MicroSave India Focus Note 26

Market Strategy Development and 3rd Generation Microfinance in India

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Introduction

Microfinance in India has evolved over the past two decades since its inception in early 1990s. The SHG-bank linkage model, its first prototype, was an offspring from an unlikely marriage between the social intermediation role of the civil society and the financial intermediation of banks, with RBI and NABARD acting as more than willing midwives.

As the business potential of microfinance dawned on many, microfinance institutions (MFIs) took on the task of both the social and financial intermediation. Thus an alternate channel for microfinance arrived (somewhat belatedly by comparison to elsewhere in the world). This was second generation microfinance for India. Most of the MFIs adopted the Joint Liability Groups (JLGs) methodology and standardisation became the new mantra for achieving rapid growth. Over the past 2-3 years, NBFC-MFIs operating under predominantly JLG-based methodology have emerged as a significant and rapidly growing force.

Nonetheless, SHG-based systems still serve three quarters of the overall microfinance clients in India and have two-thirds of the total loan outstanding[1]. Some would argue that SHG-based models are still the most relevant model for certain segments of India's poor. Nonetheless, there is growing evidence of significant problems with SHG-based models' portfolios[2], and some issues within those of JLG-based MFIs, particularly in competitive areas of the country. With competition comes change.

The Changing Environment - A Tectonic Shift?

Interestingly, the formal, public sector financial institutions (Regional Rural Banks, Cooperative Banks etc.) are still not competing in the microfinance market. But the burgeoning number of MFIs, and the relatively narrow focus of their products, has meant that intense competition has emerged, particularly in the southern states and in some limited areas of the east. This has provided microfinance borrowers with unprecedented access to credit. This has been a boon for them, but not without the concomitant vices of competition. Many of the larger MFIs are now responding to the demands of their commercial equity investors for very rapid expansion by adopting a "sales" driven approach for increasing outreach. The dash for growth has also seen several MFIs over-stretch their management capabilities and systems, resulting in significant portfolio problems.

In addition, there is growing evidence of clients "patching" loans together from several MFIs in order to meet their needs for finance. For example a high yield heifer costs around Rs. 30,000 (USD $600) – more than any one Indian MFI will lend under a traditional group-based system. The proliferation and massive growth of MFIs has meant that (so long as they are willing to sit in the groups each week) clients can access three (or more) loans from different MFIs. Unsurprisingly, while many clients successfully take multiple loans to finance larger projects, others become over indebted – this has led to growing signs of stress in MFIs' portfolios, most dramatically evidenced in Kolar district in Karnataka[3].

To respond to the cut-throat competition MFIs are trying out different approaches that range from the desperate to the deliberate. The desperate measures have bordered on the unethical like "poaching" both credit officers and even groups from rival MFIs. Other more deliberate attempts have included offering individual lending (IL) product to their old clients[4]. But the design of many MFIs' IL product is little different from their group loans – except that group guarantee is replaced by a single guarantor. Basic evaluation of the enterprise is usually performed, but the product is rarely customised to respond to cash flows, or even the financing needs, but rather reflects a pre-defined stepped loan schedule. And few MFIs invest in the skill sets required for a successful IL programme[5].

In being "reactive" to the competition (and in some cases their private equity investors), many MFIs are losing sight of the *raison d'etre* of their existence - their clients. It is increasingly clear that the challenges of competition must be countered by bringing client back as the "focus" of their business. This shift in focus will bring a "tectonic" change in the way MFIs do microfinance and see the emergence of 3rd Generation microfinance institutions (3G-MFIs).

[1] "Bharat Microfinance Report: Quick Data-2009", Sa-Dhan
[2] See *MicroSave* India Focus Note # 15 "Delinquency in Self Help Groups"
[3] See *MicroSave* India Focus Note # 25 "Dinosaurs and Rabbits"
[4] 6 of the top 50 MFIs in India are offering IL product. Refer "*India Top 50 Microfinance Institutions*; October 2009; CRISIL ratings
[5] See *MicroSave* India Focus Note 14 "Challenges of Introducing Individual Lending in India" and *MicroSave* India Focus Note 31 "Risks and Challenges in Individual Lending"

3G Microfinance Institutions: "Expansion" to "Engagement"

A 3G-MFI is continually asking itself one basic question: *"What share of my client's financial needs is being met by us?"* It will seek to be a "one-stop-shop" for all her financial needs in manner that "delights" her. The very mission of the 3G-MFI sets it apart from its competitors, as it no longer treats its client as a headcount, but as an individual with dynamic needs.

One distinct feature of any 3G-MFI is their long term market strategy. They consciously choose to pursue the strategy of product modification and new product development over market penetration and geographic expansion. This shift of strategy from "Expansion" to "Engagement" is shown in the figure below[6].

		PRODUCT		
MARKET		Existing	Modified	New
	Existing	~~Sell more of our existing products to our existing customers **(Market penetration)**~~	Modify our current products and sell more of them to our existing customers **(Product modification)**	Design new products that will appeal to our existing customers **(New product development)**
	Modified	~~Enter and sell our products in other geographic areas **(Geographic expansion)**~~	Offer and sell modified products to new geographical markets.	Design new products for prospects in new geographic areas.
	New	Sell our existing products to new types of customers (Segment invasion)	Offer and sell modified products to new types of customers	Design new products to sell to new customers (Diversification)

3G-MFIs will see the growth in terms of improvements in their clients' financial well-being, and the MFIs' ability to serve them over a long time. Some MFIs are even looking at using full life time value of customer analysis as a basis of their planning. 3G-MFIs will also grow horizontally, but this will not be their dominant strategy; and they will grow horizontally only to an extent that does not compromise their engagement with existing client segments.

3G-MFIs: How Will They Do It?

3G-MFI will operationalise the strategy of deepening engagement by:

1. Offering clients a suite of financial services in response to their full spectrum of financial needs – credit, savings, remittances, insurance etc.
2. Focusing on convenience for all clients – so that products respond to clients' needs, and not just those of the institution.
3. Leverage technology, particularly e-/m-banking to increase transaction efficiency and reduce costs.
4. Add supplementary services, such as the "livelihood" services or education/food security services[7] or possibly even health services.

One of the pioneers of 3rd generation microfinance has been the IFMR Trust Holdings, which provides "Wealth Management" support to its clients. Wealth management is a notion that transcends product-centric thinking and the traditional focus on outreach alone. The wealth management perspective calls for institutions that are embedded within the community and growing vertically rather than horizontally. It means they will serve a limited set of clients in a more comprehensive manner, rather than be spread across a large number of clients across geographies. It also means that the institution offers its services to <u>all</u> people in the communities it serves[8].

Challenges for 3G-MFI

Since 3G-MFIs look at microfinance from a different perspective; they need do things differently from other MFIs, specifically:

1. Train the front-line staff intensively for them to be able to provide "wealth management" advice.
2. Offer savings services through Money Market Mutual Funds or other collaborations.
3. Tie up with other institutions to provide tailored remittances, insurance, pensions and other products and services.
4. Optimise the use of technology to allow tie-ups and reduce time spent on processing and back-end operations.

Conclusion

Given the saturation in a growing number of geographic markets, it is imperative for the MFIs to shift from a "product centric" to a "client centric" approach. The product-centric approach worked in uncompetitive markets with a huge demand-supply gap, and when the imperative was for rapid expansion. But as the number and outreach of MFIs has grown, supply is no more a constraint in many regions.

Clients are in a position to pick-and-choose the MFI that offers them the most value. The 3G-MFIs will be quick to sense this "tectonic shift" in the dynamics of the highly competitive markets, and do everything they can to put the client back at the centre of their business. This focus will translate into a respect for client's time and dignity, and into making the entire spectrum of financial services for her livelihood available to her – a welcome prospect for both clients and those who believe in microfinance as a service for development and poverty eradication.

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[6] Based on the 'Kotler on Marketing: How to Create Win and Dominate Markets'
[7] Equitas is building in such services
[8] IFMR Trust Synthesis Newsletter August 2009