Macro potential for Microfinance Industry

India is one of the most promising markets for microfinance in the world. Banks and microfinance institutions, says **Rajeshwari Adappa Thakur**, are unveiling plans to meet the enormous demand for credit from the huge untapped market, both in urban and rural areas.

ILLUSTRATION: FARZANA COOPER

Philanthropy and profit to some may seem strange bedfellows, but they do make for a good marriage, going by the success of microfinance institutions (MFIs). India is the largest microfinance market in the world, with the sector growing at an average rate of over 50 per cent. Consequently, it is attracting domestic and foreign investors and new players, who are hoping to practice profitable philanthropy.

Close to two decades after its emergence in India, microfinance has matured from being a pure development activity to also being an economic driver at the grassroots level.

Thus, even the largest selling mobile phone maker, Nokia, is looking at microfinance as a major initiative to further increase mobile penetration in India.

Increasingly, microfinance is perceived as an effective channel for ensuring financial inclusion of the low income population and those in the informal sector.

"Enough experimentation has been done to show the sustainability and success of the microfinance models," says Vijay Mahajan, chairman, Basix (India), a Hyderabad-based livelihood promotion institution.

Microfinance, or micro-credit, typically comprises very small-sized loans of about \$100 extended to an individual or a group of individuals, which are called self-help groups (SHGs). Borrowers are generally from the weaker sections of society.

The Reserve Bank of India (RBI), the country's central bank, has urged banks to opt for the SHG model to lend to over 30 million small and micro units, to ensure they have easy access to funds.

The Indian microfinance industry comprises NGOs, trusts or societies working on a not-for-profit model, and even bigger players – like Spandana, SKS, Basix, Share Microfin in Andhra Pradesh, Cashpor in Uttar Pradesh, Grameen Koota in Karnataka – which work on a for-profit model. The microfinance industry is estimated to cover about 10 per cent of poor households in need of credit.

MFIs first emerged in the late 1990s to raise social and commercial funds for lending to the underprivileged. Today there are over a thousand Indian MFIs, most of which service the rural poor. Several

ECONOMIC DRIVER : The RBI wants banks to opt for the SHG model to lend to millions of small and micro units

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MFIs have also discovered the potential in lending to the urban poor.

Uplift, an association of urban MFIs, Society for Promotion of Area Resource Centres (SPARC), Swadhar FinAccess, Bandhan and Ujivan, are among the MFIs that operate in urban areas.

Banks find it difficult to lend to MFIs in the absence of sufficient collateral. Hence, several MFIs like Biswa, Grameen Kuta in Bangalore and Bandhan in West Bengal have transformed themselves into non-banking finance companies (NBFCs) to widen their capital base.

According to 'Inverting the Pyramid: The Changing Face of Indian Microfinance' – a report by Intellectual Capital Advisory Services Pvt Ltd (Intellecap), a leading consultancy – SHGs and MFIs had disbursed \$3.7 billion in micro-loans up to March 2007. While the SHG model provides the majority of disbursements, the MFI model has demonstrated a higher growth rate.

From 2003 to 2007, the MFI disbursement share rose from 28 per cent to 47 per cent of all Indian microfinance loans. Despite such growth, estimates suggest that the current supply of micro-credit amounts to only about seven per cent of potential demand.

According to another Intellecap study, the 60 largest MFIs had close to 10 million customers and a cumulative outstanding portfolio of \$769 million in 2007. The efficiency and profitability indicators of Indian MFIs are highly favourable compared to Asian benchmarks.

Recently, seven Indian MFIs, the highest for a country, were featured in the first ever list of world's top 50 MFIs compiled by Forbes magazine. Bandhan was ranked at the second position.

Other Indian MFIs on the list were Microcredit Foundation of India (ranked

13th), Saadhana Microfin Society (15th), Grameen Koota (19th), Sharada's Women's Association for Weaker Section (23rd), Asmitha Microfin Ltd (29th) and SKS Microfinance Pvt Ltd (44th). Forbes picked the top 50 from 641 micro-credit providers around the world.

According to the Intellecap study, the market size for microfinance in India is in the range of 58 to 77 million clients, assuming the entire poor population of the country represents potential clientele. This translates to an annual credit demand of \$5.7 to \$19.1 billion, assuming loan sizes range between \$100 and \$250.

"If we assume that the low-income but economically active population – including small and marginal farmers, landless agricultural labourers, and micro-entrepreneurs – are also potential microfinance clients, the annual credit demand goes further up to an estimated 245.7 million individuals and \$51.4 billion in annual on-lending requirements," says the report.

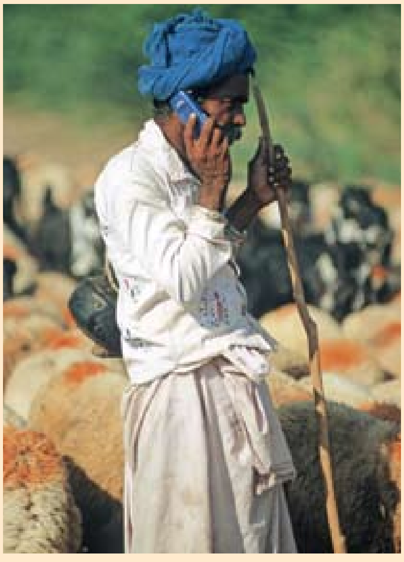
> The sector has been growing at upwards of 50 per cent per annum – even higher than the mobile phone industry.

"The demand is large, but significantly unmet," explains Mahajan of Basix. "In terms of funds, about \$15-20 billion are required at the entry level (for the first small loan) alone, according to estimates. The microfinance sector has been growing at a rate of upwards of 50 per cent per annum – even higher than the mobile phone industry."

Thanks to the high growth rate and the huge demand-supply gap, the sector is attracting several new players.

One reason that microfinance is a much sought after business is the higher

M-BANKING TO TRANSFORM MICROFINANCE SECTOR



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CHECKING ACCOUNT : The m-banking way

THE microfinance industry in India and other emerging economies is all set for a major overhaul, thanks to technology. With mobile phone usage expanding dramatically in the country, banks, cellular phone service providers and other intermediaries are entering into alliances, offering less affluent customers – including those not having access to bank accounts and credit cards – hassle-free access to funds.

Leading Indian banks including State Bank of India (SBI), ICICI Bank, HDFC Bank, Corporation Bank, Axis Bank and IDBI Bank have tied up with leading telecommunications companies such as Bharti Airtel and Reliance Communications, offering mobile banking (m-banking) services.

SBI, the largest commercial bank in the country, plans to shortly launch its m-banking services. Customers – even those with basic handsets – will be able to transfer funds up to \$35, and even pay their utility bills.

The Reserve Bank of India (RBI), the country's central bank, is finalising the guidelines for mobile payment services. Banks and MFIs are confident that once m-banking is introduced, it will gain rapid following, especially in the unorganised sector.

The RBI has stipulated that the service must be accessible on the network of all service providers and SMS should be the medium of transactions. It has also mandated a minimum four-digit mPIN for such transactions, though many banks plan to go in for a six-digit mPIN.

Banks and telecommunications companies have already launched pilot projects in some cities, tying up with petty traders, retailers, chemists, NGOs and offering a host of services. Customers will be able to open m-bank accounts at the authorised outlets by submitting photo ID proof; they will then be able to deposit, withdraw and transfer cash, pay bills or remit funds to relatives in other parts of India.

Likewise, remittances sent by relatives from abroad can be collected by the recipient in India at any of the authorised outlets, by just producing the six-digit code that is sent through an SMS.

The m-banking transaction involves multiple partners: the bank, the cell phone operator, the authorised outlet and a platform provider. mCheck, founded by Sanjay Swamy, the ceo, has emerged as a leading player in this segment. The firm, which has tied up with nearly 50 banks in India, has also launched services in Sri Lanka. It has signed up nearly 5,000 small businesses, enabling even the poor to make payments through their mobile phones.

mCheck also plans to enter into alliances with MFIs, enabling them to disburse loans to the poor through vendors – who can act as authorised outlets – in thousands of villages. It has already launched a pilot project in Andhra Pradesh.

Recent equity investments in Indian microfinance				
MFI	**SKS Microfinance**	**SHARE Microfin**	**Spandana**	**Grameen Koota**
Investment Date	March 2007	May 2007	July 2007	April 2008
Investment Size	$11.5 million	$27.5 million	$12 million	$2.3 million
Investor	Sequoia Capital, Unitus Equity Fund, Vinod Khosla, Ravi Reddy, Odyssey Capital	Legatum, Aavishkaar-Goodwell	J M Financial India, Lok Capital	Aavishkaar-Goodwell
Compiled by Intellecap				

interest rates charged for loans by MFIs (though final return on assets is much lower at about two to three per cent due to higher operational costs and interest charges). At 24 per cent, the interest rates are much higher than the average interest rates of about eight to 12 per cent enjoyed by middle class borrowers.

However, they are still cheaper than the rates charged by local moneylenders, which can be as high as 500 per cent. Hence, MFIs are the preferred option for the poor, who need very small-sized loans and convenient repayment options.

The sector has more aces up its sleeve. For instance, bad debts are as low as one to two per cent. Not surprisingly, investors continue to be excited by the high repayment rates.

Also, some studies have shown that the microfinance sector is not sensitive to swings in global economic cycles, making such investments desirable for risk diversification. Many individual investors are keen to invest in global funds aimed at promoting sustainable development across the globe through investments in MFIs in countries like India.

They are looking for multiple bottom-lines such as people, planet and profits. For instance, last year, the Switzerland-based BlueOrchard Finance SA, by way of compensating the carbon dioxide emissions produced by the air travel undertaken by its staff and office power consumption, contributed to an Indian biomass project undertaken by myclimate, a Swiss NGO.

"We can easily identify close to 40 funds interested in Indian microfinance," says Manju George, vice-president, Intellecap. "The larger MFIs are no longer marginal players, but are becoming part of the mainstream financial services industry as the boundaries are blurring."

This is one sector where more is definitely merrier. For one, it will give the poor the power of choice, and the increasing competition will possibly ease interest rates too.

Existing MFIs too are planning to scale up by increasing their geographical spread, invest in new technologies that will help to bring down costs and reach out to more people and introduce more products like insurance.

Several MFIs are in the fund raising mode and (apart from the traditional sources of funds such as bank loans or funds and grants) are in talks with local private equity funds, microfinance funds and even certain mainstream investors. Many MFIs have the size and scale required for big-ticket investments.

Equity happens to be the chosen route for most MFIs operating as NBFCs as it increases their leveraging capacity, allowing them to borrow more funds through the debt route. The other route for raising funds is that of external commercial borrowings (ECBs).

According to Intellecap, between 2004 and 2007, the microfinance sector received an equity infusion of almost $43 million, of which $38 million flowed in during the first four months of 2007.

Several international players like the International Finance Corporation (IFC), Washington, US-based Accion, UK-based CDC, Tridos of the Netherlands, FMO, a Dutch organization and Germany's KfW have made significant investments in India's micro finance sector.

Sequoia Capital, a foreign venture capital fund, had infused $10 million in Vikram Akula's SKS Microfinance. "It is wonderful to be an investor in an enterprise that not only makes economic sense, but also helps empower the people," says Mohit Bhatnagar, operating partner, Sequoia Capital India.

Individuals and foundations set up by the likes of Vinod Khosla, founder of Sun Microsystems, Unitus Equity

Unmesh Kuttan

POWER OF CHOICE : MFIs are the preferred option for petty traders, who need very small-sized loans

Unmesh Kuttan

SCALABLE MODEL : Micro-entrepreneurs are also potential micro-finance clients

Fund, the Michael and Susan Dell Foundation and the Bellweather Fund, have also infused funds into the sector.

"There are two billion people around the world, who are living on less than $2 a day," says Chris Brookfield, director, Unitus Equity Fund. "There is huge market potential in helping these individuals to rise up and work towards a better future."

Legatum, a privately owned international investment firm, announced an investment of $25 million in Share Microfin, the country's largest MFI. This is the largest investment, both domestically and internationally, made by any investor in an MFI.

"The size of the market, the low penetration rates and the high rate of growth attracts investors," says Mahajan of Basix. "It's a win-win situation for Indian MFIs as the sector stands to benefit from foreign funds by way of increased professionalism, global exposure, new networks, higher standards and ethics and a natural transfer of global expertise."

Unlike some of the other institutions, Legatum's investment in the MFI space is not part of its philanthropic efforts. "This is not part of CSR or philanthropy," says Mark Stoleson, president, Legatum. "We are looking at a sustainable and scalable model. To build a sustainable model it is important to have a for-profit model, that is efficient and has scale even as it meets the social objectives."

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Microfinance in India, he believes, is at an inflexion point. There are several social venture capital funds in India like Aavishkaar-Goodwell, which have been established with the explicit mandate to create both social and economic value. Some of their investments are in MFIs.

Given the sector's business potential, commercial banks too are increasing their exposure to the sector as part of their corporate social responsibility and to meet 'priority sector' lending needs.

Besides, some MFIs like Basix and Share Microfin are also planning to raise funds from the capital markets. "We plan to raise more funds by issuing bonds this year, and a public issue within the next three years," says Udaia Kumar, chairman and managing director, Share Microfin.

Observers, however, feel there is a need to correct the geographical skew in the MFI sector in India. About 75 per cent of all micro-credit activity is concentrated in the four southern states of Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. Besides, MFIs need to look beyond micro-credit; they need to offer full-fledged financial services for the poor, especially products like insurance.

"Most of the MFIs will become front-ends for banks," says Vikram Akula, founder of SKS, based in Andhra Pradesh. "The former will originate and service the loans, like direct sales agents (DSAs), and the latter will keep them on their balance sheets, much like ICICI Bank's existing partnership model."

The sector is also likely to see consolidation. Sandeep Farias of Unitus, a global microfinance accelerator, believes that consolidation is another way some institutions will build scale. "However, this consolidation is not likely to see a significant change in the number of institutions that are involved in microfinance," he adds.

Manju George of Intellecap says, "Microfinance as a tool has a significant role to play in improving the economic participation by end clients.

What began out of compassion has now turned into a viable business proposition. The microfinance sector has evolved from being a development focused activity into a sub-sector of the mainstream retail financial services industry with focus on social as well as economic development.

According to Professor C.K. Prahlad, renowned management expert, the bottom of the pyramid is the market of the future. And if the pot of gold is buried under the pyramid, then MFIs are best placed to dig out this treasure that has been overlooked for far too long.