

# **Scaling up Micro Financial Services: An Overview of Challenges and Opportunities**

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## **Abstract**

This paper attempts to examine specific issues in the delivery of micro financial services and outlines some new approaches towards scaling up. Section I reiterates the crucial role of micro finance in reducing vulnerability and enhancing the prospects of growth for poor households. Section II examines the broad challenges in micro finance; Section III provides an overview of the various micro financial services (insurance, savings and investment, credit and other risk management instruments). Section IV examines the issues specific to Micro Finance Institutions (MFI) in India and Section V concludes the paper by identifying the key areas for further research and debate.

## CONTENT

	Page
Introduction	4
Broad Challenges in Micro Finance Delivery	5
A Review of Progress in Micro Finance Delivery	7
A Discussion on MFI - specific Issues	13
Conclusion	18

## I. Introduction

This is the second in a series of papers on micro financial services. The first paper " Micro Financial Services: Building the Capacities of the Poorest of the Poor to Participate in the Larger Economy"<sup>1</sup> attempted to identify the pathways in which access to financial services impacts economic vulnerability and growth. It discussed the role of financial services as a coping mechanism for poor households against risks ranging from the structural (floods, cyclones) to market (enterprise failure, price fluctuations) and life cycle (health, disability, death) risks<sup>2</sup>.

Other studies have also emphasised the critical role that access to financial services play in coping with risk. This can be seen in credit usage patterns among the poor. A study in Andhra Pradesh revealed that for the poor, the main sources of risk are drought and health-related aspects with the effect that any credit availed gets utilised for these two purposes<sup>3</sup>. About 50 per cent of all risky events were characterized as "health-related" and another 28 per cent were "nature-related". The study also showed that in terms of responses to these risks, the first preference of the rural poor is borrowing (thus the high rates of indebtedness), followed by mortgaging/selling assets (often under difficult conditions that limit the value received for such assets). The poor were found lacking in knowledge about alternative risk mitigation strategies. A study by the Paradigm group on credit usage in urban slums also reveals that credit is most often taken for health purposes<sup>4</sup>.

Clearly, poor households have evolved coping mechanisms for the various risks. However, these tend to be high-cost or inefficient in nature. For instance, authors note that one of the household responses, in the absence of well-functioning financial markets, is to self-insure and over-diversify activities which makes it less efficient in generating surpluses for future investments<sup>5</sup>. Another response could be to 'under-invest' which results in sub-optimal returns from the asset so employed.

The dependence on informal mechanisms has been observed to be high among poor households. However, the effectiveness of these mechanisms to cope with risk is dependent on the nature of the risk. Informal mechanisms are more suited to high-frequency idiosyncratic risks than in dealing with low-frequency covariant risks.

Much of the micro finance development has been centred around credit. It must be noted that a credit-led coping mechanism may not be the most effective. An incomplete financial services market may also prove to be inefficient. For instance, out-of-pocket financing to tide over a health/hospitalisation event may be less efficient vis-à-vis availing of health insurance that pools risks across households<sup>6</sup>. Similarly, access to savings facilities that permit deposit of small

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<sup>1</sup> Duggal Bikram, Bindu Ananth, Kartikeya Saboo, " Micro Finance: Building the Capacities of the Poor to Participate in the Larger Economy", [icicisocialinitiatives.org](http://icicisocialinitiatives.org), February 2002

<sup>2</sup> . A survey of twelve villages in Rajasthan that analysed the reasons for households 'falling into poverty' identified them as being 1. healthcare costs 2. social expenses and 3. high-interest private debt. EPW, 2003.

<sup>3</sup> A Livelihoods Participatory Rural Assessment (PRA) was undertaken in four districts (Adilabad, Anantapur, Srikakulam, and Prakasam) during January-February, 2002 by the Society for the Elimination of Rural Poverty (SERP).

<sup>4</sup> Ramanathan Ramesh, Sharon M Barnhardt and Supriti, "Urban Poverty Alleviation in India", Ramanathan Foundation, 2002

<sup>5</sup> Hess Ulrich, Kaspar Richter, Andrea Stoppa, " Weather Risk Management for Agriculture and Agri-Business in Developing Countries",

<sup>6</sup> The choice of financing mechanism also has important implications on demand. Studies show that poorer segments have higher price elasticity for health services and conclude that the separation of contribution

amounts periodically, is crucial to building capital for the household over a longer term. Access to futures markets enables price discovery and therefore, informed cropping and investment decisions by the producer household and transfers price risk.

It appears, therefore, that if the question of access to financial services for the poor is being examined from a vulnerability and growth perspective, the whole range of financial services (including savings, investments, remittance, credit, insurance and derivatives) will have to be taken into account. This enables income smoothing, building of assets and higher risk taking ability and thereby facilitates participation in the economy<sup>7</sup>.

## II. Broad Challenges in Micro Finance Delivery

### High costs-to-serve

The key challenge in micro finance has been the costs of servicing accounts that are low in value but large in volume and entailing frequent transactions<sup>8</sup>. This has resulted in very high transaction costs. Further, most of the transactions are cash based which increase the transaction costs associated with cash handling<sup>9</sup>. Low levels of automation in disbursements and collections also contribute to higher costs.

Central to the success of micro finance experiments has been frequent and constant follow-up with the borrowers and flexibility in responses. It could be conjectured that the high recovery rates on the micro credit portfolios reported by MFIs is a direct result of the high costs incurred by way of supervision and monitoring. This would imply a trade-off between supervision cost minimisation and default rate minimisation.

This phenomenon also provides an insight into the performance of rural banks in India. The approach of banks as compared to the current set of MFIs has been less proactive and interaction with the borrower is limited. Therefore, on the one hand, repayment levels were low and the fixed cost incurred in terms of salaries and fixed assets high<sup>10</sup>. Caps on lending rates compounded the problem. The MFI model in contrast has high levels of supervision by field functionaries and pricing that recovers full costs.

### Adverse selection and moral hazard

The joint liability mechanism has been relied upon to overcome the twin issues of adverse selection and moral hazard. The group lending models are contingent on the availability of skilled resources for group promotion and entail a gestation period of six months to one year. However, there is not sufficient understanding of the drivers of default and credit risk at the level of the individual. This has constrained the development of individual models of micro finance.

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and consumption facilitated by a mechanism such as insurance will mean more adequate consumption of health services, compared with the model in which users must directly absorb all the costs of services.

<sup>7</sup> Duggal Bikram, Bindu Ananth and Kartikeya Saboo, "Micro Financial Services: Building the Capacities of the Poorest of the Poor to Participate in the Larger Economy", 2002

<sup>8</sup> Grameen models have a weekly repayment schedule for borrowers.

<sup>9</sup> A McKinsey study reveals that a typical over-the-counter cheque transaction, fully costed, costs a bank around \$3, an equivalent ATM transaction costs \$0.50, an Electronic Funds Transfer at Point of Sale (EFTPOS) transaction \$0.30 and a direct debit or credit less than \$0.10. Bekier M. Matthias, Sam Nickless, "Banks need fewer checks, not fewer branches", The McKinsey Quarterly, 1998, Number 1

<sup>10</sup> The total accumulated losses for RRBs till November 2002 is around Rs. 10347.5 million (for 29 loss making RRBs in 14 states), [www.indiastat.com](http://www.indiastat.com), Lok Sabha unstarred question No: 832

The group model was an innovation to overcome the specific issue of the quality of the portfolio, given the inability of the poor to offer collateral. However, from the perspective of scaling up micro financial services, it is important to proactively discover models that will enable direct finance to individuals. This could entail the development of credit scoring models based on the experience of MFIs and NGOs. Such parameterisation will discriminate between clients as regards preparedness for finance. It may be argued that individual lending models may not display the same portfolio characteristics as SHG. However, we cannot rule out the possibility of the right mix of incentive structures and supervision yielding an individual lending model. This is an area that needs more experimentation.

New thinking is required in the direction of individual lending models that will have in-built incentives/disincentives to repay in the absence of a group mechanism. Some of these models could entail progressive increase in lending amounts with consecutive timely repayments or the use of post-dated cheques<sup>11</sup>.

### **Exposure of poor household to multiple risks**

As outlined in the introduction, poor households contend with various risks. In a scenario where the access to risk management instruments is low, this poses a challenge to financial service providers, in particular, to lenders. Whereas idiosyncratic risk can be managed by various strategies including private insurance models, systemic risks that result in large losses are more difficult to protect against. This would include events like floods, drought and output price volatility. In the absence of hedging strategies, products like crop loans and livestock loans become extremely risky.

### **Limited delivery capabilities**

The increase in supply of micro financial services is also constrained by factors such as absence of MFIs in certain pockets of the country and the growth of existing MFIs itself constrained by lack of capital and trained human resources. A discussion on issues that constrain MFIs is dealt with in greater detail in Section IV.

There is a need to aggressively develop entrepreneur models of micro finance that expands the base of micro finance providers. This could particularly be a solution for access in difficult-to-reach areas. The entrepreneur would function practically like a moneylender providing flexible financial services and drawing refinance from banks<sup>12</sup>.

A strategy that enables increase in delivery capabilities is partnerships between the formal financial service providers and NGO/MFIs. This permits combining the capital base and product skills of the former with the 'last mile' network of the latter. This has important implications both for credit as well as insurance.

New models attempt to encourage specialization of roles. An early illustration of this was the SHG-Bank Linkage model, which builds on the strengths of the bank and the partnering NGO. These partnerships in credit need not be branch-intensive either. The model being attempted by ICICI Bank with Cashpor has the latter operating virtually as a branch of the bank, assuming responsibilities for field operations, identification of clients and continuous supervision<sup>13</sup>. The

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<sup>11</sup> Dishonouring a cheque is a criminal liability for which the offender can be jailed.

<sup>12</sup> Vijay Mahajan has conceptualised an entrepreneurship model referred to as the '3+3+3 model' where the entrepreneur is provided Rs. 3 lakhs of grant to research the geographical area and client needs and come up with a business plan, Rs. 30 lakhs of equity to start operations and upto Rs 3 crore of on-lending funds.

<sup>13</sup> The financial intermediation in this case consists of sanction of sufficient on-lending funds for the MFI to break even, approving loan proposals on the basis of MFI recommendations, bearing of credit risk whereas

success of this model will provide an alternative in areas where branch penetration is low. Such strategic partnerships based on role specialization would be crucial in enhancing micro finance delivery capabilities.

In insurance, the partner-agent model is based on the principle of an insurance company managing the risks and payouts and the NGO managing a large portion of the client relationships, underwriting and extending its field presence to the insurer. Such a partnership also helps overcome the problem of adverse selection because of the close relationships that NGOs typically have with the communities that they work with. MFIs that have identified client demand for insurance products should focus on creating partnerships with regulated insurers through which they can offer clients an insurance product suited to the micro market<sup>14</sup>.

### Off take of credit contingent on other developmental inputs

There is some debate on the quantum of 'explicit demand' for credit. While studies quote aggregate numbers in the range of Rs 15,000 to Rs 45,000 crores per annum<sup>15</sup>, it might be that a significant component of this demand is contingent on the availability of other inputs such as livelihood development support, infrastructure development or complementary financial services (insurance and savings). This implies therefore, that the provision of these enabling services would have to be addressed if the flow of credit is to be unlocked.

In the area of livelihoods training, the two distinct models currently existing in India are:

1. the NGO supported livelihood initiatives<sup>16</sup> where the NGO provides the organisation and marketing support and
2. training provided by entrepreneurship development institutes in self-employment<sup>17</sup>.

Appropriate models of business development support for enterprises of the poor have to be evolved that have clear linkages to the market, in terms of demand and quality specifications.

## III. A Review of Progress in Micro Finance Delivery

The progress in outreach and models adopted varies across the classes of micro financial services. This section will examine each of the micro financial services, insurance, savings, credit and other risk management instruments, with an emphasis on the prevailing regulatory environment and models of delivery.

### Insurance

Insurance reduces the vulnerability of poor households by replacing the uncertain prospect of large losses with the certainty of payout against small, regular premium payments. It is integral to a comprehensive risk management strategy for poor households. This includes life, health, accident and asset (dwelling, crop, livestock) insurance.

The dominant providers of insurance to the poor in India are:

1. The Government-promoted insurance schemes provided by the Life Insurance Corporation (LIC), the Postal Life Insurance (PLI) and the General Insurance Corporation (GIC)

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the role of Cashpor includes identification and motivation of poor women in the villages, group recognition, promoting and monitoring SHG savings, disbursements, tracking utilizations and field supervision.

<sup>14</sup> McCord Michael, " The Lure of Micro Insurance: Why MFIs should work with insurers", January 2003.

<sup>15</sup> "Micro Finance in India", [www.basixindia.com/publications](http://www.basixindia.com/publications)

<sup>16</sup> The interventions of PRADAN characterise this model.

<sup>17</sup> The Entrepreneurship Development Institutes in India and the RUDSETI model in Karnataka where banks collaborate with local trusts to establish and run training programmes are examples of this category.

2. The private sector insurance companies and
3. Community-based insurers such as NGOs and MFIs. The Insurance Regulatory and Development Authority (IRDA) in India lays down norms and oversees the development of the sector<sup>18</sup>. The IRDA has specified obligations of insurers to the rural and social sectors<sup>19</sup>. The latter includes the unorganised sector, informal sector, economically vulnerable backward classes and other categories, both in rural as well as urban areas.

Most insurance programmes in India have been subsidised with the Government providing a corpus to the insurer out of which premia have been partly funded. The contribution from the insured individual has largely been nominal.

The characteristics of the low-income market create certain challenges such as minimising transaction costs, coping with irregular household cash flows and contending with a limited availability of information on potential clients<sup>20</sup>. This results in poor coverage of low-income households. One study<sup>21</sup> shows that low coverage is the result of three main factors. These are:

1. heavy contributory burden
2. high cost of detecting, inspecting and collecting from the large numbers of self-employed and wage earners of micro-enterprises
3. benefits available for this group are very small and reduce incentives for affiliation.

A basic problem in insurance provision is that of adverse selection. Simply put, this is the likelihood of the most risky clients being insured. Adverse selection occurs when the individuals with a high probability of incurring a loss predominate among policyholders and low-risk individuals fail to join. There have been some innovations attempted to overcome this problem. Mandatory insurance of all clients, say, of an MFI ensures that all clients regardless of risk profiles get covered. Other mechanisms could be third party proof of disability and policy exclusions of certain categories of people. Some additional control mechanisms are photo identity cards as demonstrated in Uganda, sick sheets signed by a third party, training for groups of people and service providers and supplying client lists to service providers<sup>22</sup>.

The emergence of MFIs and NGOs willing to facilitate financial intermediation presents an important opportunity for the accelerated delivery of insurance. The joint liability mechanism has effectively countered the information asymmetry in credit delivery and could be harnessed for insurance as well. A significant component of cost has been the expenses incurred on verification of claims. The Partner-Agent model of micro-insurance where the NGO/MFI provides outreach by means of documentation support, verification and claims administration could significantly enhance the capabilities of mainstream insurers.

Partnership with insurers would be crucial for NGO/MFIs desirous of providing insurance cover to its members. Community managed insurance programmes have remained largely isolated in nature<sup>23</sup>. Unlike credit, insurance cannot be provided to small pockets as it is based on the principle of pooling risk. A large number of policyholders is important because it reduces the

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<sup>18</sup> Currently, the Postal Insurance is outside the ambit of the IRDA

<sup>19</sup> For the rural sector, in respect of a life insurer the obligation starts at 5% of total policies in the first financial year and goes upto 15% of total policies in the fifth year. In respect of a general insurer, the obligations begin at 2% of gross premium income in the first year and 5% from the third year onwards.

<sup>20</sup> Brown, Warren and Craig Churchill, " Insurance Provision in Low Income Communities: Part II - Initial Lessons Learned from Micro-Insurance Experiments for the Poor", Microenterprise Best Practices project, USAID, May 2000.

<sup>21</sup> Mesa-Lago, C, " Changing social security in Latin America: Towards alleviating the social costs of economic reform", Boulder, Colorado and London, Lynne Rienner Publishers, 1994

<sup>22</sup> Gineken Van, W, " Social Security for all Indians", New Delhi, Oxford University Press, 1998.

<sup>23</sup> Some of the examples of community managed insurance programmes are those of the Tribhuvandas Foundation (TF) and Bhartiya Agro Industries Foundation (BAIF)

potential for adverse selection and increases the likelihood that the variance of actual claims will be closer to the expected average number of claims used in calculating premiums. Insurance provision also necessitates specific skills in pricing and under writing.

For MFIs, the access to insurance for its members could result in the elimination of drivers of credit risk: the death of the earning member and death of livestock. For instance, credit-linked life insurance schemes enable the assignment of the insurance policy in favour of the lender.

The challenges vary across the type of insurance as well. While life insurance is relatively easy to administer, health insurance remains a challenge. The provision of health insurance in a sustainable manner will have to take into account factors such as cost containment, promotive care, availability of health infrastructure/providers, quality control, filters, checks and controls. Similarly, livestock insurance is constrained by the high costs of verification and moral hazard.

Research on the insurance needs of the poor is very inadequate. An understanding of insurable events that poor households deal with, as well as insights in the ability and willingness to pay for insurance will aid insurers design products that are more suited to the profile of poor households. Factors like flexible and transparent policies in insurance payouts, minimum documentation requirements and education on the concept of insurance need to be thought of while designing products for this segment.

### Savings and investment

Access to savings and investment facilities is critical for the poor. This facilitates building capital over a long term as well as to cope with income shocks in the near term. Stuart Rutherford argues that the need for a savings product that enables small frequent deposits largely arises from the multiple claims on it while asserting that the poor can save, do save and want to save money<sup>24</sup>. He identifies deposit collectors and savings clubs (such as ROSCAs and chit funds) as the means by which the poor save.

The desire to save is substantiated by instances cited of the poor earning negative returns on savings when they pay deposit takers a fee for safekeeping deposits. Instances have been cited where deposit takers in Vijayawada, Andhra Pradesh issue a card to slum dwellers for daily deposit for a fixed period, say 100 days. The saver makes regular savings and at the end of the 100 days, takes the savings back less a service charge<sup>25</sup>.

A study conducted by MicroSave identifies the reasons for the poor saving with the informal sector being willingness to accept small amounts, doorstep services and ease of joining<sup>26</sup>. These characteristics are largely absent in formal sector savings options. Marguerite Robinson further argues that the poor want the 'option' to withdraw whenever they want and that withdrawal itself may not be very frequent<sup>27</sup>.

The provision of savings remains highly regulated in India. Under the current regulations, banks are prohibited from employing 'agents' for the mobilisation of deposits from the public<sup>28</sup>. On the other hand, institutions other than banks are prohibited from engaging in deposit mobilisation.

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<sup>24</sup>Rutherford Stuart, "The Poor and their Money", January 2000

<sup>25</sup> *ibid*

<sup>26</sup> [www.microsave-africa.com](http://www.microsave-africa.com)

<sup>27</sup> Robinson Marguerite, "Savings Mobilization as a Financial Instrument and its Relevance for the Poor" Dec 2000

<sup>28</sup> An exception to this is the door-to-door daily collection scheme popularly known as 'pygmy deposits' where agents may be employed by the bank.

Another regulatory barrier is the stipulation on uniform rates for return for deposit products. Given the savings patterns of poor households (small but frequent deposits), the transaction costs of providing services are likely to be higher. This rationale is similar to charging higher rates of interest on micro loans. This might explain the low penetration of savings bank accounts in rural areas. The rural penetration of bank deposit accounts is as low as 18 per cent<sup>29</sup>.

Many MFIs in India provide both compulsory and voluntary savings products. Similarly, the SHGs also maintain some savings in the bank, net of internal circulation for consumption loans. However, the ease of withdrawal is a challenge for these products.

Mutual Funds and other investment products could be an avenue for the poor to build capital. These can be designed to enable relatively small deposits.

## Credit

Most of the models in the micro finance sector have revolved around credit. The regulation for micro credit in India is fairly liberal with interest rates being completely deregulated except in the case of bank lending directly to individuals for amounts less than Rs. 200,000<sup>30</sup>. An added incentive for banks has been the reckoning of micro credit as constituting priority sector advances<sup>31</sup>.

The dominant models of micro credit are:

1. The SHG-bank linkage programme<sup>32</sup> and
2. The NGO/MFI model<sup>33</sup>. Other models include the cooperative model and the recent innovation of banks lending with the NGO/MFI as the administrative partner with risk sharing<sup>34</sup>. An analysis of the trends in the SHG-Bank Linkage programme reveal that NGOs and other Self-Help Promoting Institutions (SHPIs) are gradually playing less of a financial intermediation role and limited to social mobilisation<sup>35</sup>.

It is critical to develop innovative distribution strategies for micro credit. The traditional purveyors of rural credit, i.e., the rural banks, are beset with high overheads and poor recovery rates. The MFIs are largely concentrated in the southern states of India. There is negligible micro credit activity elsewhere, in particular in the North and North-East regions. Portfolio growth for existing MFIs is constrained by various factors discussed in Section IV. Therefore, although the demand supply gap is pegged to be between Rs. 12,500 - 32,500 crores, the distribution infrastructure to fill this gap is not apparent<sup>36</sup>. There is a need for new networks that will enable delivery of financial services, including credit.

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<sup>29</sup> Duggal Bikram and Amit Singhal, "Extending Banking to the Poor in India", March 2002

<sup>30</sup> RBI guidelines, February 2000. "As mentioned in our circular RPCD.No.PL.BC. 94/04.09.01/98-99 dated April 24, 1999, interest rates applicable to loans given by banks to micro credit organisations or by the micro credit organisations to Self-Help Groups/member beneficiaries has been left to their discretion. The interest rate ceiling applicable to direct small loans given by banks to individual borrowers, however, continues to remain in force".

<sup>31</sup> *ibid*

<sup>32</sup> The SHG bank linkage programme has disbursed loans aggregating Rs. 20,487 million to 717,360 SHGs with refinance support of Rs. 14,188 million from NABARD as of March 2003<sup>32</sup>.

<sup>33</sup> MFIs would have cumulatively disbursed funds approximating Rs 300-350 crores to date.

<sup>34</sup> See Section IV for more details on this model

<sup>35</sup> Analysis based on data provided by NABARD. "Progress of SHG-Bank Linkage in India, 2002-2003".

<sup>36</sup> The demand-supply gap is derived from demand estimates for micro credit ranging between Rs. 15,000 crores-Rs. 45,000 crores and the disbursements being approximately Rs. 2500 crore.

New networks that leverage technology such as Wireless in Local Loop provide connectivity to even remote villages<sup>37</sup>. These networks are capable of providing multiple services such as agricultural information, education and health applications and communication. Therefore, the overhead costs get shared among multiple services. The unit cost of delivering credit through this channel is, to that extent, lesser as opposed to the traditional rural branch model. Connectivity also enables updation of databases real-time and remote monitoring.

Most of the micro credit activity has been concentrated in rural areas. The few models of urban micro credit are SEWA Bank, Working Womens' Forum, Sanghamitra and YUVA. There is a need to aggressively develop models for urban credit whose context is different owing to the mobility of borrowers and engagement in informal sector activity which has a different set of risks associated with it. The urban sector might also have a different demand profile in terms of purposes of borrowing and unit sizes that needs to be better understood.

### Other risk management instruments

The Assessing the Impact of Microenterprise Services (AIMS) baseline studies in Zimbabwe, Uganda, India and Peru found client households to be highly diversified. The household income in most cases was typically a mix of enterprise revenue, daily wage, casual part-time income, remittance income and rental income<sup>38</sup>. As mentioned in the introduction, such diversification makes it difficult for the household to build reserves and break out of poverty. If poor households have to migrate to higher risk-taking, they will need access to instruments that will enable them to manage this risk effectively. Arguments against complete reliance on self-insurance through diversification mechanisms also point out that this strategy is expensive and unreliable in times of extreme events like drought<sup>39</sup>. Idiosyncratic risk can be managed through savings, credit and some forms of insurance. However, in order to cope with risks arising from weather parameters, price volatility and disasters, other instruments are necessary.

Commodity price volatility in India and other developing countries has been traditionally dealt through state provided mechanisms such as the minimum support price and buffer stocks. There is considerable new thinking in the area of market-based approaches such as forwards, futures, options and swaps to enable risk management for poor households<sup>40</sup>.

Index based insurance products provide an opportunity to provide insurance to farmers and the rural poor without incurring the high overheads of loss adjustment and supervision typical of traditional crop insurance products. Since the index provides a transparent mechanism to compute payouts, claims settlement can be immediate.

ICICI Lombard General Insurance Company Limited has launched a pilot in index based rainfall insurance with the clients of Krishna Bhima Samruddhi, a Local Area Bank in Andhra Pradesh<sup>41</sup>. An index was created based on an analysis of historical correlation between rainfall and crop (groundnut) yield. The index is created by assigning weightages to critical time periods. The past weather data is then mapped on to this index to arrive at a normal threshold index. The actual

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<sup>37</sup> N-logue Communications, a company incubated by IIT Madras, has built an entrepreneur-led business model for deploying rural internet kiosks across the country. The technology used is cordECT wireless in local loop.

<sup>38</sup> Cohen Monique, "Microfinance, Risk Management and Poverty", Assessing the Impact of Microenterprise Services, March 2000.

<sup>39</sup> Larson Donald, Panos Varangis and Nanae Yabuki, "Commodity Risk Management and Development", Development Research Group, 1998

<sup>40</sup> The Commodities Risk Management Group (CRMG) of the World Bank is an important player in this area and aims to enable smallholder producers of developing countries to access the same risk management instruments available to producers in developed countries.

<sup>41</sup> The Krishna Bhima Samruddhi Bank is the local area bank of the BASIX group of companies

weather data is then mapped to the index to arrive at the actual index level. In case there is a material deviation between the normal index and the actual index, compensation is paid out to the insured on the basis of a pre-agreed formula. For the purposes of the contract, the measurements are tracked at a reference weather station. The farmers purchase the insurance contract directly and in the event of the payout, the bank receives the payout as an agent of its clients. This amount may be used by the bank to settle interest or principal payments payable to it in the event of rainfall shortage.

Given the access to an instrument that protects against rainfall volatility risk, it might be possible for several MFIs to build or enhance their crop loan portfolio. Banks should actively seek to combine lending with other risk management instruments. The relationship between risks to the client and risks to the loan portfolio is critical in the micro finance industry. Products, services, and delivery mechanisms that are designed to improve the capacity of clients to deal with the risks in their lives (reduce their vulnerability) and to reduce the risk of taking loans can lead to better payment, fewer dropouts, and accordingly lower operating costs<sup>42</sup>.

A pilot in commodity price risk management has also been attempted in Uganda where members of a coffee growers' cooperative have been provided a put option on their coffee stocks.

The broad challenges of participation in commodity derivatives markets have been identified as being problems related to aggregation of risks from smaller entities, basis risk, lack of local reference prices, low levels of liquidity or absence of markets for certain commodities internationally, low levels of know-how and counterparty risk<sup>43</sup>.

In India, the biggest issue is that of imperfectly functioning commodity markets. This is characterised by limited price discovery mechanisms, absence of linkages between geographically isolated markets even for the same commodity and no systematic processes and facilities for cleaning, grading, sorting, warehousing and transportation of commodities. This forces lenders to largely ignore the commodity as collateral both pre and post-harvest, significantly increasing the cost of finance and excluding several potential borrowers whose primary collateral base may only be a commodity<sup>44</sup>. Moreover, regulation prohibits banks from hedging commodities<sup>45</sup>.

Commodity exchanges present a significant opportunity for better price discovery and access to price risk management instruments. Derivative contracts could be a cost-effective route to managing price and weather risks.

#### **IV. A Discussion on MFI - specific Issues**

MFIs have emerged as an important conduit of financial services for the poor in recent years. However, they represent a diverse set of organisations with varying capacities. It may be useful to look at MFIs in a disaggregated manner to understand this diversity.

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<sup>42</sup> Jennefer Sebstad and Monique Cohen (March 2000) *Microfinance, Risk management, and Poverty*. The study involved seven MFIs across four countries. The selected MFIs had programmes running for at least five years, were operationally sustainable or close to it, and had a voluntary savings component.

<sup>43</sup> Larson Donald, Panos Varangis and Nanae Yabuki, "Commodity Risk Management and Development", Development Research Group, 1998

<sup>44</sup> Mor Nachiket, Bindu Ananth, Sonu Agarwal "Improving Rural India's Access to Credit", Presentation at the International Task Force Meeting, June 2003

<sup>45</sup> Section (8) of the Banking Regulation Act, 1949 prohibits banks from buying, selling and bartering of goods other than as realisation of security given to or held by it.

1. The top ten MFIs in terms of performance account for over 40% of the total portfolio outstanding<sup>46</sup>.
2. Operational self-sufficiency ranges from 40 per cent for 'early MFIs' to greater than 100 per cent for mature MFIs.
  - Mature MFIs are few: BASIX, SHARE and SEWA Bank
3. Only one MFI, Bharatiya Samruddhi Finance Limited, has been able to raise capital from mainstream markets.
4. Legal form of MFIs range from:
  - Not-for-profit MFIs (Societies, Public Trusts and Section 25 companies)
  - Mutual benefit MFIs (State credit cooperatives, National Credit cooperatives and Mutually Aided Cooperative societies)
  - For-profit MFIs (NBFCs)

In the context of the growing number of MFIs, the challenges to scaling up for MFIs are discussed in this section. The discussion has been structured along two broad themes. These are:

1. Access to capital for increasing micro finance outreach
2. Capacity building for micro finance

### Access to Capital for Increasing Micro Finance Outreach

The deficiency of capital is believed to constrain the growth in outreach of MFIs. It appears that even when MFIs become profitable, accumulated profits will not support the kind of growth required to dramatically scale up. Until recently, donor grants and soft loans have been utilised by many of the MFIs to support their operations both in the early years and to scale up. However, such grants, already limited in size and availability, are becoming harder to access as the pool of global MFIs grows. The other sustainable options for MFIs are tapping public debt and equity markets for growth. Regulatory concerns make mobilisation of deposits difficult for MFIs, be they NGOs or registered as NBFCs<sup>47</sup>. If an MFI opts to become an NBFC, it should be able to satisfy the entry-level capital requirements of Rs. 20 million. In India, there has been strong advocacy for bringing down the capital entry norms for NBFCs in the business of micro finance.

Diluting the entry norms for deposit mobilisation from the poor will have to be accompanied by an increase in the levels of supervision by the regulator. Other researchers raise similar concerns about diluting the capital entry norms for MFI NBFCs and suggests the alternative of permitting NGOs to invest in such for-profit entities, without prejudice to their tax status<sup>48</sup>.

The other option for MFIs is to raise equity. To date, Bharatiya Samruddhi Finance Limited (BSFL) is the only MFI that has adopted this route for raising capital. Most of the MFIs in India had their origin as NGOs and commenced micro finance in addition to the other developmental activities. Many of the MFIs are hence registered as not-for-profit entities that make it an unattractive choice for conventional equity investors<sup>49</sup>. The low profitability margins of micro finance operations currently is yet another factor which renders it unattractive for potential equity investors. The profitability of MFIs is not very high because of factors like high initial investment, and high 'cost-to-serve' stemming from the intense supervision requirements, and

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<sup>46</sup> Sinha Sanjay, " Financial Services for Low Income Families: An Appraisal" , IIMB Management Review, June 2003

<sup>47</sup> If the NGO earns a substantial part of its income from lending activity, it violates section 11(4) of the Income Tax Act and could lose its charitable status under Section-12. In the case of NBFCs, deposit mobilisation is not possible at least for the first three years, till a satisfactory credit rating is obtained. Borrowing from foreign institutions is also hard due to the credit rating requirements imposed by RBI.

<sup>48</sup> M. S. Sriram and Rajesh S. Upadhyayula 'The Transformation of Microfinance in India: Experiences, Options and Future', Indian Institute of Management, Ahmedabad, September 2002

<sup>49</sup> Out of an estimated number of 666 MFIs in India, 400 are registered as Public society/ Trust. Ibid.

the time lag between group formation and credit off-take. All this translates into barriers to raise equity capital.

Since mainstream lenders are not familiar with the micro finance industry, it is hard for the MFIs to leverage their existing equity. Commercial lenders are ready to provide only a conservative leverage on this unfamiliar asset class due to the high-risk perception of unsecured lending to the poorest strata of the society.

Capital adequacy is going to become increasingly significant in a scenario where the resources that will allow the scaling up of MFIs come from commercial and development banks and through savings mobilisation. The Basel Accord puts the capital adequacy ratio for banking institutions at eight per cent. There is no formal standard for MFI capital adequacy as yet; the figure most agreed-upon is in the range of 20 per cent<sup>50</sup>. The current capital adequacy of MFIs ranges from 2.80 in the case of Cashpor to 92.24 in the case of BSFL.

Some recent innovations show the way for overcoming the capital constraints discussed above without major regulatory changes.

#### **4.1.1 Strategic partnerships between MFIs and banks with risk sharing**

A potential solution to the capital constraint could be to transfer the credit risk from the MFI to the mainstream lender through innovative partnerships. A partnership may be worked out between mainstream banks/Financial Institutions and MFIs drawing upon the comparative advantages of each. The MFI draws upon its skills to contribute the social intermediation aspects<sup>51</sup>. The bank can carry out the financial intermediation and therefore, bear the credit risk.

This will effectively leverage the risk capital that already exists with banks. The ICICI Bank – Cashpor Financial and Technical Services (CFTS) partnership in the Chandauli district of U.P. is an example of such a partnership. In this case, ICICI Bank provides the necessary financial resources in terms of working capital assistance to the partner to meet administrative costs when cash flows are inadequate; and lends directly to the borrowers bearing the entire risk. Cashpor establishes the micro finance structures (SHGs/ JLGs) and the requisite disbursement, monitoring and collection mechanisms and systems.

This model can be scaled up when embedded with incentives for the partner MFI to maintain collection performance. This would be done by providing collection incentives and review triggers related to portfolio performance. ICICI Bank has proposed some innovative structures that take these factors into account.

The structure has two components:

1. Financing instrument for the MFI portfolio
2. Credit enhancements

The former could take the route of a portfolio buyout of the MFI or a continuous arrangement of on-tap securitisation. The credit enhancement of the MFI portfolio could be provided in the form of a First Loss Default Guarantee (FLDG) backed by:

1. an overdraft limit,
2. the excess spread on the portfolio or

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<sup>50</sup> Joanna Ledgerwood Sustainable Banking with the Poor: Microfinance Handbook: An Institutional and Financial Perspective, The World Bank, Washington D.C, 1998. However according to Joanna, this initial capital-asset ratio is subject to downward adjustment as the institution and industry gain further experience.

<sup>51</sup> Social intermediation includes group promotion, monitoring, collection, delinquency management, field supervision and reporting to the bank.

### 3. third-party guarantees.

If the credit enhancement takes the form of an FLDG backed by an overdraft (OD) limit, the bank sanctions the MFI a limit to the extent of a specified percentage of the MFI receivables purchased by the bank. The OD limit will be drawn down only in the event of default.

Excess spread is the difference between the rate of return expected by the bank on the micro finance portfolio and what the MFI charges the final borrower. This could be as much as 12-24 per cent to account for the transaction costs incurred by the MFI in administering the portfolio. This excess spread could be trapped in a separate account and provide an FLDG to the bank. The amounts so accumulated in the account would be paid to the MFI upon the maturity of the designated portfolio after adjusting for losses, if any.

The third option is for funding agencies in micro finance to provide an FLDG to the bank in the form of cash security.

The advantages of the above structures are that:

- It separates the risk of the MFI from the risk of the underlying portfolio. The micro finance portfolio has exhibited negligible loss ratios<sup>52</sup>. Despite this, the cost of commercial funds for MFIs has been high, due to their poor capitalisation<sup>53</sup>.
- The structure being scalable in nature can provide continuous funding for MFIs that have supervision structures in place.
- The credit risk assumed by the MFI is limited to the FLDG that it provides the bank. Therefore, the capital that needs to be allocated by the MFI to this activity is dramatically reduced.
- The structure through the various FLDG options provides a mechanism to incentivise MFIs to sustain performance on collection.

#### **4.1.2 Creating a tradable market for micro finance portfolios**

The process of transformation of financial claims into marketable securities is termed securitisation. It is widely employed by firms ranging from housing/ mortgage finance companies to insurance companies as an instrument to access capital markets.

This seems to be an ideal tool for MFIs whereby their cash flows or claims against third parties (borrowers), either existing or future, are identified, consolidated and separated from the originating entity (in this case the MFI), and then transformed into "securities" to be offered to investors. Transforming a claim on a third party as a marketable document affords to the issuer the rare ability to originate an instrument which hinges on the quality of the underlying asset. In other words, as the issuer is essentially marketing claims on others, the quality of his own commitment becomes subsidiary, the credit rating of the issuer becomes less significant, and the intrinsic quality of the asset more critical. This becomes decisive in that MFI portfolios have exhibited stable repayment rates.

Another possibility is that the portfolios originated by MFIs could be marketed to banks and be traded between banks. This will help the banks meet their priority sector targets, the

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<sup>52</sup> The peer group analysis of Portfolio quality and efficiency across 148 MFIs gave the average PAR (>90 days) as 2.1 with a standard deviation of 1.9. Microbanking Bulletin: Focus on Transparency, November 2001, Issue No. 7.

<sup>53</sup> See for instance, CRISIL's rating rationale for BSFL. It says that " the inherent risks of micro finance such as credit exposure to the economically disadvantaged classes of the society whose inherent borrowing profile is weak, high operating costs due to the small size of loans and wide geographical coverage necessitate a fairly long period to stabilise operations. Besides, extraneous factors like floods and drought can have a strong impact on cash flows of borrowers and consequently impact the asset quality of the lender."

performance for which ranges widely among the banks. In 2000-01, while majority of the banks (75 per cent) achieved the overall priority sector target of 40 per cent, the stipulated targets could be met by <10 per cent of them<sup>54</sup>. It has been suggested that the Inter Bank Participatory Certificates (IBPC) Scheme be revised to enable those banks which have surpassed their priority sector obligations to securitise and sell their advances to the banks which could not fulfil the same. This consolidated IBPC may be termed as Priority Sector IBPC or Agricultural Sector IBPC as the case may be. However, in case of Agriculture Sector IBPC, sellers would be only five banks while as many as 53 banks would be buyers<sup>55</sup>. In this case, the MFI originated portfolios could be marketed as direct agricultural sector lending. This will also bring down the pressure on the MFI for capital adequacy as well as provisioning requirements owing to the nature of this portfolio.

There is a role for organisations modelled on the lines of the Small Business Administration in the USA. The SBA was set up to help small entrepreneurs in the USA set up successful enterprises. The SBA enables its lending partners to provide financing to small businesses when funding is otherwise unavailable on reasonable terms by guaranteeing major portions of loans made to small businesses<sup>56</sup>.

Both the above suggested methods place emphasis on the quality of portfolio; thus incentivising MFIs with good portfolio performance.

### Capacity Building for Micro Finance

There are several funds that have been earmarked specifically for the development of the micro finance sector. These include the Rural Promotion Corpus Fund (Rs. 92 crores), the Credit and Financial Services Fund (Rs 40 crores), and the Microfinance Development Fund (Rs 100 crores). These funds are typically used for training purposes, start-up capital for MFIs and to meet the group promotion expenditure of NGOs. Further, funding agencies provide grant support for several capacity building activities. In order that these funds are put to the best use, it is critical to understand what are the specific 'capacities' that need to be invested in.

The most critical of these capacities is to equip MFIs with capabilities to analyse and monitor their own performance. This would make the development of a set of financial and accounting standards for this sector necessary. Sa-dhan, the industry association of MFIs in India, has been engaged in the development of these standards. Efforts will have to be made for these standards to gain acceptance both by MFIs as well as commercial banks who seek to work with MFIs.

Training initiatives that enable successful MFIs to 'franchise' their model to emerging MFIs could hasten the scaling up process considerably. This becomes crucial as many MFIs are in fact 'transformed NGOs' and would need to acquire skill sets in financial management and portfolio tracking.

Most MFIs function in a decentralised manner with field officers capturing field level data manually and doing data entry at a unit office/branch level. The data from the various unit offices/branches is then periodically transmitted to the head office for aggregation. As the micro finance operations acquire scale, automation and reliable Management Information Systems (MIS) become important. In a study conducted by M-CRIL, it was found that a number of MFIs do not have adequate systems even to track basic member and borrower information while

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<sup>54</sup> Compiled from The Report on Trend and Progress of Banking in India 2000-01 by C. L. Dadich in Redesigning Priority Sector Lending Operations in Liberalised Regime. Bank Economists' Conference 2002.

<sup>55</sup> Agriculture Sector IBPC supply/ surplus is Rs.108 crore as against the demand for Rs. 12834 crore. Ibid.

<sup>56</sup> See Rao Rohini, " Declining Credit-Deposit Ratio in the North-east: Causes and Remedies", iciciresearchcentre.org, July 2003, for a detailed discussion on SBA and similar models.

others did not have systems that enabled ease of data transfer between field and head offices and tracking of portfolio quality on a continuous basis<sup>57</sup>.

Currently, a considerable proportion of capacity building funds are expended for group promotion. This has the effect of dependence on external funds for maintaining growth. An innovation proposed by DHAN Foundation is for banks to invest in group promotion as business development expenditure. Alternatively, agencies like Cashpor Financial and Technical Services recover this cost from the borrowers. Reckoning this expense in transactions cost is necessary when pursuing commercial models of micro finance.

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<sup>57</sup> Sinha Sanjay, " Financial Services for Low Income Families: An Appraisal", IIMB Management Review, June 2003.

## V. Conclusion

This paper has attempted to assess progress in the delivery of micro financial services and assemble new thinking on scaling up. While the regulatory framework and models of delivery vary for savings, insurance, credit and derivatives, the broad challenges are similar. These are the high costs to serve, adverse selection and moral hazard, limited delivery capabilities, exposure of poor households to multiple risks and the dependence on other developmental inputs.

The broad elements of a strategy to scaling up micro financial services would therefore examine:

1. Innovative distribution models including entrepreneur-led models that leverage technology and expand the base of micro finance providers
2. Strategic partnerships between formal financial service providers and MFIs/NGOs/other SHPIs that combine product skills with origination and supervision capabilities. Such partnerships can be scaled up by embedding risk sharing designs in the model.
3. Bundling credit with other risk management instruments such as insurance and derivatives that mitigate risk both for the household and the lender
4. Individual models of micro finance that would work in the absence of group liability. This would necessitate detailed understanding of the drivers of credit risk and
5. Innovation in products based on research that identifies the demand profile of poor households for various services. This is especially crucial for savings and insurance products.
6. Increasing the outreach of MFIs by pursuing partnerships, accessing capital markets and addressing financial capacity building needs.

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