Microfinance in India:

General Background

- Population : 1.17 bn (2008)
- Main towns : Chennai (6.5mn), Delhi(12.8 mn), Kolkata(13.2 mn), Mumbai(16.3 mn)
- Currency : Indian Rupee (INR or Rs)
- Exchange rate : USD = Rs 47 (average 2009-10)
- Fiscal Year : 1st April - 31st March
- **Development Indicators :**
  - Population below poverty line (National) : 27.5 % (2004-05)
  - GNI per capital (Atlas method, USD) : 1,070 (2008)
  - Adult Literacy Rate (15 years and above) : 66 (2007)
  - Mortality Rate (child<5 years) : 69 per 1000 (2008)
  - Life expectancy at birth : 64 years (2008)
  - HDI : 0.612 (134 out of 182 countries) (2009)

Historical Evolution

The evolution of Indian Microfinance sector can be broadly divided into four distinct phases:

Phase 1: The cooperative movement (1900-1960)

During this phase, credit cooperatives were vehicles to extend subsidized credit to villages under government sponsorship.

Phase 2: Subsidized social banking (1960s - 1990)

With failure of cooperatives, the government focused on measures such as nationalization of Banks, expansion of rural branch networks, establishment of Regional Rural Banks (RRBs) and the setting up of apex institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small Scale Industries Development Bank of India (SIDBI), including initiation of a government sponsored Integrated Rural Development Programme (IRDP). While these steps led to reaching a large population, the period was characterized by large-scale misuse of credit, creating a negative perception about the credibility of micro borrowers among bankers, thus further hindering access to banking services for the low-income people.

Indicator	2008-09
Nominal GDP (USD bn)	1512.4
Real GDP Growth (%)	6.7
Consumer Price Inflation (avg, %)	9.1
Exchange rate (avg vs USD)	50.4
External Debt (year-end, USD bn)	229.5
External Debt (as a % of GDP)	19.9
FDI (USD mn)	17.5
FDI (as a % of GDP)	1.3

Phase 3: SHG-Bank linkage program and growth of NGO-MFIs (1990 - 2000)

The failure of subsidized social banking triggered a paradigm shift in delivery of rural credit with NABARD initiating the Self Help Group (SHG) Bank Linkage Programme (SBLP), aiming to link informal women's groups to formal banks. The program helped increase banking system outreach to otherwise unreached people and initiate a change in the bank's outlook towards low-income families from 'beneficiaries' to 'customers'. This period was thus marked by the extension of credit at market rates.

The model generated a lot of interest among newly emerging Microfinance Institutions (MFIs), largely of non-profit origin, to collaborate with NABARD under this program. The macroeconomic crisis in the early 1990s that led to introduction of the Economic Reforms of 1991 resulted in greater autonomy to the financial sector. This also led to emergence of new generation private sector banks that would become important players in the microfinance sector a decade later.

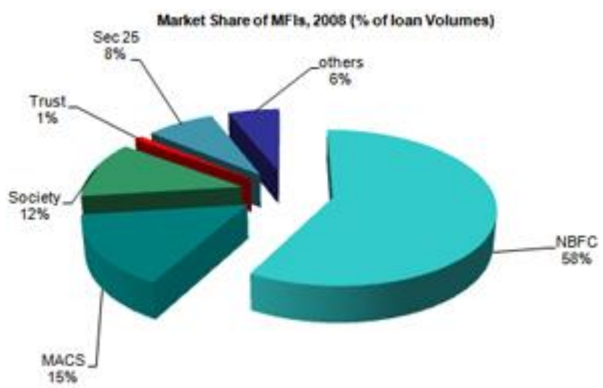
Phase 4: Commercialization of Microfinance: The first decade of the new millennium

Post reforms, rural markets emerged as the new growth drivers for MFIs and banks, the latter taking interest in the sector not only as part of their corporate social responsibility but also as a new business line. On the demand side, NGO-MFIs increasingly began transforming themselves into more regulated legal entities such as Non Banking Finance Companies (NBFCs) to attract commercial investment. MFIs set up after 2000 saw themselves less in the developmental mould and more as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies and strategic alliances.

The microfinance sector as it exists today essentially consists of two predominant delivery models the SBLP and MFIs. As of March 2009, SBLP has over 4.4 mn loan accounts with outreach of over 54 mn. By 31st March 2009, the MFIs reported a total client base of 22.6 mn. The overall coverage of the sector (outstanding accounts of members of SHGs and clients of MFIs) is estimated to have reached 76.6 mn as on March 2009. After adjusting for overlaps the net client base of the microfinance sector is estimated at 70 mn with outstanding micro-credit portfolio of about USD 4.4 bn However, approximately 90 mn low income households remain under-served. Four out of five microfinance clients in India are women.

Types of MFIs

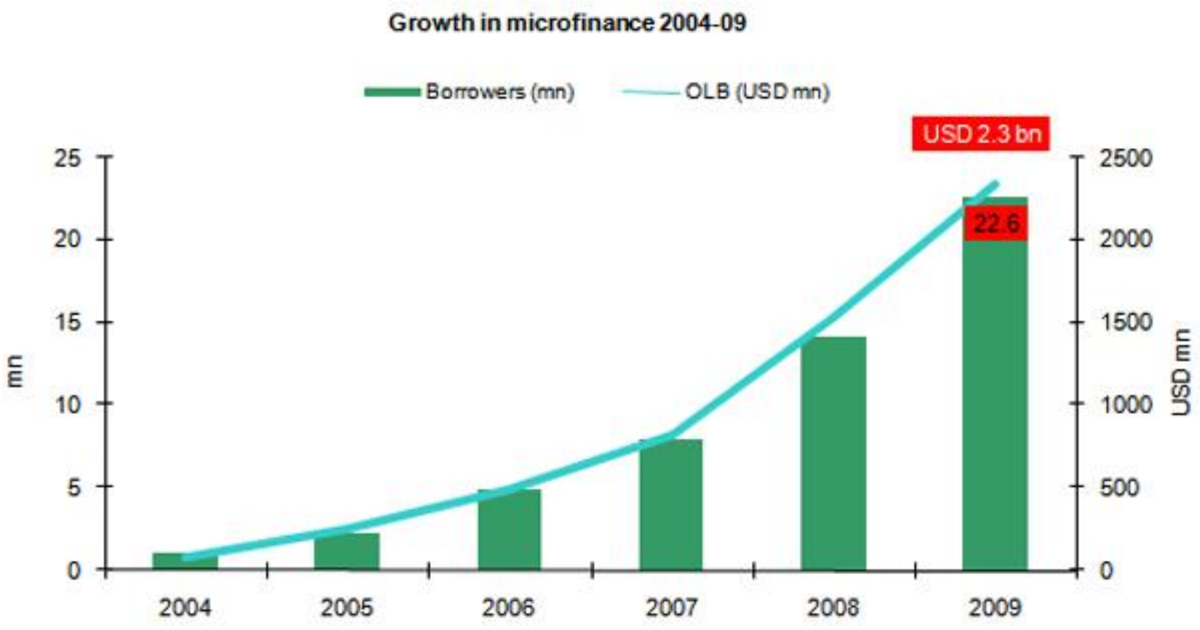
The different legal forms under which MFIs registered are Societies, Trusts, Section 25 (Not-for-Profit) companies, Non-Banking Finance Companies (NBFCs), Cooperative Societies and SHGs Federations. Of these only NBFCs are for profit, rest fall under non-profit categories. The overwhelming majority of MFIs are Societies and Trusts, followed by Cooperative and Section 25 companies. Among the large MFIs, most are NBFCs. The share of NBFCs in portfolio outstanding has grown from 50.5% (2005) & 71.3% (2007) to 76.0% currently. As per estimations, the top 20 MFIs account for 80% of the total portfolio.



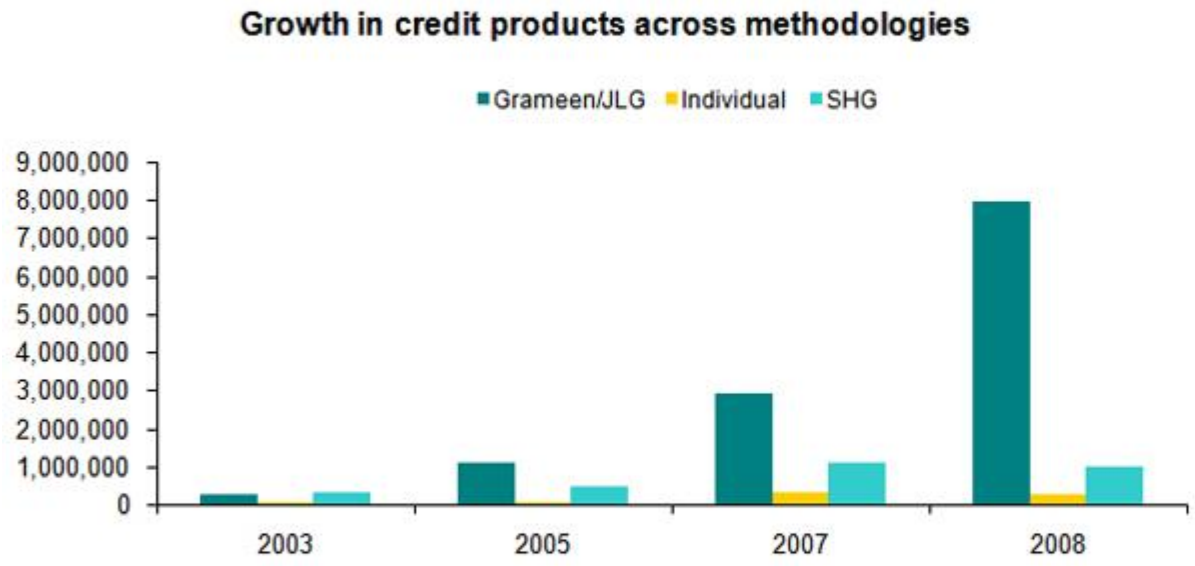
There is no centralized database on the number of microfinance institutions that operate in the country; however, estimates have put it anywhere between 800 and 1,200.

Major highlights of the sector

Outreach



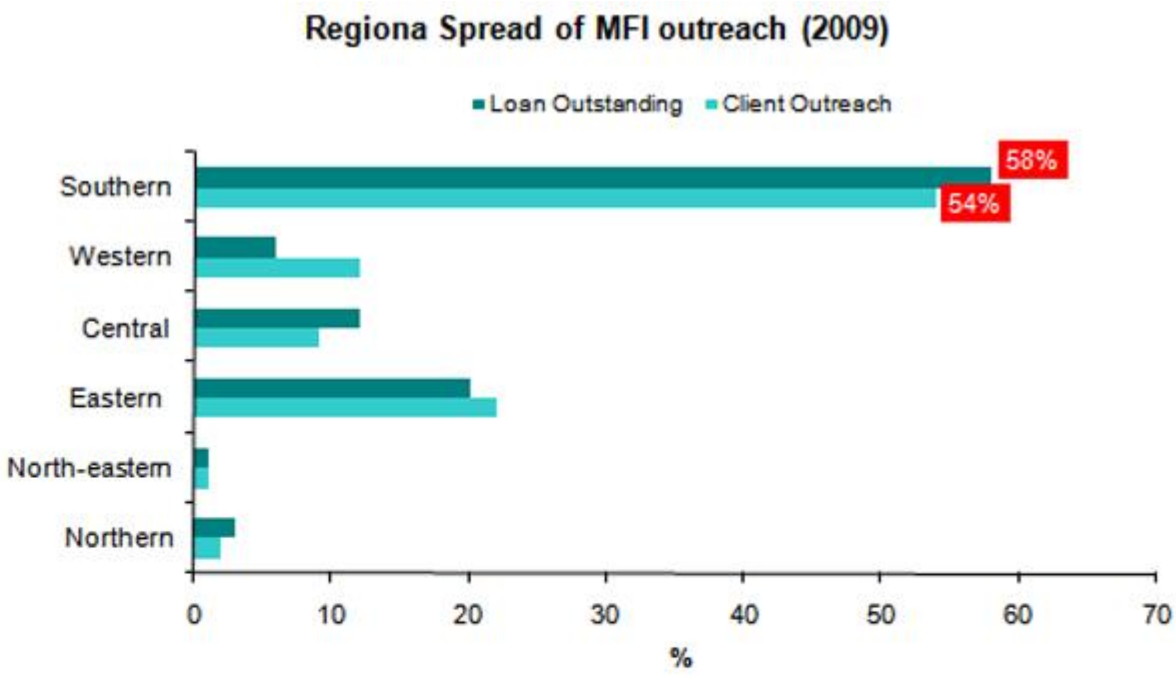
As of March 2009, the MFIs in India reported a client base of 22.6 mn with an outstanding portfolio of more than USD 2.3 bn. The MFIs at the end of March 2009, served 13.2 mn rural clients and 16.8 mn female borrowers. Of the total borrowers 7.6 mn are from social disadvantages groups.



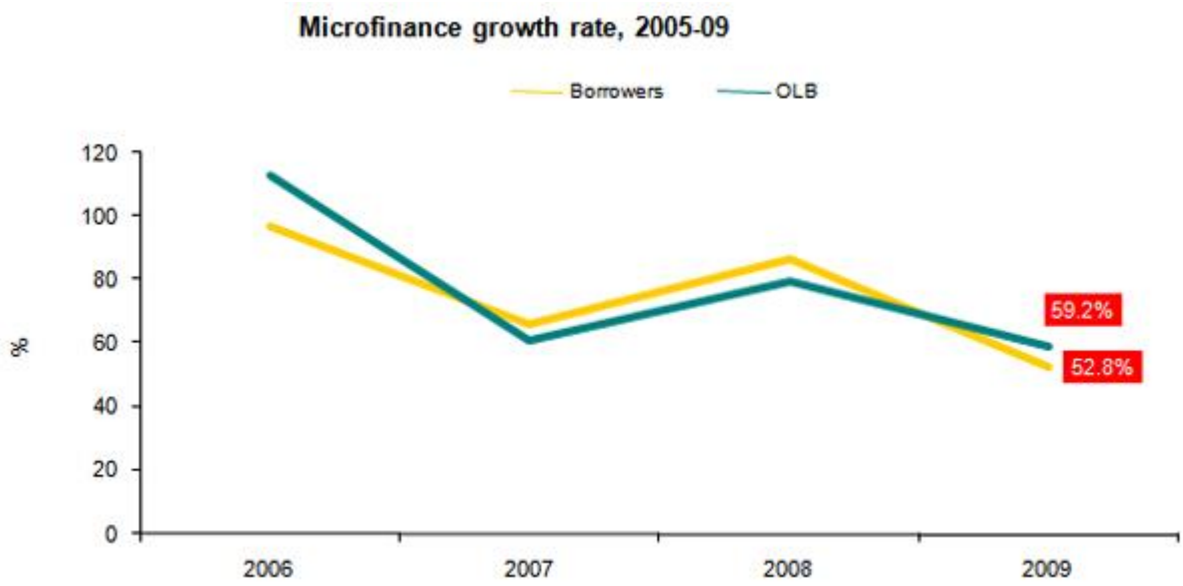
The average loan size for Individual loan, JLG and SHG loans are Rs 8,307 (USD 187), Rs 5006 (USD 11) and Rs 3,412 (USD 76) in 2009.

In terms of region the southern region continue to dominate and one out of every two MFI clients still from the southern states. However, eastern and northern regions are expanding. Andhra Pradesh, Karnataka, West Bengal, Tamil Nadu and Orissa are the top five states in terms of total client outreach.

Growth



Over the past five years, the sector has delivered a Compounded Annual Growth Rate (CAGR) of 86% in the number of borrowers and 96% in portfolio outstanding. In the 12 months from March 2008 to March 2009, the microfinance industry experienced a 59% growth in its client base from 14.2 mn to 22.6 mn and 52% growth in its portfolio outstanding which increased from USD 1.5 bn to USD 2.3 bn.



Products

Given the fact that NBFCs and other forms of MFIs are not legally allowed to offer savings and there are regulatory and practical hurdles in offering other services such as insurance, the product basket is concentrated on provision of loan. 'Plain vanilla' loans for income generation purposes constitute 95% of an average MFI's portfolio. Credit-linked life insurance is another standard offering of MFIs, though provision is to mitigate credit risk while earning commissions from insurance companies. In terms of methodology, most large MFIs use the Grameen methodology and Joint Liability Groups (JLG). Over the years, lending based on Grameen and JLG has increased at a very fast pace compared to other forms of lending. Most MFIs under JLG and Grameen have weekly or fortnightly repayment while SHG model has monthly repayment structure.

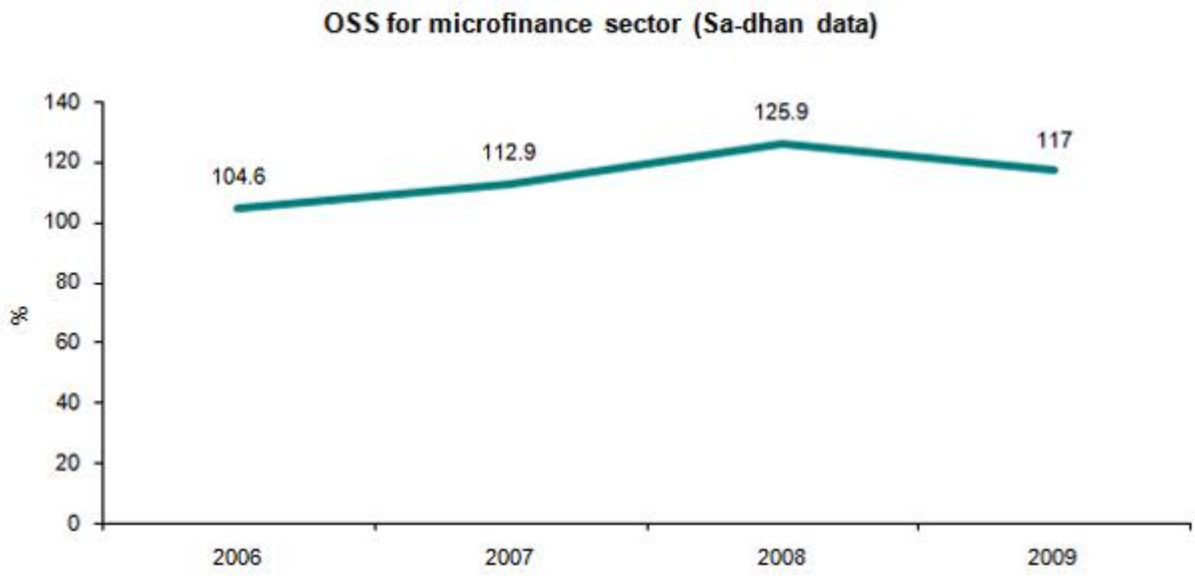
Model	Average loan size (Rs)	Average interest and other charges paid by customers (Rs)	Cost as % of loan
Individual	8,307	1,821	22
JLG	5,006	1,244	25
SHG	3,412	596	17

Based on the Sa-Dhan Study (2008), SHG lending model comes at the least cost to the customers and individual lending at the maximum cost.

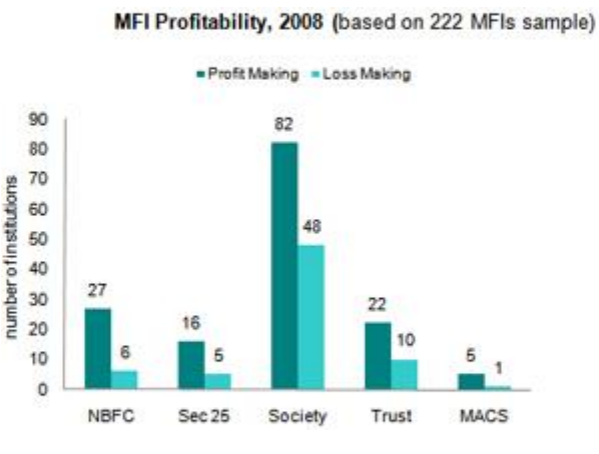
With increasing competition and demand for other financial services, MFIs are now piloting on a range of financial products including pensions and savings. There is also a growing interest from the corporate sector in leveraging the MFI's established delivery channels to seek entry into rural and urban low income customer segments. As a result, many strategic alliances are being forged between MFIs and corporate players to offer non-financial products like which can be mutually beneficial by reducing transaction costs, augmenting institutional profitability and creating better access to products.

Sustainability

The data from 190 MFIs in Sa-dhan Side by Side Report 2009, show that Operational Self Sufficiency (OSS) has been improving over the years. The data also shows that OSS tends to increase with portfolio size and operational years of the MFIs. The further break down of data according to legal form for 2009 shows that MFIs registered as trusts have highest OSS.



Another study by CRISIL based on sample of 50 MFIs also shows OSS to be above 100% across various legal types and lending methodologies.



Of the 222 MFIs that reported information in State of the Sector Report 2009, 70% MFIs were profit making. Profits were reported by 84% of the large MFIs and 80% of medium MFIs. Only 58% of small MFIs were profitable.

The microfinance business model in India typically generates a Return on Equity ('ROE') of between 20% and 30%, driven by financing from commercial banks, strong operating efficiency and high portfolio quality.

Meso level infrastructure

In line with the growth of retail institutions, the meso level infrastructure as also developed.

There are a number of TA providers like Microsave, EDA Rural Systems, ACCESS Development Services, Centre for Microfinance -Institute for Financial Management and Research, Bankers Institute of Rural Development, Micro Insurance Academy, Tata-Dhan Academy, M2i consulting, Sambodhi, BASIX and Intellelcap among others offering a range of technical services. With increasing focus on Investment, the capital advisory services are much in need and a few agencies are finding niche in them, most notably Grameen Capital India, Intellicap and Unitus, which has extensive presence in India.

Among the rating agencies, M-CRIL, CRISIL and SMERA are most notable. More MFIs are being rated as they approach bank and other commercial investors to meet their debt and equity needs. Out of 233 MFIs reporting to Sa-dhan 2008 report, M-CRIL rated 43, CRISIL rated 56 MFIs and all other rating agencies carried out ratings for 38 MFIs.

There is also a considerable interest in various aspects of technology contributing to the microfinance sector. An integrated MIS, mobile devices, smart-card solutions and score-cards are some examples of such technological innovations, which are increasing becoming popular among MFIs and many technology firms are offering products and solutions to growing needs of the MFIs.

Sa-dhan is national network of over 200 MFIs, playing a key role in policy advocacy and addressing issues such as code of conduct among members, data collection and transparency for the sector. Recently a new network of NBFCs, Microfinance Institutions Network (MFIN) is created by leading NBFCs to cater to the policy advocacy and other needs of this group of MFIs. At present 34 MFIs are members of MFIN.

At present, there is no Credit Bureau; however, MFIN is working in that direction with leading MFIs those are its members. MFIS has partnered with Credit Information Bureau (India) Limited (CIBIL) to start a Microfinance Credit Information Bureau.

Competition

In the past few years, Indian microfinance has seen unprecedented growth with large MFIs expanding their active borrower base by about 110% making the sector one of the fastest growing worldwide. This trend was reinforced by and in turn further accelerated the commercialization of the industry. Commercialization is characterized by increased competition for the clients with an objective to seek profitability. The above reasons have lead to competition for the same clients in many parts of the country including Andhra Pradesh, Karnataka, Madhya Pradesh, West Bengal, Uttar Pradesh, Orissa, Tamil Nadu and Chhattisgarh. This leads to multiple memberships, over-indebtedness by the microfinance clients. According to Sa-dha, 3 or 4 out of 10 MFI/SHG clients are multiple borrowers (Sa-Dhan, 2006).

However, the competition has not led to MFIs distinguishing themselves by geographic areas or by differentiating products to different client segments.

Risks

Externally, the sector is always under scrutiny due to perceived high interest rate by the political class and many policy makers. Populist policies such as waiver of loans and capping on interest rate MFIs can charge continue to bring credit and reputation risk for the MFIs. However, in last few months, there has been move by few MFIs to decrease the interest rate to counter some of these allegations and pass on gains of efficiency brought by higher volumes to the clients.

A rapid increase in global commercial investments in microfinance has also surfaced an array of associated risks for investors and microfinance institutions to manage. The investment landscape is marked with challenges like potential changes in regulatory statutes, portfolio dependence on a single product offering, political challenges to profitability, high regional concentration and the near total dependence by Indian MFIs on local banks for debt capital.

Regulations

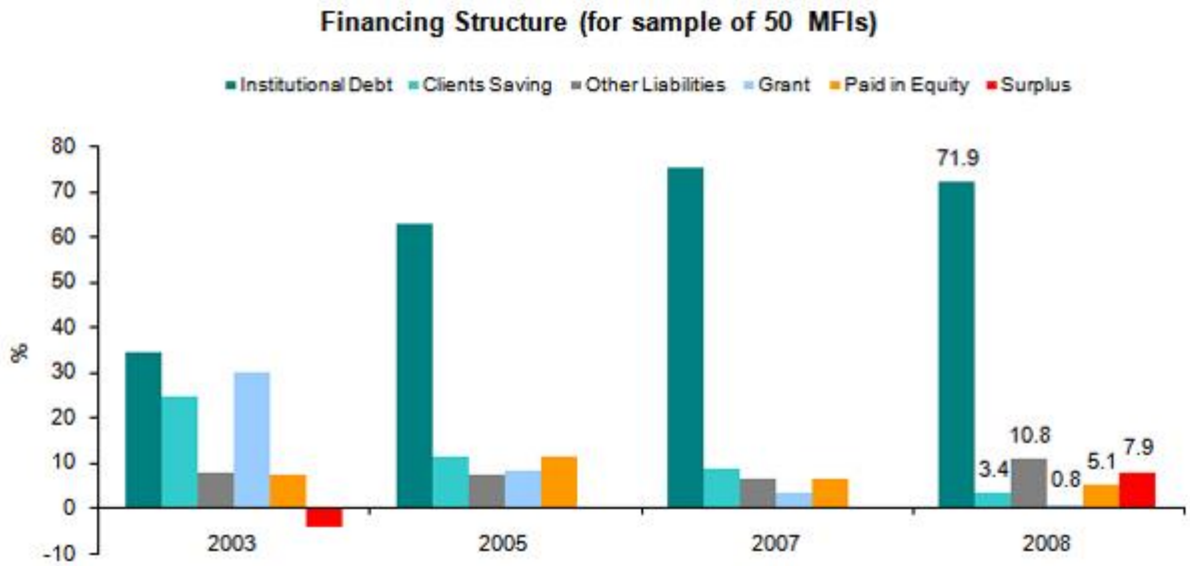
At the policy level, MFIs have achieved greater legitimacy with the government as an important mechanism for financial inclusion, and increasingly MFIs are mentioned in relevant policy documents.

However, at present, only MFIs registered NBFCs are regulated, implying only 75% of the institutions involved in microfinance are unregulated though by loan volumes 77% of microfinance sector is regulated by the central bank.

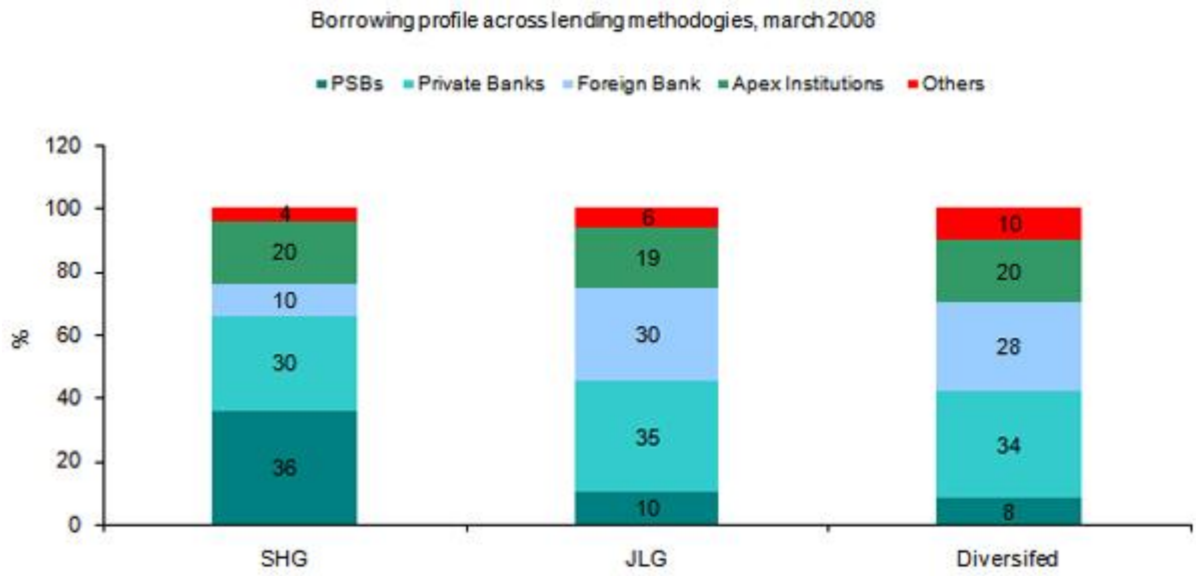
The Microfinance Sector Development and Regulation Bill 2007 was tabled in the Parliament. The Bill, forms the first legal document that defines 'microfinance', sets down exclusive guidelines for the Indian microfinance industry and a promotional and regulatory framework for MFIs, especially those carrying out MF in a non-profit form. The bill has, however, lapsed now and according to the sector experts, the bill in its present form might not secure the objectives of regulation of the sector in a broad way by excluding NBFC and Section 25 companies out of its purview.

Financing

With the increasing commercialization of microfinance sector in the country, the financing structure is changing. The share of client savings and grants has reduced over the years. Grants are becoming scarcer and savings as source of financing is also decreasing as more and more MFIs transform into regulated structure of NBFC and the central bank does not allow these institutions to raise deposit.



Concomitantly, debt has become the dominant source of finance for Indian MFIs. The share of debt in top 10 MFI finances is very high at 71.9% in 2008. The commercial banks along with government apex institutions like SIDBI are major sources of debt funding to MFIs. Debt funding requirements are high due to the restriction to raise funds through savings. It is important to highlight that borrowing from the commercial banks is an important source of financing to MFIs. As per the central bank regulation domestic and foreign commercial bank are required to lend 40% and 32% of fund to priority sector and lending to microfinance qualifies as priority sector lending. This policy has been a key factor in commercial banks lending to MFIs. Most banks continue to lend only to top tier institutions. As of March 2009, banks and financing institutions had a total exposure to MFIs of USD 2.45 bn. This represents an almost 150% increase from the exposure in March 2008 of USD 984.8 mn and a 200% increase from the exposure in March 2007 of USD 805.6 mn. Besides term loans, there has been a rise in non-traditional products such as non-convertible debentures, securitizations and portfolio buyouts available to MFIs through domestic as well as foreign debt funds. As a result, today, larger MFIs have adequate and easy access to debt financing. However, smaller and emerging MFIs are still struggling to find adequate funds as they have unproven business models and present a higher default risk to banks. Alternative debt providers are emerging in an attempt to fill this gap with subordinated-debt, guarantees and pooled securitizations.



Another study by CRISIL for the sample of top 50 MFIs gives the sense of borrowing profile across lending methodologies clearly showing Public sector banks inclination towards SHG model.

Market Gaps and Challenges

Despite the rapid expansion of microfinance, large areas of India continue to be underserved. The penetration potential of the existing microfinance model is between approximately 90 mn households, out of which 22.6 mn are existing customers. This implies an large unaddressed demand. Currently, as many as 54% of all microfinance clients are concentrated in the Southern States: Andhra Pradesh, Karnataka, Kerala and Tamil Nadu. The fact that many states and regions of the country are not served by the MFIs present an opportunity for future growth.

Services	Demand (US$ bn)
Credit	59.8
Credit among Below Poverty Line	5.7
Credit among Small and Marginal Land Owners	27.1
Credit among Agriculture Labour	15.0
Credit among Microentrepreneurs	8.8
Credit among Urban Low Income Population	3.2
Savings	3.0
Insurance	0.5
Remittances	9.5
Micropensions	0.5
Total	**73.2**

In terms of financing gaps, the Indian microfinance industry is expected to reach 110 mn borrowers and USD 30 bn loan portfolio by 2014 and will require a huge capital inflow both in debt and equity, according to a latest report by Intellecap. A survey by research firm Venture Intelligence reveals that the microfinance sector would need USD 3-5 bn over the next 4-5 years.

There are also gaps and challenges at institutional level. While some of the leading MFIs, such as SKS, Share, Spandana, Ujjivan, Equitas and BASIX are setting the pace for the sector with innovations in products, processes and funding structure, there are hundreds of medium and small MFIs which are operating on a small scale with great need for training in building their institutional capacity to run microfinance on sound financial principles. The MFIs face enormous challenge in finding and retaining skilled human resources; Sa-Dhan has estimated the human resource requirements at 240,000. It is estimated that manpower constitutes 70% of operating costs for the MFIs.

Key Contacts

- **National Bank of Agriculture & Rural Development (NABARD)**
  www.nabard.org

- **Small Industries Development Bank of India (SIDBI)**
  www.sidbi.com

- **Reserve Bank of India (RBI)**
  www.rbi.org.in

- **ACCESS Development Services**
  www.accessdev.org
- **Sa-dhan**
  www.sa-dhan.org