



## Inverting the Pyramid

The  
Changing  
Face of  
Indian  
Microfinance

Published by



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Intellectap has undertaken pioneering initiatives in the field of finance and strategy in the microfinance sector, and seeks to leverage this experience to other areas that benefit social and economic development. Intellectap is committed to value creation by accumulating and disseminating knowledge, providing strategic support to development initiatives and incubating new ideas that will shape the development industry.

For more information about Intellectap, please visit [www.intellectap.net](http://www.intellectap.net).

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## ACKNOWLEDGEMENTS

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Microfinance never ceases to fascinate us. Each time we approach it, we are awed by the immense potential that this powerful tool holds to touch lives and shape positive economic outcomes.

Interspersed with inspiring successes and healthy debates, the Indian microfinance space continues to redefine itself, innovate in products and delivery channels, and join forces with the most sophisticated capital market actors to create financial access to the many un-banked poor.

This report is an attempt to capture the evolution of Indian microfinance, gauge its performance thus far, and map its future potential. In this effort, we were supported by many individuals who extended their time and ideas to push our thinking, question our inferences, and validate and guide our analysis.

First and foremost, the team's gratitude goes to those Indian microfinance practitioners who responded to our request for participation in the research and provided us with timely data on their growth and performance. It is their pioneering and persistent efforts which form the foundations of this industry that is attracting worldwide attention.

For their thoughtful insights, financial support, and attention towards this report, we thank the International Finance Corporation. Our special thanks to the IFC team members: Mr. Deepak Khanna and Mr. Gilles Jacques Galludec who reviewed the draft and offered valuable insights.

The team has benefited from the views and perspectives of a number of bankers, investors, and professionals in the Indian microfinance space, who in their own capacities play critical roles in taking this industry forward. Our special thanks to Mr. Vineet Rai, Founder-Director of Intellectap and Managing Partner of Aavishkaar-Goodwell for pushing our thinking and guiding us through the creation of this study.

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We hope to keep this effort going every two years and track the Indian microfinance space and its journey spanning the twin worlds of business and development. We look forward to your feedback and comments.



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## LIST OF ABBREVIATIONS

B	Billion
BPL	Below Poverty Line
BPO	Business Process Outsourcing
CAGR	Compounded Annual Growth Rate
CGAP	Consultative Group to Assist the Poor
CLO	Collateralized Loan Obligation
GOI	Government of India
ECB	External Commercial Borrowing
FWWB	Friends of Women's World Banking
HR	Human Resources
HUDCO	Housing and Urban Development Corporation
HUL	Hindustan Unilever Limited
ICT	Information and Communication Technology
INR	Indian Rupee
IPL	International Poverty Line
IPO	Initial Public Offering
IT	Information Technology
KYC	Know Your Customer
LAB	Local Area Bank
M	Million
MBB	Micro Banking Bulletin
mF	Microfinance
MFI	Microfinance Institution
MIS	Management Information System
MSDF	Michael & Susan Dell Foundation
NABARD	National Bank for Agriculture and Rural Development
NBFC	Non-Banking Finance Company
NGO	Non-Government Organization
NPL	National Poverty Line
POS	Point-of-Sale
RBI	Reserve Bank of India
RMK	Rashtriya Mahila Kosh
ROA	Return on Assets
ROE	Return on Equity
SEWA	Self-Employed Women's Association
SHG	Self-Help Group
SIDBI	Small Industries Development Bank of India
SML	SHARE Microfin Ltd.
USD	United States Dollar
WWB	Women's World Banking
WWF	Women's Welfare Forum



Today, microfinance in India is part of the larger financial framework and Microfinance Institutions (MFIs) are emerging as social businesses within this framework, catering to an untapped market segment while creating value for their shareholders. MFIs have emerged as the most important channel in Indian microfinance supply with a market share of almost 47 percent, growing rapidly compared to the Self Help Group (SHG)-Bank Linkage channel. In the last five years, Indian MFIs have demonstrated impressive growth rates, compelling financial performances and increasing efficiencies, faring exceptionally well when benchmarked against their Asian counterparts. With very high growth rates, many in the range of 75-100% portfolio growth annually, MFIs are reaching out to their clients faster with higher loans sizes. The decreasing rates charged to clients and declining cost ratios along with rising competition is making room for competitive pricing in the Indian microfinance space. In addition, such a scenario triggers innovations in financial instruments, delivery channels and business partnerships that overcome the legal and market-related constraints in reaching out to the poor.

Exceptional business leaders, benevolent donors, risk-taking bankers, and forward-thinking equity investors have played key roles in this growth story. Finance, a key driver in making the above growth happen continues to be a major determinant of the future directions of Indian microfinance. In addition, progressive regulation, innovative business strategies and investments in institutional capacities will have roles to play in promoting this growth. Given their past performance and key drivers, the Indian MFIs are expected to build a portfolio of USD 6.27 billion (INR 251 billion) over an active borrower base of 48.7 million by 2012 in the most likely growth scenario. To support this growth, both large and small MFIs will require cumulative equity capital of USD 535 million (INR 21.7 billion) and debt of USD 5.46 billion (INR 221 billion).



## INTRODUCTION

# The Changing Face of Indian Microfinance

India's growing economy has rapidly attracted global attention. Amidst the euphoria, an area gaining increasing policy attention is the "inclusive growth" across population segments. In turn, one of the key drivers for such growth is a well-developed and inclusive financial system.

A scan of the recent speeches by key policy actors such as the Finance Minister, Governor of the Reserve Bank of India and Chairman of NABARD reveals the consistent mention of microfinance as one of the focus areas towards promotion of inclusive financial systems in India. In 2004, Mr. Vinod Khosla<sup>1</sup>, a venture capitalist, called it 'one of the most important economic phenomena since the advent of Capitalism and Adam Smith' and used an Indian Microfinance organization; SHARE to illustrate its potential to impact lives. SHARE, then an MFI with 0.2 million clients and approximately USD 19 million in portfolio size, has evolved into a financial institution with more than 10 million clients and USD 91.7 million (INR 3.9 billion) in portfolio by March 2007. In addition, it managed to attract an external equity infusion of USD 27.5 million (INR 1.1 billion) in 2007.

SHARE's exceptional growth that started from being an NGO in 1992 to the financial institution that it is today is representative of the larger evolution of Indian microfinance. Today, Indian microfinance has evolved into an ecosystem with massive outreach and impacts, diversity in approaches, increasingly mainstream terminologies and financial instruments, acknowledged by policy makers and wooed by commercial financial actors. It is observed in great detail and debated with passion by economists, business men, regulators and development workers alike.

While the expectations placed on microfinance by each of the above actors vary and are at times conflicting, all of them are interested in the status of Indian microfinance, its potential and challenges. This publication by Intellectcap is an attempt to map the Indian microfinance landscape, with specific focus on the Microfinance Institutions (MFIs) and their potential to be unique businesses attracting commercial financial and human resources to reach out to the hitherto un-banked segments of the population.

### Chapter Organization

In the following chapters, *Inverting the Microfinance Pyramid: The Changing Face of Indian Microfinance* analyses the market dynamics of Indian microfinance including demand and supply side factors, key players, and the past performance and future potential of microfinance providers. It is expected to assist investors, entrepreneurs, donors, policy makers, and academics in making informed decisions on their involvement in the Indian microfinance industry.



Chapter One, *Redefining Micro: The Emerging Pattern* focuses on the key trends in the microfinance industry, changing definitions of what is understood as “microfinance markets,” ongoing changes in institutional structures, profiles, and the motivations of key actors and their operational strategies.

Understanding the demand for microfinance is central to any discussion on the way forward for the industry. Chapter Two *Gauging the Depths: Market Demand for Indian Microfinance* delves into poverty statistics, banking, and entrepreneurship to shed light on the potential overall market size for microfinance in India.

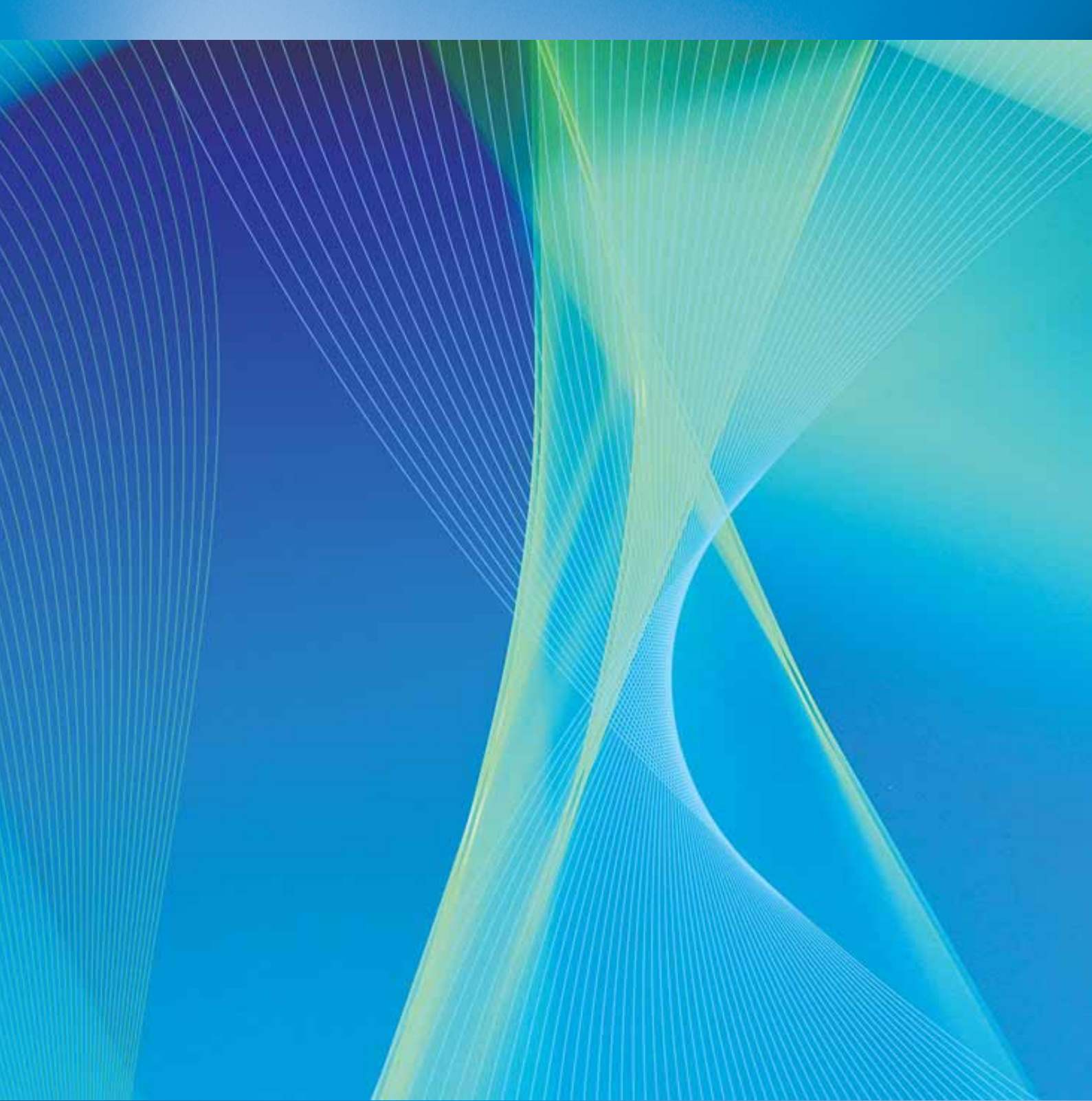
Chapter Three, *A Drop in the Ocean: The Supply Side Story*, examines the ongoing initiatives providing microfinance services across geographies and client segments. It covers the two primary models for microfinance delivery in India – the Self Help Group (SHG) -Bank Linkage channel and the Microfinance Institution (MFI) channel, their outreach, evolution, respective shares in microfinance supply and geographic distribution in relation to the demand for microfinance and incidence of poverty across the country.

In Chapter Four, *Indian MFIs: On the Sustainability Path*, examines Microfinance Institutions (MFIs), a key set of microfinance providers who have shown aggressive growth, financial performance, and movement towards sustainability. Primary data was collected from a set of 60 MFIs who participated in an Intellect survey<sup>2</sup>. These MFIs were then further divided into three tiers based on their balance sheet size to analyze their growth and financial performance between 2003 and 2007.

Chapter Five, *Indian Microfinance: Through the Investment Lens*, paints a picture of what the Indian microfinance industry may look like in 2012 and identifies the key drivers that will define its future growth. Further, guided by the data from the MFI sample discussed in Chapter Five, Chapter Six estimates the industry's financial requirements to support this growth. Chapter Six also identifies the key supporting factors that are required to carry such growth forward.

The final chapter, *The Journey has just begun....* highlights the microfinance industry's triumph in bringing together sound business principles and MFI practices to play a role in building financial access, promoting livelihoods, and enhancing social returns. This final chapter also reiterates microfinance's role in creating blended value for sustainable businesses while advancing India's development.

<sup>2</sup>Participating MFIs are listed down as Appendix 1.



# Chapter 1

## Redefining Micro: The Emerging Pattern



For more than two decades, microfinance initiatives have supported low income Indian households with access to financial services. Drawing from the sector's evolution so far, this section explores microfinance's position within the Indian financial system and the key trends that define the industry today.

### 1.1 Evolution of Microfinance in India: A Historical Perspective

In line with worldwide trends, microfinance in India emerged as an effort to reach out to the un-banked, lower income segments of the population. Most microfinance initiatives were a response to the “white spaces” left by the relatively widespread banking infrastructure in the country.

In the early 1960s, India realized the high welfare costs that resulted from the financial exclusion of low income segments, then predominantly dwelling in the country's rural areas. For those who had access to financial services, the cost of doing business with informal credit providers was very high. Identifying access to credit as an integral component of its development plan, the government initiated focused initiatives to rectify the imperfections in rural credit markets. Until the late 1960s, the credit delivery system in rural India was largely dominated by the cooperative segment. The period between 1960 and 1990, referred to as the “social banking” phase, saw a series of measures nationalization of private commercial banks, expansion of rural branch networks, extension of subsidized credit, establishment of Regional Rural Banks (RRBs) and the establishment of apex institutions such as the National Bank for Agriculture and Rural Development (NABARD) and the Small scale Industries Development Board of India (SIDBI). By the early 1990s, these measures showed results in terms of impressive rural outreach and credit volumes. However, it was also found that the institutional structure was neither profitable nor suitable to the needs of low income population segments. The decade also saw the creation of many civil society initiatives such as the SEWA Bank<sup>3</sup> and the Women's Welfare Forum (WWF) extending credit to women workers in the unorganized economy.

After 1990, India witnessed the second phase of initiatives in rural credit delivery. These mirrored other initiatives across the globe in the 1980s that operated on certain common principles such as the reliance on peer pressure as opposed to physical collateral, self-sustainability, and self-help. It is during this period that “microfinance,” as it is understood today, first emerged on the Indian development scene. NABARD initiated the Self Help Group (SHG) - Bank Linkage program, which links informal women's groups to formal banks. This concept held great appeal for non-government organizations (NGOs) working with the poor, prompting many of them to collaborate with NABARD in the program.

...from subsidized,  
social banking...

...to semi-formal  
market based  
solutions...

<sup>3</sup>SEWA Bank: “A group of self employed women first formed their own organization in 1972 when the Self Employed Women's Association (SEWA) was registered as a trade union in Gujarat, with the main objective of strengthening its members bargaining power to improve income, employment and access to social security.” More information available at: [www.sewabank.com](http://www.sewabank.com).

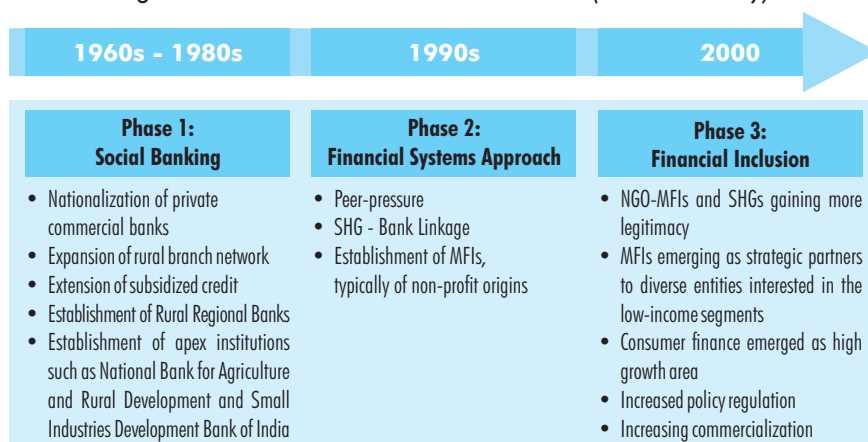


...to increased integration with the mainstream.

Such initiatives then led to the development of a new paradigm for what is now known as “commercial microfinance” or the “financial system approach.” This period was marked by the extension of credit at market rates, unlike the focus on subsidies during the social banking phase. This period also witnessed the entry of another set of stakeholders Microfinance Institutions (MFIs), largely of non-profit origins, with existing development programs. Financial intermediation emerged as the new development mantra for engaging with the poor. They were supported in this effort by apex institutions such as SIDBI, Rashtriya Mahila Kosh (RMK) and Friends of Women's World Banking (FWWB)<sup>4</sup> through extension of on-lending funds. Though initially aided by international donors and soft loans, many of the NGO-MFIs went on to access commercial loan funds from domestic banks and achieved extensive client outreach.

In 2000, the third phase in the development of Indian microfinance began, marked by further changes in policies, operating formats, and stakeholder orientations in the financial services space. In the current decade, India witnessed a surge in its economic growth, a result of the reforms initiated in the early 1990s. Amidst the general economic euphoria, a growing emphasis emerged on “inclusive growth” and “financial inclusion.” Microfinance and rural markets are seen as key drivers to meet this objective and informal actors including NGO-MFIs and SHGs, pioneers in the space, have gained greater legitimacy. This period also saw many NGO-MFIs transform into regulated legal formats such as Non-Banking Finance Companies (NBFCs). Commercial banks such as ICICI Bank adopted innovative ways of partnering with NGO-MFIs and other rural organizations to extend their reach into rural markets.<sup>5</sup> MFIs have emerged as strategic partners to individuals and entities interested in reaching out to India's low income client segments. Consumer finance, primarily driven by auto finance, housing finance, and consumer durable finance, emerged as high growth area<sup>6</sup> within the financial system with many players competing for market share. There is increased policy recognition, the latest measure being a specific microfinance bill proposed to be discussed in the state parliament in the near future<sup>7</sup>.

Figure 1: Evolution of Microfinance in India (1960s to Today)



<sup>4</sup>Set up in 1982, FWWB is a non-profit organization and an affiliate of Women's World Banking. More information available at: <http://fwwbindia.org/site/index.html> and <http://www.swwb.org/>.

<sup>5</sup>Bindu, Ananth. 2005. 'Financing microfinanceThe ICICI Bank Partnership Model', *Small Enterprise Development*, 16 (1): 5765.

<sup>6</sup>USD 10-11 billion market for unsecured credit growing at 25-30 percent. Information available at: <http://www.indiadaily.com/editorial/18091.asp>. "The new bubble of India Citi Financial and GE Money chasing Indian Subprime Markets, September 3rd."

<sup>7</sup>Union Finance Minister in Lok Sabha: "Micro Financial Sector (Development and Regulation) Bill 2007. Bill No 41 of 2007." Introduced on March 20th, 2007.



### Indian Microfinance Today: Key Trends Shaping its Future Course

This section discusses the five prominent trends visible in the Indian microfinance industry. The focus is primarily on MFIs and institutional initiatives which have microfinance as their core activity.

#### Trend # 1: Blurring Boundaries, Changing Transaction Sizes: Redefining “Micro”

In the 1990s, microfinance was by and large understood as an activity that was adopting business principles but carried on by an “alternate sector” other than the government or the commercial sector and done exclusively or predominantly with the “poor.” While it typically meant lending small amounts to smooth consumption, a similar loan provided by a RRB for instance, was not necessarily considered microfinance<sup>8</sup>. MFIs and SHGs were therefore mainly acknowledged as microfinance providers.

According to the proposed microfinance bill, an amount not excluding USD 1,235 (INR 50,000) lent to an individual or microenterprise would qualify as microfinance. Today, many NGO-MFIs that began operations in the 1990s have transformed into regulated entities providing much larger loans to a much wider client base. Many MFIs have clients who have completed 3-4 loan cycles and who are now seeking loans closer to USD 1,250 (INR 50,625). For instance, the average loan size for Indian MFIs with portfolios above USD 25 million (INR 1.01 billion) grew from USD 161 to USD 201 (INR 6,520 to INR 8,140) between 2003 and 2007, with an increasing number of loans being above USD 247 (INR 10,000)<sup>9</sup>. A parallel trend is the increased activity in the meso-level segment<sup>10</sup>, which largely extends consumer credit. Led by pioneers such as Citi Financial and GE Money, today this space has players such as HSBC's Pragati Finance, Standard Chartered's Prime Financials, Fullerton India, and DBS Cholamandalam. In an effort to find new growth segments, there are attempts by many of the above players to 'downscale' and explore low income markets.

Though their average loan size is above USD 2,500 (INR 101,250), many NBFCs such as Fullerton have extended loans as low as USD 250 (INR 10,000). MFIs' growing loan sizes and NBFCs' downscaling have made it increasingly difficult to demarcate the boundaries between these institutions.

Traditionally, microfinance clients were self-employed microentrepreneurs for whom credit served the purpose of consumption smoothing, investment in productive assets, or working capital for income-generating activities. The Reserve Bank of India (RBI) defines microfinance as “the provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve their living standards<sup>11</sup>.” While such clients have been largely excluded from the credit extended by commercial banks, many formal providers such as Axis Bank<sup>12</sup> are now initiating pilot programs for lending to farmers for agri-supply chain financing; amounts which would fall well within the lending range of MFIs.

#### Key Indian mF Trends

1. Changing transaction sizes
2. Development initiatives to social businesses
3. Diversification
4. Reaching out to un-reached
5. Increasing policy regulation

...MFIs  
extending higher  
loans and  
NBFCs introducing  
lower loans...

<sup>8</sup>Sriram, MS and R, Upadhyayula: *The Transformation of Microfinance in India: Experiences, Options and Future*. 2002

<sup>9</sup>Intellecap analysis of MFI sample data

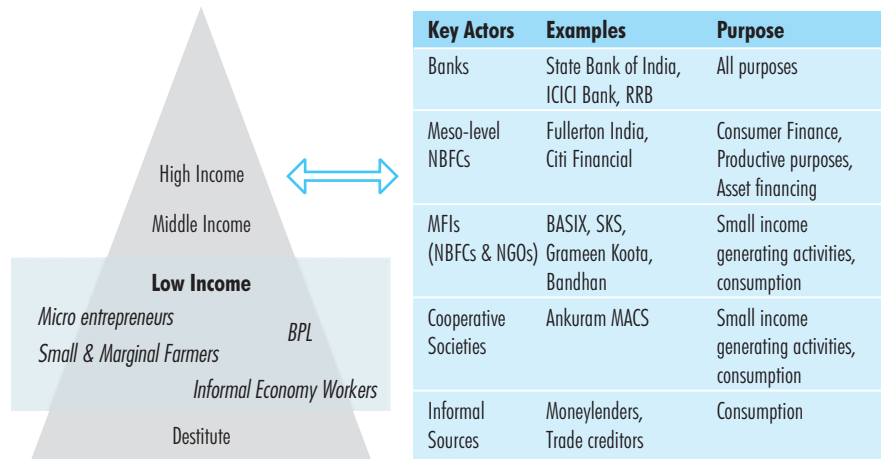
<sup>10</sup>Meso level consumer lending segment is estimated to have a USD 10-11 billion market for unsecured credit growing at 25-30 percent

<sup>11</sup><http://www.rbi.org.in/scripts/FAQView.aspx?id=7>

<sup>12</sup>Axis Bank and ITC have initiated a pilot to finance farmers supplying to ITC. Source: Intellecap Interview with ITC



Figure 2: Potential Microfinance Client Base and Supply Side Actors



So, what qualifies as “microfinance” in India? While there seems to be no distinct criteria that differentiate “microfinance providers,” there is definitely a graduation path visible for a low income client for whom access to formal banks was not possible a few decades back. The future of microfinance is limited only by the ambitions of MFIs, and NBFCs and banks active in the sector.

Trend # 2: Development Initiatives Becoming Social Businesses

Today's MFIs, particularly those which were founded after 2000, look and think differently from those of the 1990s. Many of these “second generation” MFIs are promoted by entrepreneurs with mainstream corporate experience. Such entrepreneurs have run businesses as opposed to their first generation MFI counterparts who were largely development workers. Among first generation MFIs, the role generally assumed was that of a facilitator, constituting a segment of the civil society attempting to make the poor bankable. Today, MFIs relate better to the market and see themselves as businesses in the financial services space, catering to an untapped market segment while creating value for their shareholders. This overriding shift in orientation from development to social entrepreneurship has brought about changes in institutions' legal forms, capital structures, sources of funds, growth strategies, and strategic alliances. Key differences in the character traits of first and second generation MFIs are outlined in Table 1.

...changes in institutions' legal forms, capital structures, sources of funds, growth strategies, and strategic alliances.



**Table 1: Comparing Second Generation MFI Traits with Those of First Generation MFIs**

Character Traits	First generation MFIs (90s)	Second Generation MFIs (00s)
Promoter Profiles	Development workers	Entrepreneurs, Professionals with mainstream banking, consulting, or corporate experience
Motivations	Client outreach, Poverty alleviation	Shareholder value creation (social and financial), institutional sustainability
Legal Forms	Not for profit forms: Society/Trust	For-profit forms: Non Banking Finance Company (NBFC)
Capital Structures	Mostly grant and debt funded	Equity, debt, portfolio sale, exploring capital markets, future plans for IPOs
Geographic Ambitions	Regional	National and in some cases, global
Growth Strategies	Organic: Slow, branch by branch expansion	Inorganic: Fast, exploring mergers, acquisitions and franchising
Product Focus	Single product: General purpose loan	Multi-product: Diversification into individual loans, asset financing, housing loans, insurance, remittances
Strategic Alliances	Donors, Technical assistance partners, NGOs	Equity investors, Lenders, Mainstream financial businesses, retail players
Time Taken for Break-even	Five to six years	One to one and a half years at the branch level, Two to three years at the head office level
Human Resources	Development/Social welfare professionals with expertise in community mobilization, project management	Management graduates, expertise in business disciplines such as finance, technology, marketing.
Governance	Largely patrons of the NGO	Relevant expertise for institution
Perception of Microfinance Users	Beneficiaries, unable to access formal markets	An untapped customer segment

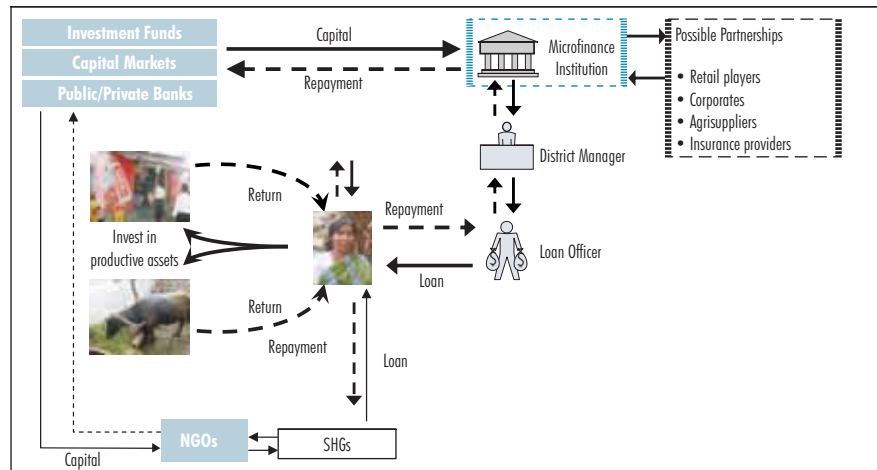
Many first generation MFIs have subsequently transformed into regulated, for-profit business models and legal structures. The common triggers for conversion are MFIs' increasing balance sheet sizes, the need to provide a larger number of services, the desire to attract mainstream capital and human resources, and growing attention from tax authorities on MFIs' increasing surpluses. Today, many such MFIs have become the preference of mainstream commercial investment funds. Simultaneously, large corporate firms such as Reliance, Bharti, and Muthoot Finance have expressed their interest in entering into the microfinance industry<sup>13</sup>. Even amidst concerns of commercialization of the industry built on the sweat equity of development workers, microfinance is emerging as an attractive business and investment opportunity for a diverse range of players with different motivations. *The emerging microfinance market place can be represented as in Figure 3.*

...Attracting mainstream capital, human resources and corporations.

<sup>13</sup>[http://economictimes.indiatimes.com/Reliance\\_Bharti\\_may\\_storm\\_microfinance/articleshow/1525627.cms](http://economictimes.indiatimes.com/Reliance_Bharti_may_storm_microfinance/articleshow/1525627.cms), [http://swwb.org/eNews0407/april07\\_2.html](http://swwb.org/eNews0407/april07_2.html)



Figure 3: Emerging Microfinance Market Place



Trend # 3: Diversification & Linkages in Search of Value Creation Opportunities

Until recently, microfinance activities were primarily focused on credit. With growing portfolios and increasing client bases, second generation MFIs have started to explore the provision of additional financial and non-financial services. Today, many Indian MFIs target a wide range of financial products that permit poor households to not only access credit but also remittances, savings, pensions, and insurance.

...Moving beyond credit...into additional financial and non-financial services.

Some of the largest MFIs in the country boast of over one million clients and plan to take their clients base to 5 million in the next five years. While the creation of this client base is part of an effort to further their outreach, these MFIs are increasingly realizing the potential of providing services such as insurance, remittances and supply chain financing for agri business activities through their already established delivery channels. Similar to mainstream banks' strategy of adding fee-based income streams to increase institutional profitability by cross-selling products such as insurance, MFIs can also reduce the transaction costs of new services and eventually, reduce the cost of their primary offering, credit.

Spandana, one of the largest MFIs in India has tied up with Western Union Money Transfer<sup>14</sup> to offer remittance services to its clients. BASIX works with corporates such as Frito Lay and ITC<sup>15</sup> (See Box 1) to provide supply chain financing to microentrepreneurs and small farmers. Many MFIs are also exploring the possibility of housing finance<sup>16</sup> and financing assets such as tractors, farm equipments, and catalytic converters for automobiles.

<sup>14</sup>Western Union is a global consumer-to-consumer money transfer service provider. More information available at: www.westernunion.com.

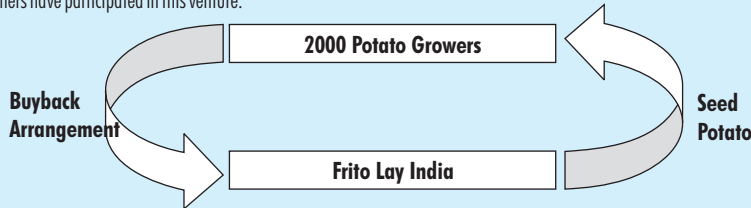
<sup>15</sup>BASIX: "11th Annual Report 2006-2007." Pg. 7.

<sup>16</sup>Largely home repairs, extensions and renovations



Box 1: Microfinance & Supply Chain Partnerships BASIX and Frito Lay

"BASIX is collaborating with PepsiCo for Frito Lay chip grade potato farming in Jharkhand. In 2005-2006, 216 farmers participated. In 2006-2007, seeing the significant increase in crop yield, delivery of quality planting material at field and advantages of pre-determined price and harvest from field with yield, ease of credit and crop insurance, more than 1,100 farmers have participated in this venture."



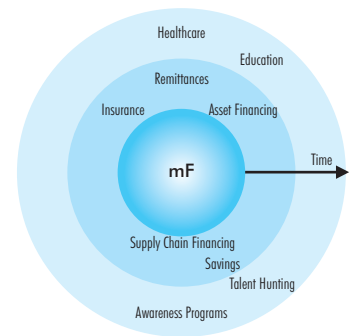
Source: Basix 11th Annual Report 2006-2007.

SHG channel initiatives have also adopted a similar strategy of bundling products and services. In its project, *Shakti*, Hindustan Unilever Limited (HUL) retails its fast moving consumer goods (FMCG) products through entrepreneurial SHG members. Similarly, TATA-AIG takes the services of MFIs to gain referrals of entrepreneurial women among their SHG or Grameen groups, who then act as agents for selling their insurance policies. State run programs such as *Kudumbashree*<sup>17</sup> in Kerala leverages its extensive SHG network to deliver corporate products as well as providing a medium to facilitate transactions with the government.

Some industry experts believe that the potential of leveraging MFIs' network is immense and attractive to mainstream corporate players who seek entry into rural and urban low income customer segments. Strategic alliances between MFIs and corporate players can be mutually beneficial, as they reduce transaction costs, augment institutional profitability, and create better access to products and services.

In addition, proposed policy changes such as the Business Correspondent model<sup>18</sup>, which allows NGOs to act as banks' agents would have implications for the range of services that will be bundled together to reach out to low income segments. A parallel trend is the increasing interest of localized entities such as rural kiosk providers to add microfinance services to their portfolios and leverage their existing rural networks.

The potential of leveraging MFIs' network is immense and attractive to mainstream corporate players.



<sup>17</sup> www.kudumbashree.org

<sup>18</sup> http://www.sa-dhan.org/circular/Business\_Facilitator\_and\_Correspondents.doc



#### Trend # 4: Reaching Out to the Un-reached: Moving Beyond 'Rural' and 'South'

Indian microfinance, especially in the current decade has shown impressive growth. In addition to this growth the sector's pattern of outreach is encouraging. One can see a movement towards un-reached areas, which indicates more balanced growth across the country. Two important visible trends that substantiate such activity include:

- Movement toward Un-Reached Geographies
- Growth of Urban Microfinance

#### Breaking the Dichotomy: Movement toward Un-Reached Geographies

Until the last decade, Indian microfinance outreach through both MFIs and SHGs was concentrated in a few southern states including Andhra Pradesh, Kerala, Karnataka, and Tamil Nadu. Many states in the north, east, and northeastern parts of the country, which have a much higher incidence of poverty and a higher latent need for microfinance services, performed poorly when benchmarked for their extent of microfinance activity. As of 2007, More than 75 percent of the loan portfolio held by MFIs is concentrated in the southern states<sup>19</sup>. Almost 90 percent of the portfolios of the four large MFIs in the country SHARE, Spandana, SKS, and BASIX are in South India, particularly in the state of Andhra Pradesh. As of March 2007, the cumulative disbursements under the SHG-Bank Linkage Program in the southern region constituted 75 percent of the total nation wide disbursements<sup>20</sup>. This posed a severe challenge for development planners and microfinance stakeholders.

This decade saw a highly encouraging trend with MFIs, who earlier had a state-wide or regional presence starting to venture into other states, to achieve growth nationally. West Bengal, Orissa, Assam, Bihar, and Jharkhand are a few states, which have emerged as new growth areas. At least seven MFIs currently have a presence in more than five states in India, including BASIX, SKS, SHARE, Spandana, Bandhan, ASMITA, and ESAF.

The demand and supply trends across the various zones of the country and the activity in specific states are discussed in further detail in Chapters 2 and 3.

#### Dispelling the Myth of Rich Urban India: Advent of Urban Microfinance

Until the 1990s, Indian microfinance, and Asian microfinance as a whole, was a rural phenomenon, as opposed to experiences in other regions such as Latin America. In this decade, development planners and microfinance practitioners began noticing the sharp increase in urban poverty while rural poverty declined both as a percentage of the population and in absolute terms. Between 1991 and 2001, the poverty growth rate in urban India was almost twice the rural growth rate<sup>21</sup> (Refer Figure 4).

Today, India's urban and semi-urban areas are believed to offer equally attractive, if not more attractive markets for microfinance products and services. Given the higher population densities within urban as compared to rural markets, it seems likely that greater efficiencies can be achieved in urban markets.

...the underdeveloped states,  
the new growth areas  
for microfinance.

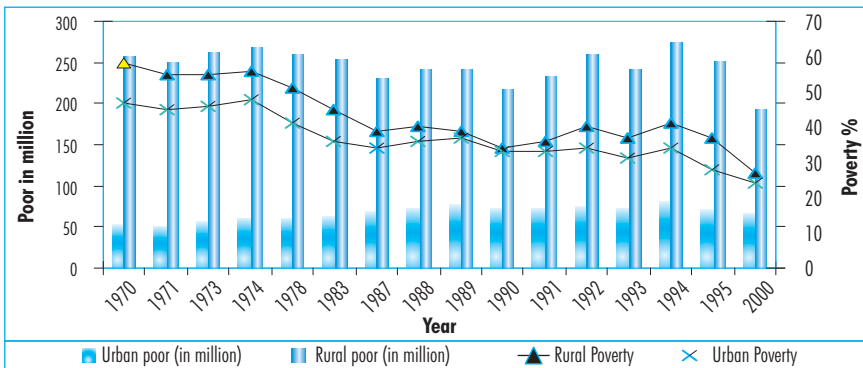
<sup>19</sup>Intellect estimates using primary data from MFIs

<sup>20</sup><http://www.nabard.org/pdf/Regional%20spread0607.pdf>

<sup>21</sup>Thirty two percent for urban India compared to 17.9% for rural India, Census 2001



Figure 4: Urban Versus Rural Poverty in India



Source: CARE, Intellectap, ICICI Bank, MSDF: "A Promise to Pay the Bearer: An Exploration of the Potential for Urban Microfinance in India." 2006.

This realization has also led to increased interest from MFIs in urban microfinance as established rural MFIs (e.g. BASIX, SHARE, Spandana, SKS) have entered urban markets and some new generation MFIs have an exclusive focus on urban areas (e.g. Ujjivan, Swadhaar). This interest in urban microfinance has also been marked by the formation of specialized funders for particular microfinance initiatives such as the Michael and Susan Dell Foundation (MSDF).

...urban microfinance, attractive markets for existing and new MFIs.

Table 2: Rural and Urban Differences in Indian Microfinance

Rural Microfinance (origins in the 1990s)	Urban Microfinance (origins in the 2000s)
<b>Leadership</b>	
<ul style="list-style-type: none"> <li>• NGO Leaders, mostly with a social motive</li> <li>• NABARD, as part of its focus on rural areas</li> </ul>	<ul style="list-style-type: none"> <li>• Successful Mainstream Finance, including Commercial banks</li> <li>• Successful Rural MFIs, wanting to address poverty holistically</li> <li>• Ex employees of Rural MFIs, wanting to become entrepreneurs</li> </ul>
<b>Motivations</b>	
<ul style="list-style-type: none"> <li>• Developmental Strategy with a historic focus on rural areas</li> <li>• Poverty Alleviation in the rural areas</li> </ul>	<ul style="list-style-type: none"> <li>• Quicker Sustainability, making business sense</li> <li>• Market driven, focusing on the delivery of Financial Services</li> <li>• Growing inequality between the rich and the poor</li> </ul>
<b>Institutional Finance</b>	
<ul style="list-style-type: none"> <li>• National and International Donors, with social and development motives</li> <li>• Government, with development motives</li> </ul>	<ul style="list-style-type: none"> <li>• Social Venture Funds, with double bottom line returns in mind</li> <li>• Private Foundations, with double bottom line returns in mind</li> </ul>
<b>On-lending Finance</b>	
<ul style="list-style-type: none"> <li>• Public Sector Banks, as stipulated by policy</li> <li>• Private Banks, as stipulated by policy</li> </ul>	<ul style="list-style-type: none"> <li>• Overwhelmingly Private Banks, making more business sense</li> </ul>
<b>Methodology</b>	
<ul style="list-style-type: none"> <li>• Self Help Groups</li> <li>• Grameen Groups</li> <li>• Joint Liability Groups</li> </ul>	<ul style="list-style-type: none"> <li>• Diverse methodology, including Joint Liability Groups, Self Help Groups, and Individual Lending</li> </ul>

Source: CARE, Intellectap, ICICI Bank, MSDF: "A Promise to Pay the Bearer: An Exploration of the Potential for Urban Microfinance in India." 2006.



**Trend # 5: Increased Policy Recognition and Affirmative Actions**

The policy outlook towards microfinance has evolved in parallel to its market development. The sector's overriding trend is the shift in focus from "social banking" driven by a belief that the poor cannot save or repay, to an integrated "financial systems" approach looking at the poor as clients with distinct product needs. There is increased acceptance of the inappropriateness of the banking institutional structure to serve low income clients and the advantages of facilitating and partnering with localized, informal MFIs in order to fill the demand-supply gap. Some key elements of this shift are outlined in Table 3.

*Table 3: Shift in Policy Approach to Indian Microfinance*

ELEMENT	PAST	PRESENT
State's role	Provider directing finance to the users	Facilitator for development of a stable financial market
Policy focus	Directed lending to the under privileged and 'un-bankable'	How to reduce transaction costs in reaching out to the clients? How to integrate the clients to the mainstream, achieve inclusive economic growth?
Regulation	Fragmented, often unclear regulatory framework	Specialized regulation proposed for alternate microfinance providers
Operational strategy	Provide incentives to existing formal institutions to channel credit to 'priority' segments.	Facilitate creation of alternate institutions better suited to service low income segments. Facilitate innovative partnerships for integration between formal and informal service providers
View of microfinance users	Seen as beneficiaries for subsidized products	Seen as potential clients for market based solutions

...shift in policy focus from 'social banking' to an integrated 'financial systems' approach

Various government measures in late 1990s and since 2000 reflect the shift in the policy thought process. For many years, the national budget and many policy documents equated microfinance in India to NABARD and the SHG-Bank Linkage Program. Post 2000, the budget speeches by the Finance Minister and policy stakeholders such as the RBI Governor and Chairman of NABARD began to acknowledge the role of MFIs in reaching out to India's poor and facilitate financial inclusion. The evolution in the policy approach to microfinance providers after year 2000 is highlighted in Figure 5.



Figure 5: Policy Attention to Microfinance After 2000

1999	--- Official definition of microfinance by RBI
August 2000	--- 'Micro Credit/Rural Credit' included in the list of permitted non-banking financial company (NBFC) activities considered for Foreign Direct Investment (FDI)
2005	--- MFIs acknowledged for the first time in the Budget Speech by the Finance Minister "Government intends to promote MFIs in a big way. The way forward, I believe, is to identify MFIs, classify and rate such institutions, and empower them to inter-mediate between the lending banks and the beneficiaries."
January 2006	--- Announcement of the business correspondent model
February 2006	--- Budget Speech by the Finance Minister promises a formal statutory framework for the promotion, development and regulation of the microfinance sector
March 2006	--- Comprehensive guidelines by RBI on loan securitization
July 2006	--- RBI master circular allows NGOs involved in microfinance to access External Commercial Borrowings (ECB) up to USD 5 million (INR 20.25 crores) during a year.
March 2007	--- Finance Minister introduces the "Micro Finance Sector Development and Regulation Bill 2007" in Lok Sabha

A key highlight of such policy changes is the Microfinance Sector Development and Regulation Bill 2007 tabled in the Parliament. The Bill, if enacted would form 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 microfinance in a non-profit form. Key highlights of the Bill are presented as Box 2.

Microfinance Sector Development and Regulation Bill 2007, a key policy measure for Indian microfinance.

**Box 2: Highlights from India's Proposed Microfinance Bill 2007**

- NABARD (National Bank) will be empowered to be the regulator for India's microfinance sector
- The GOI may form a Micro Finance Development Council to provide "advise on formulation of policies, schemes, and other measures required for the growth of the microfinance sector"
- Non-profit MFIs must register under the Micro Finance Development Council
- Microfinance would be considered any amount not exceeding USD 1,234 (INR 50,000) lent to an individual / enterprises
- Any entity which "intends to commence the business of offering thrift services to eligible clients" must register with the National Bank
- The National Bank will establish the Micro Finance Development and Equity Fund



## Chapter 2

### Gauging the Depths: Market Demand for Indian Microfinance



Over the past five years, Indian microfinance has emerged as one of the most dynamic markets in the world. Understanding its market opportunity is essential to taking forward any discussion on strategies and operations. However, specific demand estimates for Indian microfinance are relatively non-existent. In this section, we look at the available data on income, demographics, and financials to draw approximations on the potential microfinance opportunity in India.

## 2.1. Estimating Demand for Microcredit

To estimate India's annual microcredit demand and identify the potential users of credit, we analyzed data along the following variables:

- Incidence of Poverty using Census 2001 population data, poverty ratios, and average loans sizes for potential microfinance clients
- Economic Activities of Low Income Segments assessing demand for financial services from marginal and small operational landholders, landless agricultural laborers, and non-agri microentrepreneurs
- Penetration of formal banking services exploring the current outreach of financial services

### Incidence of Poverty

Understanding the 'poor,' a segment with credit needs for consumption smoothening and deployment in productive activities, is important in estimating annual microcredit demand. India's current population, corrected for 1.6 annual percent population growth since 2001, is estimated at 1.1 billion people<sup>22</sup>. Further, according to the 2001 census, a poverty ratio of 26 percent of India's population lives below the national poverty line (NPL), which corresponds to 289.6 million people, while 34.7 percent or 386.5 million people live below the international poverty line (IPL)<sup>23</sup>. Assuming one microfinance client per household and given that the average number of people per household is five<sup>24</sup>, the potential number of below poverty line (BPL) microfinance clients ranges from 57.9 million to 77.3 million.

To determine the amount of on-lending capital required for these BPL clients, an annual average loan size of USD 98.8 (INR 4,000) to USD 246.9 (INR 10,000) is used<sup>25</sup>. Applying these loan amounts to the poor population identified above, the annual credit demand could result in financing requirements of USD 5.7 billion (INR 231.6 billion) USD 19.08 billion (INR 773 billion).

Indian poor, estimated to be in the range of 57.9 million to 77.3 million, form the primary market for microfinance

**Table 4: Annual Microfinance Demand (Using National Poverty Line Statistics)**

Loan Size (USD)	Potential Clients NPL	Financial Requirements- National USD	Financial Requirements- National INR crores
98.8		5,718,518,519	23,160
123.5		7,148,148,148	28,950
148.1		8,577,777,778	34,740
172.8	57.9 M	10,007,407,407	40,530
197.5		11,437,037,037	46,320
222.2		12,866,666,667	52,110
246.9		14,296,296,296	57,900

<sup>22</sup>Population arrived at by applying a 1.6% population growth (taken from CIA figures) to the 2001 population as stated by 2001 census and year-on-year until 2007. Sources: (1) <https://www.cia.gov/library/publications/the-world-factbook/print/in.html> and (2) [http://www.censusindia.net/t\\_00\\_003.html](http://www.censusindia.net/t_00_003.html). Census data available in Appendix 2 and at [http://www.censusindia.net/t\\_00\\_003.html](http://www.censusindia.net/t_00_003.html)

<sup>23</sup>UNDP estimate in 2003

<sup>24</sup>[http://www.censusindia.net/hh\\_series/web/data\\_highlights\\_hh1\\_2\\_3.pdf](http://www.censusindia.net/hh_series/web/data_highlights_hh1_2_3.pdf)

<sup>25</sup>Average loan size data is from Intellectap's analysis of cumulative MFIs.



Table 5: Annual Microfinance Demand (Using International Poverty Line Statistics)

Loan Size (USD)	Potential Clients IPL	Financial Requirements- National USD	Financial Requirements- International INR
98.8	77.3 M	7,634,567,901	30,920
123.5		9,543,209,877	38,650
148.1		11,451,851,852	46,380
172.8		13,360,493,827	54,110
197.5		15,269,135,802	61,840
222.2		17,177,777,778	69,570
246.9		19,086,419,753	77,300

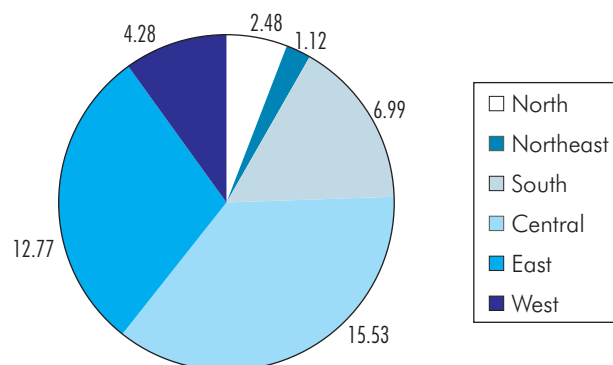
...There exists regional differences in microfinance demand in India.

When poverty ratios are further applied, the regional differences in annual demand for microfinance services become apparent<sup>26</sup>. There is a greater concentration of poor people in Central and East India. In addition, when regional microfinance demand is assessed according to average loan size<sup>27</sup>, the annual on-lending requirements for each region are show in Table 6.

Table 6: Annual Microfinance Demand by Region<sup>28</sup>

Region	Total Population	Average Poverty Ratio	Number of Poor	Average Loan Size (USD)	Average Loan Size (INR)	Financial Requirement (USD)
North	146,271,590	11%	17,071,984	145	5,900	2,486,875,909
Northeast	42,740,550	17.96%	7,677,271			1,118,348,067
South	246,759,584	19.45%	47,994,739			6,991,393,630
Central	281,436,280	37.9%	106,664,350			15,537,795,865
East	249,991,960	35.08%	87,697,180			12,774,848,211
West	163,949,577	17.95%	29,428,949			4,286,915,001

Figure 6: Regional On-Lending Requirements (USD Billions)



<sup>26</sup>Poverty ratios were applied to each state to arrive at the total number of poor using the 2001 census. Figures were then totaled according to regional breakdowns. <http://planningcommission.gov.in/news/prmar07.pdf>.

<sup>27</sup>Based on a cumulative average loan size of USD 145.67 or INR 5,900 from data collected.

<sup>28</sup><http://planningcommission.gov.in/news/prmar07.pdf>



## GAUGING THE DEPTHS: MARKET DEMAND FOR INDIAN MICROFINANCE

Finally, although Indian microfinance has historically been known as a rural phenomenon, urban microfinance is attracting increasing attention. Using the 2001 census data and 2004-2005 rural and urban poverty ratios, we have found that there are approximately 44.1 million poor rural households and 16 million poor urban people that are potential microfinance clients<sup>29</sup>. When an annual average loan size of USD 146 (INR 5,900) is applied for rural areas, annual on-lending requirements by microfinance providers are approximately USD 6.39 billion (INR 259 billion) annually. A differentiating element of urban and rural microfinance is the greater annual average loan size offered to urban microfinance clients, which are often individual borrowers. Assuming an annual average urban loan size of USD 198 (INR 8,000) to USD 246 (INR 10,000) the annual MFI on-lending for urban microfinance is approximately USD 3.16 to USD 3.95 billion (INR 128 billion INR 160 billion).

### Economic Activities of Low Income Segment

Given that there are many individuals in the low income segment who might not qualify as 'poor' under the national or international poverty line but need small amounts of credit for economic activities, understanding such economic segments could prove useful while estimating microcredit demand. This segment includes landless agricultural workers and laborers, small and marginal farmers, rural artisans and craftsman, and those who are self-employed in the informal sector. Given difference in income, albeit incremental, it is important to note that small and marginal farmers and microentrepreneurs or the self-employed typically have a slightly higher income than laborers. Therefore, the first group requires credit for productive purposes, while very poor individuals such as landless agricultural laborers, typically need credit primarily for household consumption. While a number of these individuals may not fall below the national or international poverty lines, many still do not have access to credit and other mainstream financial services. Consequently, these low-income groups should be included in the potential market that Indian microfinance providers can serve.

In 2005, the number of operational landholdings in India was 137.6 million<sup>30</sup>. Of these, 80% or 110.5 million<sup>31</sup> were cultivated by marginal and small farmers, who hold less than 1 hectare<sup>32</sup> and between 1-2 hectares, respectively. If one landholding per household is taken, then there are 110.5 million landowners that could be potential microfinance clients. Assuming annual credit demand of USD 250 (INR 10,125) per landholding, the annual on-lending requirements by microfinance providers to serve this population could be estimated at around USD 27 billion (INR 1.1 trillion).

While the above segment represents the bottom of the pyramid in terms of landholdings, a large percentage of the total credit need comes from another portion of the rural economy landless agricultural laborers. Estimates from the Commerce Ministry indicate that there are 100 million landless agricultural laborers across the country<sup>33</sup>. With an average USD 150 (INR 6,075) annual credit demand from a client within this segment, the industry will require approximately USD 15 billion (INR 607.5 billion) in annual on-lending capital to address their credit needs.

There is a high demand for microcredit amongst low income economic segments.

<sup>32</sup> 1 hectare equals 2.5 acres

<sup>33</sup> Commerce Ministry:  
[http://commerce.nic.in/PressRelease/pressrelease\\_detail.asp?id=2053](http://commerce.nic.in/PressRelease/pressrelease_detail.asp?id=2053)

<sup>29</sup> Figures derived using 2001 census data at <http://www.censusindia.net/results/rudist.html> and 2004-2005 poverty ratios from <http://planningcommission.gov.in/news/prmar07.pdf>. Refer to Appendix 3.

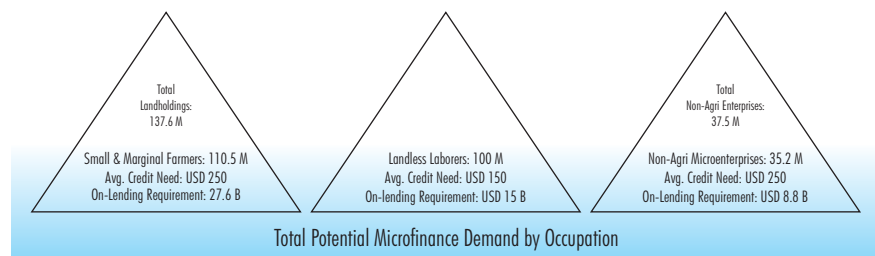
<sup>30</sup> This number was derived by applying the average growth rate between 1975 and 1995 (approximately 9%) to 1995 data on operational landholdings. Source: Agricultural Census Division, Ministry of Agriculture, New Delhi.

<sup>31</sup> The number of small and marginal landholdings in 2005 was calculated by using the %age of small and marginal farmers in 1995. Source: Source: Agricultural Census Division, Ministry of Agriculture, New Delhi. The Department of Commerce estimates the number of small and marginal farmers to total 127 M in 2007. Source: [http://commerce.nic.in/PressRelease/pressrelease\\_detail.asp?id=2053](http://commerce.nic.in/PressRelease/pressrelease_detail.asp?id=2053)



Looking beyond agricultural employment, another occupational segment with credit demands are non-agri enterprises. In India, of the 42.12 million enterprises operating in 2006, 35.7 million constituted such a segment within which 98.6 percent were microenterprises<sup>34</sup>. The number of non-agri microenterprises therefore totals 35.2 million. This segment, like small and marginal landholders, requires an average annual credit amount of USD 250 (INR 10,125). Given this figure, the annual on-lending requirements to serve this segment amount to USD 8.8 billion (INR 356.4 billion).

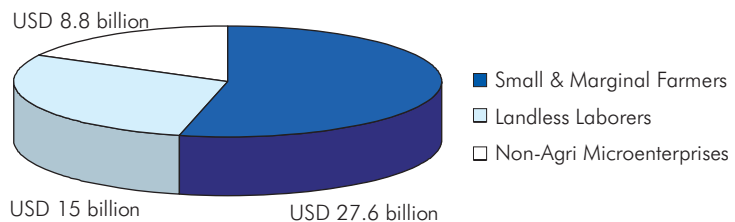
**Figure 7: Population Segmentation as Potential Microfinance Clients**



If credit needs of low income, economically active population is included, the microcredit demand is as high as USD 51.4 billion (INR 2.08 trillion)

Combined, these three population sets amount to 245.7 million people with a total annual credit demand of approximately USD 51.4 billion (INR 2.08 trillion). The share of each of the above population sets in total microfinance demand is presented in Figure 8.

**Figure 8: Microfinance Demand by Occupational Segments**



### Penetration of Formal Banking Services

Exploring the extent of financial inclusion or exclusion by formal banking services is also one of the indicators of the need for microfinance. In this report, we explore key data on financial inclusion: a) the number of adult people that have bank accounts, and b) those that have access to credit accounts. Across India, approximately 59% of the population has bank accounts, which leaves approximately a half billion people un-banked<sup>35</sup>. If we apply the national poverty line to this level of bank infrastructure only 169 million people have bank accounts<sup>36</sup>. Furthermore, considering the fact that many individuals have multiple bank accounts, the number of low-income Indians who are unable to access even a single account would be much higher.

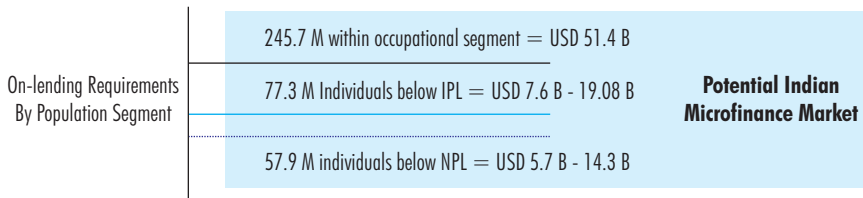
<sup>34</sup>Micro-enterprises are defined as those employing less than 10 workers. Source: Government of India Provisional Results of the Fifth Economic Census - June 2006.

<sup>35</sup>Thorat, Usha. Speech: "Financial Inclusion The Indian Experience." [http://www.rbi.org.in/scripts/BS\\_SpeechesView.aspx?Id=342](http://www.rbi.org.in/scripts/BS_SpeechesView.aspx?Id=342).

<sup>36</sup>An assumption made here is that the proportion of poor people in the un-banked population is the same as the proportion of poor in the total population. Hence, we assume 26% of the total un-banked are poor.



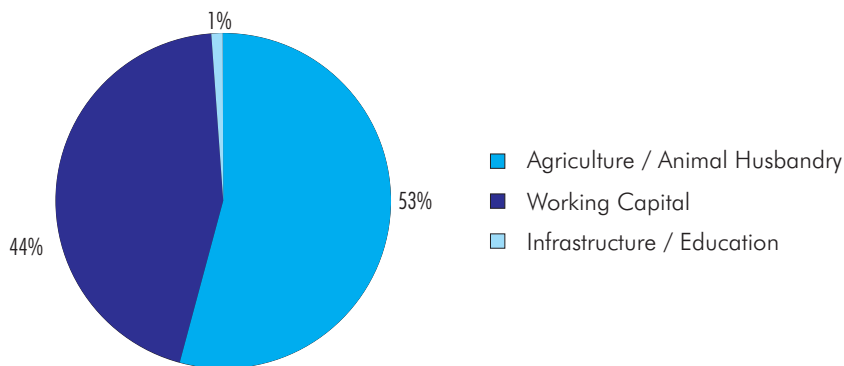
**Figure 9: Total Potential Annual mF Demand**



## 2.2. Nature of Credit

The high credit demand figures in terms of both the number of low-income people that are potential microfinance clients and the actual amount needed as on-lending capital, makes it clear that the Indian microfinance industry has a large base to serve. Since we have estimated such demand above, it is now important that all stakeholders are aware of the purpose of the capital that is channeled from capital providers to MFIs and further on-lent to clients. In its 2005-2006 Annual Report, FWWB presents data on activity-wise loan outstanding for its 79 partner MFIs<sup>37</sup>.

**Figure 10: Activitywise Loan Outstanding (2005-2006)**



It is also important to note that if one includes additional services such as housing finance and asset financing, on-lending requirements for MFIs would increase. This is due to the size of the loans, which are greater than the average loan size for working capital and consumption loans.

## 2.3. Demand for Microfinance Services in Addition to Credit

While discussing India's potential microfinance opportunity, it is important to examine services beyond credit. Broad estimates of the potential demand for microinsurance, remittances, and micropensions, for instance, are made below:

### Box 3: Annual Microfinance Demand in India

Estimating the Annual Microfinance Demand in India

Assuming the entire poor population in India as potential microfinance clients, the market size for microfinance in India appears to be in the range of 57.9 to 77.3 million clients translating to an annual credit demand of USD 5.7 to 19.1 billion (INR 230 to 773 billion). If we assume the economically active low income occupational segments such as the small and marginal farmers, landless agricultural laborers, and microentrepreneurs, are microfinance clients as well, then the annual credit demand goes further up to an estimated 245.7 million individuals and USD 51.4 billion (INR 2.1 trillion) in annual on-lending requirements.

<sup>37</sup>FWWB Annual Report 2005-2006. Page 4.



**Substantial demand exists for micro savings, insurance, remittances and pensions.**

**Savings:** Low income segments save for insurance against emergencies, social events, investment, and future consumption needs. One of their primary needs is access to safe, convenient mechanisms to hold their savings. Savings, therefore, form an integral part of the microfinance services sought by such segments. According to a 2002 study, the mean savings amounts per member under the SHG-Bank Linkage Program stood at USD 60 (INR 2,103)<sup>38</sup>. Extrapolating this figure and applying it to the total number of households below poverty line (57.9 million), the potential annual savings base would be around USD 3 billion (INR 12,170 crores).

**Insurance:** Though the demand for microinsurance is not very well articulated, it is well understood that microcredit customers' incomes are both low and variable. Such client segments need insurance services for assets including crops, livestock, and houses. In addition, access to such services reduces the need to access expensive credit from informal sources in the event of contingencies such as illness and death. If one applies an annual average insurance premium of USD 8.88 (INR 360) to our range of microfinance clients 57.9 to 245.7 million individuals the total annual demand for microinsurance could be anywhere between USD 500 million to USD 2.18 billion (INR 20.2 billion to 88.3 billion)<sup>39</sup>.

**Remittances:** Remittances are also emerging as a financial service relevant to low income segments. According to the World Bank, the total worker remittances to India as of 2006 amounted to USD 25.7 billion (INR 1.0 billion), (10% of global remittances and almost 3% of India's GDP) making it the world's largest recipient country<sup>40</sup>. Major providers of this service and estimates on their market shares and costs are presented in Table 7.

**Table 7: Major Service Providers with Market Share and Cost**

	<b>Banks</b>	<b>Money Transfer Organizations</b>	<b>Exchange Houses</b>
Market Share	65-70%	20-25%	5-10%
Cost of Sending USD 200 (INR 8,100) from US to India	7%	8.3%	12.2%

Source: WWB 2004, Orozco 2003<sup>41</sup>. Note: Exchange houses are typically ethnic stores run by Indian's in the originating country

Low income segment workers, who typically lack bank accounts in originating and recipient countries, access money transfer organizations or exchange houses for sending amounts in the range of USD 25 to USD 494 (INR 1,000 to INR 20,000)<sup>42</sup>. A 2006 RBI study found that almost 30 percent of the total remittances received were less than USD 500 (INR 20,250) in value. Assuming that 30 percent of the total remittance senders are low income clients, the potential annual market for small remittances would amount to USD 8.5 billion (INR 344.3 billion).

<sup>41</sup>WWB Presentation at Conference "Sending Money Home: An Analysis of the Remittance Market between the United States and the Dominican Republic" MIF-IADB, Earth Institute at Columbia University, November 23, 2004.

<sup>42</sup>Source: Study team's discussions with money transfer organizations operational in India

<sup>38</sup>Puhazhendi, V & Badatya, K.C; SHG-Bank Linkage Programme for the Rural Poor An Impact Assessment , Paper presented at the seminar on SHG-Bank Linkage Programme at New Delhi, Nov 2002.

<sup>39</sup>Research done by MFI BASIX in 2006-2007 indicates that the average insurance premium per annum ranges from USD 5.9 USD 11.85 (INR 240-INR 480). We therefore apply that average of USD 8.8 (INR 360). Reference available at <http://www.adb.org/Documents/Events/2007/Microinsurance-Sector-Development/P.Gunaranjan2.pdf>

<sup>40</sup>World Development Indicators database, April 2007, [www.worldbank.org](http://www.worldbank.org)



In addition, migration across states within individual Indian states is on the rise. According to the 2001 census, there were 39.9 million total migrant workers in India, of which 11.3 million (28.5% of total) were marginal workers<sup>43</sup>-an additional segment that requires remittance services. The average amount transferred by a domestic worker amounts to about USD 84 (INR 3,400)<sup>44</sup>. Assuming the above figures, a broad market estimate for the domestic annual remittance market can be pegged at USD 960 million (INR 38.4 billion). The figure below presents cumulative growth in the inflow of remittances to India over a three year period<sup>45</sup>.

**Micropensions:** With cultural changes such as the breaking-down of the joint family system, micropensions assume increased relevance in the Indian microfinance space. According to the 2001 census, India's elderly<sup>46</sup> population stood at 76.6 million, while projections indicate a rise to 97.3 million in 2010<sup>47</sup>. Many elderly individuals rely on working family members in the absence of their own social security<sup>48</sup>. Given this situation, many individuals in the current unorganized workforce would be interested in a well-designed micropension scheme<sup>49</sup>. Even if we assume that one working member each from 30 percent of the total poor households sign up for such a scheme at an average defined annual contribution of USD 30 (INR 1,200)<sup>50</sup>, that would represent an annual market of around USD 520 million (INR 21 billion).

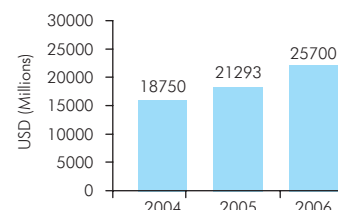
**Table 8: Estimated Demand across Microfinance Services**

MICROFINANCE DEMAND (USD)		
Service	Lower Limit	Upper Limit
Credit: BPL	5.7 billion	19.1 billion
Credit: Small & Marginal Land Owners	27.1 billion	
Credit: Ag Laborers	15 billion	
Credit: Microentrepreneurs	8.8 billion	
Credit: Urban	3.16 billion	3.95 billion
Savings	3 billion	
Insurance	500 million	2.2 billion
Remittances	8.5 billion (International) and 960 million (Domestic)	
Micropensions	520 million	

Ultimately, it is evident that the annual microcredit market size, according to occupational segments and BPL statistics ranges from a minimum of 57.9 to 245.7 million low-income individuals. Consequently, annual on-lending requirements also range from USD 5.7 billion to USD 51.4 billion. Demand for insurance, on the other hand, amounts to USD 0.5 million to 2.18 million annually. The market base for annual savings is approximately USD 3 billion while that of remittances is USD .96 billion. Finally, the annual micropension market totals around USD .52 billion. It is important to note that these figures reflect broad estimates, based on the assumption that it is not only below poverty line individuals that require microfinance services, but anyone in the low-income demographic who is unable to access formal financial services.

## Low income segment workers incur high costs to access money transfer facilities

**Figure 10: Growth in Remittance Inflows to India 2004-2006**



<sup>48</sup>Report No. 507 on "Morbidity, Health Care and the Condition of the Aged" based on the 60th round of National Sample Survey (NSS) found 67% of the elderly in rural India and 64% of those in urban India depended on others for their day-to-day maintenance. Available at [http://www.mospi.nic.in/nssso\\_press\\_note\\_21march06.htm](http://www.mospi.nic.in/nssso_press_note_21march06.htm)

<sup>49</sup>Analysis by the Invest India Incomes and Savings Survey 2007 released by IIMS Dataworks indicates that close to 30 million workers are ready to participate in the new pension scheme considered by the government. Since this included workers from across income segments, its difficult to disaggregate the data for low income segments.

<sup>50</sup>Corresponds to the average contribution by clients of the first Indian micro pension scheme launched by UTI and SEWA. <http://southasia.oneworld.net/article/view/130625/1/2249>

<sup>43</sup>Who worked for less than 183 days in the twelve months preceding the census.

<sup>44</sup>Calculated from the client transactions of Shramika Sahayojya, an initiative of Gujarat based NGO, Adhikar.

<sup>45</sup>World Bank Statistics

<sup>46</sup>Assumes UN definition of people aged above 60 years

<sup>47</sup>World Population Prospects: The 2006 revision, UN Population Division, <http://esa.un.org/unpp/p2k0data.asp>



## Chapter 3

### A Drop in the Ocean: The Supply Side Story



## A DROP IN THE OCEAN: THE SUPPLY SIDE STORY

Reaching out to India's vast low income population with flexible financial services presents a formidable challenge. India's financial service providers range from formal banks to informal actors such as moneylenders and semi-formal players such as microfinance institutions. The spectrum of actors in the provision of financial services in India is mapped as Figure 11.

**Figure 11: India's Financial Service Providers: Level of Access**

Formal	Semi-Formal	Informal
Apex DFIs Commercial banks Regional Rural Banks (RRBs) Cooperative Banks Non-Banking Finance Companies Post office network Insurance companies Mutual Funds	Microfinance Institutions (MFIs) SHG-bank-linkage program	Moneylenders Trade creditors Local shopkeepers
<b>Low</b>	<b>Level of Access</b>	<b>High</b>

The status of the country's banking infrastructure, a formal institutional source, has progressed significantly since the 1960s when social banking reforms were initiated. As of June 2006, India had an extensive network of 222 commercial banks with 69,417 branches. The average population served by a bank branch has come down from 64,000 in 1969 to 16,000 in 2006<sup>51</sup>. However, there remain disparities in the geographic distribution of bank branches and credit extension. Many regions such as the Northeast, East, and Central India still have an average population per branch much higher than the all India average. The addition of branches is also relatively low in such regions.

There are disparities in the geographic distribution of bank branches and credit extension

**Table 9: Bank Coverage by Region**

Region	No. of branches	Average population per branch	No. of branches opened in previous year
All-India	69417	16000	933
North	11634	13000	286
North East	1913	22000	18
East	12074	20000	94
Central	13879	20000	138
West	10738	15000	145
South	19179	12000	252

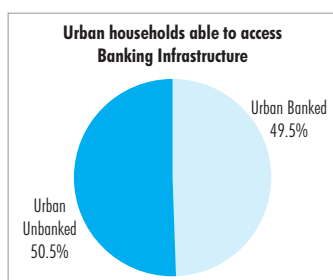
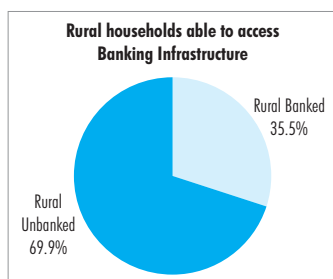
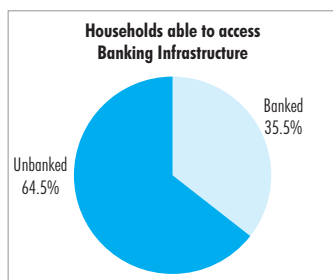
Regions that are not sufficiently serviced by bank infrastructure

While Indian banks' extension of credit continues to grow, many sections of the population remain excluded from the banking system. According to the 2001 Census, more than half of India's population does not have access to the formal banking system. Even more alarming, financial exclusion is much higher in rural areas, home to a large proportion of low income individuals.

<sup>51</sup>Report on Trend and Progress of Banking in India 2005-06, Reserve Bank of India - <http://rbidocs.rbi.org.in/rdocs/Publications/PDFs/73830.pdf>



**Figure 12: India's Banking Infrastructure Level of Access<sup>52</sup>**



**No. of Households with access to Banking Services**

- Rural HHs: 40,160,000
- Urban HHs: 20,650,000
- Total: HHs: 60,800,000

As of 2002, an analysis of the sources of credit access to Indian households<sup>53</sup>, the percentage share of institutional providers of credit was around 57.1 percent in rural India and 75.1 percent in urban areas. Of the non-institutional credit sources, moneylenders hold an alarmingly high share of 30 percent in the total indebtedness of rural households. This indicates that banks and other institutional credit suppliers are unable to meet the needs of many households<sup>54</sup>.

It is well known that a large portion of the above households who continue to access expensive, informal credit belongs to the low income segments. Most often, such credit is accessed at exorbitant interest rates, sometimes averaging 48 percent per year<sup>55</sup>. It is in this context that semi-formal interventions such as the SHG-Bank Linkage Program and fast growing MFIs become relevant in the supply of microcredit.

### 3.1 Semi-Formal Providers of Microcredit

Launched in 1991, the SHG-Bank Linkage Program aims to connect low-income and un-banked individuals to formal banks. In its most popular form, NGOs facilitate bank linkages through community mobilization and investments in client capacity building and financial literacy<sup>56</sup>.

In the latter channel, MFIs are localized financial institutions that access social and commercial funds to further on-lend such capital to clients after covering their costs and margins. Their legal constitutions include for-profit, non-profit, and mutual benefit forms.

Some of the key characteristics that distinguish these two channels are shown in the table below:

**Table 10: Microfinance Delivery Channels in India**

Self-Help Group Model	MFI Grameen Methodology
<ul style="list-style-type: none"> <li>• 10-20 members/SHG</li> <li>• Approximately 6 month wait before bank loan disbursed to group</li> <li>• Members must lend internally before receiving first bank loan</li> <li>• Bank loan eventually disbursed to group, which further allocates funds</li> <li>• NGO assists SHG with development initiatives (financial literacy, basic accounting)</li> </ul>	<ul style="list-style-type: none"> <li>• 5-10 members/ Joint Liability Group (JLG)</li> <li>• Average 2 weeks 1 month wait before loan disbursed to group by MFI</li> <li>• MFI allocates funds to individual members</li> <li>• MFI helps conduct weekly meetings for loan disbursement and repayment</li> </ul>

### Microcredit Supply under the SHG-Bank Linkage Program

Data shows that SHG-Bank Linkage microcredit supply has grown tremendously since its implementation in 1991. By March 2003, the SHG channel had reached 11.6 million households with a cumulative loan disbursement of USD 506 million (INR 20.5 billion). Between 2003 and 2007, the SHG channel continued to maintain high growth.

<sup>52</sup>Census 2001

<sup>53</sup>The 59th round of NSSO All India Debt and Investment Survey, Jan- Dec 2003. <http://mospi.nic.in>

<sup>54</sup>Household Indebtedness in India as on 30.06.2002. All India Debt & Investment Survey

<sup>55</sup>RFAS Finance Access Survey 2003 conducted by the World Bank

<sup>56</sup>[http://www.nabard.org/microfinance/support\\_ngo.asp](http://www.nabard.org/microfinance/support_ngo.asp)



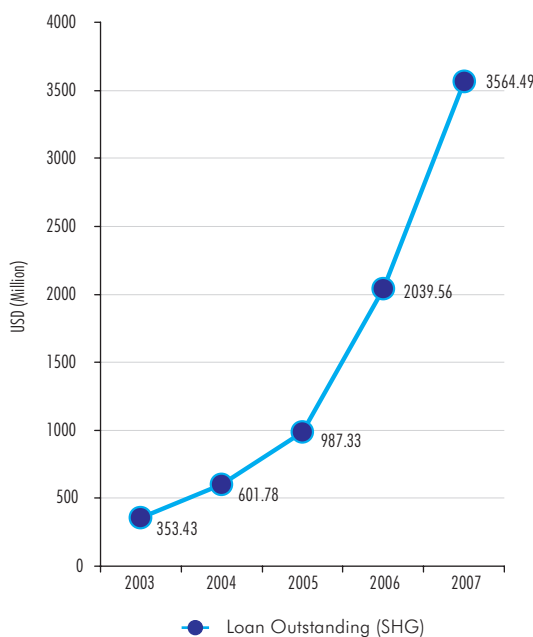
According to NABARD progress reports, as of March 31, 2007, cumulatively, 2.92 million SHGs have been linked to approximately 500 banks. Ten percent of the total banks linked to SHGs were commercial banks, while 19.2 percent and 70.6 percent were regional rural and cooperative banks, respectively<sup>57</sup>. Cumulative loan disbursements to SHGs totaled nearly USD 4.45 billion (INR 180.4 billion) as on March 31, 2007. The progress of annual disbursements under the SHG-Bank Linkage Program during 2003 to 2007 is as follows<sup>58</sup>:

Table 11: SHG Loan Disbursement (2003 - 2007)

USD Million	2003	2004	2005	2006	2007
Cumulative Disbursement	505.85	964.00	1,703.33	2,814.19	4,454.49
Yearly disbursement	170.49	285.85	426.32	1,110.88	1,640.29

Assuming a three year loan repayment period<sup>59</sup>, the SHG outstanding loan portfolio is estimated at USD 354.5 million (INR 14.4 billion) as of March 2007 (See Figure 13). This translates into a 59 percent CAGR between 2003 and 2007.

Figure 13: Estimated Loan Outstanding under the SHG Bank Linkage Channel (2003-2007)



Regionally, SHG supply is greatest in the south. In the 2006-2007 financial year, however, SHG supply realized 55 percent growth in the north, 59 percent in the northeast, 72 percent in the east, 36 percent in central India, 74 percent in western states, and 58 percent in south India<sup>60</sup>.

### Microfinance Delivery Channels

#### Self-help Groups (SHG)

SHGs are typically self-formed groups of 10-20 members who collect six months of savings and disburse loans from that pool of funds before a loan from a bank to which they are linked, is disbursed to them. During this time, the intermediary NGO assists the group in setting up its process and carrying out weekly meetings for loan disbursement and collection. Such lending also contributes to RBI's priority sector lending requirements, which have been stipulated for Indian banks.

#### MFIs

MFIs' primary lending methodology is through the Grameen Methodology, in which four to six members come together to form a group and access a loan. MFIs loan to individuals within the group, however, the entire group is responsible for repaying the loan.

Source: (1) RBI stipulates that domestic and foreign banks operating in India must direct a certain percentage of their advances to certain "priority sectors" including agriculture, small scale industries, small road and water transporters, small business, microcredit, education software, and housing. More details are available at: <http://www.rbi.org.in/scripts/FAQView.aspx?Id=8>.

Sa-dhan: "An Introduction to Microfinance Delivery Models in India." August 2003. Available at <http://www.sa-dhan.net/AdIs/Microfinance/Article/Publications/PerspectivePaperNo3.pdf>

<sup>57</sup> "SHG Bank Linkage Program in India: Highlights as on 31 March, 2007." Available at <http://www.nabard.org/pdf/highlights%200607.pdf>

<sup>58</sup> Progress of SHG-Bank Linkage in India 2005-2006, NABARD & <http://www.nabard.org/pdf/Regional%20spread0607.pdf>

<sup>59</sup> Data on repayment of loans under SHG-Bank Linkage is unavailable. For the purposes of estimating the outstanding portfolio under this channel, we assume an average repayment period of 3 years on the cumulative loan disbursements.

<sup>60</sup> <http://www.nabard.org/pdf/Regional%20spread0607.pdf>



The diagram below shows the percentage of total SHG microcredit supply by region.

Figure 14: SHG Model-wise Linkage (Cumulative as of March 2007)

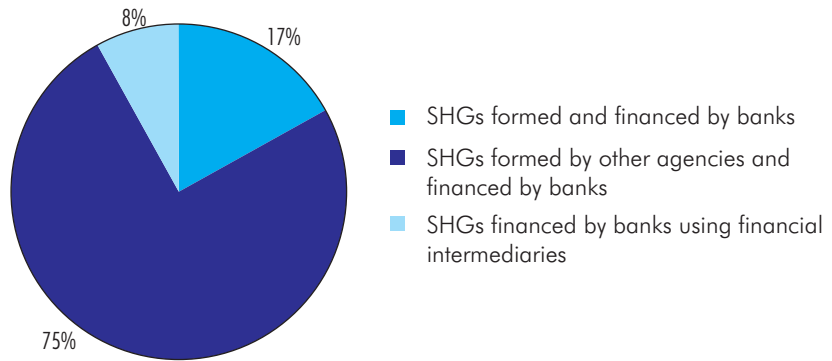


Figure 15: SHG-Bank Linkage: Participating Banks

NABARD's SHG-Bank linkage program has been successful due to the participation of both public and private banks.

**State Bank of India**  
 SHGs linked (Cum. 2006) : 392,494  
 Disbursed (Cum. 2006) : INR 20.473 B

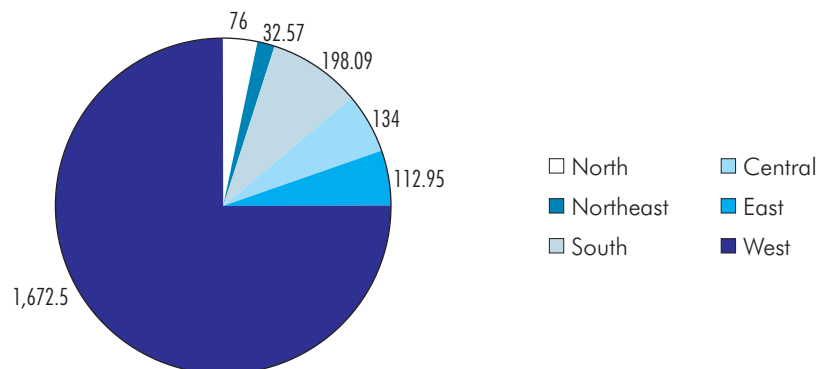


**ICICI Bank**  
 SHGs linked (Cum. 2006) : 17,755  
 Disbursed (Cum. 2006) : INR 4.125 B



Progress of the SHG-Bank Linkage Program in India.

Figure 16: Total SHG Microcredit Supply by Region





### Microcredit Supply by MFIs

In comparison to SHG-Bank Linkage, MFIs are estimated to have disbursed USD 1,729 million (INR 70 billion) to 7.94 million borrowers as of March 2007. Their cumulative outstanding loan portfolio in the same month is estimated to be USD 824 million (INR 33 billion). This translates into impressive CAGRs of 79 percent and 71 percent, respectively, over the last five years. Figures 17 and 18 below plot both Indian MFI borrower and portfolio growth over a five year period.

Disbursements of USD 1729 million (INR 70 billion) to 7.94 million borrowers as of March 2007

Figure 17: Growth in Borrowers under the MFI Channel (2003-2007)

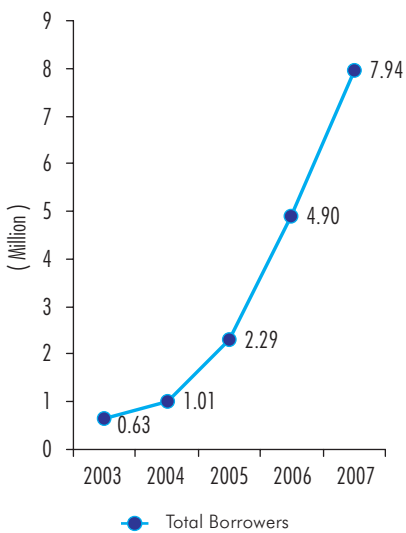
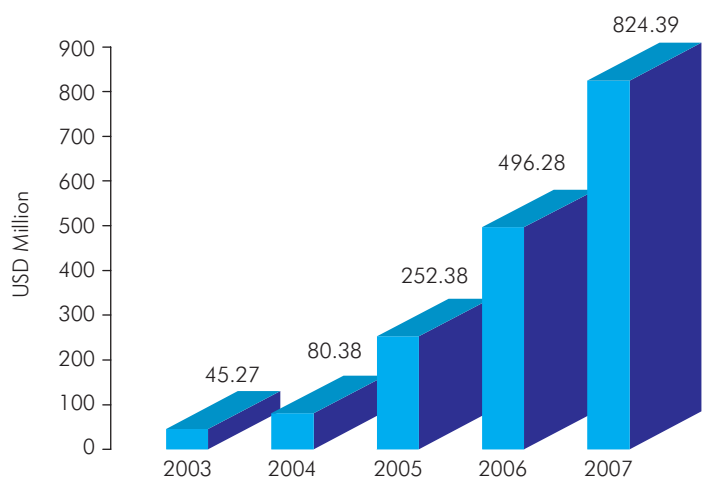


Figure 18: Growth in Outstanding Loan Portfolio under the MFI Channel (2003-2007)



Until 2005, microfinance activity was predominantly concentrated in the south, specifically in Andhra Pradesh. An evolving industry and mindset, which has attracted more attention to Indian microfinance, has however, encouraged both small and large MFIs to begin fulfilling their national aspirations. Many of the larger and growing MFIs have begun to venture out of their home states to reach out to new client segments.

#### Microfinance in the Northeast

Microfinance supply in Northeast India remains low due to various reasons. Society-MFI Grameen Sahara, which operates out of Assam, has found that topography, terrorism, the region's population structure, and natural causes discourage capital providers as well as entrepreneurs interested in starting institutions.

Mr. Sarat, Grameen Sahara's founder, explains that capital is a major constraint as donors, funders, and investors see many problems that could affect repayment. However, without proper financial support, MFIs in the area are unable to build sufficient institutional capacity to recruit and retain the necessary human resources, develop products suitable to the region's conditions and clients' needs, and further efficiency and growth. Mr. Sarat remains optimistic however, as he sees a movement towards better infrastructure, greater awareness, and of the region's large untapped market opportunity. - Intellect Interview with Grameen Sahara



In Table 12 below, we profile select MFIs who have been following a multi-state growth strategy:

**Table 12: MFIs Following a Multi-State Growth Strategy**

MFI	North	South	East & NE	West
BASIX - BSFL	MP, Jharkhand, Rajasthan	AP, Karnataka	Orissa,	Maharashtra
SHARE	MP, Rajasthan	AP, Karnataka		Maharashtra
SPANDANA		AP, Karnataka		
SKS	UP, MP, Chattisgarh, Jharkhand, Rajasthan	AP, Karnataka	Orissa, WB	Gujarat, Maharashtra
ASMITA		AP, Karnataka	Orissa	
Ujjivan	Delhi	Karnataka	WB	
ESAF	Chattisgarh	Kerala, Tamil Nadu		Maharashtra
KAS Foundation	MP, Chattisgarh	Tamil Nadu	Orissa, WB	Maharashtra
CASHPOR	UP, Bihar			
AWARENESS		AP	Orissa, WB	
Bandhan	Bihar, Jharkhand		Assam, Tripura, WB	

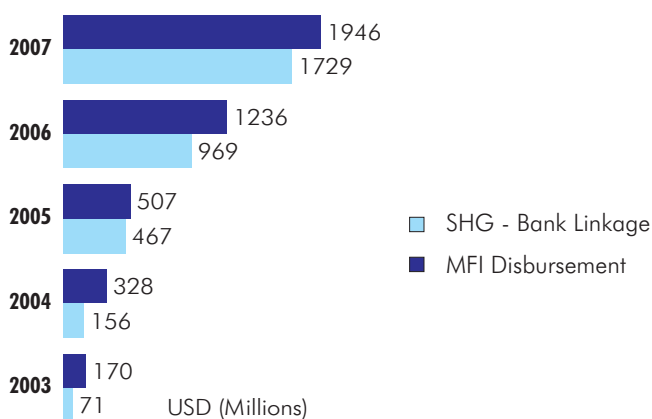
From 28% in 2003, the share of MFI disbursements in total disbursements increased to 47% in 2007

In a parallel trend, many new MFIs have initiated operations in areas such as the northeast and east, where microfinance supply was almost negligible due to infrastructural and political constraints. For instance, FWWB's partners in these regions, who were earlier concentrated in the south, have seen an increase by: nine partners in West Bengal, five partners in Jharkhand, four in Orissa, one in Uttar Pradesh, and one in Assam as of March 2006<sup>61</sup>. The adjacent box profiles one such MFI, Grameen Sahara, which has initiated operations in the northeast.

**Comparing the Two Microfinance Channels: SHG-Bank Linkage Program and MFIs**

It is evident that both SHG and MFI channels have seen a high level of activity within the last few years. As of March 2007, the two channels have collectively disbursed around USD 3.7 billion (INR 149 billion), addressing almost seven percent of our demand estimates of USD 51.4 billion (INR 2.08 trillion). Figure 19 shows the relative increase in disbursements by each channel during the period 2003 to 2007.

**Figure 19: Growth in Cumulative Disbursements by SHG and MFI Channels (2003-2007)**



<sup>61</sup> FWWB: "Annual Report 2005-2006."



The MFI channel is steadily increasing its share in Indian microfinance supply. From 28 percent in 2003, the share of MFI disbursements in total microfinance disbursements has increased to 47 percent. Figures 20 and 21 compare the percentage share of both channels in India's total microfinance disbursements.

Figure 20: Share of SHG-Bank Linkage and MFIs in Microfinance Disbursement (2003)

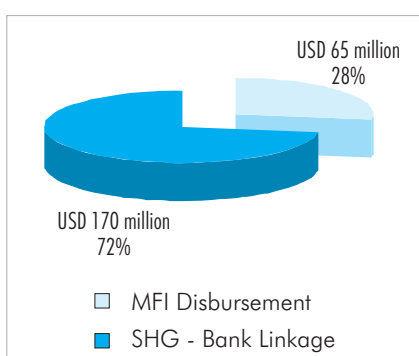
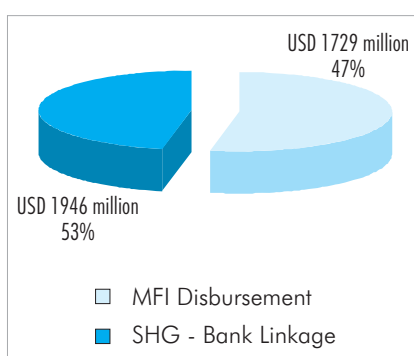


Figure 21: Share of SHG-Bank Linkage and MFIs in Microfinance Disbursement (2007)



In addition, there are instances of NGOs involved in SHG-Bank Linkage program transitioning into a direct on lending MFI model. The key trigger identified by such NGOs is the need for continued access to finance for the SHGs promoted by them.

### Supply of Microfinance Services in Addition to Credit

While credit has been the primary product offered to microfinance clients since the start of microfinance, the industry is increasingly finding ways to provide additional services such as savings, insurance, remittances, and pensions. While the proposed Microfinance Bill 2007 may determine whether or not savings can be formally collected, an increasing number of partnerships could advance the industry in terms of other services. Increasing migration within and outside of India necessitate remittance services for low-income individuals. Insurance and pensions also remain important in order to address unexpected events and risks as well as the needs of elder low-income individuals.

#### Box 4: SHG Facilitator to Micro-Lender: ASA, Bhopal

'Cost of credit and receipt of actual credit are two main areas which accounts for the difference between SHG-Bank Linkage and the direct lending through an MFI model. SHG-Bank Linkage model makes available credit at a cheaper rate but actual credit delivery is not certain, while in direct on-lending model it is vice versa. Since our main credit portfolio is agriculture, timely credit is imperative and formed the primary reason which drove us for the change.'

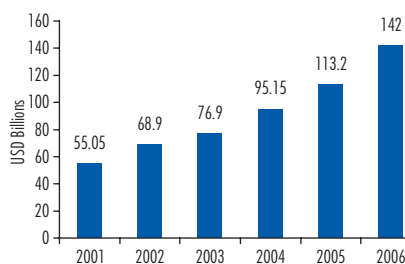
-Mr. Ashish Mandal

Mr. Mandal is the Founder of Activists for Social Action (ASA), an NGO in Bhopal, Madhya Pradesh focused on rural development. In 2006, ASA, who had been following the SHG-Bank Linkage strategy, initiated a direct on lending model, with expectations of better control over the flow of credit to the SHGs.

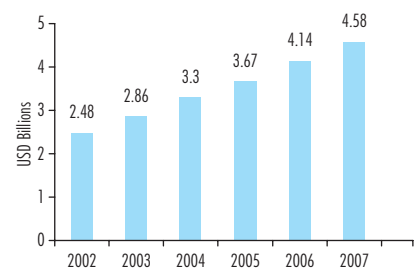


**Savings:** One of the ways to measure India's level of savings is its number of savings accounts. The figures 22 and 23 below present information on a) the cumulative growth of such accounts since 2000, and b) small savings such as deposits through post office schemes, which may be more representative of savings accounts for lower-income individuals:

**Figure 22:** Number of Savings Deposits with Commercial Banks



**Figure 23:** Outstanding Post Office Savings Deposits 2002-2007



Source: <http://rbidocs.rbi.org.in/rdocs/Bulletin/PDFs/79857.pdf>

Post offices are a possible channel savings facilitator in regions where physical infrastructure or bank branches is lacking or limited. As shown in the graph above, post office schemes are generally for small savings, which have flexible withdrawal features.

The Microfinance Bill, if passed in its current form, may have potential implications on savings, as it facilitates NGO-MFIs in offering savings facilities to clients<sup>62</sup>. Such MFIs should be registered as non-profits or Section 25 companies, which can also become agents for banks that are offering savings through the banking correspondent model.

**Insurance:** Insurance supply to low-income segments is difficult to measure in India. However, as a percentage of GDP in 2006-2007, it is reported that general insurance accounted for three percent while life insurance accounted for 1.8 percent<sup>63</sup>. Further, at the beginning of 2006, life insurance providers "underwrote premiums of USD 7.3 billion (INR 296.6 billion)" while non-life insurers "underwrote a premium of USD 3.05 billion (INR 123.7 billion)." The current insurance penetration scenario is an improvement over the level of life insurance penetration in 2005 at 2.53 percent and 0.62 percent for non-life insurance<sup>64</sup>.

**Table 13: Number of Registered Insurers in India (2006-2007)<sup>65</sup>**

Type of Business	Public Sector	Private Sector	Total
Life Insurance	1	15	16
General Insurance	6	9	15
Re-insurance	1	0	1
Total	8	24	32

**BASIX**  
Insurance Services



MFI BASIX in Andhra Pradesh provides insurance services that cover health and livelihoods risks including death and disability, weather, livestock, and microenterprise asset insurance.

Clients pay a monthly installment to BASIX which typically ranges from USD 5.9 to USD 11.85. By year-end 2006, BASIX was able to cover approximately 450,000 clients.

Source: BASIX 2006-2007 Annual Report pg. 33.

<sup>62</sup>"Micro Financial Sector (Development and Regulation) Bill 2007." Bill No. 41 of 2007. March 2007.

<sup>63</sup>[http://www.ibef.org/industry/insurance\\_industry.aspx](http://www.ibef.org/industry/insurance_industry.aspx)

<sup>64</sup>IRDA Annual Report 2005-2006. <http://www.irdaindia.org/>

<sup>65</sup>IRDA Annual Report 2005-2006. <http://www.irdaindia.org/>



## A DROP IN THE OCEAN: THE SUPPLY SIDE STORY

With a large number of mainstream life and general insurance providers, there is increasing potential for MFIs to tie up with such entities to offer insurance services to lower-income clients. The 2005 microinsurance regulation stipulates that NGOs, MFIs, and SHGs can act as agents to distribute insurance to their clients.

**Remittances:** With approximately USD 25.7 billion (INR 1.04 trillion) in remittances flowing into India in 2006, it is important to understand the entities that are able to service such inflow. As of June 2006, approximately “Eighty-seven commercial banks [were] designated as authorized dealers, while there [were] 53 Money Transfer agents.” Remittances are also transferred through a number of informal agents including “unregistered entities such as hawala dealers, returning migrants, friends, relatives and trading companies. Designated post offices can also receive remittances<sup>66</sup>.” With growing low-income client bases, MFIs can play an important role in providing remittance services to their clients. An initiative in this direction is the partnership forged between Western Union Money Transfer and Spandana<sup>67</sup>.

**Pensions:** Sufficient data to determine pensions supply to low-income individuals or microfinance clients is currently unavailable. However, the industry has recently witnessed UTI, a mainstream mutual fund taking an active role in the provision of micropensions. Following the launch of the scheme with SEWA Bank<sup>68</sup> in early 2006, UTI added new partners such as SHEPHERD, a southern MFI, and Compfed, a Bihar based milk producers' federation.

While both the MFI and SHG channels are making progress, it has become clear that combined, their efforts are barely touching the surface. In absolute terms, the SHG channel has spurred greater outreach. However, with 28 percent disbursement in 2003 to 47 percent in 2007, MFIs are clearly reaching out to a larger client base within shorter time periods. Further, although poverty appears highest in the northeast, east, and central regions, it is evident that there is a movement towards tapping into the market potential and filling the demand-supply gap of those regions. Traditional services combined with the market for insurance, remittances, and pensions, which are currently small in supply, show good growth, but even more potential for the future industry.



**WESTERN UNION**

### SPANDANA - Western Union

#### Money Transfer Scheme

In May 2007, MFI SPANDANA partnered with Western Union, a money transfer services provider, to facilitate inward remittances receipt among SPANDANA's clients in peri-urban and rural areas. The scheme will reach out to 1 million people in Andhra Pradesh, and later extend into the neighboring states of Karnataka, Tamil Nadu, Orissa, and Maharashtra.



### SEWA - UTI Micropension Scheme

In early 2006, SEWA Bank partnered with the Unit Trust of India (UTI) to start a micro pension scheme. SEWA will collect small contributions from its members that is transferred to UTI, which will open individual retirement accounts, “from where cash will be invested in debt and equity.” Through this vehicle, members are able to invest in the India stock market. The scheme is already reported to have attracted close to 25,000 members.

<sup>66</sup><http://www.imf.org/external/np/sta/bop/2006/luxgrp/pdf/india.pdf>

<sup>67</sup><http://www.microfinancegateway.org/content/article/detail/40476>

<sup>68</sup><http://www.sewabank.com/uti-sewa-bank-pension.htm#>



## Chapter 4

### Indian MFIs: On the Sustainability Path



With almost 47 percent market share in Indian microfinance supply as of March 2007 and substantial movement towards viability and sustainability, MFIs are emerging as major players in Indian microfinance. In the last five years for instance, they have demonstrated both strong financial performance and increasing efficiency. In this section, we therefore discuss the growth and performance of a sample of 60 Indian MFIs over the past five years. The list of participating MFIs is provided in Appendix 1.

To facilitate our analysis, Indian MFIs were divided into three Tiers based on their portfolio size. Table 14, below, contains the classification parameters of each MFI tier.

**Table 14: Classification of Intellecap Sample MFIs by Tiers**

Tier	Portfolio Size (USD)	Portfolio Size (INR)	Generic Characteristics of the Tier
1	> 25 M	>1000 M	<ul style="list-style-type: none"> <li>• Large institutions</li> <li>• Established track-records</li> <li>• Mostly for-profit forms</li> <li>• High profitability</li> <li>• Early signs of diversification</li> </ul>
2	7.5 M-25 M	300 M-1000 M	<ul style="list-style-type: none"> <li>• Early growth stage</li> <li>• Started generating profits</li> <li>• Mostly non-profit forms, which are considering transformation into a for-profit form</li> <li>• Rapidly scaling with single product</li> </ul>
3	< 7.5 M	< 300 M	<ul style="list-style-type: none"> <li>• Start-up and early growth stage</li> <li>• Low ability to leverage funding</li> <li>• Incurring early stage losses</li> <li>• Mix of non-profit forms finding difficulty in scaling up and rapidly scaling up for-profit forms</li> </ul>

This chapter analyses the growth and financial performance of 60 Indian MFIs in the Intellecap sample

According to the above categorization, the distribution of MFIs in the sample is as presented in Table 15.

**Table 15: Distribution of Intellecap Sample MFIs by Tier**

Category	Tier 1 (> USD 25 M)	Tier 2 (USD 7.5M-USD 25 M)	Tier 3 (USD <7.5 M)
No. of MFIs	9	13	37

Data collection was facilitated through a questionnaire containing quantitative and qualitative data variables. We collected quantitative data on variables such as financials, growth figures and loan sizes, while qualitative data included variables such as legal forms, loan types, and geographic focus. The study sample covers the top nine Indian MFIs with portfolios above USD 25 million within the Tier 1 segment and all 13 Indian MFIs with portfolio sizes between USD 7.5 million and 25 million in the Tier 2 segment. Of those MFIs with portfolio sizes less than USD 7.5 million<sup>69</sup>, a sample of 37 was included in the study. Data on select MFIs was triangulated with data from www.mixmarket.org

<sup>69</sup>While no single database of all MFIs in India exists, estimates suggest there could be as many as 800-1000 MFIs in the country. Intellecap estimates that many of these MFIs are likely to hold loan portfolios less than USD 1,250,000.



The distribution of the MFIs in the sample by legal form is presented as Table 16.

Table 16: Distribution of Intellecrap Sample MFIs by Legal Form

Society	Trust	Co-op	Section 25	LAB	NBFC
27	6	3	3	1	20

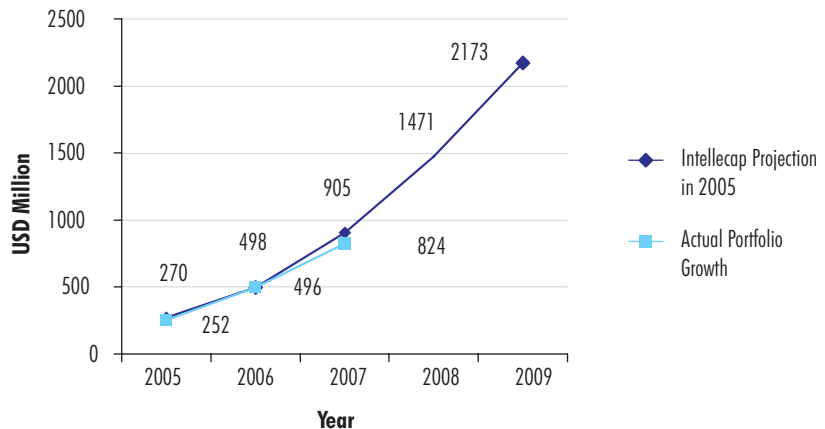
The objective of the analysis was to understand the status and trends in the growth, profitability, and efficiencies of the sample set of MFIs. Variations across tiers and legal forms were studied to gather insights on their effect on the performance of the MFIs. This analysis forms the basis of Intellecrap's projections on the future direction for growth of Indian MFIs over the next five years as presented in Chapter 5.

#### 4.1 Intellecrap Projections in 2005 versus Actual Portfolio Growth

In 2005, Intellecrap made projections on the growth and financing capital requirements of Indian MFIs between 2005 and 2010<sup>70</sup>. Based on a sample of 40 MFIs, it projected a cumulative portfolio of USD 905 Million (INR 36.6 Billion) by March 2007 for Indian MFIs. In comparison, the Indian MFIs are estimated to have recorded a portfolio of USD 824 Million (INR 33.4 Billion). This includes a cumulative portfolio of USD 769 Million (INR 31.1 Billion) reported by the 60 sample MFIs participating in the 2007 update and an additional USD 56 Million which is assumed to be a conservative estimate for cumulative portfolio of those Tier 3 MFIs who were not part of the 2007 update. The estimate of USD 56 Million assumes the existence of 250 additional Tier 3 MFIs with average borrowers of 5000, average loan size of INR 3000. The progress of the Indian MFIs over the period 2005 to 2007 is presented as Figure 24 below:

Actual growth rates closely mirrored Intellecrap projections done in 2005

Figure 24: Intellecrap Projections versus Actual Portfolio Growth (2005-2007)





As predicted in the 2005 report, the ongoing supply of commercial debt funds by domestic banks and emergence of additional equity funds focused on India has had a key role to play in making the predicted growth happen. In Section 4.2, we delve deeper into the growth demonstrated by the 60 sample MFIs during the period 2003-2007 and in Chapter 5 we re-look at the predictions made in 2005 and revise them slightly based on current market trends and some key assumptions on future.

### 4.2. 2003-2007 Consistent, Impressive Growth

- .....Reaching out to their clients faster with higher loan sizes
- .....High CAGRs across tiers and legal forms
- .....For profit legal forms i.e. NBFCs show higher utilization of assets

Between 2003 and 2007, the 60 sample MFIs increased their outreach of 0.76 million clients to 9.76 million clients. In the same period, the active borrowers grew from 0.46 million to 6.69 million. This translates into a loan portfolio of USD 769 million (INR 31.14 billion) and assets of USD 915 million (INR 37.05 billion) by March 2007<sup>71</sup>. The industry recorded impressive CAGRs of 71 percent, 79 percent, and 76 percent in its client base, portfolio size, and assets, respectively.

...impressive CAGRs of 71 percent, 79 percent, and 76 percent in its client base, portfolio size, and assets, respectively

Figure 25: Growth in Portfolio of Intellectap MFI Sample (2003-2007)

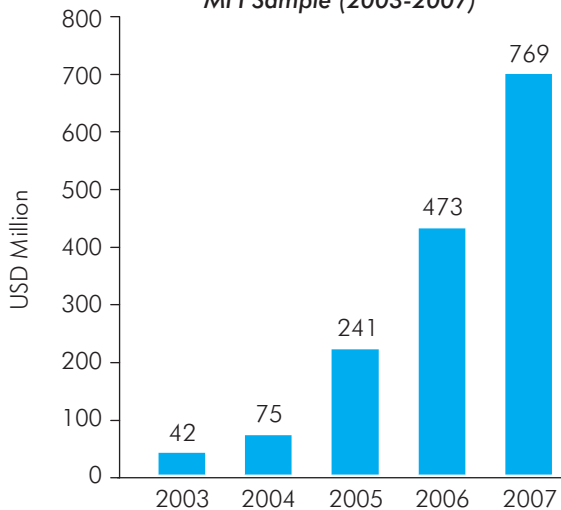
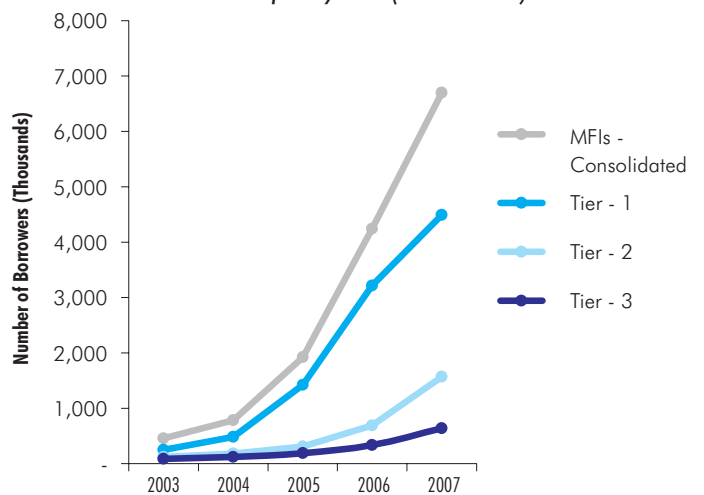


Figure 26: Growth in Borrowers of Intellectap MFI Sample by Tier (2003-2007)



<sup>71</sup>Loan portfolio includes both owned and managed portfolio.



Indian MFIs show higher asset utilization and greater outreach than the MBB sample MFIs

A comparison of Indian MFIs against a sample of Asian MFIs in terms of average assets, loan portfolio and borrowers is presented in Table 17. This comparison is between 42 Indian MFIs from the Intellectap sample and 50 Asian MFIs featured in the Micro Banking Bulletin (MBB)<sup>72</sup> for 2005.

**Table 17: Intellectap Sample Averages Compared to MBB Averages (2005)**

	MBB Sample, Asia	Intellectap Sample, India
Total Assets (USD M)	7.13	6.36
Loan Portfolio (USD M)	5.10	5.73
Active Borrowers	32869	45822
Portfolio/Assets Ratio	76%	89%
Average Loan Outstanding (USD)	121	204

In comparison to its Asian counterpart, an average Indian MFI shows high asset utilization and an ability to service a higher number of clients with a high average loan size. The above factors seem to help Indian MFIs to cater to a high proportion of their clients with a relatively lower asset base.

**Table 18: CAGRs of Intellectap Sample for Portfolio, Assets, and Borrowers (2003-2007)**

	Loan Portfolio	Total Assets	Total Borrowers
Consolidated	79%	76%	71%
Tier 1	81%	80%	78%
Tier 2	79%	73%	67%
Tier 3	72%	66%	48%

Tier 1 MFIs constituted 67 percent of the total MFI portfolio and recorded an 81 percent portfolio CAGR

With nine MFIs, the Tier 1 category, contributed heavily to the above growth. As of March 2007, they held a portfolio of USD 515 million (INR 20.85 billion) constituting 67 percent of the total MFI portfolio, while recording an 81 percent portfolio CAGR. This portfolio was built on an active borrower base of 4.5 million, which grew by 78 percent during the last five years. Seven of the nine MFIs in this category are NBFCs, which leveraged<sup>73</sup> their high equity base to access on-lending funds and generate economies of scale. A key factor contributing to high leverage among Indian MFIs, particularly those in the Tier 1 category, is the high proportion of managed portfolio in their operations<sup>74</sup> compared to owned portfolios. High average disbursement amounts, which increased from USD 161 to USD 201 (INR 6,520 to INR 8,140) during the period, also contribute to portfolio growth. 2003 to 2007 average loan size behavior across tiers is presented as Appendix 5. Additionally, Tier 1 MFIs show a large proportion of active borrowers in their client base and a high portfolio to assets ratio (Refer Figure 27 and 28).

<sup>72</sup>Micro Banking Bulletin (MBB): "Trend Lines 2003-05 MFI Benchmarks." Issue No. 14, Spring 2007. Available at: <http://www.mixmbb.org/en/>.

<sup>73</sup>Leverage is calculated as: (on-lending funds including savings)/equity

<sup>74</sup>'Managed portfolio' refers to off balance sheet lending carried out by MFIs on behalf of banks (e.g. under the partnerships model initiated by ICICI Bank). In such a model, the microloans are originated in the bank's books while the MFI acts as the facilitator and servicer of the loans for a service fee. In the case of certain Tier 1 MFIs, the proportion of managed portfolio to total portfolio is as high as 45 percent. Source: Financial statements of Tier 1 MFIs and Intellectap discussions with MFIs' senior management.



Figure 27: Share of Each Tier in Total MFI Sample Portfolio (2007)

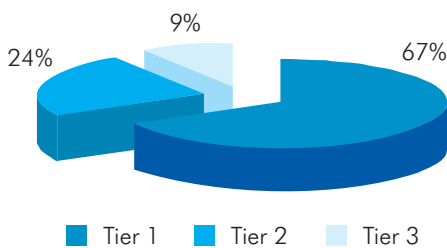
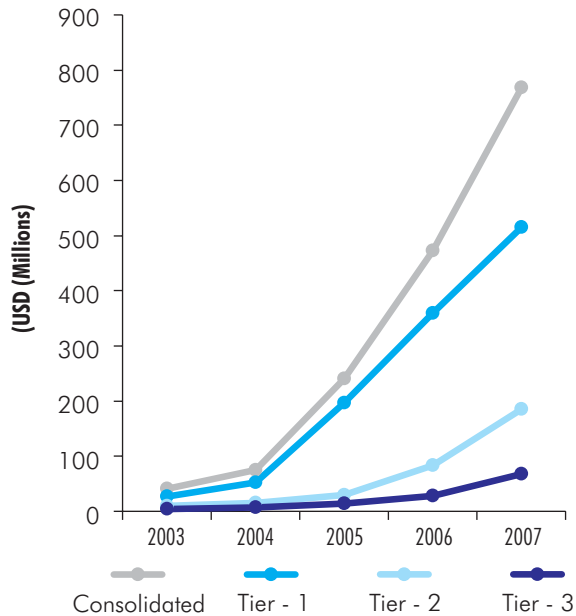


Figure 28: Growth in Portfolios of Intellectap Sample MFIs by Tier (2003-2007)



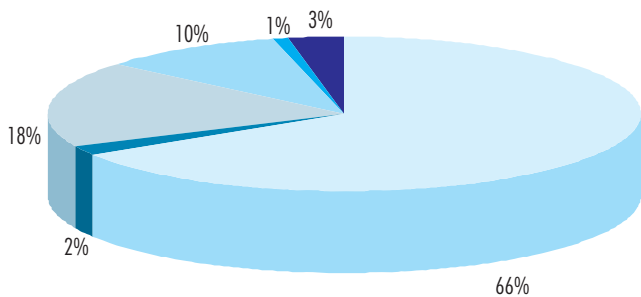
In comparison to Tier 1 MFIs, Tier 2 and Tier 3 MFIs witnessed lower portfolio and client growth rates. As of March 2007, Tier 2 MFIs held a portfolio of USD 186 million (INR 7.53 billion) constituting 24 percent of the total MFI portfolio and recorded a fairly high portfolio growth rate of 79 percent. Tier 3 MFIs held a portfolio of USD 67 million (INR 2.71 billion) constituting the remaining nine percent of the total portfolio and recorded a relatively lower growth rate of 72 percent. The average disbursement amounts for Tier 2 and Tier 3 MFIs were USD 195 (INR 7,900) and USD 170 (INR 6,885), respectively, in 2007. Unlike Tier 1 MFIs, the majority of Tier 2 and Tier 3 MFIs show a large proportion of inactive borrowers in their client base and lower portfolio to asset ratios, a possible indication of their inability to continually access commercial funds. In comparison to Tier 1 MFIs, Tier 2 and Tier 3 MFIs had relatively lower levels of internal accruals and hence a lower equity base with which to leverage on-lending funds. In addition, many Tier 2 MFIs record losses in their initial years possibly because of their investments in building up their operations.

NBFCs constituted 66 percent of the total MFI portfolio, followed by societies at 18 percent and trusts at 10 percent

As of March 2007, NBFCs constituted 66 percent of the total MFI portfolio, followed by societies at 18 percent and trusts at 10 percent (Refer Figure 29) . Of the current NBFC MFIs, many were societies and trusts before they adopted a for-profit legal form. Following a similar path, many existing societies and trusts are exploring transformation into NBFCs.

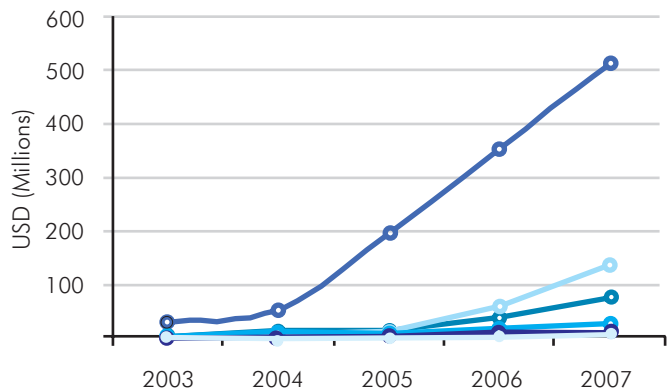


Figure 29: Share of Each Legal Form in Total Sample MFI Portfolio (2007)



□ NBFC ■ Co-Operative □ Society □ Trust ■ LAB ■ Section 25

Figure 30: Growth in Portfolios of Sample MFIs by Legal Form (2003-2007)



■ NBFC ■ Trust □ LAB □ Society ■ Section 25 ■ Co-Operative

### NBFCs, societies and trusts recorded CAGRs higher than MFIs with other legal forms

In line with the above trend, NBFCs, societies and trusts recorded CAGRs higher than MFIs with other legal forms. Despite their high portfolio base, most Tier 1 NBFC MFIs show an exceptional growth rate of 78 percent. High levels of access to commercial funds and high average loan disbursement amounts have contributed to high growth. Appendix 5 presents the upward growth in average loan disbursement amounts by legal forms between 2003 and 2007. Backed by commercial funding, NBFCs were able to create a high borrower base and maintain a high portfolio to assets ratio. With debt of Indian MFIs at 10-14 times equity, they enjoy much higher leverage than their global counterparts. However, they will need equity to move into their next growth phase. SKS Microfinance, for example, was able to access commercial equity in 2006-2007, which will further help them leverage commercial on-lending funds in the future.

Both societies and trusts exhibit very high growth rates. Societies achieved 98 percent portfolio growth with leverage of 18 times their equity capital, while trusts recorded 84 percent portfolio growth, leveraging their equity base 23 times. However, their relatively low equity base (donated equity) may be insufficient for them to continue such high leverage rates in the future; a potential impetus for exploring a regulated, for-profit legal form (e.g. NBFC). In addition, many of the societies currently access savings although there is a visible decline in the proportion of savings<sup>75</sup> in their financing mix. When compared to NBFCs, societies, trusts, and cooperatives show lower portfolio to asset ratios in the range of 60-80 percent. This indicates the potential for improving efficiency in their growth pattern.

Cooperatives and the Local Area Bank recorded high leverage of seven times equity in 2007, a substantial portion of this coming from low cost savings. LAB finances 56 percent of its assets with savings mobilized from its clients.

<sup>75</sup>Details presented and discussed further in Figure 43 in Chapter 5

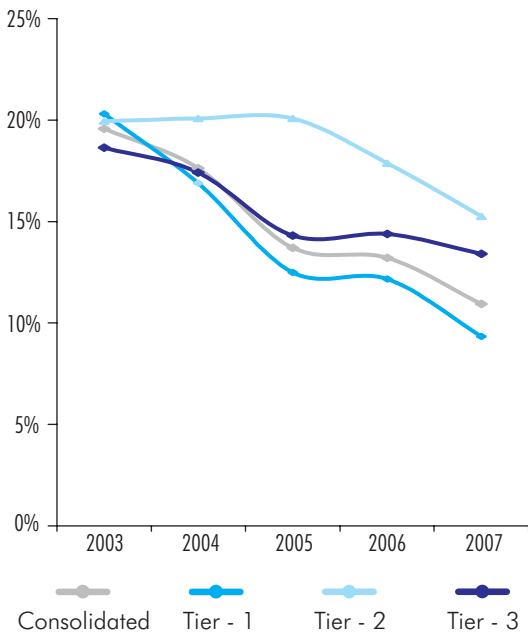


**4.3 Rising Efficiency in Loan Operations (2003-2007)**

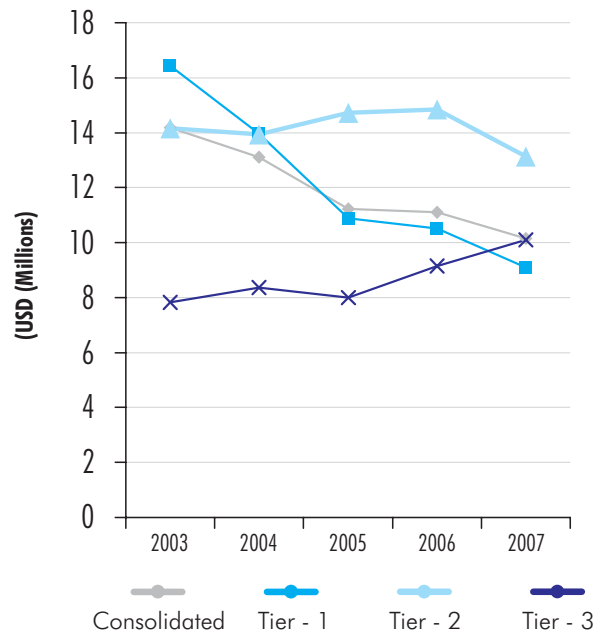
- .....Reaching out to their clients at lower costs
- .....Operating Cost Ratio decreased from 20 percent to 11 percent
- .....Cost per borrower decreased from USD 14 to USD 10

Between 2003 and 2007, Intellectap's MFI sample demonstrated improvement in their operating efficiencies. The sample's operating cost ratio decreased from 20 percent in 2003 to 11 percent in 2007. During the same period, the cost per borrower for the sample came down from USD 14 to USD 10.

**Figure 31: Operating Cost Ratio of Sample MFIs by Tier (2003- 2007)**



**Figure 32: Cost per Borrower of the Sample MFIs by Tier (2003-2007)**



Indian MFIs show higher efficiency when compared to the Asian MBB MFIs' cost averages. The operating cost ratios and cost per borrower across the MBB and Intellectap samples for 2005 are presented in Table 19.

**Table 19: Intellectap Sample's Cost Averages Compared to MBB (2005)**

	MBB Sample, Asia	Intellectap Sample, India
Operating Cost Ratio	19%	14%
Cost per Borrower (USD)	29	11

Indian MFIs show higher efficiency when compared to the Asian MBB MFIs' cost averages.

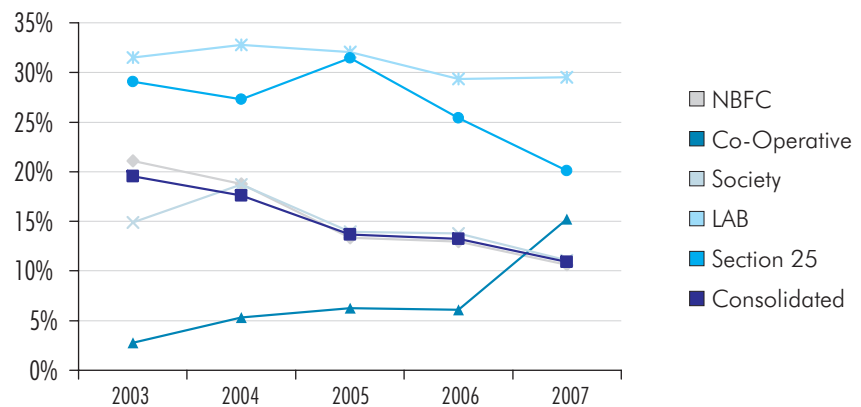


Tier 1 MFIs demonstrated a substantial decrease in their operating cost ratio from 20 percent to nine percent.

Between 2003 and 2007, Tier 1 MFIs demonstrated a substantial decrease in their operating costs ratio from 20 percent to nine percent. Over time, they have reduced the cost of servicing their borrowers, which is reflected in the decline of their cost per borrower from USD 16 to USD nine. Rising loan sizes, standardized processes, and their ability to reap the benefits of growing economies of scale, have contributed to this decline. While Tier 2 MFIs have also managed to bring down their operating costs ratio from 20 percent to 15 percent, their cost per borrower saw a marginal decline from USD 14 to USD 13. Their relatively low active borrower to client ratio likely indicates their inability to serve a large segment of their registered client base. While this is a generic trend across Tier 2 MFIs, it is important to note that the ratio is highly influenced by three MFIs: AWARENESS, Sarvodaya Nano Finance Limited, and BWDA who show high inactive client bases.

In comparison, Tier 3 MFIs show a decline in operating cost ratio from 19 percent to 13 percent and a rise in cost per borrower from USD 8 to USD 10. This is perhaps due to the presence of a large number of societies and trusts that maintain a relatively low proportion of active borrowers in their client base and are too young to reap the benefits of scale.

Figure 33: Operating Cost Ratio of the Sample MFIs by Legal Form (2003-2007)



NBFCs and Societies have improved on their operating cost ratios to bring them down to around 11 percent

An analysis across legal forms shows that NBFCs and Societies have improved on their operating cost ratios to bring them down to around 11 percent. NBFCs show a decline in their cost per borrower from USD 17 (INR 688) in 2003 to USD 11 (INR 445) in 2007. The societies maintained their cost per borrower at a relatively low figure of USD 8 (INR 324). Both NBFCs and societies are largely present in the Tier 1 category and enjoy high economies of scale. Trusts, though showing a decline in their operating cost ratio from 11 percent to 8 percent, saw an increase in cost per borrower from USD 5 (INR 202) to USD 9 (INR 364), which can be attributed to the relatively low proportion of active borrowers in their client base. Section 25 Companies and the Local Area Bank show relatively high operating cost ratios of 20 percent and 30 percent respectively, although the ratios show a decline over the period. Consistent with this trend, the LAB's cost of servicing a



borrower is fairly high at USD 32 (INR 1296) although it has shown a declining trend over the last five years. Co-operatives show an increase in the operating cost ratio from three percent to 15 percent and an increase of cost per borrower from USD 2 to USD 16. This segment's trend is largely attributable to an outlier, AMMACTS, which reports a very low operating costs ratio averaging around four percent.

**4.4 Rising Returns, Lower Portfolio Yields, and High Leverage (2003-2007)**

- .....Increasing efficiencies and returns with rising scale
- .....Yield on portfolio decreasing over time
- .....Increasing financial leverage across tiers

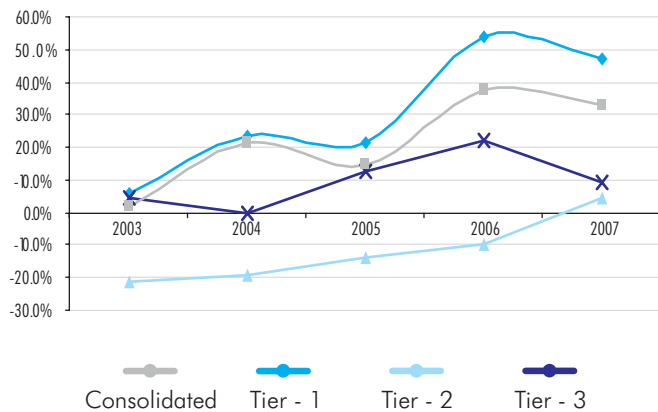
Intelcap sample MFIs demonstrate increasing returns with increase in scale. The ROA for the sample rose from 0.57 percent in 2003 to 2.65 percent in 2007 and corresponding ROEs increased from 2.2 percent to 33.2 percent. Figures 34 and 35 presents the ROA and ROE trends by MFI tiers for 2003 to 2007.

High operational efficiencies help Indian MFIs maintain healthy margins even while reducing portfolio yields

**Figure 34: Return on Assets of Sample MFIs by Tier (2003-2007)**



**Figure 35: Return on Equity (ROE) of Sample MFIs by Tier (2003-2007)**





The rising efficiency discussed earlier, in terms of declining operating costs, is a major contributor to the rising profitability. As a result, the average profit margin of 0.56 percent in 2003 maintained by the sample MFIs increased to 2.56 percent in 2007. In addition, the rising efficiency have helped the sample MFIs reduce their average yield from 32 percent in 2003 to 24 percent in 2007. Figures 36 and 37 plots the behavior of average profit margin and yield on portfolio across the three tiers between 2003 and 2007.

Figure 36: Profit Margin of Sample MFIs by Tier (2003-2007)

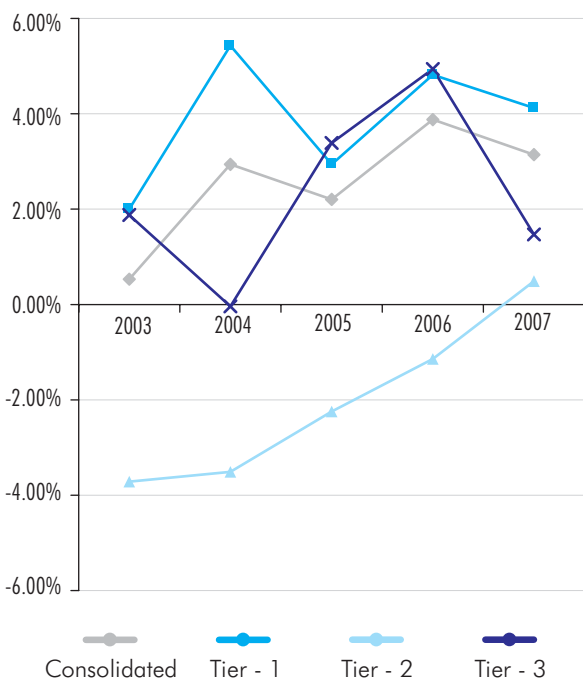
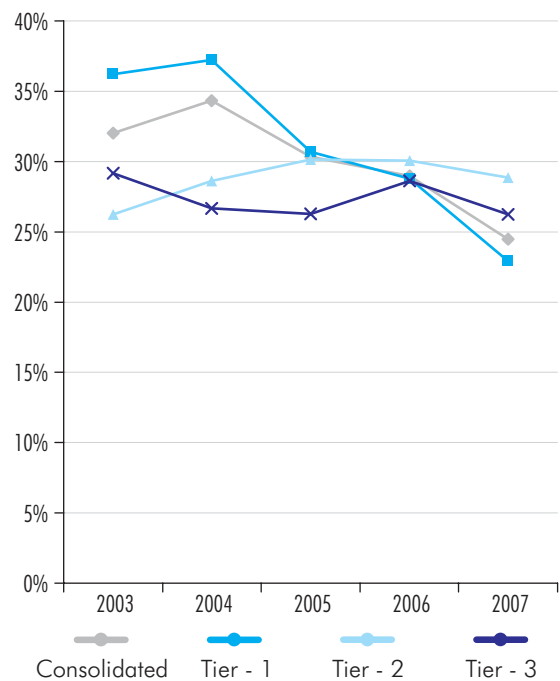


Figure 37: Yield on Portfolio of Sample MFIs by Tier (2003-2007)



Average ROE of Indian MFIs was 15.8% when compared to 10.8% of MBB sample.

In 2005, Indian MFIs were more profitable than their Asian counterparts. The return on equity for Indian and Asian sample MFIs stood at 15.8 percent and 10.8 percent, respectively. The high return on equity highlights the higher leverage realized by Indian MFIs. In 2005, the average debt -equity ratio for an Indian MFI was 7.5 when compared to a relatively low 2.9 for the MBB Asian sample<sup>76</sup>. With a marginally higher yield on portfolio when compared to the MBB sample, Indian MFIs exhibit a healthy profit margin of 2.37 percent. In comparison, the Asian sample presents an average profit margin of 1.3 percent.

Table 20: Intelicap Sample's Profitability Ratios Compared to MBB (2005)

	MBB Sample, Asia	Intelicap Sample, India
Return on Assets	2.4%	2.08%
Return on Equity	10.8%	15.8%
Profit Margin (after tax)	1.3%	2.37%
Yield on Portfolio	29.3%	30.7%



Tier 1 MFIs mirror the trends in the consolidated MFI sample with a rise in average ROA, ROE and profit margin over the last five years. Tier 1 MFIs saw a rise in ROA from 1.8 percent to 3.6 percent, a rise in ROE from 6.4 percent to 47.6 percent and an improvement in its margin from 2.2 percent to 4.2 percent. They were able to bring down their yield from 36 percent to 23 percent and reduce their interest rates to clients. In addition to the increasing efficiency and decreasing costs, a key factor contributing to this performance is the high leverage they have maintained during the period as discussed earlier. Starting with a debt-equity ratio of 3.18 in 2003, Tier 1 MFIs show a leverage of 10.72 by 2007. In 2006, the same was as high as fourteen. The relatively high proportions of managed portfolio maintained over the period could be one of the reasons why the MFIs attained such leverage. In a parallel trend, Tier 1 MFIs show a decline in their financing costs from 12 percent in 2003 to seven percent in 2007, again attributable to the high proportion of managed portfolio<sup>77</sup>. Another reason for this could be the rise in internal accruals, which brings down the need for external borrowings. However, given such high leverage, Tier 1 MFIs will require additional equity capital in the near future<sup>78</sup>.

Starting with a debt-equity ratio of 3.18 in 2003, Tier 1 MFIs enjoyed a leverage of 10.72 times by 2007.

Figures 38 and 39 show the behavior of debt-equity ratios and financing cost ratios of the Intellectap sample by tiers.

Figure 38: Debt Equity Ratios of Sample MFIs by Tier (2003-2007)

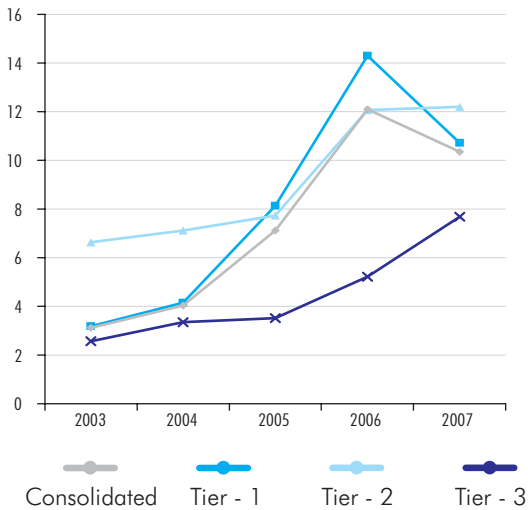
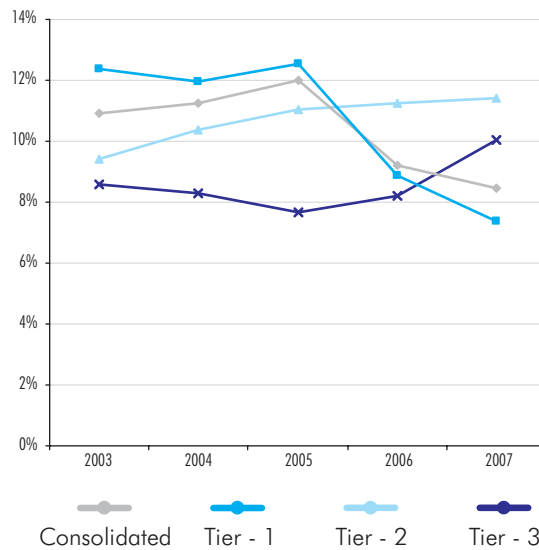


Figure 39: Financial Cost Ratio of Sample MFIs by Tier (2003-2007)



<sup>77</sup>Certain MFIs who hold portfolio under the partnership model, record the interest margin earned as net income after deducting the interest due to ICICI. To that extent, the interest payment to ICICI is usually not recorded in the profit and loss statement. Therefore, the financing costs are understated.

<sup>78</sup>This analysis excludes analysis on any developments post March 2007. Two of the Tier 1 MFIs, SHARE and Spandana, had equity infusions into their capital structure in the financial year 2007-2008.



Tier 2 MFIs need equity, critical to leverage debt and support growth

Tier 2 MFIs, in comparison, show a similar decline in costs but an increase in financing costs and yields. They have seen a rise in their ROA from -2.3 percent to 0.4 percent between 2003 and 2007 and a rise in ROE from -20.4 percent to 5.1 percent during the same period. Similar to Tier 1 MFIs, they have leveraged their equity capital (including grants) to access commercial bank funds, recording a debt-equity ratio of 12 in March 2007. An additional reason for the rise in financing costs is the decline in the proportion of savings, a low cost source of funds in the total financing mix for many of the Tier 2 societies. Also, unlike Tier 1 MFIs, the MFIs in this segment were incurring losses until recently and therefore do not have substantial internal accruals. To capitalize on their leverage and reduce their yields, many of them may need an equity infusion in the short term, which is a clear stimulus for transformation into a for-profit form.

Early growth stage Tier 3 MFIs are relatively less leveraged at 7.7 times equity. Their financing costs have shown an increase and the role of savings in their capital structures is diminishing. While some of the MFIs in this segment are incurring losses, there are some young for-profit NBFC MFIs, which are leveraging commercial equity to access commercial capital.

Figures 40 and 41 presents portfolio yield and profit margin for sample MFIs by legal form. NBFCs, the best performers in terms of profitability, mirror the financial performance of Tier 1 MFIs largely on account of their substantial representation in this segment. In addition to a substantial reduction in operating costs as discussed earlier, NBFCs show an increase in their profit margin, rising from 3.7 percent in 2003 to 6.0 percent in 2007.

Figure 40: Yield on Portfolio of Sample MFIs by Legal Form (2003-2007)

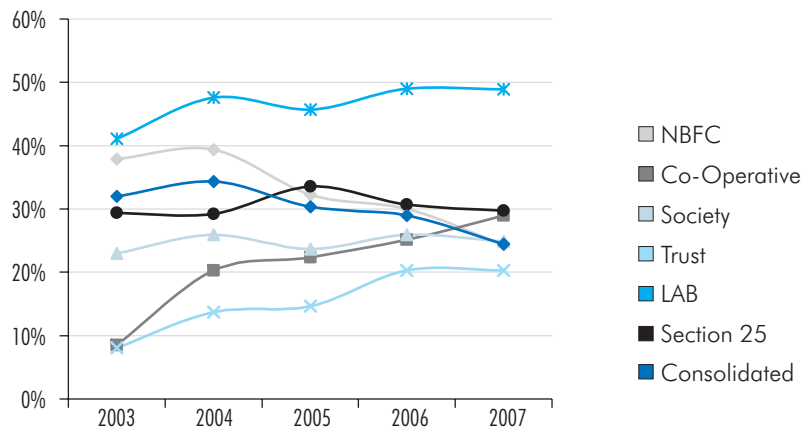
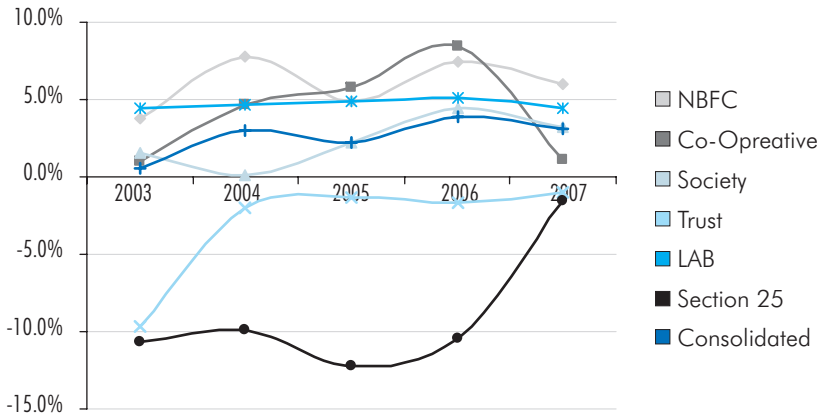




Figure 41: Profit Margin of Sample MFIs by Legal Form (2003-2007)



Despite being unable to access savings, NBFCs were able to bring down their financial cost ratio from 13 percent in 2003 to seven percent in 2007, a performance that can be attributed to their high proportion of managed portfolios and internal accruals. Taking advantage of the efficiency and leverage, NBFCs were able to reduce their interest yield from 38 percent in 2003 to 24 percent in 2007. In comparison to NBFCs, societies show a lower ROA of 2.5 percent in 2007, and enjoy a similar yield and exceptional leverage of 18. This is a potential indicator of the need for equity in the near future for further growth.

With greater scale, Indian MFIs are demonstrating rising efficiency and potential to reach out to a larger number of low income clients while maintaining viable, sustainable operations. They are emerging as an attractive asset class for investors seeking social and commercial returns. There is a correlation between rising efficiency and margins with the choice of a for-profit legal form such as an NBFC. MFIs, especially those in the Tier 1 category, which have managed to create substantial scale, are able to attract mainstream financial resources (equity and debt), and bring down financing costs through innovative arrangements such as the partnership model. Savings and grants have played an important role in the start-up and early growth stage of many MFIs. However, with such resources becoming increasingly inaccessible, many MFIs, especially those in the Tier 3 category, have chosen to adopt for-profit legal forms so they can more easily access commercial equity and debt capital earlier in their lifecycle.

Indian MFIs fared impressively in efficiency and profitability when compared to Asian MFIs surveyed by MBB. Taking advantage of the large amounts of debt capital extended by commercial banks in India, they were able to scale up their portfolios, enhance their ROEs, and offer competitive pricing to their clients.

Taking advantage of the large amounts of debt capital extended by commercial banks, Indian MFIs were able to rapidly scale up their portfolios, enhance their ROEs, and offer competitive pricing to their clients.



## Chapter 5

### Indian Microfinance: Through the Investment Lens



Many may consider India's enormous demand-supply gap in financial services itself an indicator of the microfinance industry's future potential, if only due to the sheer number of un-banked people. While such extensive demand forms the foundation on which the Indian microfinance success story has evolved so far, it has also benefited from many supply-side drivers. Exceptional business leaders, benevolent donors, risk-taking bankers, and equity investors have played key roles in this growth story.

Several of the microfinance interventions that were initiated before the 1990s were pioneered by leaders passionate to make a difference in the lives of low income individuals. Many created non-profit organizations<sup>79</sup> with a mandate to economically empower the poor; in turn, adopting microfinance as a tool to reach out to and provide as many low income people with one of the most critical developmental inputs: credit. An in-depth understanding of the rural landscape and strong community mobilization skills helped them exponentially scale up their MFIs' portfolios within the brief span of a decade. Many NGOs who had achieved large scale transformed themselves into regulated for-profit forms. Such a move helped these institutions access commercial financial resources, skilled human resources for middle and senior management positions, a clear regulatory framework, and increased credibility as 'businesses' instead of development interventions. There are many more NGO-MFIs who are currently undertaking microfinance activity and are keen to transform into NBFCs to reap such benefits. Interestingly, many of the MFIs that have started operations in 2006-2007 began their operations as NBFCs. Such MFIs include Arohan Financial Services, Ujjivan, and Sonata Microfinance.

Availability of finance played a significant role in assisting Indian MFIs achieve their present scale. Donations, savings, commercial debt, and equity all emerged as funding sources for MFIs across their lifecycles. For many MFIs, donors provided grants and quasi-equity for institutional capacity building and to cover initial lifecycle stage business losses. Apex lending institutions such as FWWB and RMK also provided early stage seed capital, which helped raise banks' confidence.

Similarly, market rate on-lending capital from banks (e.g ICICI, ABN AMRO, UTI, and Standard Chartered) has helped MFIs scale up their outreach and diversify their product offerings. Such activity has spurred innovations in delivery channels and approaches. The ICICI Bank Partnership Model for example, has allowed MFIs to increase their client base and enjoy high leverage. The high leverage is evident from the movement of debt-equity ratios of the 60 MFIs in the Intellectap sample over the last five years.

**Table 21: Debt Equity Ratios of 60 MFIs in Intellectap Sample (2003-2007)**

Year	2003	2004	2005	2006	2007
Debt-Equity Ratio	3.68	4.57	7.51	12.53	10.69

MFI Transformations Post 2000		
MFI	Started in	Transformed in
SKS	1998	2005
SHARE	1989	2000
SPANDANA	1997	2004

**Finance - Donations, Savings, Commercial Debt and Equity - form the key driver for the growth of Indian MFIs**

<sup>79</sup>An exception would be BASIX, which started as a NBFC in 1996.



Of the USD 43 million in equity in Indian MFIs, USD 38.2 million (INR 1.54 billion) flowed in during the first four months of 2007

The post 2000 period saw the entry of commercial equity investment into Indian MFIs' capital structures. Between 2004 and 2007, the space received an equity infusion of almost USD 43 million (INR 1.74 billion). The growing acceptance of commercial capital is evident when one recognizes that of the USD 43 million in equity, only USD 4.5 million (INR 182.25 million) was invested between 2004 and 2006, while USD 38.2 million (INR 1.54 billion) flowed in during the first four months of 2007<sup>80</sup>.

The microfinance industry's largest equity infusions into SKS Microfinance, SHARE, and Spandana reflect the rapidly changing microfinance environment. Prior to 2007, investments into Indian MFIs were typically less than USD 1 million (INR 40.5 million). Less than one year later, SKS Microfinance received USD 11.5 million (INR 465.75 million) from Sequoia Capital<sup>81</sup>. When institutional investor Legatum Global Development invested USD 27.5 million (INR 1.13 billion) in SHARE Microfin Ltd. (SML) it became not only the largest equity investment in Indian microfinance in India, but globally<sup>82</sup>. Spandana's investment of USD 12 million (486 million) also heavily added to the industry's investment inflow.

Figure 42: Recent Large Investments into Indian MFIs<sup>83</sup>

SKS Microfinance		SHARE Microfin Ltd. (SML)		Spandana	
Investment:	USD 11.5 M	Investment:	USD 27.5 M	Investment:	USD 12 M
Investor:	Sequoia Capital	Investor:	Legatum, Aavishkaar Goodwell	Investor:	JM Financial India, Lok Capital
Total Loan Portfolio:	USD 11.67 M	Total Loan Portfolio:	USD 95 M	Total Loan Portfolio:	USD 104.9 M
Total Client Base:	877,000	Total Client Base:	1 million	Total Client Base:	972,212
Stated Objectives of Investment:	Enable SKS to scale operations. SKS will likely go through an IPO or acquisition within 3-5 years.	Stated Objectives of Investment:	Grow SHARE'S client base to 6 million clients by 2012.	Stated Objectives of Investment:	Enable Spandana to enlarge its capital base and scale up geographical

### 5.1 Indian Microfinance: Key Drivers of Future Growth

Current initiatives appear inadequate when compared to the demand for microfinance services. The ability to reach out to this client base would therefore continue to be the prime industry growth driver. Microfinance interventions provide existing and new entrepreneurs with the ideal opportunity to achieve their dual ambitions of social impact and wealth creation. Their success or failure in contributing to Indian microfinance supply would be affected by multiple factors. It is the collective evolution and refinement of these factors over the coming few years that can propel the industry forward and create substantial impact. In this section, we discuss some of the drivers that will determine the growth and performance of Indian microfinance.

<sup>80</sup>Intellicap: "Microfinance Insights: Microfinance & Capital Markets Where are We Headed?" Vol. 3, June 2007. Pg. 36.

<sup>81</sup><http://www.sksindia.com/07mar29.htm>

<sup>82</sup>[http://www.sharemicrofin.com/resource\\_news.htm](http://www.sharemicrofin.com/resource_news.htm)

<sup>83</sup>[http://www.vccircle.com/blog\\_archives/2007/3/29/2843037.html](http://www.vccircle.com/blog_archives/2007/3/29/2843037.html) and [http://www.sharemicrofin.com/resource\\_news.htm](http://www.sharemicrofin.com/resource_news.htm)



### Availability of Finance

A major contributing factor to the industry's growth so far availability of suitable and timely finance will continue to be a major driver for growth and performance. With grant funds becoming scarce, commercial debt and equity will have large roles to play in MFIs' capital structures.

In response to this situation, the industry is witnessing a proliferation of international and domestic investment funds that have a focus on Indian microfinance. Intellect estimates at least 40 funds and corporations that have plans for Indian microfinance. Appendix 6 provides a list of such funds and corporations. Since the microfinance business model has been proven, many of the above funds are willing to take highly risky equity positions in start-up MFIs<sup>84</sup>.

With equity infusion in their capital structures, MFIs will be better placed to further leverage commercial debt. Guarantee providers such as Grameen Foundation and Deutsche Bank can improve MFI credit ratings and support debt mobilization. In addition, select banks such as ABN-AMRO have initiated plans to introduce syndicated lending to MFIs.

In early 2007, the industry witnessed a reduction in loan disbursements under the partnership model<sup>85</sup>, a major contributor to high leverage. The liquidity crunch that hit most MFIs arose when RBI raised concerns over the adherence to customer identification norms and recordkeeping. Another related concern is the inability of MFI branches in remote villages to make regular cash transfers as and when they are collected. It is therefore critical to synchronize the cash flows between the MFI and the bank.

Many MFIs with high proportions of managed portfolio under the partnership model until approximately year-end 2006 found it difficult to achieve their growth targets in the first half of 2007<sup>86</sup>. Given that the crunch was highly unexpected, many of them did not have back-up plans to finance their growth. In a positive development, many MFIs are trying to use the opportunity to diversify their lender base, consolidate their internal control systems and strengthen their policies on human resources, disclosure, and organizational processes. In addition, many are adopting information technology (IT) solutions that facilitate data collection, reporting, and the implementation of know-your-customer (KYC) norms. A major contributor to MFI portfolio under management, ICICI Bank, renewed its lending while this report was being written. The progress of lending under this channel would have a critical role to play in defining the growth figures of Indian MFIs by March 2008.

The industry is witnessing a proliferation of international and domestic investment funds with focus on Indian microfinance

Off balance sheet lending will have a critical role to play in defining the growth of MFIs

<sup>84</sup>Bellwether has already invested into many start-up MFIs, while Aavishkaar Goodwill and Opportunity International have announced plans to do so.

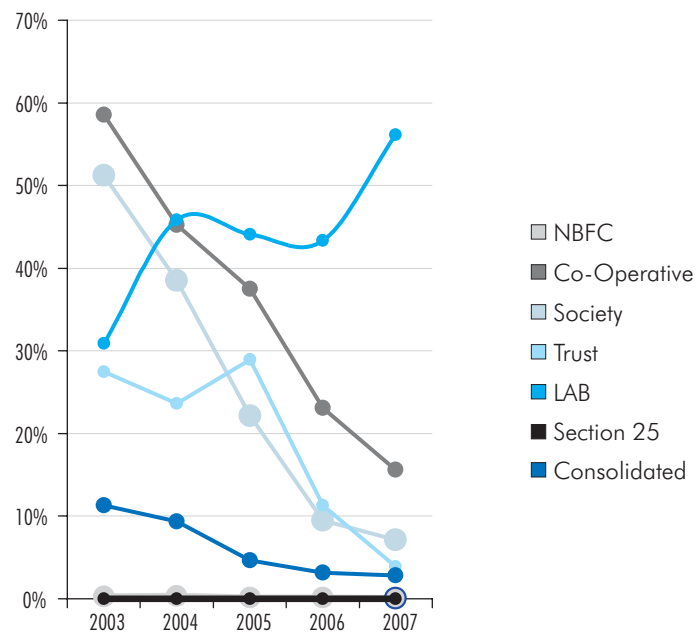
<sup>85</sup>RBI: "RBI raises doubts on micro credit." February 2007. Available at: [http://www.symbiotics.ch/en/microfinance\\_archives\\_2007.asp?id=b319](http://www.symbiotics.ch/en/microfinance_archives_2007.asp?id=b319); Discussions with MFIs

<sup>86</sup>Discussions with select MFIs with high partnership portfolios (sometimes, as high as 40-45% of total portfolio).



Many of the leading NBFC MFIs and technical professionals in the space are exploring innovative ways to access lower cost on-lending funds. In the past, savings has been a low cost source of funds for many NGO-MFIs which provide the service to their clients. Savings mobilization is stopped however, after NGO-MFIs transform into regulated NBFCs. NBFC MFIs are not permitted to mobilize savings unless the Central Bank licenses them upon satisfying stringent conditions such as three years of operations and high investment grade ratings. Interestingly, there is a downward trend in savings mobilization among non-profit forms such as societies and trusts. Many are phasing out the proportion of savings in their capital structure. Figure 43 outlines the behavior of savings in the capital structures of the MFI sample between 2003 and 2007.

Figure 43: Proportion of Savings in Capital Structure by Legal Form (2003-2007)



Savings, a diminishing role in financing microcredit

Savings reduction can be attributed to many NGOs considering transformation into NBFCs. Such MFIs would then require regulatory approval to continue savings collection. A high cost of collection of savings, especially if done on a small scale, is often also quoted as a reason.

In the absence of savings, Tier 1 and 2 MFIs with substantial portfolios, are exploring capital markets instruments such as bond issues, portfolio sales, and collateralized loan obligations (CLOs) as options to reduce the cost of funds. Indian microfinance has seen a few portfolio sales in the last few years. In 2004, ICICI Bank completed the first portfolio buyout in Indian microfinance by purchasing USD 4.3 million (INR 174 million) of Share Microfin's loan portfolio. Grameen Foundation provided a guarantee to facilitate the loan from ICICI Bank. Since then, several innovative structures have been tested, including an "On-tap Securitization" mechanism between Citibank and BSFL (BASIX) in which



new loans generated by BSFL are bought by Citibank on a monthly basis. Recently, Citibank announced a massive rural financing program under which it would purchase loans originated by SKS India in 2007-2008. The program will deliver income-generating loans of between USD 123 USD 494 (INR 5,000 to INR 20,000) to a population of over 200,000 un-banked customers spread across 7,000 villages in 11 states of the country by financial year 2007-08<sup>87</sup>.

Bonds and securitization are yet to be explored in Indian microfinance. Such instruments demand large size transactions and diversified microfinance portfolios as underlying assets against which the securities are issued in capital markets. In addition, there are legal and market-related challenges, which need to be addressed before such structured instruments are introduced to the Indian microfinance space (See Box 5). Select MFIs are working towards IPOs and raising public capital for growth.

### **Box 5: Sailing into the mainstream: Collateralized Loan Obligations (CLO) in Microfinance**

A CLO is a special kind of debt financial instrument backed by a pool of loans. Although common in mature capital markets, it is in nascent stages in microfinance. In a typical CLO structure, the financial institution's loans are sold to a Special Purpose Trust, and are then repackaged into pass through securities (PTCs), which are sold to investors. Other important players include a rating agency and credit enhancement providers (usually banks in the form of guarantees). Intellectap is currently in the process of structuring a CLO issue that will likely pool the loans of multiple MFIs.

#### **Challenges in the Indian Context**

**Placement:** The RBI makes foreign investment in CLOs complicated, so Intellectap's issue will focus on purely domestic investors.

**Structuring:** While MFIs are looking for longer term capital (up to five year tenor), the CLO issue is unlikely to be longer than the tenor of the underlying loans (which are typically one year). A structure in which the loan pool would be replenished annually would require specific RBI approval to be considered as a 'true sale'. Intellectap is exploring ways to work with MFIs and investors to arrive at the best fit structure.

**Pricing:** Though the issue will likely be classified as priority sector lending, pricing may be challenging. CLO securities with the highest rating even within the priority sector offer fairly high return to investors, while the rates MFIs already obtain on term loans from banks are relatively low. This creates a slim margin in which to structure the issue.

**Rating:** It is important that the CLO issue achieve the highest rating, but to do so may require a large amount of credit enhancement, which would raise the price of the issue.

**Capital market instruments: future financing options for Indian MFIs**

<sup>87</sup>[www.citibank.com/citigroup/press/2007/070509a.htm](http://www.citibank.com/citigroup/press/2007/070509a.htm)



### Progressive Regulation

There is currently increasing policy attention towards microfinance and 'financial inclusion.' This is evident when the proposed Microfinance Bill is examined. The bill's current provisions would direct all non-profit MFIs currently lacking a formal statutory framework for their operations to register and report regularly to proposed regulator NABARD. In addition, the bill could potentially bring in a formal definition of 'microfinance.' Although the bill would form the first legal document that recognizes NGOs' microfinance activity as legitimate, many large NGOs may want to weigh the implications of the bill against the benefits of a for-profit legal form, which can better attract commercial resources.

Additional regulatory provisions with implications for the sector's growth include RBI's guidelines for the 'business correspondent' and 'business facilitator' model<sup>88</sup>. Through this model, banks can appoint non-profit legal entities such as "NGOs, farmer's clubs, and community based organizations" to provide facilitation services to the banks<sup>89</sup>. In the business correspondent model, banks can avail MFI services to undertake activities within the normal course of bank business such as disbursement of small value credit and collection of small value deposits. Issued in January 2006, there is still lack of clarity on banks' implementation of this model. However, clarity on this regulation could provide non-profit MFI forms with an option to increase their outreach and fee incomes tremendously.

In the case of NBFCs, the for-profit legal form that generates the most investor/lender confidence, there are several regulatory provisions that are unclear at this stage. While the initial set of guidelines allowed non-deposit taking NBFCs to act as a business correspondent<sup>90</sup>, RBI revoked the same in a later circular<sup>91</sup>. Another restrictive measure is on such MFIs' access to External Commercial Borrowings (ECB). While NGOs involved in microfinance were given special permission to access ECBs up to USD 5 million (INR 202.5 million) within a financial year<sup>92</sup>, NBFCs have not been granted permission. Further, the minimum capitalization required for an NBFC is high at USD 494,000 (INR 20 million), which hinders many microfinance entrepreneurs and NGOs from adopting this legal form.

MFIs' legal constitutions hold multiple implications for their ability to access financial resources, grow their portfolios, and offer a range of services to their clients. The refinement of the above regulatory provisions in the next five years will play a critical role in determining the scale and performance of Indian MFIs.

### Innovative Business Strategies

Today, many trends indicate further movement towards industry consolidation. MFIs that began operations in the 1990s focused on single products, while today, select Indian MFIs are adopting various diversification strategies. Further, MFIs that once expanded in contained areas are now exploring new geographies. Finally, delivery channels that were once straightforward and limited are now becoming more innovative and flexible.

For an NBFC, the legal form that generates most investor/lender confidence, there are several regulatory provisions that are unclear or constraining

<sup>88</sup><http://fiuindia.gov.in/downloads/68417.pdf>

<sup>89</sup>[http://rbi.org.in/scripts/BS\\_CircularIndexDisplay.aspx?id=2718](http://rbi.org.in/scripts/BS_CircularIndexDisplay.aspx?id=2718)

<sup>90</sup><http://www.rbi.org.in/commonman/Upload/English/Notification/PDFs/69492.pdf>

<sup>91</sup>ibid

<sup>92</sup>External Commercial Borrowings (ECB) for Non-Government Organizations (NGOs) engaged in micro finance activities under Automatic Route, RBI/2004-05/434 A.P.(DIR Series) Circular No. 40, April 2005, <http://rbi.org.in/Scripts/NotificationUser.aspx?id=2212&Mode=0>



Product and services diversification enables MFIs to spread their risk, which is institutionally beneficial as well as attractive to capital providers. The increasing availability of potential partners in the commercial space assists in the provision of insurance, remittance, and other asset-financing products. SEWA Bank for instance, partnered with the Housing and Urban Development Corporation (HUDCO) in 1987 to facilitate the construction of houses for low-income segments. By 2000 it had provided approximately USD 4.4 million (INR 180 million) in housing loans to its clients<sup>93</sup>. Ultimately, it is a way for MFIs to leverage players and instruments that do not exist in-house, continue to generate revenue, and contribute to the development of sustainable operations.

Regions in India that microfinance has not yet reached such as the north, east, and central regions are increasingly seeing higher levels of microfinance activity. Many MFIs, which have primarily operated in South India, are diversifying their risks and extending their operations to under-served regions. Such regions show high poverty rates and huge untapped microfinance demand. Inorganic and regional diversification will enable a greater number of players to identify mechanisms to meet demand.

With competition setting in, MFIs are witnessing overlap between their clients. Through examination of clients' needs and competitor MFIs' product portfolios, MFIs can design strategies to serve the same client with credit and a wide variety of financial services. Additionally, if MFIs leverage existing infrastructure, they can reduce delivery costs and associated interest rates to clients. Many large MFIs such as Spandana are already exploring products such as tractor financing and dairy supply chain financing to widen their portfolio and deepen their relationships with clients. Exploration could also give rise to partnerships with mainstream businesses that procure or sell to low income client segments.

Along with competition, the industry is expected to soon witness trends such as corporate and meso-level NBFC downscaling, and mergers and acquisitions. Corporates such as Reliance Retail and Bharti, for instance, have announced plans to facilitate rural supply chain linkages by entering the microfinance space<sup>94</sup>. Similarly, NBFC Muthoot, which offers meso-level financing, plans to enter into a partnership with WWB to serve lower income clients<sup>95</sup>. NBFC Fullerton India also plans to tie up with MFIs and/or SHGs as part of its rural credit disbursement plan<sup>96</sup>. Large MFIs may find inorganic growth options through the acquisition of smaller MFIs. In turn, smaller MFIs could adopt a mergers strategy to leverage common resources and complimentary strengths as well as achieve economies of scale<sup>97</sup>. The franchising model, with demonstrated scalability in mainstream businesses, currently being piloted by Intellectap, has the potential to contribute to outreach of smaller MFIs and start-up organizations.

According to Spandana's Founder - Executive, Ms. Padmaja Reddy, "It (partnership) is an opportunity for us to create greater value for our clients without incurring too much additional cost."

**Diversification in products, services and geographies will support growth and spread risk of MFIs**

**Competition, mergers, acquisitions and franchising could be inorganic growth strategies for MFIs**

<sup>93</sup><http://www.sewabank.com/housing-loan.htm>

<sup>94</sup>[http://economictimes.indiatimes.com/Reliance\\_Bharti\\_may\\_storm\\_microfinance/articleshow/1525627.cms](http://economictimes.indiatimes.com/Reliance_Bharti_may_storm_microfinance/articleshow/1525627.cms)

<sup>95</sup>[http://swwb.org/eNews0407/april07\\_2.html](http://swwb.org/eNews0407/april07_2.html)

<sup>96</sup>[http://microfinancejobs.com/news\\_desc.php?id=52](http://microfinancejobs.com/news_desc.php?id=52)

<sup>97</sup>Indian Microfinance saw a portfolio between two small entities: Sonata Microfinance and Jeevika More information available at: [http://72.14.235.104/search?q=cache:\\_GgDxo\\_19hMJ:www.microfinancegateway.org/redirect.php%3Fmode%3Dlink%26id%3D40219+Jeevika+Sonata+merger+microfinance+gateway&hl=en&ct=clnk&cd=3&gl=in&client=firefox-a](http://72.14.235.104/search?q=cache:_GgDxo_19hMJ:www.microfinancegateway.org/redirect.php%3Fmode%3Dlink%26id%3D40219+Jeevika+Sonata+merger+microfinance+gateway&hl=en&ct=clnk&cd=3&gl=in&client=firefox-a)



## Technology has implications for growth, standardization, transparency and risk management

### Online Lending Platforms



Kiva, a non-profit platform, has been connecting individual lenders to microfinance borrowers through their 63 Field Partners (MFIs). Buzz around Kiva has spread rapidly through the media and word of mouth, capturing the attention of lenders who would not otherwise have an interest in microfinance. Over USD 10 million has been lent through Kiva in the past three years since its inception.

[www.kiva.org](http://www.kiva.org)



GlobeFunder is aiming to harness the power of scale through a for-profit model, and plans to launch a peer-to-peer lending platform first in the US in late 2007, followed in early 2008 by a similar platform in India catering to microfinance clients. Like Kiva, GlobeFunder will make use of MFIs as intermediaries, and will incorporate market-based interest

In addition, the adoption of suitable technology solutions will help MFIs standardize their processes, create efficiencies, and help reduce transactions costs associated with servicing millions of low-income clients. Institutionally, improved technology solutions can assist MFIs with managing and mitigating risks such as fraud, as well as mistakes on account of manual transactions. Sector level technology infrastructure is also important. A credit bureau for instance, can help track multiple financing of clients and foresee the probability of defaults and systemic failures. Ultimately, technology refinement and application enhances the attractiveness of the industry to external players. Cost-reducing technologies encourage commercial players that have historically shied away from serving low-income clients to engage with MFIs. While many technology initiatives are being designed and piloted (See Box 6), ensuring their wide-scale application will be an inherent challenge for many technology service providers.

### Box 6: Technology in Microfinance

Technology service providers such as FINO, A Little World and Cranes Software are exploring smartcards and biometrics products, among other solutions. MFIs are also studying the application of products such as management information systems (MIS), branchless-banking technologies, and point-of-sales devices. An MFI using an enhanced MIS can operate based on "real-time connectivity between its branches and head office." In 2006, Citibank launched a "biometric ATM with multi-language voice navigation features for microfinance customers" with MFIs BASIX and Swadhaar FinAccess. BASIX also uses handhelds, enabling field officers to keep better transactions and repayments records.

Sources:

<http://www.microfinanceindia.org/index.asp?P=L&ID=41>

<http://www.citigroup.com/citigroup/press/2006/061201d.htm>

Along with the MFIs, funders, donors, and other intermediaries are expected to develop diverse strategies and business models. Many are exploring technology solutions such as online lending platforms that facilitate the general public's participation in financing microfinance. Institutional investors and lenders on the other hand can use provisions such as the 'business correspondent' and 'business facilitator' models to partner with MFIs, help reach out to more clients, and augment profitability.

### Human Resource and Institutional Capacities

Microfinance's transition from a development intervention to a social business is evident in its increased emphasis on institutional capacities and human resources. In the past, MFIs were often criticized over the absence of middle and senior management. While field staff continue to be the center of MFI operations, these teams also require strategic managers capable of steering the organization forward.



Today, traditional MFI managers with developmental backgrounds are being replaced by those professionally trained in management disciplines and other industries. Recognition of microfinance as a legitimate business model is attracting high quality human resources and managerial talents.

In microfinance field operations, the sector will witness substantial demand for specialized human resources. Given the growth in rural India's service sector, the demand for staff with an understanding of rural markets is on the rise. Geographical expansion will require specialized HR needs such as local recruitments and cultural and linguistic integration issues. Appropriate training programs across strategic, tactical, and operational management topics is required to help build capacity among human resources within MFIs. While some large MFIs have adopted the concept of an in-house training program, some are exploring partnerships with training agencies.

Standardizing systems and processes is critical to reach substantial scale. In addition, MFIs' institutional capacity to effectively deploy their capital and create value is critical in boosting investor confidence. Rising competition for clients and external funding is a clear incentive for MFIs to streamline their operations and increase efficiency. Technical service providers and the application of mainstream business principles will play a key role in enhancing capacities.

### 5.2 Indian Microfinance: Future Outlook (2008-2012)

Over the last five years, Indian microfinance has shown exceptional performance in terms of outreach and increased profitability. In the coming five years, finance will continue to be one of the key drivers for this industry. While many quasi-commercial and commercial investors see the industry as an emerging asset class, it will be critical to invest in institutional capacity to channel capital and maintain growth and financial performance.

In this section, we estimate the industry's capital requirements in order to maintain its growth trajectory. Drawing from the Intellectap MFI sample's past performance and benchmarking data against the generic MFI lifecycle behavior, we make inferences on the future growth of the Indian microfinance industry. More specifically, sample MFIs' portfolio and borrower growth are extrapolated until 2012. Assumptions are made on the portfolio size as of March 2007 for those Tier 3 MFIs excluded from the Intellectap sample and new MFIs that may emerge in the next five years. Key assumptions for the projections are presented as Appendix 7. The projections span across three growth scenarios: high, moderate, and low. Following the growth projections, estimates are made on the capital requirements for each MFI tier.

Quality human resource  
and streamlined  
processes are critical  
for MFI scale



**Indian MFIs: Future Directions for Growth (2008 - 2012)**

By 2012, Indian MFIs are expected to build a portfolio of USD 6.27 billion (INR 254 billion) over an active borrower base of 48.7 million in the most likely scenario. Projected portfolio and borrower growth across three scenarios are presented as Tables 22 and 23.

**Table 22: Projected Portfolio Growth of Indian MFIs (2008 - 2012)**

Portfolio (USD Million)	2008	2009	2010	2011	2012
Low	1283	1953	2873	4025	5285
Most likely	1327	2086	3172	4602	6270
High	1371	2225	3495	5243	7401

**Table 23: Projected Borrower Growth of Indian MFIs (2008 - 2012)**

Borrowers (Million)	2008	2009	2010	2011	2012
Low	11.8	17.2	24.3	32.5	40.8
Most likely	12.2	18.4	26.9	37.4	48.7
High	12.6	19.6	29.6	42.7	57.8

Intelicap projects the loan portfolio of Indian MFIs to be USD 6.27 billion (INR 254 billion) over an active borrower base of 48.7 million by 2012 in the most likely scenario

In the most likely scenario, the nine Tier 1 MFIs are likely to constitute 62 percent of the Indian MFI portfolio base with a share of USD 3.88 billion (INR 157 billion) 28.5 million borrowers. With a high portfolio bases, Tier 1 MFIs may be expected to decrease their growth. However, many of these MFIs are expected to leverage their existing infrastructure to offer clients higher loan sizes and diverse loan products, which will help them maintain fairly high growth rates.

**Figure 44: Indian MFIs' Projected Borrower Growth (2003-2012 - Most Likely Scenario)**

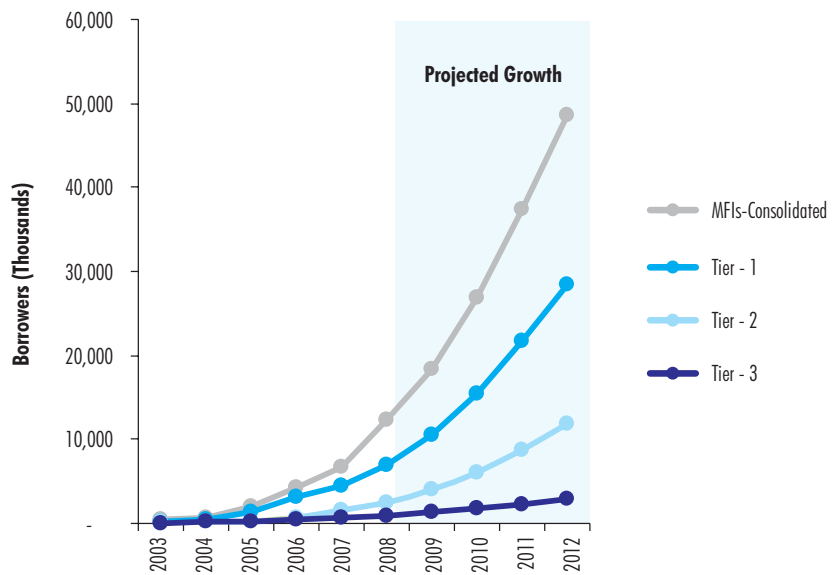




Figure 45: Indian MFIs' Portfolio Growth by Tier (2003-2012 - Most Likely Scenario)

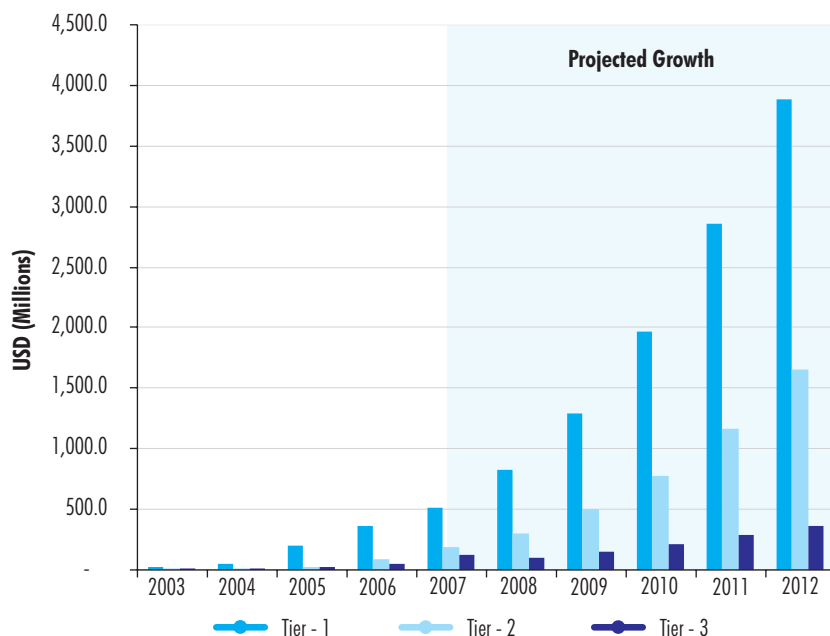
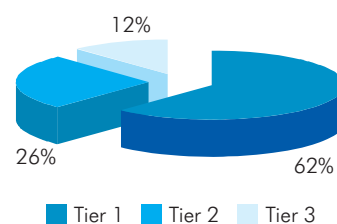


Figure 46: Share of Total Portfolio of Indian MFIs by Tier (2012 - Most Likely Scenario)



Mirroring Tier 1 MFIs' growth characteristics in the last five years, current Tier 2 MFIs will constitute a key growth segment for the next five years. Together, the 13 MFIs are expected to build up a portfolio of USD 1.65 billion (INR 66.7 billion) over a borrower base of 11.8 million. Their share in the total MFI portfolio is expected to go up from 24 percent in 2007 to 26 percent in 2012. Many of the current Tier 2 MFIs are likely to move into the Tier 1 segment during this period. Table 24 presents the MFIs who are most likely to progress into the Tier 1 segment in the next two years, given adequate access to funding.

Table 24: Tier 2 MFIs Likely to Move into Tier 1 Category by 2009

2008	2008
AWARENESS	AMMACTS
BWDA	ESAF
CASHPOR	Grameen Koota (GK)
Mahasamam Trust	Sarvodaya Nano Finance Limited
ASA-GV	BSS
	SWAWS

Eleven of the existing Tier 2 MFIs are expected to move into the Tier 1 segment by 2009

<sup>77</sup>Certain MFIs who hold portfolio under the partnership model, record the interest margin earned as net income after deducting the interest due to ICICI. To that extent, the interest payment to ICICI is usually not recorded in the profit and loss statement. Therefore, the financing costs are understated.

<sup>78</sup>This analysis excludes analysis on any developments post March 2007. Two of the Tier 1 MFIs, SHARE and Spandana, had equity infusions into their capital structure in the financial year 2007-2008.



Projections for the Tier 3 MFI segment in the most likely scenario includes those for 37 MFIs from the Intellectap sample, an additional 250 potentially scalable MFIs assumed to be in existence in 2007, and a group of 135 MFIs<sup>98</sup> that may be created in the next five years. In the most likely scenario, this segment is expected to constitute 12 percent of the total MFI portfolio with a portfolio of USD 0.74 billion (INR 29.9 billion) over a borrower base of 8.4 million by 2012. Select MFIs from the Tier 3 segment are likely to move into the Tier 2 segment between 2008 and 2012. Table 25 presents the MFIs who are most likely to move into Tier 2 segment in the next two years.

Table 25: Tier 3 MFIs Likely to Move into Tier 2 Category by 2009

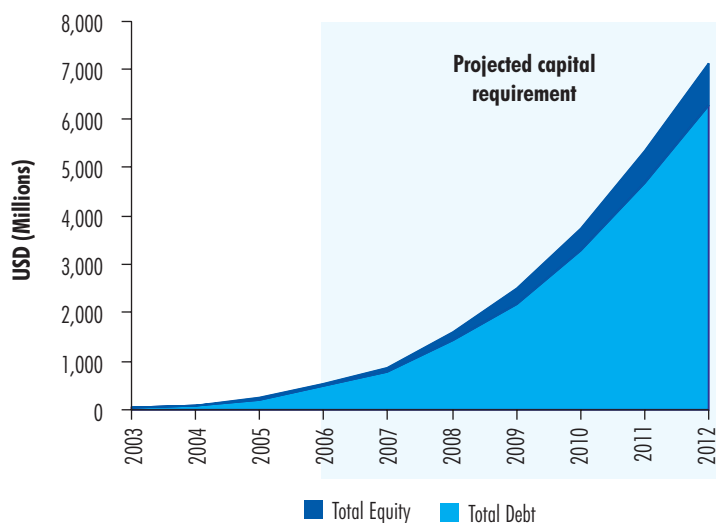
2008	2009
Gram Utthan	KBSLAB
KOTALIPARA DEVELOPMENT SOCIETY (KDS)	PRAGATI SEVA SAMITI (PSS)
Satin Credit Care	RASS
	SANGHAMITRA RURAL
	VILLAGE WELFARE SOCIETY (VWS)
	ASOMI

Nine of the existing Tier 3 MFIs are expected to move into the Tier 2 segment by 2009

Financing Indian MFIs: Capital Requirements for Future Growth

To achieve the above growth projections, Indian MFIs require continued access to appropriate financial instruments at optimal costs. Figure 47 presents the debt and equity positions of Indian MFIs over the next five years in the most likely growth scenario.

Figure 47: Indian MFIs' Capital Requirements (2003-2012 : Most Likely Scenario)



<sup>98</sup> Refer Appendix 7 for the breakup of startup MFIs across the projection horizon

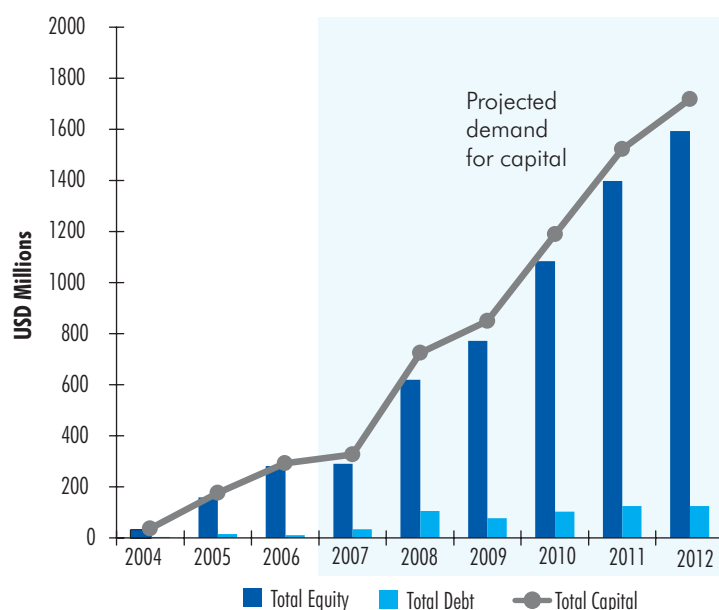


To maintain the above debt and equity position in the most likely scenario, the sample Indian MFIs will require external infusion of both equity and debt capital. Intellecap estimates the total capital requirement of Indian MFIs to be around USD 6,004 million (INR 243 billion). Key assumptions in arriving at the above estimate includes those on the quantum of average annual retained earnings of MFIs in each tier, a prudent capital adequacy ratio, and the likely portfolio to total assets ratio to be maintained by each tier. Table 26 presents the Indian MFIs' annual capital requirements over the next five years across the three growth

**Table 26: Annual Debt and Equity Capital Requirements of Indian MFIs by Scenario (2008 - 2012)**

Capital Requirements (USD Million)	2008	2009	2010	2011	2012	Total
Low	671	745	1000	1217	1279	4912
Most likely	724	849	1189	1523	1719	6004
High	777	960	1397	1876	2248	7258

**Figure 48: Indian MFIs' Capital Demand (2003-2012 : Most Likely Scenario)**



**Equity Capital**

The Indian MFIs will need equity capital to leverage debt, cover up losses, maintain a healthy capital adequacy ratio, and make investments in building their institution. Indian MFIs have been maintaining relatively high levels of leverage of more than 10 percent and will need equity infusions to maintain their leverage in the future. The start-up and Tier 3 MFIs require equity capital to build their portfolios and cover their initial operating losses. In addition, MFIs will need equity capital to maintain a healthy capital adequacy ratio and leverage debt funds for growth. For the above projections, a 12 percent capital adequacy ratio of % is assumed for Tier 1 and Tier 2 MFIs while a ratio of 15 percent is assumed for Tier 3 and start up MFIs<sup>99</sup>. Table 27 presents the Indian MFIs' annual equity capital requirements across the three growth scenarios.

Intellecap estimates the total capital requirement of Indian MFIs to be around USD 6,004 million (INR 243 billion) by 2012 in the most likely scenario

<sup>99</sup>The extra provision for Tier 3 and start-ups is assumed keeping in mind the initial losses they will incur before they start generating revenues.

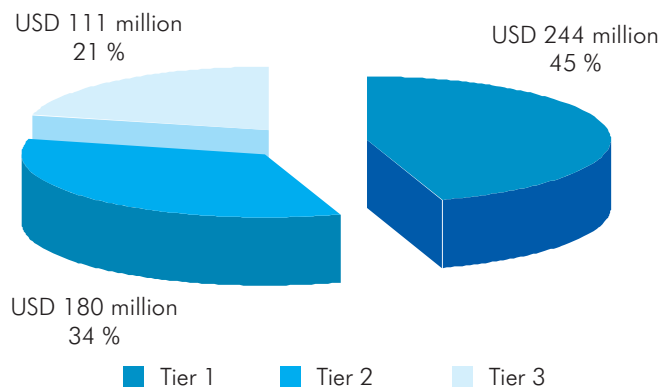


**Table 27: Annual Equity Requirements of Indian MFIs by Scenario 2008 to 2012**

Equity Requirements (USD Million)	2008	2009	2010	2011	2012	Total
Low	98	66	84	95	84	428
Most likely	104	77	104	125	125	535
High	110	89	126	160	176	661

In the most likely scenario, the cumulative external equity requirement of USD 535 million (INR 21.66 billion) would be spread across the three MFI tiers as USD 244 million (INR 9.88 billion), USD 180 million (USD 7.29 billion), and USD 111 million (INR 4.49 billion), respectively. Figure 49 presents the break up of potential external equity capital requirement across the three MFI tiers.

**Figure 49: Demand for External Equity Capital by Tiers (2008-2012)**



Intellectap estimates the cumulative external equity requirement for Indian MFIs by 2012 to be USD 535 million (INR 21.66 billion) in the most likely scenario.

**Debt Capital**

The sample MFIs will need both short and long term debt capital to fuel their projected growth. While short term on-lending funds will remain the key driver of their scaling up process, they may need long terms funds of a quasi-equity nature to partially fund their institution building process.

Table 28 presents the Indian MFIs' annual on-lending debt capital requirements over the next five years across the three growth scenarios.

**Table 28: Annual Debt Requirements of Indian MFIs by Scenario (2008 2012)**

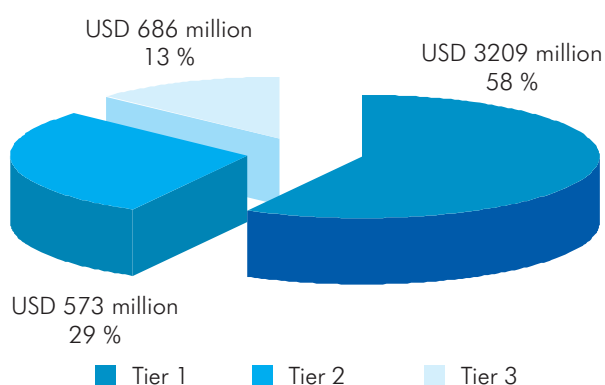
Debt Requirements (USD Million)	2008	2009	2010	2011	2012	Total
Low	573	679	916	1122	1195	4484
Most likely	619	772	1085	1398	1593	5468
High	666	871	1271	1716	2073	6597

<sup>98</sup> Refer Appendix 7 for the breakup of startup MFIs across the projection horizon



In the most likely scenario, the cumulative external debt requirement of USD 5.46 billion (INR 223.13 billion) will be spread across the three MFI tiers as USD 3.2 billion (INR 126.9 billion), USD 1.57 billion (INR 63.58 billion), and USD 686 million (INR 27.78 billion) respectively. Figure 50 presents the break up of potential debt capital requirement across the three MFI tiers.

Figure 50: Demand for External Debt Capital by Tiers (2008-2012)



Intellectap estimates the cumulative debt requirement for Indian MFIs by 2012 to be USD 5.46 billion (INR 223.13 billion) in the most likely scenario.

The above estimate takes into account only the debt and equity capital requirements of the MFIs to build up their projected portfolios. It does not include the finance that will be required at the sector level to be channeled towards infrastructure such as a credit bureau, policy advocacy, and technical assistance interventions (e.g. training and capacity building). As in the past, donor funds will have a critical role to play in addressing such needs. Given the scarcity of such funds and the emergence of commercial capital to fuel MFI operations, channeling donor funds towards those needs in a manner that complements commercial capital is necessary. It is only with the presence of an appropriate policy framework for the sector and ongoing investments in MFI capacities that the above discussed portfolio projections will become a reality.

As discussed earlier in this section, the financing horizon of Indian MFIs seems much brighter compared to the past five years. Equity, a critical requirement to support the next MFI growth phase, is no longer an unfamiliar instrument in the industry. Today, there are investment vehicles such as NABARD's Microfinance Development Fund and many international private funds focused on India. In addition, many NBFCs and corporate businesses have expressed interest to become private equity providers.



In addition to financing sector level infrastructure, donor funds can play a complementary role to commercial finance in financing Indian MFIs

Most importantly, there are many funds such as Bellwether and Lok Capital that have already made investments into start-up and established MFIs. Aavishkaar Goodwill and Opportunity International have announced plans of making part of their investments into start up MFIs, which is a significant development over the earlier focus of many funds on more established MFIs. Given the industry's potential, it is expected that many more funders with an Indian focus will emerge. In an optimistic scenario, Indian microfinance may also witness at least one IPO in the next five years.

Indian commercial banks will likely continue to be the major source of short term on-lending debt funds for MFIs. Though experiencing slow growth, the partnership model can be a key source to leverage debt funds from banks, overcome the equity capital requirement, and enhance financial incomes. Provided a progressive legal environment emerges, MFIs with larger portfolio bases can consider portfolio sales and true securitizations as options. Guarantee providers can help facilitate access to debt funds, particularly for the Tier 3 and start-up MFIs. Syndicated lending can help reduce the transaction costs of financing MFIs. Long term structured arrangements such as bonds and CLOs will help reduce the cost of funds for MFIs below commercial term loans.

Though not included in the above finance estimates, savings may prove to be a low cost source of funds for many MFIs. NGO and co-operative MFI forms may particularly benefit provided they are legally allowed to collect savings as proposed in Microfinance Bill 2007.

In addition to financing sector level infrastructure, donor funds can play a complementary role to commercial finance in financing Indian MFIs. Some of the mechanisms employed could be the provision of guarantees and quasi-equity such as concessional loans.

While supply side financing of Indian MFIs looks reasonably attractive, it is critical to note that the demand side needs substantial augmentation in capacity to absorb such capital. It is already evident that there are too many investors chasing too few MFI investments. Concerted efforts need to be made in building up the demand side, especially from the Tier 2, 3, and start-up MFI groups, to ensure a steady pipeline for investors and increased microfinance outreach.

In the past, many MFIs have been accused of putting growth first and ignoring the need to invest into their institutional capacities. Even while MFIs are increasingly taking the shape of financial service providers, there is much to improve in terms of their governance, management abilities and systems. In 2006, a few MFIs in Andhra Pradesh were accused of unethical recovery practices followed by high negative publicity in the media. The incident underlined the need for sound governance practices that manage both internal and external risks for the organization. With ever growing portfolios and diversification, the MFI boards need to be augmented in terms of skill sets, experiences and specific strategic expertise they bring to the MFI's future growth plans.



Those MFIs with ambitions of becoming large financial institutions will need sound middle managers especially in areas such as financial management and IT. Scaling up and interacting with mainstream financial actors and regulators will also demand skill sets different from the ones held by the staff involved in early Indian microfinance.

Standardized processes and systems and sound technology is required to support the future growth. Many MFIs have not paid attention to such areas in their operations so far. Not only would such efforts form the basis of sound internal control, risk management, and efficiency but also prove to be helpful in maintaining transparent operations and regular disclosure to external stakeholders including regulators and financial partners.

The commercialization of microfinance has also brought forth risks that were hitherto unfamiliar to many MFIs who had social origins. Developing strategies to manage such risks and create efficiencies in their processes and systems would demand technical assistance providers with expertise business principles, while also sensitive to development needs. A combination of adequate, timely, and low cost financing, and simultaneous investment into internal MFI capacities is required to achieve the above projected growth numbers.

**A combination of adequate, timely, and low cost financing, and simultaneous investment into internal MFI capacities is required to achieve the above projected growth numbers.**



## Chapter 6

The journey has just begun...



## THE JOURNEY HAS JUST BEGUN...

Over the past 50 years, India has transformed its financial services industry from an inward facing system to one that has found a substantial position within the global economy. Liberalization of the financial markets in the 1990s piqued interest from international investors and lenders who quickly foresaw the monetary benefits of an emerging economy. Soon followed by the business process outsourcing (BPO), information and communications technologies (ICT), and retail boom, India's market opportunities have attracted a host of players eager to tap into its enormous potential. With a population of 1.1 billion people of which a substantial segment does not have access to formal financial services businessmen, development practitioners, technology providers, corporates, and capital providers have identified and implemented initiatives aimed at reducing the country's large income disparities. Through their experiences, it has become clear that it is ultimately the combination of diverse approaches, business models, and stakeholders, across multiple industries, which can uplift India's economically disadvantaged and further drive its growth.

As a microcosm of the country's larger economic trends, we have also seen financial services provision to the poor gradually transform from a single, rural credit delivery approach into a legitimate business. Known today as microfinance, this industry is noticeably attracting an increasing amount of financial capital, human resources, and innovative ideas to promote and stimulate the inclusion of low-income demographics into the formal financial system. The evolution of microfinance has been underway for a few decades. However, it is the current convergence of a few distinct trends that will likely have a tremendous impact on outreach, livelihoods, and more substantial socio-economic integration.

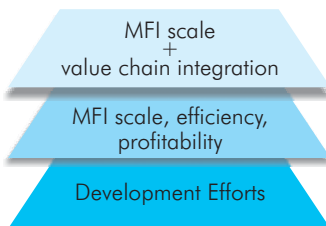
When looking back at the emergence of the microfinance industry, it appears that the most significant and rapid advances occurred over the last 15 years. A simultaneous shift from: narrow to broad mindsets, development interventions to social businesses, minimalist credit to product diversification, regional to national ambitions, and towards actual policy regulation, is increasingly creating a more holistic approach to financial inclusion and improved living standards for low-income individuals. A microfinance client in the 1980s for instance may have received microloans to purchase buffalo, but would not have been able to more formally hold her savings, protect her family against disasters/ emergencies, receive remittances, or utilize the money for larger asset purchases. Twenty years later today, a client is likely receiving a bigger loan amount in her first loan cycle, is offered microinsurance ranging from health to livestock to weather services, and is able to avail some type of asset financing (e.g. housing loans).

Essentially, commercialization within microfinance, in concurrence with India's market evolution, has allowed for greater outreach, collaboration, and institutional inputs. At times, it seems the industry has actually "unlearned" many of the development philosophies and strategies upon which it was built, but cannot continue to rapidly grow.

...narrow to broad mindsets, development interventions to social businesses, minimalist credit to product diversification, regional to national ambitions, and greater policy acknowledgement, is increasingly creating a more holistic approach to financial inclusion



...it looks like the industry will soon add another layer to its current focus on scale, efficiency, and profitability, by incorporating more integrated inputs



Today, we increasingly see business solutions and protocol applied to MFIs' operations. Equity infusions into MFIs' capital structures have grown and financial instruments have become more sophisticated, as represented by 2007's SKS, SHARE, and Spandana investments and the 2004 SHARE securitization. MFIs supplement microcredit with additional products such as insurance and emergency loans customized to the needs of their clients. Tier 1 MFIs are beginning to achieve national scale while many regional Tier 2 players have immediate plans for multi-state expansion. Older MFI management teams are gradually adopting more commercial mindsets, while new entrepreneurs increasingly with business backgrounds are aware, from the outset, that mainstream capital and solutions are necessary to build institutional capacity, become sustainable, and create scale. MFIs are exploring new and improved technology including more robust management information systems, branchless banking, and point-of-sales devices to increase efficiency and reduce operating costs. Further, entrance into urban markets by players such as Ujjivan, and the provision of individual loan products are broadening markets that require the business of microfinance. Bank and meso-level NBFC downscaling ICICI, Fullerton India, and Muthoot Finance for instance shows an increasing interest in expanding business, creating shareholder value, and serving low-income individuals. Finally, Reliance and Bharti have announced plans to potentially tie up with MFIs to offer low-income clients products beyond financial services.

Given the country's dynamic microfinance environment, it looks like the industry will soon add another layer to its current focus on scale, efficiency, and profitability, by incorporating more integrated inputs. If this is the case, what services should we expect a microfinance provider to extend to clients going forward?

The partnership between Indian corporate ITC and MFI BASIX may currently offer one of the best examples of where Indian microfinance is heading...

Box 7: Microfinance & Supply Chain Innovations ITC and BASIX

In a pilot underway in Hyderabad, ITC and BASIX have partnered with each other to work with 20 women head-load vendors who sell 10-15 kilograms of vegetables per day. BASIX extends working capital loans of USD 247 (INR 10,000) and provides capacity building and business development services to these women, while ITC supports them through supply chain innovations. Through this model, ITC a) makes its Choupal Fresh stores available to the vendors, who can now avoid bargaining at traditional mandis and also replenish their stock from the stores as and when required, and b) attempts to design user-friendly pushcarts, which manage temperature control and produce quality. The benefits of the ITC-BASIX partnership/model are provided below:



**Vendors** : Augments vendors' incomes from USD .75 USD 1 (INR 30-40) per day to an average of USD 3.7 (INR 150) per day.

**BASIX** : Creates another way to achieve its mission to enhance livelihoods.

**ITC** : Provides an opportunity to scale up its business while creating triple bottom line returns economic profits, enhanced client incomes and creation of an environment friendly distribution network.

Source: Intellectap Interview with Mr. Siva Kumar, Chief Executive Agri Business, ITC Limited. "Synergies between the Indian Agri-retail Sector and Microfinance Institutions." Microfinance Insights, Issue # 4

In line with India's larger growth story, it seems that microfinance may be most effective when pushed forward through innovative partnerships. The early days of microfinance saw NGO-MFIs provide credit in addition to other development services (e.g. education, health, sanitation). However, today, MFIs that have scaled up their outstanding loan portfolios under for-profit legal structures are criticized for sacrificing development benefits to sustainability. One possible resolution to the emerging debate on minimalist credit versus responsible development credit may lie in the increasing integration of microfinance with the larger economic mainstream. Working in partnership with mainstream companies, current and future MFIs have a number of opportunities to offer an expanding set of financial and non financial products along with other capacities and client support services.

Through partnerships, such as that of ITC and BASIX, MFIs can continue to leverage their core competencies as localized institutions that have an understanding of clients' needs. In turn, corporate and retail partners can help link MFI clients to supply chain networks ranging from agriculture to artisans' inputs. Such a model also enables corporates and mainstream companies to tap into a new market and expand their own businesses. Spandana's Founder-Executive, Ms. Padmaja Reddy recently stated that, "Financing agriculture or dairy supply chains, farm machinery such as tractors, investments in rural infrastructure, and solutions such as energy are potential areas where microfinance could play a role<sup>100</sup>."

Ultimately, microfinance as it stands today has the potential to create tremendous scale. Additional value chain integration through overlapping business models, solutions, and partnerships however, can further enhance the double bottom line returns of the microfinance industry and promote livelihoods and greater socio-economic integration of low-income clients .

A possible resolution to the emerging debate on minimalist credit versus responsible development credit may lie in the increasing integration of microfinance with the larger economic mainstream

<sup>100</sup>Intellectap Interview with Ms. Reddy. "Business Partnerships are an Opportunity to Enhance Value for Clients." Published in Microfinance Insights, Issue # 4.

## APPENDIX 1: 2007 INTELLECAP STUDY PARTICIPANTS

- Adhikar
- Acts Mahila Mutually Aided Co-Operative Thrift Society (AMMACTS)
- Arohan
- Activists for Social Alternatives (ASA)
- Asmitha Microfin Limited (AML)
- Asomi
- AWARENESS
- Bandhan
- Belgharia Janakalyan Samity
- Bharatha Swamukti Samsthe (BSS)
- Bhartiya Samruddhi Finance Limited (BSFL)
- BWDA Finance Limited(BFL)
- CAMEL MAHILA MACTS LIMITED
- Cashpor Micro Credit (CMC)
- Darabar Sahitya Sansad ( DSS)
- Evangelical Social Action Forum (ESAF)
- Gram Bikash Kendra
- Gram Utthan
- Grameen Koota (GK)
- Grameen Sahara
- HOPE Foundation
- Institute for integrated Resource Management (IIRM)
- JEEVIKA Livelihoods Support Organization
- KAS Foundation
- Krishna Bhima Samruddhi Local Area Bank Limited
- Kotalipara Development Society (KDS)
- KRUSHI
- Lok Biradari Trust
- Mahasemam Trust
- Mahashakti Foundation
- Mahila Kalyan Samiti Dhori, Bokaro
- MIMO Finance
- Nav Bharat Jagruti Kendra (NBJK)
- Nirmaan Bharati Samajik and Arthik Vikas Sangathan
- People's Action for Development and Education
- Pragti Seva Samiti (PSS)
- Priyasakhi Mahila Sangh (PMS)
- Rashtriya Gramin Vikash Nidhi - Credit And Savings Programme
- Rashtriya Seva Samithi (RSS)
- Saadhana MicroFin Society
- Sahara Uttarayan
- SANGAMAM Women's Multipurpose Thrift And Credit Cooperative Society Ltd
- Sanghamithra Rural Financial Services
- Sarvodaya Nano Finance Limited (SNFL)
- Satin Creditcare Network Limited
- Share Microfin Limited (SML)
- Shree Kshethra Dharmasthala Rural Development Project (SKDRDP)
- SKS Microfinance Private Limited (SKS)
- Star Micro Service Society
- Sonata Finance Pvt. Ltd.
- Spandana Sphoorty Innovative Financial Services Ltd.
- Swadhaar Finaccess
- Sharada Women's Association for Weaker Section
- Ujjivan Financial Services Private Limited
- Vedika Credit Capital Limited
- Village Financial Services Pvt. Ltd.
- Vivekananda Sevakendra -o- Sishu Uddyan



## APPENDIX 2: POPULATION DATA

This data is taken from Census 2001. It is available at [http://www.censusindia.net/t\\_00\\_003.html](http://www.censusindia.net/t_00_003.html)

### Population

State Code	India/State/Ut	Persons	Males	Females	Sex ratio
	India	1,028,610,328	532,156,772	496,453,556	933
01	Jammu & Kashmir	10,143,700	5,360,926	4,782,774	892
02	Himachal Pradesh	6,077,900	3,087,940	2,989,960	968
03	Punjab	24,358,999	12,985,045	11,373,954	876
04	Chandigarh	900,635	506,938	393,697	777
05	Uttaranchal	8,489,349	4,325,924	4,163,425	962
06	Haryana	21,144,564	11,363,953	9,780,611	861
07	Delhi	13,850,507	7,607,234	6,243,273	821
08	Rajasthan	56,507,188	29,420,011	27,087,177	921
09	Uttar Pradesh	166,197,921	87,565,369	78,632,552	898
10	Bihar	82,998,509	43,243,795	39,754,714	919
11	Sikkim	540,851	288,484	252,367	875
12	Arunachal Pradesh	1,097,968	579,941	518,027	893
13	Nagaland	1,990,036	1,047,141	942,895	900
14	Manipur	2,166,788	1,095,634	1,071,154	978
15	Mizoram	888,573	459,109	429,464	935
16	Tripura	3,199,203	1,642,225	1,556,978	948
17	Meghalaya	2,318,822	1,176,087	1,142,735	972
18	Assam	26,655,528	13,777,037	12,878,491	935
19	West Bengal	80,176,197	41,465,985	38,710,212	934
20	Jharkhand	26,945,829	13,885,037	13,060,792	941
21	Orissa	36,804,660	18,660,570	18,144,090	972
22	Chhattisgarh	20,833,803	10,474,218	10,359,585	989
23	Madhya Pradesh	60,348,023	31,443,652	28,904,371	919
24	Gujarat	50,671,017	26,385,577	24,285,440	920
25	Daman & Diu	158,204	92,512	65,692	710
26	Dadra & Nagar Haveli	220,490	121,666	98,824	812
27	Maharashtra	96,878,627	50,400,596	46,478,031	922
28	Andhra Pradesh	76,210,007	38,527,413	37,682,594	978
29	Karnataka	52,850,562	26,898,918	25,951,644	965
30	Goa	1,347,668	687,248	660,420	961
31	Lakshadweep	60,650	31,131	29,519	948
32	Kerala	31,841,374	15,468,614	16,372,760	1058
33	Tamil Nadu	62,405,679	31,400,909	31,004,770	987
34	Pondicherry	974,345	486,961	487,384	1001
35	Andaman & Nicobar Islands	356,152	192,972	163,180	846

Source: Primary Census Abstract : Census of India 2001

Note: @<sup>1</sup> - Excludes Mao-Maram, Paomata and Purul sub-divisions of Senapati district of Manipur. The population of Manipur including the estimated population of the three sub-divisions of Senapati district is 2,291,125 (Males 1,161,173 and females 1,129,952)

## APPENDIX 3: 2004-2005 POVERTY RATIOS

This data is taken from the Planning Commission of the Government of India. It is available at: <http://planningcommission.gov.in/news/prmar07.pdf>

S. No.	Statue/U. Ts	Rural		Urban		Combined	
		%age of Persons	No. of Persons (Lakhs)	%age of Persons	No. of Persons (Lakhs)	%age of Persons	No. of Persons (Lakhs)
1	Andhra Pradesh	11.2	64.70	28.0	61.40	15.8	126.10
2	Arunachal Pradesh	22.3	1.94	3.3	0.09	17.6	2.03
3	Assam	22.3	54.50	3.3	1.28	19.7	55.77
4	Bihar	42.1	336.72	34.6	32.42	41.4	369.15
5	Chhatisgarh	40.8	71.50	41.2	19.47	40.9	90.95
6	Delhi	6.9	0.63	15.2	22.30	14.7	22.93
7	Goa	5.4	0.36	21.3	1.64	13.8	2.01
8	Gujarat	19.1	63.49	13.0	27.19	16.8	90.69
9	Haryana	13.6	21.49	15.1	10.60	14.0	32.10
10	Himachal Pradesh	10.7	6.14	3.4	0.22	10.0	6.36
11	Jammu & Kashmir	4.6	3.66	7.9	2.19	5.4	5.85
12	Jharkhand	46.3	103.19	20.2	13.20	40.3	116.39
13	Karnataka	20.8	75.05	32.6	63.83	25.0	138.89
14	Kerala	13.2	32.43	20.2	17.17	15.0	49.60
15	Madhya Pradesh	36.9	175.65	42.1	74.03	38.03	249.68
16	Maharashtra	29.6	171.13	32.2	146.25	30.7	317.38
17	Manipur	22.3	3.76	3.3	0.20	17.3	3.95
18	Meghalaya	22.3	4.36	3.3	0.16	18.5	4.52
19	Mizoram	22.3	1.02	3.3	0.16	12.6	1.18
20	Nagaland	22.3	3.87	3.3	0.12	19.0	3.99
21	Orissa	46.8	151.75	44.3	26.74	46.4	178.49
22	Punjab	9.1	15.12	7.1	6.50	8.4	21.63
23	Rajasthan	18.7	87.38	32.9	47.51	22.1	134.89
24	Sikkim	22.3	1.12	3.3	0.02	20.1	10.14
25	Tamil Nadu	22.8	76.50	22.2	69.13	22.5	145.62
26	Tripura	22.3	6.18	3.3	0.20	18.9	6.38
27	Uttar Pradesh	33.4	473.00	30.6	117.03	32.8	590.03
28	Uttarakhand	40.8	27.11	36.5	8.85	39.6	35.96
29	West Bengal	28.6	173.22	14.8	35.14	24.7	206.36
30	A & N Islands	22.9	0.60	22.2	0.32	22.6	0.92
31	Chandigarh	7.1	0.08	7.1	0.67	7.1	0.74
32	Dadra & N. Havell	39.8	0.68	19.1	0.15	33.2	0.84
33	Daman & Diu	5.4	0.07	21.2	0.14	10.5	0.21
34	Lakshadweep	13.3	0.06	20.2	0.06	16.0	0.11
35	Pondicherry	22.9	0.78	22.2	1.59	22.4	2.37
	All - India	28.3	2209.24	25.7	807.96	27.5	3017.20

URP consumption = Uniform Recall Period consumption in which the consumer expenditure data for all the items are collected from 30-day recall period.

### Notes :

- Poverty Ration of Assam is used for Sikkim, Arunachal Pradesh, Meghalaya, Mizoram, Manipur, Nagaland and Tripura.
- Poverty Line of Maharashtra and expenditure distribution of Goa is used to estimate poverty ratio of Goa.
- Poverty Ratio of Tamil Nadu is used for Pondicherry and A & N Island.
- Urban Poverty Ratio of Punjab used for both rural and urban poverty of Chandigarh.
- Poverty Line of Maharashtra and expenditure distribution of Dadra & Nagar Havell.
- Poverty Ratio of Goa is used for Daman & Diu.
- Poverty Ratio of Kerala is used for Lakshadweep.



## APPENDIX 4: INDICATORS, DEFINITIONS, AND ASSUMPTIONS USED FOR ANALYZING THE INTELLECAP SAMPLE MFI PERFORMANCE

Indicators	Definitions
Number of MFIs	60
Number of Active Borrowers	Number of borrowers with loans outstanding
Number of Members	Number of registered clients
Capital/ Asset Ratio Debt/ Equity Ratio	Adjusted Total Equity/ Total Assets (Total Debt+Saving)/ Adjusted Total Equity
Gross Loan Portfolio/ Total Assets Saving Ratio Active Borrower Ratio	Gross Loan Portfolio/ Total Assets Total Saving / Total Asset & Liabilities Total Active client /Total Registered Members
Portfolio Yield Profit Margin (After Tax)	Financial Revenue / Average Gross Loan Outstanding Adjusted Net Operating Income after Tax / Average Loan Outstanding
Return on Assets	Adjusted Net Operating Income after Tax/ Average Total Assets
Return on Equity	Adjusted Net Operating Income after Tax/ Average Total Equity
Financial Expense Ratio Expense Ratio Cost per Borrower Cost per Loan	Financial Expense/ Average Total Loan portfolio Operating Operating Expense/ Average Total Loan Portfolio Operating Expense/ Number of Active Borrowers Operating Expense/ Loan Portfolio Outstanding
Average Disbursement Average Loan Balance per Borrower Average Asset Average Borrowers Average Loan Portfolio	Total Annual Disbursement / Number of Active Borrowers Gross Loan Portfolio/ Number of Active Borrowers Total Asset In the sample /Number of MFIs in the sample Total Borrowers / Number of MFIs in the sample Gross Loan Portfolio/ Number of Active Borrowers

### Assumptions

- Loan loss provision reserve is assumed to be 1% of gross loan portfolio
- Tax in the case of for-profit forms is assumed to be 35%



## APPENDIX 5: SAMPLE'S AVERAGE DISBURSEMENT (USD) PER BORROWER

### Average Disbursement (USD) per Borrower by Tier (2003-2007)

	<b>Consolidated</b>	<b>Tier 1</b>	<b>Tier 2</b>	<b>Tier 3</b>
2003	141	161	147	76
2004	157	179	138	96
2005	204	224	161	123
2006	183	186	192	136
2007	197	201	195	170
<b>Average</b>	<b>176</b>	<b>190</b>	<b>167</b>	<b>120</b>

### Average Disbursement (USD) per Borrower by Legal Form (2003-2007)

	<b>Consolidated</b>	<b>NBFC</b>	<b>COOPERATIVE</b>	<b>SOCIETY</b>	<b>TRUST</b>	<b>LAB</b>	<b>SECTION 25</b>
2003	141	147	121	36	65	235	118
2004	157	141	137	30	157	252	92
2005	204	208	177	50	141	215	103
2006	183	186	207	75	165	222	102
2007	197	203	251	94	223	175	110
<b>Average</b>	<b>176</b>	<b>177</b>	<b>179</b>	<b>57</b>	<b>150</b>	<b>220</b>	<b>105</b>



## APPENDIX 6: LIST OF INVESTMENT FUNDS AND CORPORATIONS FOCUSED ON INDIAN MICROFINANCE

1. ABN Amro Fund
2. Aavishkaar Goodwill India Microfinance Development Company (AGIMDC)
3. Aureos
4. Bellwether Fund
5. Bharti Airtel
6. Blue Orchard
7. Calvert Foundation
8. Carlyle
9. Deutsche Bank
10. Developing World Markets
11. Enam
12. FMO
13. Fullerton
14. Google
15. Grameen foundation
16. Hivos-Tridos Fund
17. ICICI Bank Private Equity Group - through HNIs
18. IFC
19. JM Financial
20. Legatum Global Development
21. Lok Capital
22. Microventures
23. Morgan Stanley
24. MSDF
25. NABARD
26. Ohm Capital
27. OikoCredit
28. Omidyar
29. Opportunity International
30. Orient
31. Reliance
32. ResponsAbility
33. Saif Partners
34. Sequoia Capital
35. SIDBI
36. Unitus
37. Vinod Khosla
38. Yes Bank



## APPENDIX 7: ASSUMPTIONS FOR GROWTH PROJECTIONS OF INDIAN MFIS (2008-2012)

1. Intellectap assumes that there are 250 Tier 1 MFIs with an average borrower base of 5000 and an average loan size of USD 74 (INR 3000). Together, this group of MFIs would add USD 55.6 Million (INR 2.25 Billion) to the cumulative portfolio size of Indian MFIs by March 2007. Assumptions for their portfolio projections for 2012 are the same as those applied to the Tier 3 MFIs in the Intellectap sample.
2. The following assumptions are made regarding MFIs that would emerge in the next five years across three growth scenarios:

Number of MFIs expected to be created over the next five years in three scenarios

Scenario	2008	2009	2010	2011	2012
Low	50	40	40	30	20
Most likely	40	30	30	20	15
High	30	25	25	15	10

- A CAGR of 35% is assumed for the future growth projections of the above MFIs.
  - In addition, all assumptions made for Tier 3 MFIs would be applicable for this group.
3. Capital to total assets ratio of 12% is assumed for Tier 1 and Tier 2 MFIs and 15% for Tier 3 and start up MFIs.



## THE STUDY TEAM

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Manju Mary George

Manju's interest lies in exploring market based solutions for the challenges of global development. Prior to this research, she was involved in several of Intellectap's initiatives related to financing microfinance including a similar publication in 2005 and a technical course on MFI capital structuring.

A graduate in management, Manju spends time on books and pursuing her interests in tai chi, pottery and Spanish.



Abhijit Maheswari

Abhijit is deeply interested in finance and data analytics, and has been involved in numerous projects related to the same during his time at Intellectap. He is an avid traveler and a voracious reader, and is always up to date with the happenings in the Indian private equity space.

He lives to learn, and any initiative that requires him to delve deep into a new subject, especially related to finance, economics or data analytics, is always welcome.



Nilah Pandian

Nilah enjoys working with social entrepreneurs and investors to find solutions to global social, economic, and environmental problems. She has lived in India for nearly two years and has traveled extensively throughout Asia, Latin American, and Europe.

She loves exploring new places, eating good food, and spending time with family."



#### On the cover

The *Pyramid* is often used as a metaphor for an evolving hierarchy – be it in the 'maslow's hierarchy' or the popular 'base of the pyramid' theory. The present financing landscape in India can be imagined as a twin pyramid structure with the peaks touching each other: the upper pyramid with a very few small investors at the peak and several large investors at the wide base, the lower pyramid with a few large MFIs at the peak and several small-sized MFIs at the base. Money flows from a few risk taking investors to a few large MFIs through a tiny aperture that connects both sides. A clear challenge for Indian microfinance is to widen this aperture and invert the two pyramids to ensure a smooth flow of financial resources from a larger number of investors to a larger number of MFIs at the base. MFIs should develop sound governance structures, transparent practices and efficient systems to attract commercial capital and 'invert the pyramids'.

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