow directly from franchisees in each state, who can be lent up to 5 crores each. RMK lends at 5 percent to franchisees who onlend to smaller organizations at 8 percent. Disbursements to two intermediaries in 2004-05 were Rs 115 lakhs each. There is also a Refinance scheme under which RMK provides 100 percent refinance to Mahila Urban Cooperative Banks on loans made to poor women either directly or through SHGs.

It does not classify its partners in terms of size or type and is not equipped to monitor their progression up the size ladder let alone graduation to commercial funding. This should be a clear objective

A Nodal Agency Scheme originally introduced some years ago is being relaunched this year in revised form, under which nodal agencies will appoint experienced and energetic young persons to mobilize at least 15 quality loan proposals each from organizations in their areas for RMK financing every 6 months[17]. Another new scheme is the Working Capital Term Loan scheme under which intermediary organizations will be eligible to borrow up to Rs 1 crore per state for a maximum of three states to invest in marketing infrastructure and services (such as vehicles, sheds, etc).

As noted above, in its early days, RMK was seen as filling a valuable niche in nurturing and growing incipient, nascent NGOs, the so called the seeds and saplings, or inducting into microfinance many existing NGOs already providing services other than savings and credit, while SIDBI defined its role as financing the larger MFIs, taking over many former RMK partners. However there is not enough information in RMK's recent annual reports or elsewhere to show whether it is still playing this role. It does not classify its partners in terms of size or type and is not equipped to monitor their progression up the size ladder let alone graduation to commercial funding. This should be a clear objective, with a clear identification of technical assistance requirements to be provided by TCB service providers. For multi-activity partners (the majority) the aim should be to make the microfinance activity viable as separate profit centres.

The thrust of schemes such as the Franchisee Scheme in which RMK is at one remove from the organization lending to the final borrower, new schemes such as the nodal agency scheme, and changes such as raising the ceiling on individual borrowing (from Rs 15,000 to Rs 25,000) would seem however to be heavily on increasing portfolio size without regard to developing capacity, although the nodal agency scheme will assist in further improving the regional distribution of the portfolio. It is understood that the government has decided to increase RMK's corpus to Rs 100 crores, of which Rs 10 crores is to be the first contribution. Along with Rs 12 crores currently in the risk fund, amounts of Rs 6.7 crores in an Information, Education and Communication Fund and Rs 2.7 crores in a Promotion and Development Fund are presently earning interest in the banks (enabling interest income to exceed lending income). It is not clear why RMK should not be drawing on these funds (after drawing down on the risk fund to write off unrecoverable loan losses), and its growing corpus, to add a strong component of capacity development inputs into its assistance.

Thus the relevant model for RMK is not to try to grow into another SIDBI but to incubate even smaller organizations than FWWB currently reaches, provided they are willing to take up microfinance "professionally" (target the truly poor, equip themselves with the necessary skills and systems, and set themselves the goal of achieving sustainability for the microfinance activity). In order to do so RMK will have to greatly strengthen its own capacity to identify, appraise, monitor, and mentor such organizations, though third-party service providers if necessary, who will have to paid the requisite fees.

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It should be possible for RMK to acquire this capacity within the constraints of its present governance structure. The seven non-official governing board members should be experienced and well known microfinance leaders and professionals, and the CEO should be chosen from among the best candidates available, whether from within government or from the microfinance sector. While staff could include persons on deputation from the banks, social welfare boards, etc, it should consist primarily of the right combination of persons with a proven track record in good MFIs or SHPIs. While RMK's mission is the development of women and children, the means it has chosen is microfinance.[18]

The social rationale for funding RMK at zero financial cost is to enable it to add value to the sector by accepting a higher level of calculated risk on promising and deserving nascent organizations, especially in areas where the regular programme has not yet reached. There is no social justification for RMK funding to substitute for mainstream bank funding of SHGs and other organizations.

Endnotes

1 *It should be noted that NABARD uses Model II also to finance other apexes or bulk lenders such as FWWB and RMK described in this chapter.*

2 *This is not to say it does not play a valuable role in its region, but in the last couple of years it has been growing its role as a retail lender at the expense of bulk lending as noted below.*

3 *SFMC launched an electronic portal for information dissemination and knowledge sharing within the sector, and has promoted the development of MIS software for MFIs. Other initiatives undertaken or proposed are a publication similar to the Micro Banking Bulletin (MBB) and a common chart of accounts for the sector.*

4 *In SKS.*

5 *The CSP had about 16,000 active borrowers in March 2006 in 10 districts of Assam. The bulk of CSP's lending is through SHGs, but it also lends through smaller 5-member JLGs, and makes individual loans, and also offers a remittance service (see Chapter 5B).*

6 *Big Partners are defined as those with an outreach of more than 10,000 women and a loan portfolio of more than Rs 5 crores, ID partners as those with above 5,000 borrowers and a portfolio outstanding of Rs 1 crore, and GPs those who fall below the above limits, although they must have a minimum of 1,500 partners to be eligible at all. Partners are not allowed to graduate if they have weak systems.*

7 *Of four days each.*

8 *In 2004-05 the share of BPs went down from 37 to 26 percent, while that of ID partners increased from 44 to 53 percent and of GPs from 19 to 21 percent.*

9 *As Table 8.2 shows the current PAR of partners has dropped to 0.4 percent which should reduce the loan loss rate considerably.*

10 *Thus to qualify for the minimum sized second loan of Rs 10 lakhs, the partner has to add at least one "competent" staff in addition to the CEO, for a loan of between Rs 10 and 25 lakhs, it has to add in addition an accountant with a minimum qualification of a B.Com, and above Rs 25 lakhs a staff separately for MIS. All loans of above Rs 5 lakhs have to be backed with post-dated cheques for repayment installments, which are usually quarterly for larger loans and bullet for smaller loans.*

11 *Its inception was announced from the ramparts of the Red Fort in the prime minister's independence speech.*

12 *Of the latter, civil suits have been filed against 210 and 217 have been blacklisted on the RMK website. It is not clear what the extent of overlap is between the two categories.*

13 *24 percent of loans were overdue for more than three years, 14 percent for more than, 14 percent for more than one, and 42 percent for less than one. The auditors use the standard banking system of classifying overdues into sub-standard, doubtful and loss. They suggest a provisioning requirement of 100 percent for loans overdue for more than three years. The entire amount of overdues are covered by a risk fund of 9 crores , built up out of transfers from surpluses each year, which are overstated since they do not include provisioning expenses, and enable RMK to earn interest on its risk fund deposited in the banks.*

14 *Most FWWB borrowers qualify however for the 0.5 percent on-time repayment rebate.*

15 *The onlending rate cap was 12 percent, which has now been increased to 18 percent. There was however a 1 percent rebate for timely disbursement and 0.5 percent on timely repayment, giving MFIs an effective margin of 5.5 percent In addition there was a 1 percent rebate on expenditure by the partner on training. However few partners qualified for it. One of the most irksome procedures was having to furnish the entire list of prospective borrowers.*

16 *RMK no longer sees itself as a capacity building organization. The chapter on promotion and development has been dropped from the 2005 annual report. The policy enunciated in the previous report was that "RMK will provide capacity building assistance up to a maximum of 10 percent of loan sanctioned."*

17 *39 NOAs have been identified in 21 states. They will get performance incentives of 1 percent on disbursements and 1 percent on recoveries. The individuals selected will get a remuneration of Rs 5,000 ar month apart from TA/DA.*

18 *It must be recognized that RMK is handicapped by government procedures. The disadvantages of having IAS officers as CEOs is that their tenures are typically too short to provide continuity and the accumulation of expertise in a highly professional activity, no matter how capable and talented they may be. However there are advantages too, especially if the CEO is supported by strong permanent senior management, and suitable candidates may well present themselves from within government. The PKSF of Bangladesh provides a possible model, which although publicly funded, is governed by a board with strong representation of prominent sector leaders, and has a CEO drawn from the sector, who is not subject to the vagaries of the civil service system.*

B. Donor Participation in Indian Microfinance[1]

Donor funds have played a critical role in growing the microfinance sector in India. They have made a significant contribution to the predominant channel of microfinance in India - the Self Help Group Bank Linkage Program (SBLP) - in the form of promotional and capacity building grants for the massive number of 2.2 million SHGs and their federations

Donor funds have played a critical role in growing the microfinance sector in India. They have made a significant contribution to the predominant channel of microfinance in India - the Self Help Group Bank Linkage Program (SBLP) - in the form of promotional and capacity building grants for the massive number of 2.2 million SHGs and their federations. Contributions for the same have come from virtually every bilateral, multilateral agency and private foundation in the country, including agencies within the UN system - the International Fund for Agriculture and Development (IFAD), the World Food Program, and the United Nations Development Program (UNDP) --, multilaterals outside it like the World Bank, and government agencies such as the Department for International Development (DFID), Canadian International Development Agency (CIDA), as also private foundations like the Ford Foundation, Sri Ratan Tata Trust, HIVOS India etc. These projects helped scale up the linkage program and evolved many of the current institutional models with SHGs at their base. Mention must be made in this context especially of the UNDP SAPAP (South Asia Poverty Alleviation Program, Andhra Pradesh), IFAD MRCP (Maharashtra Rural Credit Project) and World Bank assisted Andhra Pradesh Rural Poverty Reduction Program (Indira Kranti Patham) programs[2]. At the apex level, agencies such as the Swiss Agency for Development and Cooperation (SDC) and Gesellschaft fur Technische Zusammenarbeit (GTZ) have been key technical and financial partners for the National Bank for Agricultural and Rural Development's (NABARD) promotional and refinancing role in the SHG Bank Linkage program.

For MFIs, donor funds have played a strategic role in paving the way for commercial lenders and investors. Many of the more successful MFIs in India today have their origins in organizational forms such as societies and trusts which funded their initial microfinance programs almost entirely through grants. Bilaterals such as DFID, SDC and foundations such as Ford have played a key role in this context.

BOX 8.1 Forms of donor funding in Indian microfinance

In India donor funding for microfinance has taken the form of

- Operational grants, onlending funds, transformation funds for microfinance retail institutions (such as NGOs, banks, credit unions, financial companies etc.) eg. DFID, Ford Foundation, SDC for BASIX, Cooperative Development Foundation, DHAN etc
- Components of business development services programs - SDC, ILO, Ford Foundation
- Technical assistance/capacity building project - DFID, Sri Ratan Tata Trust, SDC, Ford Foundation

BOX 8.1 Continued

- Enabling Environment (legal and regulatory framework) projects - Ford Foundation, SDC, USAID
- Corpus fund investments - Ford Foundation, Sri Ratan Tata Trust
- Support for apex institutions (national/regional networks, wholesale funds, service providers) SDC, GTZ partnership with NABARD; USAID partnerships with SADHAN and FWWB
- Components of integrated rural development or poverty alleviation program or budget support programs - DFID budget support to Andhra Pradesh, Orissa and West Bengal state governments, World Bank partnership with govt. of Andhra Pradesh

Instruments available to support microfinance projects have been

- Grants for capital
- Grants for Technical Assistance
- Loans for Technical Assistance
- Loans for capital
- Equity

Besides supporting the growth of the financial infrastructure of the sector, agencies such as DFID, Ford Foundation, SDC and USAID have funded capacity building, microfinance ratings (through Microcredit Ratings International Limited) and critical research for product and institutional innovation. They also helped set up associations of Indian MFIs such as SA-DHAN and INAFI (International Network of Alternative Financial Institutions) - towards an enabling policy regulatory environment for microfinance in India.

Significant research to highlight issues of access to financial services and evaluate specific approaches to address these issues have been facilitated by donor funding. The World Bank Rural Financial Access Survey (Shrivastava & Shukla 2003) highlighted the lack of access to finance for poor households across the range of possible services, as also supply and demand side constraints in two states - Andhra Pradesh and Uttar Pradesh.[3] Critical policy and evaluation studies have been carried out in the context of the SBLP initiated by donors like SDC, IFAD and GTZ, such as a series of studies undertaken to provide a multi-perspective evaluation of the program to mark its ten year anniversary. The studies covered the program and its impact, and evaluated the need and scope for fresh initiatives.

For microfinance institutions in particular, the reduction in aid is also partly attributable to the growing interest of commercial lenders in the sector - microfinance no longer forms a completely unknown and risky asset class for India's large network of public and private sector banks

In sum however bilateral ODA, (in fact the more significant till now in the case of the Indian microfinance sector), generally decreased starting 2003. Flows of bilateral ODA to India reduced significantly as India repaid a large proportion of it outstanding aid loans. Others scaled down as the government of India announced a reduced need for grants in aid. Agencies like CIDA (which indirectly supported SHG promotion through its social economic program besides having supported agencies like BASIX and FWWB) exited as did the Dutch aid agency. Agencies like SDC and USAID have since then restructured their program focus areas away from large scale involvement in the microfinance sector.

For microfinance institutions in particular, the reduction in aid is also partly attributable to the growing interest of commercial lenders in the sector - microfinance no longer forms a completely unknown and risky asset class for India's large network of public and private sector banks. Till 2004 MCRIL reported 31% grants in MFI sources of funds.[4] (MCRIL: 2004) By 2005 this has dropped to 8% on the current balance sheets of 84 MFIs rated between January 2003 and December 2005. (MCRIL: 2006).

Partly also, the presence of 'alternative sources' of funding such as the National Microfinance Development and Equity Fund, which while yet to make any investments, would seem from a donor perspective to be enough to fill at least short term needs in the sector. There is also a growing belief especially among multilaterals such as the World Bank that in downstreaming funds into the sector instruments other than grants and loans -equity and quasi equity -would be more effective in the near future in terms of ensuring efficiency in the market and meeting large scale needs for funding in the sector. As such the microfinance sector in India is currently seeing a distinct change in patterns of donor funding, key trends of which are briefly captured this chapter.

Setting up alternative financial service providers - Till the year 2000, most MFIs were still in the fledgling state and were unable to attract commercial funds for their operations. Bilaterals like DFID, Ford Foundation and SDC played a key and complementary role in this context by both directly capitalizing and capacitating MFIs, as also building the necessary systemic support eg. a microfinance rating agency, technical support institutions etc. for them

Growing the sector - the role of donor funding

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Of particular relevance in this context has been the DFID funded microfinance programs including the UKL 16.5 million[6] program, the India National Microfinance Support Project, managed by the apex bank Small Industries Development Bank of India, as also the UKL 9.85 million Credit and Savings for Household Enterprise program managed by CARE India. These programs at the time of their inception (mid to late 1999) were meant to fill a critical gap in the sector for professionally managed, commercially viable microfinance Institutions. The two programs were structured similarly to impact simultaneously at three levels - i) scaling up outreach through operational and transformational[7] support to retail institutions, ii) building institutional capacity and iii) creating an enabling policy regulatory environment. However the key difference between the two programs was that while CASHE initially worked with Self Help Promoting NGOs in only three states (West Bengal, Andhra Pradesh and Orissa), SIDBI supported a model neutral national program for relatively mature and more viable MFIs. Both programs charged a near-commercial rate on loans to MFIs, and allowed MFIs to charge market rates for their on-lending, as important steps towards commercializing the microfinance sector. However they did subsidise operational costs (which is a general trend with most donor funding in India).[8]

The Ford Foundation's support was similarly strategic and more focused on demonstrating that the sector could both widen and deepen access through building viable, scaleable institutional models. One of the first donors to invest in the sector - Ford's funding initially went to organizations like the Cooperative Development Foundation (1991), Friends for Women's World Banking (1993) and the BASIX group of companies (1996)[9]. Support for institutions like VIMO SEWA was aimed at taking diverse financial services like insurance to poor households. Ford covered a range of objectives and brought diverse funding instruments for partner institutions at different stages of their growth.

True to the objective of trying to reach the very poorest more remote groups and regions, Ford's investments also went to organizations like the Ankuram Sangamam Poram - a state level apex in Andhra Pradesh with over 80 SHG federations having a largely scheduled caste membership and later to Orissa where it is supporting the growth of small SHG based microfinance retailers.

Box 8.2 Two early examples of donor funding for microfinance

The BASIX investments, not just by the Ford Foundation but also SDC, CGAP (Consultative Group to Assist the Poorest) and Sri Ratan Tata Trust, is a case on how subsidies can trigger sustainability. SDC[10] which has been supporting BASIX since 1996 calls the BASIX funding 'venture grants' that helped the organization realize its potential as a laboratory for the sector - supporting both product and institutional innovation. Even as the initial capital for operations came through returnable grants, a key understanding was that these would be neither replaced nor renewed thereby facilitating transition to commercial sources.

The Friends for Women's World Banking investments help illustrate the complementarity in different forms and roles of subsidy in the sector. Support from Ford and SDC (Berne) largely took the form of corpus grants to enable FWWB to raise funds from commercial sources or funds for technical assistance for 'market building'. The different forms that Ford funding took in FWWB between 1993 and 2005, ranging from support for policy forums, to capacity building funds and finally loan fund capitalization, illustrates how donor funds have been used as an institution building tool. The World Bank housed Consultative Group to Assist the Poorest brought equity investments to FWWB. Capacity building support was provided by USAID. On the other hand DFID and IFAD funds played the role of catalysts as SIDBI provided on-lending support to FWWB.

Agencies like the Ford Foundation, SDC and USAID have also been supporting SADHAN in its effort to build an enabling policy and regulatory framework. USAID not only supported SADHAN in its advocacy work with the Ministry of Finance, but also provided technical assistance to the insurance regulator - the Insurance Regulatory and Development Authority (IRDA) especially for health microinsurance.

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Mainstreaming microfinance - SHG bank linkage initiative and institutional reform projects

One of the first agencies in the world to support an SHG based program (which it did first in Indonesia) GTZ provided both technical and financial support to adapt the model to the Indian context, pilot and upscale it. The objective of the program for Rural Financial System Development for which GTZ partnered with NABARD, was to improve the access for sustainable and qualitative improved financial services. Within this the SBLP aimed to address the issue of formal financial institutions being averse to lending to the poor due to high costs and risks involved in managing small credit amounts without the usual collateral. GTZ support has contributed to key structural changes in linkage banking through research, capacity building, product development and development of information systems. While the program itself focuses on designing, piloting and review - NABARD takes on the role of scaling up and dissemination.

SDC worked at a broad level with NABARD, specifically supporting institutional development and innovation amongst institutions like Regional Rural Banks, which catered to largely rural and poor populations. More directly in the context of microfinance, SDC also provided support in the early stages of the Self Help Group movement action research, innovation and foreign exposure focused on pro poor banking. NABARD's refinance and capacity building support was largely met since 1995 out of the Credit and Financial Services Fund (CFSF) set up with the assistance of the Swiss Development Cooperation (SDC)[11]. Most of the microfinance initiatives of NABARD have been funded through the CFSF.[12]

Multilateral agencies like IFAD, UNDP and the World Bank have played a key role in the context of the SHG Bank Linkage program, especially in terms of providing funds for social mobilization. UNDP SAPAP in Andhra Pradesh was one of the first programs supporting the piloting of SHG based institutions such as federations. Through the Maharashtra Rural Credit Program (implemented in 12 districts in Maharashtra) and later the Swashakti program, IFAD and its partners helped demonstrate the scaling up of SHG Bank Linkage and promoted quality SHGs and SHG federations. Swashakti implemented in nine states with assistance from both IFAD and the World Bank[13] supported the development of nearly 20,000 SHGs in the country.

Multilateral agencies like IFAD, UNDP and the World Bank have played a key role in the context of the SHG Bank Linkage program, especially in terms of providing funds for social mobilization. UNDP SAPAP in Andhra Pradesh was one of the first programs supporting the piloting of SHG based institutions such as federations

Subsequently one of the largest donor assisted poverty alleviation programs in the country, the World Bank supported Indira Kranti Patham, was started in 2000 with a 150 million dollar loan and had a significant microfinance component, especially for the building of community based organizations such as SHGs, village organizations and mandal (sub district) level federations. The program had, till end of 2005, brought over 500,000 SHGs into its fold. Of particular interest is the scale that the program has achieved in the context of microinsurance coverage, with more than 1.2 million poorest of the poor and poor SHG women members enrolled in the insurance program on a voluntary basis across the State. This number is expected to cross 2 million by March 2007, becoming one among the largest "micro insurance" programs in the world. (Kolavakonda:2006).

Recent trends in donor funding and related challenges for microfinance

Seven years down the line programs such as the DFID-IFAD funded SFMC and CASHE initiatives have shown positive effect not only in terms of having expanded the outreach of financial services to poor households, but also in terms of having nurtured over 100 retailers across India (although perhaps a bias for Southern states as of now - being currently corrected in the extension phase of the SIDBI program and institutionalization[14] of the CARE program).

Challenges presented in the course of these programs include capacity building which remains a key question with microfinance institutions continuing to struggle for technical support, even as well over 50% of the funds for the capacity building component of SFMC (SIDBI) remained unspent as of June 2006. Another matter of concern for donors remains the relatively unregulated nature of the sector, with very little progress in fact having been made in the area since the start of these programs despite repeated efforts of SADHAN in collaboration with SIDBI and CARE.

DFID's national level involvement in this sector through SIDBI has been extended up to March 2009, and the direction beyond 2009 will be decided in light of its forthcoming Country Assistance Plan (CAP) and developments in India (e.g. the 11th Five Year Plan). As a result especially of restructuring within DFID and a yet to be developed CAP, the future of this donor's role in the microfinance sector remains uncertain. Even if future engagement continues, it is likely to be through state government partnerships. SIDBI and CASHE like programs, may therefore be the last of their kind.

USAID, while not having a large investment in the microfinance sector, plans to wind down even its limited program in the context of a reprioritization around program focus areas. Its involvement in the field of microinsurance however, may continue through an effort to set up a microinsurance resource centre in India aimed at improving the availability of data, assessing performance, supporting product development, providing technical support to practitioners etc. SDC and Ford Foundation's support for microfinance, continues with a greater focus on supporting innovative strategic institutions such as apex institutions and initiatives that facilitate the sharing of data on the sector (such as microfinance India) rather than direct assistance to retailers.

For MFIs the entry of two new donors, the Michael and Susan Dell Foundation and the Gates Foundation provide new opportunities. The Dell Foundation focused on urban areas is currently financing approximately five MFIs per year in two ways, through equity investments in NBFCs and grants in Section 25 companies. Dell's focus is on a niche within in a niche - it identified urban India as a space where microfinance had been relatively slow in taking off. Within urban India it decided to focus specifically on providing capital for start ups, rather than for onlending thereby complementing the role of FWWB and SIDBI. This is a fairly risky segment to be SDC and Ford in rural areas - though perhaps through the slightly different strategy of bringing in professional expertise from the banking and private sector and supporting start ups with a potential for quick scalability rather than on transforming small NGOs. With grants which can fund up to 80% of operating expenses and critical equity support - this intervention is likely to provide significant impetus to the growth of the urban microfinance sector. The Gates Foundation in its turn is focused on supporting capacity building for MFIs currently largely in rural areas.

In upscaling outreach through MFIs, donor funding is also likely to address the issue of the regional bias towards south India and a historical bias towards rural India, this being part of future plans for SIDBI (which is likely to focus on both north and north eastern states), the World Bank (which may focus on select underserved northern states) and Dell (which have identified five metropolitan cities as a focus area)

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In mainstreaming microfinance, a shift can be seen in terms of the institutional focus. Whereas in the last decade the focus was largely on Regional Rural Banks, it has recently shifted to the three tier rural credit cooperative system in India, a system which is especially significant for small and marginal farmers. While not strictly in the frame of the SBLP, this nature of institution building support can have significant results for deepening credit outreach in rural areas. World Bank, Asian Development Bank (ADB), Kfw and GTZ are just some of the agencies developing programs to support the reform of the cooperative structure.

A key challenge for the sector however remains an optimal application of subsidies in terms of generating scale with sustainability through minimal grants and where possible leveraging of funds from nationally available resources.

To date alternative financial agencies like DHAN, BASIX, ASP, CDF, SKS etc use grants or loans to expand outreach - and to see further growth in the sector in terms of numbers of retailers and expansion of available retailers possibly other innovative models of financing will need to be applied. A model based purely on commercial funding (though being explored by banks like the ICICI bank) is yet to really take root. According to agencies like the World Bank this may in part be attributable to the design of instruments used, which to date have been grants and loans. The role for equity investments is increasingly clear in the context of low capital adequacy of relatively larger MFIs, and by some estimates approximates USD 245 million for the sector assuming current growth rates are maintained (MCRIL:2006). However aside from a few private investors no comprehensive solution to address this issue has yet been introduced. Finally, in the context of the rapid growth of the SHG movement ensuring quality may require more than the NABARD subsidy, recently increased to Rs 3,000 per group. Much higher estimations for promotional costs have been made (see Chapter 2) which estimates the need for approximately USD 260 per group.

Viewed, in this light the NMDEF is also a relatively small fund - and if disbursements from it continue to be slow even as donors withdraw, this may comprise a significant risk for the linkage banking program and MFIs. The question therefore becomes how should funding be obtained and designed to meet the need for promotional costs for SHGs and equity for MFIs in the next phase of growth in the sector in the context of the winding down of donor funds in the sector and slow disbursements from available national sources.

Endnotes

1 *By Rewa Misra. This chapter is not meant to be a comprehensive listing of donor funded programs, but rather aimed at tracing current and key trends in donor funding.*

2 *Part of the World Bank supported District Poverty Initiatives Program.*

3 *Mention must be made of the SDC supported rural non farm sector study which highlighted amongst other things the need and potential for financial services for non farm sector enterprises but also the need to go beyond minimalist credit (Fisher et al (1997))*

4 *Based on ratings between 2001 and 2003 for 110 microfinance institutions of which 90 were Indian.*

5 *Micro Credit Ratings India Limited*

6 *The grant helped leverage a soft loan from IFAD of value similar to the grant- making this the single largest microfinance funding partnership perhaps anywhere in the world.*

7 *Despite the large presence of microfinance institutions in India, estimated to be around 800 in number, the key issues affecting a vast majority of the institutions are lack of a commercial orientation, capital and lack of professional capacities to manage a microfinance program. The SIDBI and CASHE programs assisted in all these areas helping MFIs to graduate from being solely social intermediaries to being sustainable financial intermediaries.*

8 *DFID uses the MFI market segmentation framework of seeds, saplings and trees, ..the idea being that CASHE will help nurture the seeds and saplings so that some of these could graduate to more mature, bigger and less dependent partnership with SIDBI. Because SIDBI as a national institution was expected only to work with larger and more mature partners directly (i.e Saplings and trees). This has happened as a number of CASHE partners, who have graduated to partnerships with SIDBI and ICICI. A second route that DFID's microfinance support took was in the form of budgetary support to state governments (specifically Andhra Pradesh, West Bengal and Orissa). Relatively less information is available on the performance of these programs, being nested as they are in large scale comprehensive livelihood and/ or urban development initiatives.*

9 *The years mentioned in brackets refer to the starting points of the grants support.*

10 *The SDC grant for BASIX was identified by the Consultative Group to Assist the Poorest as a 'best practice' in its donor resource centre.*

11 *SDC through various programs for enterprise development, rural financial institutional reform, and microfinance have provided over 175 million USD to NABARD since 1995.*

12 *Source: www.nabard.org. The CFSF is now merged with other funds to form the Rural Innovation Fund.*

13 *Started with an initial outlay of approximately USD 10 million*

14 *CARE India has promoted an Indian technical services provider for the microfinance sector called ACCESS based on its experience in institution building with CASHE.*

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CHAPTER 9

Some Ongoing Research on Indian Microfinance[1]

This chapter describes ongoing research at the Centre for Micro Finance (CMF), which was established in February 2005 as a specialized research centre at the Institute for Financial Management and Research (IFMR) in Chennai, and represents the largest single concentration of ongoing research on microfinance in the country. The chapter presents some of CMF's ongoing research projects, and is divided into five sections: impact evaluation; product design; microfinance "plus"; financial and organizational issues; and sectoral and policy issues.

1. Impact evaluation[2]

While practitioners generally agree that microfinance has improved the lives of the poor, critics assert that it sometimes leads people to borrow too much, to the extent that overindebtedness can lead to suicides in extreme cases. The recent controversy in Andhra Pradesh shows that the impact of microfinance needs to be more rigorously documented in order to convince policy makers and regulators that the movement should be supported. Substantial funds are spent evaluating microfinance programmes. However, many of these assessments tend to cover organizational, financial and governance variables rather than developmental impact. While each aspect is important, rigorous investigation of the impact of microfinance on communities is crucial, in order to show whether providing financial services to the poor increases household's investment capacity and consumption or results in other improvements to their livelihoods. Only a small fraction of studies have looked at these issues rigorously.[3]

Looking at changes over time can be misleading: a number of poverty alleviation programmes may run simultaneously, making it difficult to isolate the effect of the microfinance programme alone

As a matter of fact, it is very difficult to evaluate the impact of microfinance. Looking at changes over time can be misleading: a number of poverty alleviation programmes may run simultaneously, making it difficult to isolate the effect of the microfinance programme alone. Comparing clients to non clients is problematic: people who choose to take up micro credit may be intrinsically more entrepreneurial. The ideal would be to compare the state of 'Individual A + Microfinance' against the state of 'Individual A - Microfinance'. Researchers need to create such experimental equivalents[4]. The most transparent way to do this is to run a randomized trial. This is what medical science uses to test whether a drug or vaccine is effective. A similar method can be applied to evaluate the impact of microfinance: A number of villages are selected. Half of them (the treatment villages), randomly chosen, are exposed to a micro-credit programme while the other half (the control villages) will benefit from the programme only later. The experiences of the two groups are then compared to measure programme impact.

1.1 Impact evaluation of Spandana's microcredit programme[5]

Objective and methodology This study uses a randomized design to evaluate the impacts of Spandana's[6] microfinance programme on income, consumption, usage of financial services, asset ownership, scale of business and its profitability, and intra-household decision-making among their clients in Hyderabad[7]. A baseline survey was conducted in treatment and control slums and a follow-up survey will be administered after the completion of at least one loan cycle.

Preliminary results from the baseline survey[8]

With an average family size of five and an average monthly expenditure of Rs 5,000, respondents were poor, but not ultra-poor: close to 50% of the respondents were earning under $2 a day but only 6 percent were earning below $1 a day. Businesses were very prevalent in these slums. However, these businesses had little specialized skills[9], and tended be small, with little capital, little assets and few employees[10].

The loan indebtedness figures indicate that about two thirds of the sample had at least one loan[11]. Almost half of these loans came from money lenders, while few were provided by commercial banks and almost no MFI loan was available at the time[12]. Among those households who did not have a loan, more than half said that they wanted one but could not obtain one. Loans were rarely taken for business expansion: a number of loans were used towards health related expenses. marriages, consumption purposes and for construction and renovation of houses[13]. It was also found that a third of the households had a savings account and while every fourth household had a life insurance policy, almost none had health insurance. Yet it was found that 60 percent of the households who had a sick member had to borrow to pay for the treatment (which was on average Rs 7,500)[14].

Where expansion opportunities appeared possible for these small businesses, they had not been exploited. Although a loan of Rs 10,000 is probably not sufficient for expansion, microfinance might help them expand by "forcing" them to channel additional revenues into expansion (rather than on "wasted" expenditures).

1.2 Impact evaluation of weather insurance, with SEWA, Gujarat[15]

Objective and methodology A natural disaster, such as drought or excessive rain, can cause crop failure, leading to substantial hardship manifested in reduced consumption, lower productivity, lower income, distress sales, and borrowing from moneylenders at high rates. The objective of this study is to evaluate the impact of providing rainfall insurance on reducing such vulnerabilities faced by poor agricultural households, and on improving their livelihoods. Some important questions the study seeks to answer include: how effectively does a rainfall insurance programme reduce vulnerability of poor households? How does financial literacy influence the decision to purchase insurance? How will it affect local risk-sharing? Will policy-holders undertake more projects with a higher return (such as sowing more crops)? Will there be any effect on the local price of goods, or on wage rates?

Some important questions the study seeks to answer include: how effectively does a rainfall insurance programme reduce vulnerability of poor households? How does financial literacy influence the decision to purchase insurance? How will it affect local risk-sharing? Will policy-holders undertake more projects with a higher return (such as sowing more crops)? Will there be any effect on the local price of goods, or on wage rates?

CMF will assist SEWA and ICICI Lombard in developing the product, and SEWA will offer rainfall insurance in a group of villages across three districts in Gujarat[16]. The Centre will measure and monitor household vulnerability, consumption and economic activity through surveys conducted at regular intervals during the period of the project. The baseline survey of 1500 households in 100 villages was completed before the product was marketed in May 2006.

Preliminary results Households that were rich, and those whose head was literate or educated, were much more likely to purchase insurance than those who were not. In addition, financial contracts are complicated, and it can be difficult for a farmer to understand why she should spend money now, to get an uncertain payout in the future. Indeed, the survey in three districts of Gujarat found that SEWA members had very low levels of financial literacy: when given a short test that included questions about risk, inflation, and interest rates, members scored on average no higher than they would have simply by guessing. This was so despite relatively high math skills, respondents answered, on average, two-thirds of the math questions correctly. Members attitudes towards risk also mattered. In the baseline survey, respondents played a simple game, in which they chose between a "safe" option (the certainty of Rs 50), and increasingly risky options that offered a higher return. Two months after the survey, households who had picked safer choices were much more likely to purchase insurance than those who had selected riskier options. The most important question, however, will be answered only after completion of the study: does rainfall insurance improve the welfare of the households that buy it? By carefully tracking households in 100 study villages, the Centre hopes to gain a clear understanding of the benefits, and limitations of, rainfall insurance.

2. Product design of financial services

According to Jonathan Morduch, "the full promise of microfinance can be only realized by returning to the early commitments to experimentation, innovation and evaluation"

The Grameen model is widely accepted by Indian MFIs. However, do we really know what would happen if we made fixed repayment schedules flexible, or if we moved from joint to individual liability? New products may attract more clients, lead to higher impact while keeping default rates unchanged. According to Jonathan Morduch, "the full promise of microfinance can be only realized by returning to the early commitments to experimentation, innovation and evaluation"[17]. The goal of CMF is to collaborate with MFIs and experiment in such a way that we can carefully weigh the costs and benefits of different product designs. Experimenting with various components of credit products will help understand which ones work best and develop new designs that successfully solve information problems while being innovative and closer to the clients' needs.

2.1 Flexible repayment schedules for dairy clients in KAS Foundation, Orissa[18]

Objective and methodology Most MFIs offer loan products with fixed repayment schedules - weekly or monthly. KAS Foundation (KAS), for example, has a monthly repayment system for its SHG clients. Yet fixed repayments may not be best for most clients, particularly if their income is subject to variations due to seasonal activities, business cycle, health, and other risks.

The Centre is conducting a randomized experiment to evaluate the benefits of tailoring repayment schedules to the dairy industry on the following variables: business income, productivity, households' ability to smooth consumption, and face shocks and repayment rates. In order to analyse the trade-off involved in introducing flexible repayment schedules, the experiment compares two flexible loan products to the existing product of KAS for dairy clients. The first loan product allows clients to delay payment by 2 principal installments at any point of time in the loan tenure of 24 months. The second loan product allows clients to prepay 6 principal installments and enjoy flexibility in the latter part of the loan tenure.

A baseline survey has been completed and will be followed by short household surveys conducted on a quarterly basis in order to track income flows and understand the reasons for skipping principal installments. A mid-term survey will then be conducted, as well as a final survey after one loan cycle has been completed.

2.2 Experiments on repayment schedules in VWS (Village Welfare Society), West Bengal[19]

Most MFIs have a weekly repayment schedule with weekly centre meetings to maintain low levels of default. This tends to impose a high cost structure on the MFI. However, if infrequent repayments do not produce an increase in default rate, or if this increase is lower than the reduction in transactions costs, it may well be worthwhile for the MFI to examine it as a serious alternative to the weekly model

Objective and methodology Most MFIs have a weekly repayment schedule with weekly centre meetings to maintain low levels of default. This tends to impose a high cost structure on the MFI. However, if infrequent repayments do not produce an increase in default rate, or if this increase is lower than the reduction in transactions costs, it may well be worthwhile for the MFI to examine it as a serious alternative to the weekly model. CMF uses a randomized design to examine the impact of repayment frequency on the capacity of households to smooth consumption, to manage cash flows and adapt their loan cycle to the business cycle, repayment rates and organization's transaction costs. Three repayment schedules are compared[20]: weekly meeting-weekly repayment, weekly meeting-monthly repayment and monthly meeting-monthly repayment[21].

Preliminary results So far there is almost zero percent default among all groups, and no difference in repayment between weekly schedules and monthly schedules. If the completed study confirms these results, this could lead to significant savings in terms of transaction costs. Most businesses can be categorized in two types: as "mahajan' or piece based and market based or independent businesses. For the first type, weekly payments seem to make more sense since they get paid piece wise. Market based clients seem to prefer monthly payments as they sell on credit and can not always recover their payments every week. Monthly repayment schedule could allow them to reinvest money into their business when they recover their costs. It seems therefore that the benefits of monthly payments could vary according to activity. The rest of the study will test these hypotheses. Regular business surveys as well as an end line survey will be administered.

2.3 What savings products do people want?[22]

Objective and methodology This qualitative study aimed to identify demand for, supply and usage of savings products among poor people. Qualitative interviews were conducted with savings providers and with clients of the Micro Credit Foundation of India (MCFI) in Madurai.

Findings Informal savings used by respondents include schemes at jewelry shops, buying gold, petty cash hidden around the house, unregulated chit funds, saving with moneylenders, exchanging cash gifts at social functions and schemes for small savings at school. Formal savings mechanisms include banks, insurance companies, post offices and regulated chit funds. However less than half the respondents had bank accounts and most of those were inactive; less than one-fourth of the women had post office deposits. The most popular scheme is the LIC policy with fixed deposits maturing after a period of 15-25 years with interest.

The study also looked at the demand side: First, as women's income varies seasonally some of them wished to have access to short term investments accounts where they could withdraw their money after six or nine months of regular savings. Second, most of them liked the agent system where they can make daily, weekly or monthly deposits from their doorstep. Finally, women wanted to keep the option of withdrawing their money in case of an emergency. These findings open the door to new questions: Which deposit schemes can increase savings? Would clients prefer deposit commitments, withdrawal commitment or both? Savings products need to be experimented with in a rigorous manner to find out what works and what does not.

2.4 Financial services for migrants-with Adhikar and Ajiwika[23]

Objective and methodology Migration could have important consequences for economic growth and poverty reduction by redistributing the benefits of location-specific growth. Little data exists on the prevalence of these temporary labor movements, about the conditions under which people migrate, the costs and risks, or the impact of remittances on the household and village economy. With imperfectly functioning credit and information markets, individuals may fail to reap all potential benefits. This motivates the research on the provision of financial services through the most effective channel for poor households, whose members migrate either temporarily or permanently. CMF is undertaking a set of case studies of organizations working with migrant workers to understand the dynamics and details of migration. This information will be used to design cost effective remittance services in collaboration with Ajiwika in Jharkhand, and Adhikar in Orissa. The impact of these services on migration and wage patterns, consumption and income smoothing and investment decisions of households will then be evaluated through a randomized study.

MFIs can provide innovative financial services to migrants, such as remittances linked to loans and savings

Preliminary findings When faced with severe shocks, households often resort to seasonal migration to take advantage of employment opportunities in other sectors or regions. From Orissa and Jharkhand, workers often migrate to Gujarat, where wages are higher. In some of the villages under study, more than 80 percent of the households had at least one member who had migrated for employment.

MFIs can provide innovative financial services to migrants, such as remittances linked to loans and savings. Adhikar, in Orissa, is piloting the provision of remittance services linked to both savings and loans for its members. In Jharkhand, provision of remittance services is complicated by factors, such as lack of infrastructural facilities, little faith in existing services such as demand drafts and money orders, limited information flows etc. Design of remittance services must therefore take into consideration - costs of transferring money, time involved, existing facilities and regional factors affecting employment and movement of people.

3. Microfinance "Plus"

Microfinance institutions (MFIs) differ in the extent to which they stress social objectives. Some organizations provide advice on income generation, or encourage social cohesion, for example by having clients attend all functions at each others' homes irrespective of caste or religion. Others eschew these objectives as unnecessary, and choose instead to focus on a narrow financing model. Sometimes, the same MFI is engaged in both microfinance and social services, and in many of these cases, there are questions within the MFI itself as to how much value these extra services add to their main activity. Though these social features of an MFI have added costs, they may have significant added benefits.

There are two main motivations of adding social services to the provision of microfinance services. First, the provision of services such as business training or livelihood counseling can benefit households by providing enhanced skills relating to important aspects of production, marketing, and financial management. This directly benefits the MFI as increased productivity of households improves repayment rates and reduces risk. A second and complementary motivation is that microfinance, because of its large outreach, can be an effective and sustainable delivery channel for services which have high social impact and benefits, for example simple health interventions. This is consistent with the overall objective of most MFIs, which is to contribute to poverty reduction and development of their clients.

There are currently few rigorous evaluations measuring the relative impact of microfinance only and "microfinance plus" on client well-being. Given the growing pressure on NGOs and MFIs to reach operational and financial sustainability to scale up services so as to reach a greater number of poor, it is imperative for MFIs, NGOs, donors, and policy makers to know the benefits of social interventions which could be undertaken along with microfinance.

3.1 Evaluating business training for microfinance clients with SEWA Bank[24]

here are currently few rigorous evaluations measuring the relative impact of microfinance only and "microfinance plus" on client well-being

It may be a useful investment for microfinance organizations to provide basic business and financial skills training in order to assist microfinance clients to run their businesses more efficiently. Such interventions may also improve repayment and benefit the organization. This study examines the impact of business and financial skills training for self-employed women in Ahmedebad. The intervention is based on training courses currently used by SEWA Bank[25]. SEWA Bank has found that its training has helped participants, not only because it transfers skills to them, but because it is empowering them to realize that they can run a business and can/should take a longer-term view. This evaluation study will test these ideas by collecting survey data 6 months to 1 year after the training to measure profits, business investments, and other outcomes, while comparing a treatment and control group. In addition, a main focus of the study is to measure the differential effect when women are trained alongside friends and neighbors. For a randomly selected subset of the treated group, their close peers will also be invited. The hypothesis is that there is a social dimension to learning: women might be more (or less) engaged during the training if they are with a friend. Also, as important they might be more likely to implement the skills afterwards and change aspects of their business[26].

4. Financial and organizational issues

The full potential of innovations in product design can only be realized if the organization has the capacity to implement and manage products properly. The high growth rates seen in the sector today must be matched with strengthened management focus and operational systems. The success of microfinance with respect to high repayment rates is largely explained by features such as door step services and close monitoring. These mechanisms and MFI staff incentives result in high transaction costs, the main component of the relatively high interest rates charged by the MFIs. In some parts of the country, there is growing concern that these interest rates are unjustified and usurious. In-depth research is needed to understand what are driving costs and how internal processes and policies may reduce these costs. The Centre's research projects aim at enhancing operational efficiency and financial sustainability of MFIs over the long run.

4.1 Transaction costs in group microcredit in India: case studies of three microfinance institutions[27]

Objective and methodology High transaction costs associated with microfinance are the primary reasons why interest rates are higher than rates on traditional bank loans. The study aims to understand the composition of lenders' transaction costs in the MFI group lending model, and to provide recommendations to MFIs on how to reduce their costs. Detailed case studies of three MFIs[28] were undertaken to estimate direct and indirect costs[29].

Findings ***These are discussed in*** Shankar (2006). In brief, collections are the largest contributor to direct transaction costs (28-37 percent), followed by group formation (19-23 percent). Geographic location had a major bearing on the cost structure. The time required to form groups is lower when other MFIs are also operating in the same area. Salary structure, conveyance costs and number of groups per field worker are some of the key factors of overall operational costs. The drivers of indirect transaction cost are the number of layers of fixed cost in the MFI system, and the number of mature branches. The maturity of the branch explains much of the inter-branch variation in costs.

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4.2 Activity-based-costing for microfinance with MCFI (Micro Credit Foundation of India)[30]

Objective and methodology This study uses activity based costing (ABC) to identify cost drivers of MFIs' transaction costs. ABC involves calculating resources used for each activity and then mapping those activities to every product and service that the organization offers. This allows the organization to pinpoint the profitability of each of its products and services, and the primary sources of high transaction costs. It also helps in analyzing the total cost-to-serve a customer in terms of the transaction and financing cost components. The study covers both direct and indirect drivers of transaction cost.[31]

Preliminary findings The cost structure of MCFI fits into a cost hierarchy consisting of member driven costs, group driven costs, activity driven costs, and fixed costs. Analysis of the actual cost of one zone showed that the cost-to-serve an individual varies from Rs 114 to Rs 300 per loan cycle approximately, and the cost-to-serve a group varies from Rs 2,200 to Rs 6,000 approximately. A variance analysis reveals that cost goes up because of the additional Basic Awareness Training (BAT) training required in those areas due to dissolution of the groups, turnaround of groups and members.

4.3 Staff incentives in MFIs[33]

Objective and methodology MFIs juggle with competing goals: they seek to grow quickly, serving as many poor clients as possible, while maintaining very high repayment rates. This may be time-consuming, requiring visits to clients in rural locations. As loan officers make decisions about large amounts of money, it is imperative to provide them with incentives that align their behavior with the mission of the organization. In the first phase of the project, senior level officers of 12 MFIs were interviewed to identify different incentive and compensation structures used by Indian MFIs. In the second phase of this project, the Centre will use a database of loan histories from an Indian MFI that has experimented with several remuneration schemes, to measure how responsive officers are to incentives for the number of clients, the volume of credit, and the share of delinquent loans. These estimates will be combined with estimates of the time-cost of the screening and monitoring activity, to determine how efficient the MFI operations are.

Findings from phase one The most common incentives schemes are those that encourage the field officers to attract new members or form new groups and to ensure regular repayment.

Three broad categories of incentives were listed. The first aims to foster growth of client base and loan portfolio (through incentives based on the number of active borrowers). The second category aims to increase client outreach and control portfolio quality (through incentives based on number of new clients, repayment rates or delinquency rates). The third category aims to increase client outreach, portfolio volume and control portfolio quality (through incentives for new clients and recovery amounts, portfolio volume or delinquency rates). Within each of these categories, there is a range of different schemes.

Prima facie there is no best incentive scheme, the pros and cons of each should be considered before implementing any scheme depending on the organization's objectives. The report describes some of these pros and cons, and the second phase will analyze in more depth the effects of different schemes

Prima facie there is no best incentive scheme, the pros and cons of each should be considered before implementing any scheme depending on the organization's objectives. The report describes some of these pros and cons, and the second phase will analyze in more depth the effects of different schemes.

5 Sectoral and policy issues

CMF believes that recent developments in the microfinance sector warrant taking a closer look at the accompanying social environment and policy framework. MFIs often have to face misunderstanding from the public and from politicians, which could damage their reputation and their activities. As the sector grows and competition increases, over-indebtedness of clients becomes a concern. We need to find out the extent and patterns of competition, the extent of multiple borrowing, and whether this is bad or not. We need to think of ways to manage competition so that competition affects clients positively. All these issues raise the question of a credit bureau in India as such a bureau could play a vital role in disseminating information. Research projects undertaken by the Centre in this area try to explore these issues, and come up with policy recommendations to enable growth of the fledgling sector, and increase the outreach and impact of microfinance in India.

5.1 A study of Indian microfinance regulation

Findings Based on extensive interviews with banks, MFIs, independent consultants and government officials, this study identified five pressing regulatory impediments to India's microcredit sector - interest rate regulation, transparency and disclosure norms, third party ratings, equity investment and minimum capital requirement for NBFC licenses. The report makes recommendations to policymakers on these issues, such as allowing the third party rating market to mature, softening majority ownership requirements for foreign equity holdings in NBFCs, and building a simple monitoring system to track interest rates across MFIs. The recommendations will be presented in Tripathi, Rati, and Daniel Radcliffe (Forthcoming).

5.2 Informal lending practices - Ajiwika, Jharkhand[34]

Objective and methodology This qualitative study aimed to find out what role money lenders play in providing financial services to the poor, who their clients are, and how they function. The study was conducted in the district of Deogarh in Jharkhand and 9 moneylenders, 15 clients and many other agents in the rural credit markets were interviewed.

Findings Informal money lending is still a major source of credit for the rural poor. Most of the lenders play dual roles as landlords, shop-owners and even doctors or lawyers. Moneylending took place in various forms and a substantial part of it was in kind. Moneylenders gave out loans either on guarantee or collateral. Interest rates varied from 60 to 120 percent per annum. Gold, jewelry and even livestock or paddy, were usually pledged as collateral. We found evidence of substantial hikes in interest rates over time. Although MFIs have reduced the informal moneylenders' share in the credit market, clients of MFIs are still going to moneylenders. This may be due to the need for more credit than the MFIs can provide, and the greater flexibility shown by money lenders.

5.3 Reputation and communication in microfinance[35]

Objective and methodology MFIs are often subject to misunderstanding by the public, suspicion by local politicians, and destructive and ill-informed rumors from competing MFIs. It becomes critical to understand the reputation of MFIs among various stakeholders, to what extent this reputation is negative, and why these reputations are formed. It is also critical that MFIs improve transparency, streamline their operations and develop their communications skills to develop a sound reputation and protect themselves against defamation and misinformation. To better understand these issues, CMF conducted interviews with a wide variety of microfinance stakeholders in the state of Orissa.[36]

MFIs are often subject to misunderstanding by the public, suspicion by local politicians, and destructive and ill-informed rumors from competing MFIs. It becomes critical to understand the reputation of MFIs among various stakeholders, to what extent this reputation is negative, and why these reputations are formed

Findings The study revealed three major challenges facing the microfinance sector in Orissa today. 1) Relations within the sector: Unhealthy competition among MFIs is becoming increasingly salient. MFIs had a tendency to point out the interest rates of their competitors, often without knowing what they were charging. This made prospects for shared collaboration difficult and exacerbated perceptions of the sector as not being transparent. 2) Relations with the government: government schemes and MFIs are increasingly competing for the same space, and latent tensions have emerged. At the state level, government officials by and large were judicious in their assessment of the sector. At the local level however, governmental relations were much more uncertain, and depended on the district administration. 3) Relations with the media: finally, most MFIs did not appear to have a strategic communications strategy in place to promote their work, address accusations, and control damage.

The broad recommendations are as follows: firstly MFIs need to develop a strategic, communications strategy to promote their organizations[37]. Secondly MFIs need to recognize that they operate in the same space as government and take steps to mitigate the potential conflict of interest. Lastly, MFIs need to come together to build an institution that represents the sector in Orissa on issues of mutual interest. CMF is developing a communication toolkit for MFIs in Orissa, which teaches MFI practitioners simple steps on how to talk to the media, develop a website, and develop an organizational message. A workshop on this issue may be organized.

Endnotes

1 *By Annie Duflo, Anvesha Khandelwal, Aparna Krishnan, Amy Mowl, Jyoti Prasad Mukhopadhyay, and Rati Tripathi, The authors would have liked to have covered ongoing research outside the CMF, but were unable to do so for lack of time. More information on CMF is contained in www.ifmr.ac.in/cmf*

2 *This paragraph is based Duflo and Duflo (2006).*

3 *The impact assessments done by EDA Rural System (EDA 2005) and ASA- Grama Vidiyal: Microfinance Impact Reports (2003 and 2004) focused on these aspects.*

4 *Some recent studies have tried to bypass this difficulty by comparing new entrants with old entrants. This has the advantage of being economical and easy to implement. However the set of old clients may not be same as the set of new clients. Moreover the MFI might have undergone institutional changes as a result of internal learning so that the old and new clients may not have been subject to the same policies. See (SEEP) (Undated).*

5 *Principal Researchers: Profs Abhijit Banerjee and Esther Duflo (MIT); CMF Research Associate: Keerthi Kumar and Aparna Dasika.*

6 *Spandana is an MFI operating mainly in Andhra Pradesh with more than eight lakhs clients. It offers group loans, individual loans with daily repayment and consumption loans.*

7 *Of 120 slums where Spandana was planning to expand its microcredit programme, 60 slums were randomly chosen before the programme started and are now benefiting from the microcredit programme, while credit will be introduced in the 60 other slums only later.*

8 *Only results from the baseline survey are now available.*

9 *The main activities were tailoring, general store or Kirana store, telephone booth, selling vegetables etc.*

10 *Average monthly sales proceeds were Rs 13,000, while average profit was Rs 3,040 per month. Only 2% of businesses had a partner, and only 10% had an employee. 20% used no productive assets whatsoever.*

11 *The average size of the loans was Rs 20,000 (and the median size Rs 10,000)*

12 *This was before Spandana penetration*

13 Respectively 17%, 13%, 10% and 10% of loans. Business acquisition accounted for only 7% of loans and business expansion for only 1.33%.

14 40% of the households spent Rs 500 or more on health in the last year, and their average expenditure was Rs. 7500.

15 Principal Researchers: Profs Shawn Cole (Harvard Business School), Jeremy Tobacman (Harvard University) and Petia Topalova (IMF). CMF Research Associates: Aparna Krishnan and Monika Singh

16 In each of these districts, another group of villages will be selected for comparison, where no insurance will be offered in the first year during the pilot phase of this project. Of a total of 100 villages, rainfall insurance has been offered in 33 villages only. In the next year, SEWA will expand its marketing efforts to target a greater share of the eligible population, and introduce insurance in 33 more of the study villages.

17 Morduch (1999),

18 Principal researcher: Prof. Sendhil Mullainathan (Harvard); CMF Research Associate: Jayesh Kumar Jain

19 Principal Researchers: Prof. Rohini Pande (KSG-Harvard) and Erica Field (Harvard); CMF Research Associate: Anup Roy

20 Over a period of 6 months, 1,029 clients were organized into 100 groups. A loan amount of Rs 4,000 was disbursed to each group within 7 days of formation. Each group was randomly assigned one of the three repayment schedule.

21 A baseline survey has been conducted. Regular shorter surveys are being conducted and an endline survey will take place 6 months after the groups have been formed.

22 Principal researcher: Prof. Sendhil Mullainathan (Harvard); CMF Research Associate: Elizabeth Koshy, Elsy Alcala (CMF Summer Intern)

23 Principal Researchers: Rema Hanna (New York University), Petia Topalova (IMF); CMF Research Associates: Jyoti Prasad Mukhopadhyay, and Aparna Krishnan; CMF intern: Indu Kumari

24 Principal researchers: Profs Rohini Pande (KSG-Harvard), Erica Field (Harvard) and Seema Jayachandran (Stanford); CMF Research Associates: Manasee Desai, Vanya Pasheva and Divya Verma

25 Each 2-day class will have about 10 participants, drawn from SEWA's members who own a small business (e.g., vegetable vendors) or do home-based piece work (e.g. embroidery, rolling bidis). The first day of class covers basic concepts such as keeping track of business income and expenses and options. On the second day, each woman identifies a long-term business goal (e.g., buying a sewing machine) and, through group activities, develops a short-term plan to reach that goal.

26 This is perhaps because they have a friend to discuss the training with to consolidate what they have learned or simply because having announced a goal in front of a friend acts as a commitment device.

27 Principal Researcher: Prof. Savita Shankar (IFMR) , CMF Research Associate: Vineet Sinha

28 Two or three branches were studied in each MFI.

29 The main components of direct transaction are: group formation costs, cost of direct administrative activities, and costs of monitoring; indirect transaction costs include allocated fixed costs of the branch office, regional office and head office.

30 Principal Researcher: Prof. Balasubramanian (IFMR)

31 The detailed workings are in process and will be part of the final case study and report. Some of the observations are hypotheses generated and need to be corroborated.

32 Member driven costs vary directly with the addition of members and groups. There are group driven costs like conduct of meetings [two times in a month], travel to number of groups, location of these groups i.e. contiguousness of the two groups etc. Most of the activity costs like travel, etc are group and member driven.

33 Principal Researcher: Shawn Cole (Harvard Business School). Partner Organizations: 27 MFIs across India,CMF intern: Iris Korovesi

34 CMF Research Associate: Rati Tripathi, CMF intern: Sandip Agarwal

35 CMF Research Associate: Amy Mowl , CMF intern: Carissa Page

36 In order to ensure variety within the sample, these stakeholders hailed from different communities in Orissa and represented different perspectives within the microfinance sector. This research was designed as an exploratory study to be followed by further systematic research.

37 "Communications" is not just about showing off an MFI's work (although that's a big part of it); it is also about building long-term, healthy relationships with stakeholders whose actions can have a huge influence on their organization.

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