

Scaling Up Microfinance in India: The Role of the Private Sector

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Financial inclusion—the universal provision of financial services to all citizens—is an important goal for Indian policymakers. The vast network of cooperative banks that provide credit to agriculture, the nationalization of commercial banks in 1969, and the creation of an elaborate framework of priority-sector lending were all elements of a state-led approach to meeting the credit needs of large segments of the Indian population that had no access to institutional finance. The strategy for extending the reach of the financial system relied primarily on expanding rural bank branches, setting up special-purpose, government-sponsored institutions (such as regional rural banks), and setting targets for commercial bank lending to broad sectors unable to access credit, such as agriculture and small-scale industry. The success of this strategy was mixed at best, and a large share of India's poor still have no access to financial services at a reasonable cost.

In India, financial exclusion increases with poverty. A recent household survey in India showed that 86 percent of those in India's highest income quintile have bank accounts compared with 18 percent of those in the lowest quintile. Given that a strong link has been shown between poverty reduction and access to financial services, providing India's poorest people with access to financial services is important. India's poorest need financial services for a number of reasons: they require a safe place to store their savings (however small), they need credit for both business and consumption purposes, and, given their high level of exposure to risks such as disease and crop failure, they need insurance services.

The Evolution of Microfinance in India

Microfinance appeared to hold promise for reaching people in India with no access to financial services. Microfinance arrived somewhat late in India; Bangladesh's non-governmental organizations (NGOs), for example, were already implementing a flourishing microfinance business when the first operations started in India in the early 1990s. These operations took the form of self-help groups (SHGs) made up of 15–20 people, predominantly women, who came together to gain access to saving and credit services. The National Bank for Agriculture and Rural Development, an apex development bank mandated to facilitate credit to agriculture, small-scale and cottage industries, and other rural activities, proposed that SHGs be linked to commercial banks to channel institutional credit to the rural poor. This proposal led to a pilot project in 1992 under which India's central bank, the Reserve Bank of India (RBI), allowed commercial banks to lend to SHGs without requiring collateral. This key policy change catalyzed the expansion of microfinance operations in India.

The SHG–bank linkage model grew rapidly and soon became well known as the largest microfinance intervention in the world. It initially offered promise as a good model of public–private partnership for providing microfinance because it was backed by regulatory policies that allowed commercial banks to lend to unregistered groups without taking collateral. A number of design issues ensure that it is the poor that typically use these services (although a World Bank survey in 2003 found that the ability of SHGs to target the poor varies from state to state). As of March 2007, this model had linked 41 million people to commercial banks, the cumulative credit disbursed was more than US\$4 billion, and the outstanding loan portfolio was about US\$2.4 billion (at 2007 prices). Although the SHG model still accounts for the bulk of microfinance lending in India, it faces a number of challenges. For example, the model is susceptible to political capture because politicians looking to disburse handouts at election time use SHGs for this purpose. Given the large unmet demand for credit, it became clear that alternative channels for microcredit delivery in rural areas were badly needed.

This need led to the growth of alternative institutions to serve as intermediaries in disbursing credit to the rural poor. These alternative institutions are referred to in the rest of the chapter as microfinance institutions (MFIs). MFIs in India take many forms; there are NGO MFIs, cooperative MFIs, and company MFIs. This third category refers to MFIs registered under the Indian Companies Act as “nonbank finance companies,” a classification that allows them to provide microcredit but not to take deposits, except under special circumstances. It includes barely 20 MFIs but accounts for more than 80 percent of the total MFI loan portfolio. This growth was facilitated by public policy. Banks in India are required to provide 40 percent of their credit to sectors considered high priorities, such as agriculture, small-scale industry, and vulnerable people, including the poor, those with disabilities, and

minorities. In 2000, RBI added microfinance to this list. This change released large amounts of commercial bank financing for MFIs and allowed them to scale up their lending operations rapidly. At the end of March 2007, company MFIs had an outstanding loan portfolio of about US\$1 billion to about 10.5 million borrowers (Box 28.1).

Microcredit borrowers use microloans for a variety of purposes. Although industrywide estimates of the use of loans are not publicly available, the evidence available shows that a large share of loans is used for income generation in agriculture as well as nonagricultural activities, such as animal husbandry, shopkeeping, and other microenterprises. Commercial banks in India are especially keen to finance agriculture through microcredit in order to meet their priority-sector lending obligations. A significant proportion of lending is also used to finance consumption, which is consistent with survey findings showing that the poor have a great need for loans to finance consumption-related spending, often associated with financial and medical emergencies. In fact, some MFIs provide a special category of emergency loans to their clients. The average rate of interest charged for microcredit is approximately 22–25 percent.

Box 28.1 Facts about Indian microfinance, 2006–07

Microfinance Institutions (MFIs)

Total number of MFI borrowers: 10.5 million

Total number of poor MFI borrowers: 3.2 million

Growth in number of MFI borrowers, 2006–07: 42 percent

Growth in amount of MFI loans outstanding, 2006–07: 76 percent

Average loan outstanding, MFI borrowers: US\$78.00

Self-Help Groups (SHGs)

Total number of SHG members: 26.3 million

Total number of poor SHG members: 13.4 million

Growth in number of SHG borrowers, 2006–07: 11 percent

Growth in amount of SHG loans outstanding, 2006–07: 48 percent

Average loan outstanding, SHG borrowers: US\$92.00

Source: P. Ghate, *Microfinance in India: State of the Sector Report, 2007* (New Delhi: Microfinance India, 2007).

Private Provision of Microfinance: A Case Study of ICICI Bank

A number of Indian commercial banks recognized the useful opportunity to partner with MFIs to expand microfinance outreach in rural areas. Several factors resulted in a large-scale expansion of commercial bank lending to MFIs for further lending to their borrowers. First, a large domestic market for microfinance was waiting to be served. Second, policy measures, such as including lending to MFIs in the list of priority-sector lending activities, made this option more attractive to banks. And third, banks were keen to find new avenues for lending, especially in the rural areas.

The effort was led by ICICI Bank, India's largest private-sector bank, which provided the bulk of this financing between 2003 and 2007. ICICI Bank's initial foray into microfinance was through the SHG-bank linkage model. In 2003 ICICI Bank merged with the Bank of Madura, a small South Indian bank that had a substantial rural presence in the state of Tamil Nadu and a strong network of SHGs. The merger helped ICICI Bank expand the financing of SHGs, but the pace of outreach was slow and the lack of rural branches in other states prevented ICICI Bank from scaling up SHG financing rapidly.

Starting in 2003, the bank began to experiment with other models of reaching people without access to institutional finance using MFIs. First, the bank used the MFI intermediation model, under which MFIs borrowed from ICICI Bank for lending to the end clients. The MFIs took on the risk associated with the financial performance of the groups receiving loans. Hence they had an important stake in forming high-quality groups, in contrast to the NGOs that facilitated the creation of SHGs. It proved difficult to scale up the MFI intermediation model, however. MFIs typically had small balance sheets and could take on only a limited amount of debt without becoming overly indebted, thus increasing their financial risks. Besides, MFIs were exposed to the entire risk of the clients, a situation that put undue risk on these organizations given their usually narrow geographical focus.

To prevent MFIs from becoming overindebted, ICICI Bank developed the partnership model. Under this model, existing MFIs identify, train, and promote the microfinance clients and ICICI Bank finances individual clients directly on the recommendation of the MFIs. An MFI provides a partial guarantee of the borrower's repayment (in the form of a "first-loss default guarantee"). This arrangement allows MFIs to scale up operations rapidly because the expansion of credit is no longer constrained by the size of their balance sheets. Using the partnership model, ICICI Bank's microfinance loan portfolio grew from virtually nonexistent in 2001 to about US\$350 million in March 2007, and the number of clients served rose from 20,000 in 2001 to almost 3 million in March 2007. A number of Indian banks have adopted this model for their microfinance operations.

More recently, ICICI Bank has faced some challenges with respect to ensuring full compliance with Know Your Customer (KYC) norms given the rapid growth of credit. Banks all over the world are expected to comply with KYC norms, which ensure that banks lend to bona fide borrowers for bona fide purposes. To improve compliance, ICICI Bank is issuing biometric identity cards to its customers to facilitate identification and to speed loan disbursements and repayments. These cards contain the clients' loan details and use the clients' fingerprints for purposes of identification. These measures are complemented with computerized systems at the MFIs to provide adequate management information.

As ICICI Bank gained experience in microfinance, it became apparent that the poor need more than credit. In fact, they require a range of financial services, especially risk mitigation products, given their vulnerability to shocks such as sickness and crop failure. The poor also deserve a better rate of return on their savings. ICICI Bank and its subsidiaries are working together closely to develop insurance and investment products to cater to these needs. The ICICI Foundation for Inclusive Growth was set up in 2007 to focus on increasing the incomes of low-income households by offering financial services for the poor.

Next Steps: A Broad Range of Financial Services for India's Poor

The current market for microcredit in India is estimated at around US\$25 billion (at 2008 prices), making India perhaps the largest market for this type of finance. A large segment of this market has yet to be served. There is enormous scope for microfinance to deliver a range of financial services that are currently not available to a large majority of India's poor. A significant expansion of microfinance would entail certain prerequisites in terms of institutions, innovations, and evaluation that could go a long way in developing an inclusive financial system. Some key factors that could catalyze the growth of microfinance in India include the following:

1. *There should be an expanded role for the private sector.* Donor finances have been a critical source of funding for the growth of microfinance in some countries. In Bangladesh, for example, where the level of microfinance penetration is high, donor funding was key to increasing the scale of financing available for microfinance (though large MFIs in that country have now significantly reduced their dependence on donor funds). In contrast, donors have played a relatively small role in scaling up microfinance in India. Meeting demand in the large Indian microfinance market will require a large volume of funds that can be raised only through private participation and will necessitate tap-

ping all funds—debt and equity. Although the bulk of private-sector financing to MFIs is still provided in the form of loans, Indian MFIs have started attracting equity capital. Innovative partnerships among equity and debt providers, NGOs, MFIs, governments, and other stakeholders hold the key to successfully meeting the demand for microfinance, especially microcredit.

2. *Innovative models and delivery channels will be crucial to reach scale.* Just as multiple sources of funding will need to be tapped to meet the large demand for microcredit, multiple models and delivery channels will have to be deployed to increase the availability of financial services to the underserved. There is a growing consensus that rural credit, especially for the poor, is best delivered by local institutions that have a good understanding of the financial requirements of the poor, as well as their credit histories and ability to take on debt. To its credit, the RBI has taken several steps that can help improve access. In 2005 the RBI adopted a business correspondent / business facilitator model to help build links between large banks, which have scale economies and diversified products, and local institutions or individuals, which have local knowledge and low delivery costs. Under this model, banks are allowed to appoint NGOs and other nonprofit institutions, as well as schoolteachers, retired servicemen, and other individuals, to act as agents of the bank for the purpose of offering various financial services, especially savings and remittance products. A major benefit of this policy to banks is that they can reach a large segment of the population without incurring the overhead costs of setting up branches in all areas served. This model, combined with appropriate technology such as smart cards and point-of-sale devices, can go a long way in not only improving access but also developing the financial histories of individuals in terms of savings, credit, and remittances. ICICI Bank has deployed the business correspondent (BC) model to offer savings products to small savers, reaching about 60,000 clients with the program in 2007–08. ICICI Bank is increasing the use of technology in its operations by issuing biometric smart cards through MFI partners and BCs to all borrowers. The bank is also offering banking services to its mainstream customers through mobile telephones and exploring the use of these telephones for its microfinance operations.

Another option for increasing the penetration of financial services is to allow the establishment of small banks that can focus on the poor. In India, small banks have existed for years in the form of public-sector cooperatives, but these banks have run into financial problems and are undergoing a massive restructuring. Allowing small, well-managed private banks to operate with lower capital requirements but with a tight focus on capital adequacy can be useful for provid-

ing financial services to the poor, especially those whose needs have grown too large to be reached by microfinance.

To facilitate the success of these models, the government has an important role to play in easing institutional bottlenecks such as lack of credit bureaus, land titling, tenancy rights, and a universal national identity card. Measures to improve these conditions would be critical in unlocking credit for a large segment of the poor population.

3. *A complete suite of financial products is required.* Several surveys show that more than credit, the poor require savings and risk-mitigating products such as insurance and emergency loans, especially for medical reasons. The private sector has a unique ability to adapt cutting-edge products usually designed for prime clients to fit the needs of the poor. For example, insurance companies are beginning to provide affordable insurance to meet the needs of the poor. ICICI Bank's insurance arm, ICICI Lombard, has teamed up with SKS Microfinance to offer health insurance in combination with microcredit to households below the poverty line. It has also collaborated with BASIX, another microfinance provider, to provide weather insurance to farmers. Because most MFIs in India are unable to offer savings products owing to regulatory constraints, many commercial banks are using the BC model to offer savings facilities to the poor. Banks are also working to develop reliable remittance products for India's vast number of migrant laborers who work outside of their home states. Finally, asset management companies, such as ICICI Prudential, are developing mutual funds targeted to the poor, with tiny minimum investment requirements. These funds would provide an opportunity for poor Indians to tap into the phenomenal returns offered by the Indian equity markets in recent years.
4. *Financing efforts need to be coupled with capacity-building efforts for MFIs.* MFIs face a lack of skilled workers and entrepreneurs who are willing to start MFIs. To help support the development of MFIs, the ICICI Foundation for Inclusive Growth is providing capacity-building services for entrepreneurs and technical assistance to MFIs. The objective is to create a support system that can alleviate the training and capacity-building constraints faced by MFIs. Capacity-building services for MFIs are also being offered by a number of other entities, such as Microsave India, which has training programs for MFI managers and tool kits for MFI entrepreneurs to aid them in setting up their businesses.
5. *Financing of clients needs to be coupled with efforts to build livelihoods.* Improving market access for low-income households is critical to bring about an increase in

their incomes. The ICICI Foundation is helping to link small entrepreneurs to markets by supporting the Network Enterprise Fund, which invests in a series of “network companies” that provide targeted services to entrepreneurs in areas such as handicrafts, dairy, village-based tourism, and foods. By helping members enter into structured partnerships with large companies, the network companies give entrepreneurs an opportunity to engage in markets. The BASIX Group, which is also a large provider of microfinance in India, focuses on livelihood building by offering credit and technical assistance in an integrated manner.

6. *Finally, impact evaluation should not be neglected in the rush to provide financing.* Although there is much anecdotal evidence of the impact of microfinance, there have been few rigorous assessments of the extent to which microfinance has improved the lives of beneficiaries. In recent years, the microfinance movement worldwide has come under attack as a stop-gap solution to poverty. Reliable longitudinal studies are needed to track the impact of microfinance on clients’ lives. The ICICI Foundation supports the Centre for Micro Finance (CMF), which is currently engaged in comprehensive multiyear studies that follow microfinance clients over a period of 3 to 4 years to understand the impact of microcredit on their incomes. For example, CMF researchers are examining the impact of Spandana’s microfinance program in Hyderabad on income, consumption, financial services usage, asset ownership, business scale and profitability, and intrahousehold decisionmaking. The state-owned Small Industries Development Bank of India conducted a two-stage longitudinal socioeconomic impact study to assess the development impact of microfinance programs on a national scale. The study found that on balance, the incomes of microfinance clients increased approximately 33 percent over 2 years in the program, whereas those of nonclients increased 12 percent. Microfinance also had related benefits, such as increasing the amount of assets under the ownership of women and enhancing the ability of women in the poorest income category to accumulate savings.

Conclusion

Microfinance provides a good avenue for extending financial services to India’s poor. Despite the recent success in scaling up microfinance, a number of issues need to be addressed to ensure that the poor receive high-quality services at a reasonable cost and that microfinance extends its reach to the poorest. Given the amount of Indian demand for microfinance, the private sector will have to play a much larger role in providing services, and drawing in private-sector players will require the commercial viability of microfinance. Microfinance providers (whatever their legal

form) must provide a wide range of financial services including savings and insurance. Capacity-building efforts are needed to develop a steady stream of skilled workers and managers for this industry. Periodic impact evaluations are required to provide insights into the ability of microfinance to alleviate poverty. Finally, measures must be taken to complement poor people's access to finance with access to markets, which would help them build their businesses.

For Further Reading

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