Attracting Private Capital in Pursuit of Social Goals:

A "Social Investing" Approach to Indian Micro Credit

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What is Social Investing

There is growing interest around the world in what is being termed "social investing" or investing for objectives that are not purely financial. Official donor' agencies as well as private foundations have become increasingly drawn to the notion of social investing because of a growing concern about effectiveness of aid and charitable giving. In their quest to demonstrate results and quantify the impact of their interventions, donors both public and private, previously focused on measuring non-financial returns to their grant making activities, are increasingly also targeting financial returns. Thus, within the community of private philanthropists, including amongst members of the Indian diaspora, the idea of "investing for social purposes" rather than merely "giving" is catching on. At quite another level, financial markets are also beginning to design and offer products to investors hi pursuit of objectives that are not purely financial. Hence the growth of "green funds", for example, which offer investors the opportunity signal their support only to environment-friendly companies.

There is, however, considerable confusion about the terminology to describe these new types of initiatives. Before we elaborate on phenomenon and what role "social investing" could have in the micro-finance sector, it might be useful to define more clearly the terminology used in the discourse.

The Public Goods Supply Chain

To put it in economics speak, the pursuit of a social goal involves the delivery of a public good or service. Prices of such goods are, by definition, not set purely by market forces. Therefore investing for a social goal *necessarily* implies the subordination of the pure profit motive to some other objective(s).
For example, providing credit to women from low-income households is a service that has an important "public good" aspect to it. The market, left to its own devices, does not serve this segment of the population. Or if it does, it does not do so in a manner that is socially unacceptable. Village based moneylenders do provide credit to low-income households, but they do so at rates that are usurious and predatory. Capital needed to build formal channels of credit delivery to this segment of the population at "reasonable" interest rates will most likely have to be satisfied with sub-market rates of return, at least initially. In this sense, investing to build micro-finance institutions can be regarded as social investing.

Investing in the delivery of public goods and services pre-supposes what might be called a whole supply chain. The "public goods supply chain" links three essential functions: namely, *Financing, Intermediation* and *Delivery.*

Financing is the originating point of the supply chain. It involves sourcing the capital needed to fund the production and delivery of public goods. There can be multiple sources for capital spanning the continuum between *purely for-profit or market driven investors on the one hand, to entirely not-for-profit providers on the other.* The former would provide capital strictly in order to maximize their financial return (for a given level of risk). This would include commercial debt and equity markets. The latter. source type would provide capital entirely for achieving some non-financial objective. It would include private sources, as in philanthropists, or public sources, as in governments or bilateral donors. In between, there lie a growing number of investor types that would be satisfied with different combinations of financial and non-financial returns. These would include both private sources (such as philanthropist looking for some level of sub-market financial return) and public sources (such as government contributions to the non-confessional lending though bi- and multi-lateral aid agencies).

Delivery lies at the other end of the supply chain. Like the source of finance, agents that deliver public goods and services to the ultimate client too span the spectrum from purely not-for-profit agents at one end to entirely for-profit service delivery channels at the other. We can term the for-profit delivery agents as Corporate. Not-for-profit agents can be private, as in Non-Government Organizations or NGOS or public, as in Government agencies.

Intermediation is the link in the supply chain that channels capital from various sources to the delivery agents. So far the task of intermediation in the public goods supply chain has been dominated by not-

for-profit public and private organizations. Multilateral agencies such as the World Bank and the Asian Development Bank would be examples of public intermediaries. Private foundations, trusts and charities would be examples of private intermediary organizations.

The Smart Subsidy as Catalyst

It was noted earlier that pursuing a social goal, by definition, involves subordinating the pure profit motive to other objectives. Said another way, the financing and delivery of public goods necessarily involves some kind of implicit or explicit subsidy somewhere along the supply chain.
Given that the fundamental objective of market driven sources of private capital is pure profit, it follows that the only way in which such capital can be attracted to the pursuit of social goals is if there is some other party in the supply chain that is willing and able to absorb the cost of the subsidy involved. It is quite unrealistic to expect debt and equity capital markets to provide financing for micro-credit without the involvement of some not-for-profit source as well.

However, this subsidy need not be financial in nature. Nor does the subsidy have to be permanent. Sometimes, a market failure can be corrected by removing information gaps. Market participants can, for example, be persuaded to make investments in activities previously considered too risky if regulatory uncertainty is removed, or if better information about the opportunity is disseminated to market participants. Micro-credit is a case in point. Commercial banks in India are increasingly interested in lending to the poor thanks in part to the efforts of not-for profit credit rating agencies to collect and disseminate data on the portfolio quality and risk return profile of lending activities of micro-finance institutions (MFIs) across the country.

Hence, the notion of a "smart subsidy". A smart subsidy applied to the public goods supply chain is one that acts as a catalyst to what should then become a self-sustaining flow of private capital to fund the delivery of a public good or service. In attracting private capital to help finance Indian MFIs, our challenge is to (a) design the supply chain in such a way that the subsidy involved is smart, i.e. that the flow of private capital to the sector is self-sustaining; (b) that the ultimate clients, i.e. low income households are well served from a social or public policy point of view; and (c) that this call be done on a large scale.

The Development of the Microfinance Sector in Asia

It is well recognised that access to financial markets is important for poor people. Like all economic agents, low-income households and micro-enterprises can benefit from credit, savings and insurance services. Such services help people take advantage of profitable business opportunities and increase their earnings potential, manage risk and smooth consumption. In many developing countries, as much as 60 per cent of households are low income. Access to financial services can be extraordinarily powerful for spreading economic opportunity and fighting poverty.

There is also plenty of evidence to suggest that the impact on poor households is substantially greater through the empowerment of women. Women are the primary custodians of family unit's welfare. Providing women with access to finance has a huge impact on levels of educational attainment by children in poor households, on quality of health and nutrition in the households and on the pace of accumulation of household assets. Women from low-income households have also proven to be systematically better credit risks than male borrowers from similar households. By directing loans to poor women micro-finance has been shown to be an extremely effective and economical way to attack poverty.[1]

1. See for example, M. Pitt and S. Khandker, "Impact of Group Based Credit Programmes in Poor Households In Bangladesh: Does the Gender of the Parties Matter?" Journal of Political Economy, 106, 1998.

Microfinance is defined primarily as the provision of unsecured, short-term loans, typically less than Rs. 10,0000, to individuals or groups of mostly women borrowers and/or to microentrepreneurs from low-income households. The term is also increasingly applied to the provision of other financial services to low income clients (e.g., savings accounts and insurance).

Microfinance provides the working poor with access to more affordable capital. Studies of the development impact of microfinance are compelling. For example, a recent study on the impact of microfinance programmes in India covering schemes across 11 states concluded that within the households that participated in the study, income per household rose 33 per cent, average employments in person-days per year rose 18 per cent, the proportion of households below the poverty line declined from 74 per cent to 57 per cent; average value of assets per household increased some 72 per cent from Rs 6,843 to Rs. 11,800, with almost 60 per cent of all households reporting an increase in the value of their assets. Other reported benefits include a marked decline in family violence.[2]

The origins of modern microfinance can be traced to the mid-1960s, when a number of multilateral institutions, government agencies and non-profit organisations began to analyse and develop credit programmes to assist the world's poor to achieve sustainable economic development. It was noted fairly early on that local moneylenders and middlemen were able to achieve high repayment rates from loans to poor households relying on peer-based, non-collateral borrowing and repayment. So development organisations began experimenting with the creation of affordable credit programmes applying a variety of operating techniques.

In an unsecured lending business, borrower information quality and monitoring techniques are critical. Micro credit programmes developed a variety of methods to minimise and manage credit risk. Three principal lending techniques evolved: (i) group lending; (ii) village banking; and (iii) individual micro-lending. Group lending programmes, pioneered by Grameen Bank of Bangladesh[3], involve the cross-guaranteeing of loans within a group of mostly women from low-income households. The rationale behind group lending is that peers have better information on the economic activities of their neighbours. That they are able to put more pressure, and a different kind of pressure, on borrowers than institutional staff are willing and able to do — reputation among peers is a stronger motivator then the potential loss of physical collateral. In addition, borrowers feel more obligated to repay when the members of their immediate community of friends stand to lose rather than a faceless institution. Micro credit programmes employing the "village banking" model make loans to a community group, which then on-loans the funds to within their community. The rationale for this model is an extension of that for the group-lending model.

Individual lending, as the name implies, provides credit to borrowers on an individual basis. On-site visits to the borrower's place of business are standard operating procedure for such micro-credit programmes. An on-site visit can confirm the existence of the business and is the most reliable way to obtain a sense of the scale and profitability of the borrower's business activities. Peer review is another important information gathering technique for individual micro-credit programmes. As part of the peer review, lenders interview friends, neighbours, relatives, and long-time business associates to verify and obtain additional information about the prospective use of borrowed funds. Group lending, village banking and individual lending continue to be the core operational models for microfinance today.

Commercial Viability of the Microfinance Sector in Asia

Many leading MFIs have achieved operating cost self-sufficiency (defined as covering operating costs) for over a decade. Micro credit programmes have surprised economists and conventional finance professionals with their high loan repayment rates, which are often above 95 per cent. Academic studies have sought to explain the surprisingly high repayment rates given the perceived risk level for this type of credit investment. Many of the studies conclude that because, outside of micro credit, there is such a shortage of capital amongst this borrower class, the borrowers believe that they cannot afford to default, because a default would likely result in a permanent loss of access to this source of capital.

2. Puhazhendi and Satyasi, 2001, Impact Assessment of Self Help Groups-Bank Linkage Programme, NABARD, Mumbai.
3. Todd, Helm, 1996, Women at the Center: Grameen Bank Borrowers After One Decade, Dhaka University Press Ltd.

Table 9.1 provides an illustrative example of the revenue and cost structure of a sample of *self-sufficient* MFIs in Asia[4], with all numbers expressed as a percentage of the MFIs' gross loan portfolio:

Table 9.1

MFI Business Model as a Percentage of Average Gross Loan Portfolio

Interest & Fee Income	33.5
Loan Loss Provisions	1.8
Interest Expense(1)	8.1
Net Interest Income	23.6
Operating Expenses	22.5
Income Before Taxes	1.1
Taxes	0.3
Net Income	0.8

(1) Assumes Portfolio is 67 per cent financed with liabilities paying a blended rate of 12 per cent.

As Table 9.1 indicates, the interest rates charged by typical MFIs are quite high relative to bank loans (30-35 per cent compared to 9-13.5 per cent for the banks). But as we will argue below, banks byand-large are unable to reach the poor clients that MFIs reach and some forms of bank financing have some form of subsidy implicit in them. Moneylenders are the only alternative source of credit for low income households and they charge interest rates that range anywhere from about 40 per cent to 20 per cent, with an average rate of close to 60 per cent[5]. That is why there is in fact great demand for MFIs credit from poor households.

One of the reasons why self sustaining MFIs do need to charge rates that are higher than typically charged by banks is that their operating expenses are high relative to more conventional financial institutions. This is principally because microfinance is a labor-intensive business: a typical MFI has thousands of loans outstanding with thousands of borrowers, resulting in significant monitoring and administrative costs. Moreover, MFIs provide the convenience of at-the-doorstep-banking to their clients. MFIs are mobile banks in that they deliver credit and service their portfolio at the domicile of the client (typically the village) – they do not require for clients to make their way to a branch. A fairer comparison of rates charged by MFIs *versus* banks would adjust the latter rates for transaction costs (number of visits to the bank, documentation, and in some cases also bribes) incurred by borrowers. So adjusted, the cost of average bank loans in India, for example, is closer to 22-23 per cent.[6]

In addition to covering operating costs, an increasing number of non-commercial MFI investors have required MFIs to earn a return on invested capital. The rationale for this is to improve accountability, cost efficiency, and to continue the evolution of the sector toward commercial viability, and to demonstrate to commercial investors that the sector can earn a return on capital. As shown in the Table 9.2, a review of 10 leading MFIs in Asia suggests that over recent years the best MFIs are paying debt investors an annual return of close to 10 per cent, and are earning an average (unrealized) return on accounting equity of over 10 per cent.

4. Based on data from M-GAIL, Microfinance Review, *2003,* Micro Credit Rating International Ltd., Gurgaon.
5. P. Basu and N. Verma, *Improving* Access to Rural Finance in India: An *Overview,* World Bank, 2003.
6. Vijay Mahajan and Bharti Ramola Gupta, Microfinance in *India,* Banyan *Tree* and Bonsai, World Bank, 2003.

Table 9.2
Return on Capital of a Sample of Asian MFIs Based on
Most Recent Rating Conducted by M-CRIL
(US$ in Millions, Unless Otherwise Indicated)

Portfolio Characteristics	
Average Gross Loan Portfolio	$1.3
Average Annual Portfolio Growth Rate	34%
Average Number of Clients	32,100
Aggregated Number of Clients	528,000
Average Loans in Arrears (>60 days)/Portfolio	2.8%
Return on Capital	2.1%
Average Return on Assets (ROA)	
Average Return on Equity (ROE)	10.0%
Average Interest Expense/Debt Outstanding	10.0%

Notes: Data covers top 10 MFIs from a sample of Asian countries. Averages represent "weighted-averages" of each category for the 10 MFIs. Source: *M-CRIL Microfinance Review* 2002, Micro-Credit Ratings International Ltd.

The indicators above do not include data from the four giant and enormously successful MFIs in Bangladesh, namely Grameen, BRAC, Proshika and ASA, that each have 1-3 million clients because these are not rated by M-CRIL. It also excludes Bank Rakyat Indonesia, a government owned community bank that has also achieved very significant outreach with commercial viability. What all of this suggests is that there is enormous room for microfinance to grow and that prospects for creating commercially viable MFIs that are also capable of delivering financial services to large communities of poor people at affordable rates are quite promising.

The Indian Micro-finance Sector[7]

Although access to financial services can be a very effective anti-poverty instrument, because of their special features, financial markets often serve poor people badly. Lack of collateral and high transaction costs means that the poor are most often excluded from financial markets. On the face of it, India has a deep financial system. Financial assets amounted to about $430 billion or about 93 per cent of GDP in India compared to 68 per cent of GDP in Mexico, a country with a per capita income that is ten times higher ($4,440 vs. $440). India also has a very large network of commercial bank branches – 66,500 of which almost half are in rural areas. As a result, India compares favorably in terms of branch density '(average population served per commercial bank branch) of 12,800 vs. a similar number for Mexico. However, India's financial system has been relatively unsuccessful in allocating resources to the country's private sector. Private credit as a share of total bank assets is only 36 per cent compared to about 50 per cent in Mexico. In particular though, despite all the infrastructure of rural bank branches and rural cooperative banks, the Indian financial system has failed to provide access to the poor, especially the rural poor. Almost 60 per cent of households do not have access to a bank account; only 20 per cent of rural households have access to credit from a formal source; 87 per cent of marginal farmers do not have access to any formal credit.[8] It takes between 4-7 months for a formal loan to be approved. Bribe taking by personnel of rural financial institutions is rampant with bribe amounts varying from 10-20 per cent of the loan amount.[9]

An estimated 260 million Indians live below the poverty line, of which about three-quarters live in rural India. What this implies is that about 42 million households in India do not have access to credit. If households living near the poverty line are also included, it is estimated that about 60 million Indian households do not have access to credit today. Various studies have found that the average annual potential credit usage of poor households varies from Rs. 3000 to 9,000. This would suggest an unmet demand of between Rs. 175 - 535 billion rupees per annum.[10]

7. This section draws heavily from World Bank, Priya Basu and Niraj Verma, 2003.
8. World Bank-NCAER, Rural Finance Access *Survey,* 2003.
9. World Bank, Priya Basu and Niraj Verma, 2003.
10. V. Mahajan and B.R. Gupta, *Micro Finance in India, Banyan tree or Bonsai,* World Bank, 2003.

Faced with this problem of insufficient outreach of the financial system to the poor, the government of India, NGOs and financial institutions have all made attempts to bridge the gap. *Self-Help Group—Bank Linkage Programme is* an important initiative in this regard. The SHG programme involves organising the poor (mostly women) into groups of 15-20 persons that are encouraged to save collectively. These groups are then linked to the mainstream banking system, thus allowing them access to credit. The SHGs is essentially a variation on the village-banking model described earlier - the groups at the core of this model, save, borrow and rpay collectively. Once the group is formed, the tasks of credit evaluation, loan monitoring and collection are all left to the group itself. The success of this model thus depends critically on the quality of the groups. Here the programme has relied heavily on NGOs and Regional Rural Banks (RRBs) to promote, nurture and strengthen SHGs. This involves inculcating the savings habit amongst group members, teaching group members book-keeping skills, keeping the group members cohesive and then introducing them to a bank.

The number of SHGs has grown very rapidly from just 500 or so in the early 1990s to over 800,000 in 2003. SHG-Bank Linkage Programme today reaches about 12 million women and their households. It has cumulatively over the past decade provided about Rs. 22 billion in loans, with loans outstanding amounting to about Rs. 11 billion. It has in effect become the dominant mode of micro- credit in India. But even so, this programme meets only 2.0-6.2 per cent of the estimated annual demand for credit from low-income households in the country.

The great merit of the programme is that it reduces the transaction costs to the banks because the bulk of the underwriting and loan monitoring responsibility is transferred to the group itself. But although the banks offer loans to SHGs at 12-13.5 per cent, the on-lending cost to ultimate borrowers who are the group members is still about 24 per cent.[11] Moreover, this cost does NOT include the full costs of promoting and supporting the SHGs, a task currently outsourced to NGOs and RRBs. It is estimated that if these costs were properly accounted for, the effective lending rate from the banks to SHGs would be in the 22-28 per cent[12] range, and consequently the cost to the ultimate borrower would be closer to 34-40 per cent.[13]

Second, scalability and sustainability are matters of serious concern. A sample of 61 SHGs surveyed in India had an average return on assets of H2.5 per cent, with over half the .sampled groups showing returns worse than (–)15 per cent on assets.[14] The evidence suggests that as the SHG-Bank Linkage Programme has caught on, quantitative targets set by government for group creation have begun to take priority over the quality of the groups promoted. A recent survey by the *Andhra Pradesh Mahila Abhivruddhi Society* (APMAS) showed that only 17 per cent of groups created in Andhra Pradesh (a state that is a leading proponent of the programme) were of adequate quality to be linked to banks.[15] Indeed this finding is also reflected in the M-CRIL survey, which indicates that the share of the portfolio at risk (more than 60 days overdue) for SHGs was over 19 per cent, more than six times that for *Grameen* type MFIs in the portfolio.[16]

Grameen Type and Other Specialised MFIs. Outside of the SHG programme, there have been a number of initiatives to promote *Grameen* type MFIs and other specialised MFIs that follow the individual lending model. None of these initiatives, however, enjoys widespread government support and overall their outreach remains very limited. According to M-CRIL, the largest 49 such MFIs had total outstanding loans of about Rs 3.6 billion in 2003, and reached less 1.4 million borrowers in total.[17] The bulk of the MFIs, with some notable exceptions, continue to be run on a not-for-profit basis by a variety of NGOs. Most operate on a sub-optimal scale, heavily dependent on grant financing, with no assurance sustainability.

11. Basu and Verma, op. cit.
12. S. Sinha, 2003, "The Outreach Conundrum: Can India's Regional Rural Banks Really Serve Low Income Clients", M-CRIL, Gurgaon.
13. According to the Ministry of Rural Development, promotion costs about Rs. 10,000 per group.
14. M-CRIL op. cit.
15. Mahajan and Gupta, op. cit.
16,17 M-CRIL *op.* cit.

The lack of debt financing is NOT a constraint to the development of these MFIs. Indeed, there is an abundance of debt capital available. Domestic commercial banks have shown an increasing willingness to lend to MFIs as a cost-effective, and even profitable way, of meeting their priority sector targets (targets set by government to meet certain social objectives). To the extent that there is a shortage of capital, it is equity capital that has been short supply. Because they are run as not-for-profit entities, no equity financing is forthcoming to adequately capitalise these MFIs. Hampered by skewed capital structures, a lot of MFIs are unable to access debt financing from commercial banks.

The biggest hurdles to the scalability of non-SHG type MFIs in India are (i) the philosophical and attitudinal resistance of most NGOs and MFIs themselves to functioning in a more commercially focused manner, (ii) the acute shortage of managerial talent and institutional bandwidth in this sector and (iii) the maze of regulations that restrict the operation of foreign donors and/or investors in India's financial sector.[18]

The bulk of Indian MFIs see themselves as providers of development assistance to the poor. The dominating perspective is one that regards the poor as unable to carry debt on commercial terms and/or unable to make productive use of credit without training/ advice or some form of technical assistance. As a result, the overwhelming majority of Indian MFIs are high cost, small-scale operations that struggle to survive on a self-sustaining basis and rely heavily on uncertain on government/donor support. One of the big problems in this regard is the lack of commercial orientation of the NGOs that operate these MFIs. Government intervention in the sector is often politically motivated and tends to be infected with a subsidy culture. This has served to further corrupt the institutional culture of the MFI sector and undermine its financial viability.

Summary Diagnostic. The MFI sector is surprisingly under-developed. The commercial viability of the micro credit sector in India has been established in only a few and mostly small-scale programmes in the country. The full potential of the sector remains unexplored. The Indian Government's interventions in this sector have had moderate success and, even with a growing number NGOs venturing into micro finance, the reach and scale of these initiatives remains very limited compared with the estimated demand for micro credit.
Perhaps the single biggest obstacle to scalability in this sector is not a shortage of financing, but rather a lack of commercial orientation. Most Indian MFIs now have access to some debt financing if not from commercial banks, then from public sector intermediaries. Although many are still constrained by the lack of equity capital, almost all MFIs suffer from an acute shortage of management talent and perspective.

To use the vocabulary of the public goods supply chain, the Indian MFI sector has so far attracted capital from mainly not-for-profit financing sources in the form of government sponsored schemes with implicit subsidies and grants from the donor community. The intermediaries have overwhelmingly been government owned financial institutions (state owned commercial banks, RRBs, NABARD), none of which operate for a purely for-profit motive. And the delivery agents have also been mostly not-for-profit players including and variety of community managed MFIs (such as the SHGs), or NGO managed MFIs (such as the *Grameen* type MFIs and individual banking type entities). The real bottleneck to the growth and sustainability of the MFI sector in India comes at the level of intermediaries and delivery agents. The intermediaries are mostly intermediating credit to low income households on a non-commercial basis — this segment of their business operations is not sustainable and would become even less so if they were to be burdened with the task of really scaling up their interventions in the MFI sector. At the level of the delivery agents, there is very limited absorptive capacity. NGO delivery channels are tough to scale up. For one, being grant financed,

18. For a description of the regulatory hurdles, particularly to equity investment in the MFI sector see Basu and Verma, *op. cit.*

NGOs often run into funding fatigue after they reach a certain size. But more importantly, their institutional culture and mind-set is often ill suited to create service delivery organizations of scale — NGOs are very effective in serving the needs of small communities of clients, but are unable to serve large populations efficiently. Because of its not-for-profit orientation the MFI delivery channel in India risks becoming a growing source of bad debt creation.

The challenge is how to attract for-profit financing sources to fund the delivery of affordable financial services to the poor but in a way that is commercially viable and scalable.

Lok Capital: A Model for Creating Large Scale, Commercially Viable MFIs in India

Given the above diagnostic, we concluded that any intervention intended to help the MFI sector should aim to (i) mobilise for profit equity and debt capital (in an environment in which there does not appear to be any shortage of debt financing); (ii) back and nurture MFI managerial talent; and (iii) contribute to institution building. These three aims being very similar to the objectives of investors in early stage companies, we believe that a *"venture capital approach"* suits the needs of the Indian MFI sector. The idea is to create an appropriate entity/platform or a venture fund that would allow persons with venture capital experience to invest in a selection of suitable Indian MFIs with the objective of bringing equity capital to the table and nurturing these "investee companies" to grow and evolve along commercial lines.

However, venture funding by itself is unlikely to yield results for two reasons. First, the rates of return required by venture investors are probably too high to create MFIs capable of being self sufficient at lending rates that are affordable (say 25-30 per cent). Second, venture investors by themselves cannot resolve the problem of the lack of management capacity and skills. They need a pool of skilled managers to back and to nurture. The development of such a pool of skills has a strong public good element to it and so requires financing from not-for-profit sources of funding. A parallel capacity building facility financed through grant financing is therefore also required to help deliver long term technical assistance and training support to those MFIs that would be the recipient of equity investments from the venture fund.

The *Lok Capital* initiative was launched in 2001 with the objective to (a) mobilise and direct private (mainly equity) capital to fund micro-finance activities first and foremost in India, but eventually also elsewhere in the world; (b) fund/provide long term management and technical support for the development of commercially sustainable MFIs; and (c) disseminate information about, and inform the public policy debate on, innovative ways of empowering the poor, especially poor women and the rural poor. Lok Capital is raising the first India focused venture fund managed by local professionals, with a significant on-the-ground presence, capable of making long-term equity investments in, and delivering effective non-financial local assistance to, MFIs in India.

The Lok Capital Group comprises several entities: Lok Foundation, Inc., a New York based, not-for-profit corporation operating as a charitable foundation; Lok Fund, LLC, a New York based limited liability company, and a New Delhi based services company, Lok Capital Services Pvt. Ltd., and its affiliate, EDA Rural Systems Pvt. Ltd., a Gurgaon based management-consulting company focused on delivering technical assistance to MFIs and NGOs in India and elsewhere in Asia. Together the various entities of Lok Capital function like a U.S. style venture firm (financed through the Fund), supported, however, by a strong capacity building function (financed through the Foundation) and delivered through LCS and EDA Rural Systems, two on-the-ground services companies based in India.

The Foundation, which is the Managing Member of the Fund, is organised to (i) act as a catalyst for directing private capital to MFIs in India and possibly elsewhere in developing Asia, (ii) fund and provide long term management and technical support to these MFIs and (iii) act as a platform for disseminating knowledge and encouraging debate on innovative ways of empowering the poor, especially poor women and the rural poor.

The Foundation will pursue objective (i) by acting as the Managing Member of the Fund. The Fund is to be a receptacle for mobilising patient capital from social investors, both institutional and individual, that are willing to participate as Members and entrust the Foundation with the task of directing/managing equity investments into MFIs in India, and possibly elsewhere in developing Asia.

In pursuit of objective (ii), the Foundation will mobilise grant financing from institutions and individual contributors worldwide. These funds will then be deployed through LCS, a New Delhi based service company intended to facilitate the investment activities of the Fund, EDA Rural Systems, an India based management-consulting company with whom the Foundation and Fund have a renewable service contract, and/or other appropriate service providers that are able to deliver long term capacity building services to MFIs that the Fund has invested, or may invest, in.

In pursuit of objective (iii), the Foundation will seek to share *Lok* Capital's experience in applying venture techniques to supporting MFIs and to forge partnerships with other NGOs, Foundations, or commercial organisations that are willing to experiment with new approaches to empowering the poor across South and South-East Asia.

Contributors to the Foundation would be eligible for a tax deduction for United States income tax purposes to the extent permitted by law. In addition, they can expect to take satisfaction from acting as a catalyst (through the Foundation's capacity building activities and its role as Managing Member of the Fund) for attracting private risk capital to MFIs.

The Fund will be the first India-focused venture fund managed by local professionals, with a significant on-the-ground presence, capable of making long-term equity investments in, and delivering effective non-financial local assistance to, MFIs in India. The Fund's investment objective is to provide capital appreciation by making selected equity investments in MFIs located in India. The Fund's activities are also to be overseen by the Foundation's directors and executive officers.

LCS, incorporated in New Delhi, is a wholly owned subsidiary of the Fund. LCS's function is to provide "venture services" to the Fund. LCS will identify potential investments; conduct due diligence on potential investee MFIs; help execute transactions on behalf of the Fund, once the investment decision has been made by the Investment Committee; supervise and monitor investments that have been made; and assist with "exit" strategies to liquidate investments. LCS's budget will be financed in part by the Fund and in part through a contractual arrangement with the Managing Member.

EDA Rural Systems is a private limited company incorporated in Gurgaon that provides management-consulting services and delivers technical advisory support to NGOs and MFIs in India and elsewhere in Asia. Its function would be to deliver long- term local management and technical advisory support to MFIs that the Fund has invested, or may invest, in. In addition, EDA Rural Systems will work to forge partnerships with community level NGOs to encourage them to move out of the credit delivery business and focus on their core competence, *i.e.* the targeted delivery of services such as vocational training, and preventive health care advice for example to members of their focus communities. EDA Rural System's services would be important to the Foundation's capacity building efforts and to the long-term scalability and sustainability of MFIs that might form part of the Fund's investment portfolio.

In summary, the Lok Capital model is an attempt to forge a constructive partnership between for-profit and not-for-profit sources of capital and for and not-for profit delivery agents to provide a "public good", *i.e.* affordable financial services to women from low-income households on a large scale and in a commercially sustainable manner.

In effect, the not-for-profit capital source in this model would be funding the cost of the "smart subsidy", which in this case would be to absorb a portion of the cost of capacity building both at the MFI and the

community levels, such that (i) the interest rates charged to the ultimate client remain affordable (sub-30 per cent); (ii) private commercial banks are persuaded to provide debt financing in bulk and at market rates; and (iii) the providers of equity capital are able to reap some reasonable return on their investment. This subsidy (which is to be delivered in kind in the form of training and or community support activities) would reduce the time and losses to break even and therefore improves the economics of investments from the Fund. The not-for profit Foundation thus acts as a catalyst for market driven financing through the Fund at the financing end of the supply chain. And EDA Rural Systems and partner NGOs provide not-for-profit support to the investee MFIs, the for-profit credit delivery agents.

Some Concluding Observations

- Attracting market driven equity capital to fund the delivery of affordable financial services to the poor in India will require partnership with not-for-profit financing sources that are willing to cover the cost of the subsidy implicit in the process.
- This subsidy must not be seen to be benefiting the private source of capital, but is the cost that must be borne by some not-for-profit entity in order that the poor may gain access to financial services currently denied to them.
- This subsidy can be funded through private sources of grant funding provided it is designed appropriately.
- Mobilizing market sources of financing is only part of the challenge. An equally big issue is ensuring that the service delivery channels i.e. the MFIs are efficient, have sufficient absorptive capacity, and are scalable.
- This will require creating for-profit MFIs as the main delivery channel for credit and other financial services to the poor. But there is room for such MFIs to work in partnership with not-for-profit agents such as NGOs. But must be taken to ensure that functions of each are assigned according to their respective objectives and strengths and opportunities for complementary action are fully exploited.
- In short success requires "unbundling" the financing: and delivery chain of the public good called "affordable financial services to the poor" into discrete components to be assigned to market driven as well as not-for-profit players working in partnership with one another.
- *Lok Capital* is an innovative attempt to apply these principles in practice in the Indian context.