MicroSave India Focus Note # 17

Market Conditions for Microfinance in India
Lessons Learned from *MicroSave*'s Action Research Programme 2007-2009

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Background: This note discusses the lessons learned from *MicroSave*'s two years of working in the Indian microfinance market. It highlights some of the broad issues and how these have been addressed by *MicroSave* and its partners … as well as where more detailed *MicroSave* documents are available.

Growing Competition: Competition is growing in some areas – particularly in the southern states and even in some limited areas of the north. On occasions this has led to some unsavoury practices, exacerbated by the numbers and "sales" driven nature of the expansion of the larger MFIs, which are now responding to the demands of their commercial equity investors for very rapid expansion. Staff and management are under huge pressure to form groups, and have sometimes responded by "poaching" both credit officers and groups from rival MFIs. The dash for growth has also seen several MFIs over-stretch their capabilities and systems, resulting in significant and debilitating portfolio problems – particularly in the north of the country. Further investment in processes, systems and the development of management capabilities will be essential to manage the alarming growth rates planned and pursued by most MFIs (see *MicroSave* India Focus Note # 8 "What Does Competition Mean For Indian MFIs?" for more discussion of this).

While most MFIs continue with widespread expansion with a single group lending-based product, the growth in competition has also resulted in a growing interest in individual lending, with most of the larger MFIs now offering these products too. However, many Indian MFIs continue to treat these loans as an extension of their group lending programmes, with fixed loan sizes, growing with each loan cycle, irrespective of the needs of borrower's business. There are also several India-specific challenges to individual lending that *MicroSave* documented in its India Focus Note # 14 "Challenges of Introducing Individual Lending in India".

As MFIs experiment with options to offer insurance and savings products, it is fair to assume that the product mix available to the poor clients they serve will further expand to better meet their needs. This will be particularly important as there is growing evidence that the dominant Self Help Group-based model is facing growing portfolio problems[1] and that members are unwilling to save large amounts of money through this mechanism (see *MicroSave*'s India Focus Note # 6 "Savings Services for the Poor – An Old Need and A New Opportunity for MFIs in India" for a discussion of this).

Offering Savings Services and E/M-banking: At the same time as India has seen growing access to credit for the poor, the Reserve Bank of India has been pushing banks to open "No Frills Accounts" as part of its commitment to financial inclusion. But these accounts are intrinsically loss-making for banks, so they are often poorly publicised and marketed by banks, and typically only a limited number of accounts are opened. Of those accounts opened, many/most quickly become dormant (except for those used for pensions or National Rural Employment Guarantee Scheme payments). Overall the service quality offered to No Frills Account holders is very poor – not least of all because of the costs associated with offering a good service.

E- and M-banking is acknowledged to have huge potential to create massive financial inclusion and has taken off in Brazil, Philippines, Kenya etc. In India the Banking Correspondent model outlined in the RBI circular of January 2006, opened the door for India to realise this potential … but excluded NBFCs (and thus most large MFIs) from acting as correspondents (see *MicroSave*'s India Focus Note #4 "E-Banking – The Next Revolution?"). However, the supplementary requirement for a bank branch within 15km of the agent's premises in rural areas, which was added in April 2008, may close that door – or at least restrict competition. In common with some international experience, initial rollouts in Andhra Pradesh and

[1] More than 50% of all commercial banks, regional rural banks and cooperatives are reporting <90% recovery of SHG loans.

Rajasthan have, however, seen large-scale dormancy of accounts, perhaps reflecting issues with trust and/or the quality of service problems with "No Frills Accounts" outlined above.

Social Performance Management: As elsewhere in the world, Social Performance Management in India has grown in importance, but remains largely external and donor-driven. This may well be because of the perception that it is primarily focused on depth of outreach measurement indicators. Effective Social Performance Management will have to yield real value-add for the MFIs, in terms of improving their business and both components of the double bottom line through providing actionable information about client and staff needs and perceptions. In India, Social Performance Management describing the way MFIs respond to the needs of the poor, (as well as the nature of their clients), will also be essential to manage the growing political risk. With the entry of foreign, commercial, private equity funds into the Indian microfinance market, the level of latent political risk has risen significantly. These funds are looking for capital growth of 30-40% per annum (see *MicroSave*'s India Focus Note # 5 "Microfinance Is Not An Easy Business"), and when they sell their shares to realise these type of returns, the negative publicity and backlash that is likely to occur will make the controversy surrounding Comportamos look benign.

Under-served/Challenging Areas: For all the rapid growth in joint liability group-based microfinance in India this has been focused in population-dense areas, primarily in the southern states. New approaches to delivery, refined products and even entirely different models (probably based on de-centralised systems) will be necessary to meet the needs of many of the under served and more remote areas. As noted in *MicroSave*'s India Focus Note # 9 "Reaching Remote Areas", "For many areas with limited cash economy, traditional organisations and financial products need to be harnessed and promoted for financial intermediation, since these offer low cost alternatives to more formalised, centralised systems. This will require more research to understand these organisations. Also, with the spread of mobile networks, e-banking may offer another attractive proposition."

IT Systems for MFIs in India: IT remains one of the key challenges. Start-up and small MFIs are unable to afford the more sophisticated IT systems. These MFIs then face real problems with data migration between different systems as they upgrade when they reach large enough scale to warrant investing in high-end IT systems. Some of these issues seem likely to be solved by the "Software As A Service" solutions under development by a growing number of leading software houses in India. At the same time with the potential importance of e- and m-banking solutions, MFIs are likely to need the more sophisticated IT systems necessary to support them.

The Effects of the Credit Crunch: Many MFIs were struggling to attract funds they required in the last quarter of 2008, but that in the final quarter of the year many banks (under pressure to meet their priority sector lending requirements), including the public sector banks, have started lending to MFIs. MFIs and experts expect tighter credit conditions in the new financial year, from April 2009. The entry of the public sector banks (that hitherto only lent to Self Help Groups) is a very important step forward and likely to lead to increased demands for further efficiency and reduction in interest rates, and also to increased availability of funds.

Training/Technical Assistance Provision: The major risk in the sector is the lack of management, systems and trained human resources in MFIs (see *MicroSave*'s India Focus Note # 11 "Capacity Building – Needs and Challenges in India"). Poor governance, even in the leading MFIs, has lead to a general lack of transparency in their operations. This is often compounded by the inability of the MFIs to identify/use appropriate IT solutions for their operations. In their haste to lend to the MFIs, the commercial banks lending large funds (both on and off-balance sheet) to these organisations, typically perform perfunctory and inadequate performance appraisals. With this relatively easy access to financial capital, many of the MFIs have grown too fast and have systems and management that are over-stretched. *MicroSave* is engaged in responding to this huge and pressing need for capacity development through piecemeal courses and the Applied Microfinance Institute India. Furthermore, the inward focus of Asian microfinance markets means that there remains a pressing need for pan-Asia cross fertilisation of ideas/experiences. In particular, Indian MFIs have little experience/knowledge of the lessons already learned outside India and could benefit greatly from exposure to/interaction with other Asian MFIs … and vice versa. Thus the potential for cross learning is huge (see for example *MicroSave*'s India Focus Note # 12 "Are There Lessons For India From Bangladesh?").

Conclusion: The Indian microfinance market is growing and evolving extremely quickly; with these changes come challenges and opportunities. The next few years will demonstrate if the potent combination of commercialisation, technology, and abundant debt capital has over-stretched the systems and capabilities of MFIs to breaking point … or will serve to turbo-charge successful, balanced financial inclusion that offers a range of financial services to the currently un-banked poor in India.