MICROFINANCE IN INDIA
Current Trends and Challenges

Centre for Micro Finance
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Microfinance in India: Current Trends and Challenges

1: Introduction

The microfinance sector in India, largely unfettered by tedious regulation and interference is young and dynamic. The biggest obstacle until recently was little access to commercial markets and the forbidding cost of capital funds. As private banks, spearheaded by ICICI in 2003, entered the microfinance market, this barrier has partly disappeared and microfinance is growing at a break-neck pace on all fronts viz. loan outstanding, client outreach, product and service diversification or geographic spread.

Concerns have now shifted to growth management issues such as skilled human resources, flexible product design, reducing transaction costs, ensuring adequate management information systems, standard credit information, better use of advances in technology, accessing alternative financing, expanding into underserved areas, and dealing with regulatory hurdles and political risks. There is an urgent need for structured long term financing to the sector to fully address these important issues and smoothly transition into a well functioning mature industry.

2: Supply, Demand and Potential of the Indian Market

There are very few reliable aggregate data available for the Indian microfinance market and no comprehensive database or directory of microfinance institutions.

However, India presents an obvious scope for microfinance in general and housing finance in rural India. Urban sector has traditionally been less attractive to the microfinance institutions as compared to the rural areas:

1. High migration in urban areas increases the default risk of microfinance portfolio, especially since loans are unsecured.
2. MFIs operating in urban area suffer comparison with commercial banks on interest rates.
3. Various methodologies of group formation and peer pressure are not as successful in urban areas as in rural areas.
4. Urban population mostly have a tendency of service or organized employment as compared to self employment in rural areas thereby increasing the probability of loan being utilised for consumption purposes in urban areas.

In spite of various challenges, some MFIs are now accelerating their expansion in urban areas.

2.1: Demand

There are various opinions about the microcredit demand. M-CRIL, a leading micro-credit rating agency provides a conservative estimate for the annual demand at $9.6 Bn (Rs. 480 Bn) based on 60-70 million poor families with an average household credit demand of Rs. 8,000 (less than $160)\(^1\).

Another estimate from the prominent microfinance practitioner, Vijay Mahajan\(^2\) at $30 Bn weights India with 10% of the estimated global aggregate demand of $300 Bn\(^3\).

In spite of the difficulty to classify the urban population on an occupation basis, one could broadly use self employed, service class or unemployed. There have been limited systematic analysis on credit demand/need in urban areas and more information needs to be collected. In a study conducted by Vijay Mahajan and Nagasri the demand for credit was evaluated at $180 (Rs. 9,000) per annum per household among the urban poor while the Paradigm Group survey\(^4\) estimates the same at $201 (Rs. 10,071) per annum. Considering these two estimates and the number of urban households around 20 Mn, we can infer an annual credit demand between $2.7 Bn (Rs. 137.4 Bn) to $3.1 Bn (Rs. 153.6 Bn)\(^5\).

The rural population is easier to classify according to primary occupation and income level\(^6\) and we can account for credit demand per household according to these segments. Given that population involved in agriculture have a higher credit demand due to high cost of agri-inputs.

Considering the number of households per segment, the weighted average annual credit demand per household is $420 (Rs. 21 K)\(^6\) for non-agriculture population and $1,300 (Rs.65 K) for agriculture population. The overall annual credit demand for households with income below $2 per day\(^7\) (Rs.100) therefore amounts to $ 57 to 101 Bn (Rs. 2,833—5,064 Bn). Similarly,

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\(^1\) This number was recently mentioned by Mr Sanjay Sinha, Managing Director, M-CRIL in “DEBATE: Cap the interest rate on microfinance?” The Economic Times, 21 March 2006; However many believe it on the lower side.

\(^2\) Vijay Mahajan is Chairman and Founder Board Member of BASIX, a premier livelihood promotion institution.


\(^5\) Primary occupation of rural population can broadly be classified in Agriculture or non-agriculture activities. It can further be classified based on income/person/day of <$0.6, <$1, <$2 and >$2

\(^6\) Weighted average of credit-demand per household for different income groups based on number of households and their credit requirement.

\(^7\) Assuming a conversion rate of Rs. 50 to US$1.
assuming $2 K^8 (Rs. 100 K) as the average housing loan required and taking an average repayment period of five years, we can infer an annual housing credit demand of $12—15 Bn (Rs. 592—740 Bn). Therefore, the overall annual cumulated credit demand (micro-credit and housing) would be in the range of $71—119 Bn (Rs. 3,562—5,962 Bn).

2.2: Supply

Currently, roughly 66%⁹ of the formal supply is disbursed through the Self Help Group-bank linkage route, largely financed by the National Bank for Agriculture and Rural Development (NABARD) while the rest comes from microfinance institutions (MFIs) increasingly backed by commercial banks.¹⁰

Up to March 31st 2005, a grand total of 1.62 million SHGs, representing 24.3 million poor families or approximately 121.5 million people¹¹, have received cumulative loans of over $1.4 Bn (Rs. 68 Bn) from commercial banks.¹² During the sole 2004-05 fiscal year, 573 banks participating in the SHG-bank linkage program financed 539,365 new and 258,092 existing SHGs, representing 11.2 million families or 56 million people over 31 States and Union Territories and 572 of the 602 districts of India. The amount of loans disbursed by banks to SHGs during this fiscal year amounts to $600 Mn (Rs. 29,900 Mn), i.e. an average of $751 (Rs. 37,546) per SHG. That figure displays a growth of 49% over the previous year’s figure of 361,731 new SHGs linked to banks. The increase in credit flow to SHGs over the previous year is 61%, showing a growth in the average credit size disbursed to SHGs.

Sa-Dhan, an association of 139 community development finance institutions states that the total portfolio outstanding of its members has risen 2.5 times from $90 Mn (Rs. 4.3 Bn) in 2004 to $210 Mn (Rs. 10.6 Bn) by March 31st 2005. The client outreach during the same period rose by 96% from 3.3 million to 6.48 million.

Despite these efforts, the World Bank estimates that the Indian microfinance activity currently reaches only 4% of the poor.¹³ In a sample study of 40,000 households cited by Sa-Dhan, the “money-lender” is still supreme, holding average outstanding loans at $418 (Rs. 20,908). Similarly, a 2003 national government survey found that 22% of all cultivator households access credit from informal sources and only 27% from formal sources.¹⁴

Whichever source used, it clearly appears that, in spite of the rapid growth in the past two years, the supply of credit is well below the demand. There was a total credit supply of $1.5 Bn (Rs. 75 Bn)¹⁵ in non-agriculture, of $25.1 Bn (Rs. 1,253 Bn) in agriculture and none in rural housing.

Therefore, the annual supply-demand gap of credit is in the range of $45 to 93 Bn (Rs.2,234—4,629 Bn).

3: Structures¹⁶

3.1: Credit Delivery Models

The SHG-bank linkage model and the joint liability group model (widely called the Grameen model although Grameen with its particular features is actually a subset of joint liability) are the most prominent microfinance operational models in India. Although some MFIs use one model exclusively, most use both or hybrid models.

A self-help group (SHG) is a group of around fifteen to twenty poor individuals—usually women—who provide financial support to one another in the form of pooled savings and internal credit assistance. SHG members generally use the loan for both consumption and productive purposes. Given the fungible nature of money, most MFIs do not scrutinise loan utilisation. The bank issues a loan to the group, after rating them based on their savings and internal credit behaviour. The loans are kept on the bank’s balance sheet. The SHG can also lend internally both before and after the bank linkage takes place. The SHG may choose to keep only part of their savings in the bank account, partly in order to maintain internal financing capability for emergency loans.

A joint-liability group (JLG) is a small group of borrowers (typically 4-5) who are jointly liable to an external lender (MFI) for a loan that they receive. Unlike the SHG, the sole purpose of existence of a JLG is to receive a group loan from an MFI.

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9 Based on a presentation by Niraj Verma, World Bank in 2006
10 By this phrase, we mean MFIs operating in partnership with a bank under the ICICI Partnership Model or as Business Correspondents.
11 Average size of a family is taken as five members.
12 NABARD. Progress of SHG-bank linkage in India 2004-2005.
14 Chidambaram P. Government of India Union budget speech. 28 February 2006.
15 Figures taken from NABARD and extrapolated based on market share.
16 More information on the topics discussed in this section can be found in the Centre for Micro Finance FAQs.
3.2: Regulation and Legal Forms

At present, there is not one universal legal definition or form or parliamentary regulation or regulatory authority for what constitutes a MFI in India. We broadly apply the term to an organisation engaged in lending of very small amounts to low-income households previously disconnected from or underserved by the formal banking sector. The organisation may be for or not for profit. It may operate under a variety of legal forms governed by different pieces of legislation and different regulators.

There are nine broad legal forms. MFIs are registered as Societies as per Societies Registration Act 1860 or state legislation and as Trusts as per Public Trust Act 1920 or Indian Trust Act 1882. Section 25 companies are registered as per the Companies Act (1956) with permission from central Government. These three types of organizations are not directly governed by any regulatory authority.

Other legal forms including NBFCs registered as Section 25 companies, for profit NBFCs, Cooperative Banks and Local Area Banks are regulated by the Reserve Bank of India (RBI). Cooperatives are registered as per the State, National and MACS Acts and governed by the State Registrar of Cooperatives. Union Finance Minister P. Chidambaram has promised to table a bill to provide a formal statutory framework for the promotion, development and regulations of the microfinance sector at the 2006 Parliament Budget session. The nine legal forms an MFI could take and the permissible microfinance services for each form are listed in Annex 2, Table 1.

3.3: Financing Models

Traditionally, civil society organisations financed all operational and capital costs incurred for small lending activity through donor funds. Now, MFIs take on commercial debt for on-lending and raise capital by securitization of assets and portfolio sales. Other avenues available are equity investment, quasi-equity through the partnership model, and loan guarantor funds.

1. **On-lending** involves the MFI borrowing from banks and then lending that money to clients. On-lending is the predominant model of financing.

2. **Securitization:** In India, in the absence of a secondary market for microfinance securities, people often use the term synonymously with portfolio sales. The first step of a securitization is the buy-out of a micro-finance loan portfolio against a purchase consideration calculated by computing the net present value of receivables at an agreed discount rate. The originator (MFI) or a third party (such as USAID or Grameen Foundation USA) provides partial credit protection i.e. credit enhancement to the investor (Bank) in the form of a guarantee or overcollateralisation etc. amounting to a certain percentage of the receivables under the portfolio by way of a lien on fixed deposit. The MFI continues to service the loan portfolio in exchange for service fees. Although ICICI has purchased several microfinance portfolios, there have been only two securitization deals. In 2004, the largest ever securitization deal in microfinance was signed between ICICI Bank and SHARE Microfin Ltd, a large MFI operating in rural areas of the state of Andhra Pradesh. Technical assistance and the collateral deposit of $325 K (93% of the guarantee required by ICICI) were supplied by Grameen Foundation USA. Under this agreement, ICICI purchased a part of SHARE’s microfinance portfolio against a purchase consideration calculated by computing the Net Present Value of receivables amounting to $4.3 Mn (Rs.215 Mn) at an agreed discount rate. The interest paid by SHARE is almost 4% less than the rate paid in commercial loans. The other deal was conducted by ICICI Bank and BASIX in 2004 for a part of their portfolio amounting to $842 K (Rs.42.1 Mn). After this deal, BASIX felt that the reporting requirements imposed by ICICI were too demanding and decided to raise funds henceforth by other means.

3. Few MFIs receive much **equity funding,** and few large institutions invest in equity. The exception to this latter rule is the Bellwether Fund, which has invested millions of dollars into microfinance start-ups. Foreign private equity funds entering the sector include ACCION Equity Fund and Lok Capital.

4. **ICICI Bank created the partnership model** (see text-box on following page) three years ago but competitors such as Housing Development Finance Corporation (HDFC) have started to copy it. It involves lending money directly to an MFI’s clients, while the MFI services the loan and charges a service fee to the client. Thus the effective interest rate to the client is higher than the ICICI Bank rate as stated on official bank documentation. To incentivize the MFI to efficiently collect repayments, the MFI must repay all the defaults up to a certain limit. This is the dominant mode of financing in India right now.

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MFIs receive charitable grants from numerous domestic and international donors. Two types of grants are used: operating grants which can only be used to meet operating costs, and capital grants which go straight into an MFI’s equity.

4: Financial Performance

Indian MFIs are going through a massive growth phase, sparked by increased international attention in 2005 (UN Year of Micro-Credit) but more pertinently, new and better access to relatively low cost capital from banks led by ICICI Bank. Below we highlight some interesting facts about the Indian microfinance market:

1. Market leaders: A Mix-Market survey found that large MFIs (seven institutions from their sample of 28) dominate the market. Large MFIs hold 81% of the overall loan portfolio and serve 67% of borrowers. The three largest institutions, which alone covered 54% of borrowers, are NBFCs based in south India.

2. Efficiency, Productivity and Outreach: In 2004, the average Indian MFI spent less than two thirds of the amount that it cost the average South Asian institution to serve each borrower. Moreover, whereas the average South Asian MFI served 219 borrowers per staff member, Indian institutions reached 439 borrowers per staff member (see Annex 3, Figure 2). While microfinance in India does not reach the per capita volume it does in Bangladesh, Indian medium and large scale MFIs demonstrated some of the highest sustained growth rates over the years 2003 and 2004, many averaging 100%. Over this period, outreach in the sector more than doubled; the number of borrowers served grew by 108% while the loan portfolio increased by 139%.

3. Asset Quality: Institutions sometimes undertake aggressive write-offs to sanitize their portfolios and only write-off ratio will reveal the genuineness of PAR. With 4% of their portfolio at risk over 30 days and 0.5% of write-off ratio Indian MFIs maintain good portfolio quality. Sadhan states PAR over 60 days as 2.2% suggesting that a significant amount of repayments are received from significant borrowers after 30 days.

Current Repayment Rate helps in understanding the repayment behavior of clients and performance of the institution in the on-going period (as defined by the MFI). Current Repayment Rate can especially be useful when the institution displays a large disbursement exposure and performed remarkably well during previous years as compared to the current period.

The soundness of asset quality can be inferred from Sadhan’s study which states a Current Repayment Rate of 97.7% for Indian MFIs, much higher to its benchmark of 90%.

4. Leverage: Indian MFIs also enjoy unprecedented access to financing by banks and other financial institutions, making them amongst the most highly leveraged institutions in the world. According to M-CRIL, the average Capital Adequacy Ratio (CAR) of Indian MFIs is 18.4% while the median of 17.3% indicates that 50% of the MFIs have a CAR below this level. As many as 49 MFIs (45% of the total) have a CAR below 12%—the minimum level specified for non-banking finance companies (NBFCs) by the Reserve Bank of India (see Annex 3, Figure 3). It is therefore questionable for future growth, how Indian MFIs can attract further investment with such a thin layer of capital to allow loss absorption in case of default. Such a high leverage raises questions about the ability of MFIs to access good rating for their existing portfolio in order to use mainstream financial instruments such as securitisation. While largest MFIs (with portfolio above Rs 10 crore) are the most susceptible to envisage securitisation, 7 out of 8 largest MFIs display a CAR < 20% in India.

Similarly as per debt-equity estimates of leverage estimation, the average debt-equity ratio for Indian MFIs rated by

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M-CRIL\textsuperscript{21} during 2003-05 was as high as 11.8 (excluding MFIs with negative net worth). This is much greater than the relatively prudent ratio of 7:1. While low debt-equity of most MFIs restricts their growth (due to their limited ability to borrow for operations), the bloated debt-equity ratio increases the sector risk of the MFI model of microfinance. However, changes in this ratio are more significant in absolute value like increasing trends may denote an MFI exhausting its fund raising capacity while decreasing trends suggests that it does not sufficiently leverage the funds that it may not have sufficiently leveraging the fund sources.

5. **Profitability**: While most MFIs are close to attaining full operational self-sufficiency, large institutions have exceeded the mark (see Annex 3, Figure 1). The data also suggests medium and large MFIs enjoy high returns on equity. The Micro Credit Ratings International Ltd (M-CRIL) Micro Finance Review 2003 (revised February 2004) analyses the performance of MFIs in the Asian region as seen through 110 ratings conducted by M-CRIL from September 1998 to June 2003. According to this study, 23 of the 110 MFIs rated (out of which 104 were Indian) have generated sufficient profits to contribute to their capital from internal accruals.

 Sa-Dhan in its study on a sample of 74 MFIs states Operational Self Sufficiency 110\% (FY 2005) against its benchmark of 100\%. While most MFIs are close to attaining full operational self-sufficiency, large institutions have exceeded the mark (see Annex 3, Figure 1).

**Return on Equity**: The ROE ratio is an important tool for shareholders to determine how much income their investment is generating, relative to the risk involved, and how it compares with alternative investments. MIX survey, on 28 Indian MFIs has indicated an RoE of (10.2\%). The optimal Range as per ACCION is > 15\% indicating that the Indian MFIs do not present an attractive opportunity.

**Return on Assets**: The ROA measures the net income earned on the assets of a credit and saving institution. It differs from the ROE ratio since it measures the return on all funds used to finance the institution (equity and liabilities), not only on the funds owned. As per the MIX data, Indian MFIs have a RoA of (1.5\%). The optimal Range as per ACCION is > 3\% indicating that the Indian MFIs are still lagging behind on the profitability front.

5: **Growth Strategies**

The SHG movement enjoys immense political and non-government support in India. Union Finance Minister P. Chidambaram had words of praise and promise in his budget speech 2005-06. He proposed to extend the SHG-bank group linkage to cover another 385,000 SHGs in 2008-07.

At the moment, in terms of credit outlay, the sector is divided between bank-linked SHG members and MFI clients at a ratio of 3:1. Both channels are growing rapidly but as the sector penetrates the national consciousness, more investors, entrepreneurs and professionals are attracted to the MFI model. Current trends suggest that the market division between the largely state bank financed SHG and private bank financed MFI route will reverse in the next few years.

There are three main expansion strategies for microfinance institutions:

1. **Horizontal growth**—the MFI chooses plain vanilla products (usually just loans) and replicate across all branches to expand their client base and geographic coverage.

2. **Vertical growth**—the MFI chooses to maintain a particular client profile and geographic coverage but diversify its products and services instead. Thus catering to changing needs of the customer, the MFI converts itself from a standardized retailer into a full service local financial institution. The MFI is now a “credit +” provider offering insurance, savings, money transfer, remittance, larger loan sizes, individual consumer loans, personal loan products and ancillary business services such as connecting clients to previously non-existent or inaccessible markets and livelihood opportunities.

3. **Franchisee**—the MFI appoints a local entrepreneur as its franchisee and allows her to conduct business under an established name and methodology.

6: **Sectoral challenges**

As microfinance activity evolves into a full fledged industry, a multitude of issues ranging from staff recruitment to advances in technology must be urgently addressed. In this section, we spell out the issues and on-going efforts to fill the identified gaps.\textsuperscript{22}


\textsuperscript{22} These challenges were identified in “10 by 10: A vision for the sector. Ambitious but Possible” ICICI Bank Executive Director Dr. Nachiket Mor’s presentation at Sa-Dhan Annual Policy Conference on “Expanding Frontiers of Microfinance”, 23-24 January 2006.
6.1: Human Resources

The pool of skilled microfinance professionals in India is still quite small. It is not uncommon to find senior practitioners involved in more than one organization, serving on either the governing body or management team. Younger employees often hop organizations or leave to start new ones. Despite good pay scales, it is difficult to attract qualified graduates, accountants, MBA or IT degree holders as microfinance is still not perceived as a viable business opportunity and professional workplace. A minimum of 20,000 executives are required across the sector over the next four years, particularly at positions such as Chief Financial Officer, Chief Technology Officer, Chief Information/Innovation Officer, and Director of Human Resources. As MFIs transform themselves into local financial institutions, some with increasing national presence, the need of the hour is training and capacity building of over 200,000 local field staff over the next four years.

◊ MFI Careers: A dedicated HR company has recently been founded by ICICI Bank, Centre for Micro Finance and HR consultancy firm, Mitra. The company will conduct detailed analysis of the job profiles and other HR needs of the sector. It will promote the sector to potential recruits with strong advertising and image-building exercises.

6.2: Product

At present, MFIs tend to be rigid on product features such as loan amount, repayment schedule, and loan tenure. MFIs need to explore new and more flexible products to satisfy latent demand. Please see Annex 1 for a full discussion of which financial products can and do the poor access in India.

◊ Centre for Micro Finance (CMF): CMF conducts rigorous experimental research on product design and impact evaluation. CMF also takes up shorter projects on other issues such as market research and case studies.

6.3: Transaction cost

MFIs currently incur very high operational costs, especially at loan origination and during monitoring because of doorstep service and little or no deployment of technology solutions. This is a critical concern in the face of rising competition, public scrutiny and political interference.

6.4: Technology

Technological innovations such as smart cards, biometric IDs, and rural kiosks that can help control costs are crucial for a safe and rapid scale up.

◊ Financial Innovations Network and Operations (FINO): FINO is a proposed for-profit technology solutions platform for banks and MFIs.

6.5: Finance

In fact, capital infusion is no longer a problem in India primarily because of short term bank loans and off balance sheet financing via the popular partnership model. Donors like to fund integrated health or education project proposals from non-profit organizations that include the self-sustaining activity, relatively cheap short term debt and limited access to long term debt is readily available Small Industries Development Bank of India (SIDBI) provides grants and subsidized credit, NABARD manages a microfinance development and equity fund and now, private equity funds have also entered the sector.

However, MFIs are lacking some forms of capital:

» MFIs have not issued bonds. Bond issuance would allow MFIs to diversify their funding sources, which are dominated by a few large commercial banks and government-sponsored apex organizations like NABARD and SIDBI. For example, MFIs have not yet securitized loan portfolios on the main stream financial market and a few deals have mainly been bilateral. MFIs need to securitize their loan portfolios to raise cheaper capital and to shift their credit risk onto institutions that are better fit to manage risk.

» MFIs have been unable to access long-term debt from banks. Long-term debt would help finance expansions that may not provide net cash inflows early enough to repay short-term debt.

» Large MFIs rarely receive equity investment. MFIs can leverage equity investment to continue current growth trajectories while maintaining capital adequacy norms. A major challenge to attract more equity is to have a recognized valuation model and a clear exit rate for investors.

◊ Grameen Capital India (GCI): Grameen Foundation USA, ICICI Bank and ITCO Consulting recently co-founded GCI to provide financial and advisory assistance to MFIs.

◊ Rating Agencies: MFIs in India are rated by two leading financial rating agencies, CRISIL and M-CRIL.
6.6: Geographic concentration

Microfinance tends to be concentrated in rural areas as opposed to urban areas and in South India as opposed to North India. 58% of NABARD’s clients live in one of the four states that make up South India and 78% of loans facilitated by NABARD were distributed in South India. Furthermore, 8 of the top 10 MFIs work in South India. No one is entirely sure why microfinance is more concentrated in the South, but numerous hypotheses, mostly related to socio-economic and regulatory climate, have been given. Both existing players and new comers should reach out to untapped regions.

6.7: Regulatory

Much progress has been made recently and more is promised on this count. Some of the key hurdles are anti market measures such as a price ceiling on bank loans less than $4K (Rs. 200 K) and subsidy based credit programs often promoted by state governments and supported by development agencies. The idea of a lenders forum has been mooted by SIDBI. One of the main impediments to the creation of a standard credit bureau is the lack of a unique identifier e.g. a national social security number.

6.8: Political

From the point of view of all stakeholders but above all the lender, populist politics is in fact the most significant challenge the Indian sector faces today. Two of India’s largest MFIs recently faced government action prompted by public complaints against them of misbehavior and malpractices such as hidden charges and effective interest rates of 35-50% on a declining basis in the southern state of Andhra Pradesh. Operations across 50 branches of the two MFIs were seriously affected for many weeks and government officials instructed MFI clients not to pay back their loans. These two MFIs decided to cut their interest rates to 15% diminishing rate on new loans as of April 1st 2006 and communicated this to the Chief Minister. A group of the top MFIs operating in Andhra Pradesh met and formally adopted a uniform code of conduct that forbids violent or abusive behavior on the part of the loan recovery officers. 73 of Sa-Dhan’s 139 members have already adopted the code. On-going consultations between stakeholders such as Sa-Dhan, SIDBI, ICICI Bank, HDFC, RBI and state government officials are helping diffuse the situation. Such incidents highlight the sharp need to regulate unknown start ups and ensure larger MFIs adhere to consistent good governance, transparency and accountability standards. They further remind overconfident MFIs of the immeasurable value of complying with prudent financial norms and practices and strengthening internal risk absorption and management facilities.

All in all, we believe that facing political realities will help the adolescent microfinance sector step towards maturity by weeding out undesirable elements and organizations. Dealing with the present situation effectively will certainly furnish MFIs with the confidence and determination to fulfill their mission of financial inclusion of the poorest population.

7: Policy—Changes and Trends

The RBI and the Ministry of Finance are strongly supportive of the microfinance movement. In his 2005-06 Budget speech, the Finance Minister said, “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 intermediate between the lending banks and the beneficiaries.”

The Finance Minister raised NABARD’s $20 Mn (Rs. 1 Bn) microfinance development fund to $40 Mn (Rs. 2 Bn) and rechristened it microfinance development and equity fund. Additionally, SIDBI draws on an $21,600 (Rs. 1.08 Mn) grant from U.K. Department for International Development (DFID) for capacity building support and an $20 Mn (Rs. 1 Bn) soft loan from the International Fund for Agricultural Development (IFAD) for on-lending on very attractive terms.

A big step forward for the sector was in January 2006 when RBI carried out the Ministry’s request to permit deposit mobilization by MFIs appointed as Business Correspondents. Starting in the fiscal year of 2005, RBI allowed NGO-MFIs to borrow up to US$5 million during a year from external commercial sources through an authorized dealer under the automatic route. In March 2006, RBI came out with comprehensive guidelines on loan securitization, enabling a clean separation of assets between the originator and the owner and clearly defining roles of other parties involved in a securitization deal. Such policy milestones are shaping the fast paced thriving sector today.

Yet there is much to be done. The vast infrastructure of the Indian Postal Service must be exploited to scale up microfinance activity under the Business Correspondent or some other channel. A stable and conducive policy environment is necessary for other initiatives such as a single credit bureau, biometric IDs or smart cards and weather stations. We believe that while the sector at this stage needs a laissez-faire environment, policymakers should be on a continuous vigil and deliver concurrent improvements in policy and regulation. All organizations engaged in microfinance should be brought together under a single legal

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status and regulatory authority. Reacting to the high cash transaction and absorption necessitated by the popular partnership model, the regulator should pronounce certain capital adequacy ratio requirements and insist on standardized quality audits.

8: Conclusion

As we go forward from here, the most salient point to remember is not past successes or present impediments but the future potential of this market. According to an April 2006 McKinsey India survey, rural India has the potential to become a US$500 billion market by the year 2020. It remains to be seen whether today’s MFIs, banks, lenders and investors have the tenacity, dexterity and wit to retain first mover advantage.
## Annex 1

### Financial Products—Access and Demand

<table>
<thead>
<tr>
<th>Product</th>
<th>Demand/Access</th>
<th>Source</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>SAVINGS</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Liquid</td>
<td>Yes. / Poor access to formal savings accounts. Savings are often done in groups.</td>
<td>Mainly SHGs. Deposit taking NBFCs such as Peerless and Sahara India operate in northern states. Commercial banks entering through Business Correspondent route.</td>
</tr>
<tr>
<td>» Illiquid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Mandatory</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Voluntary</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>CREDIT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Hypothecation</td>
<td>Yes. / Increased access to formal sources such as rural banks, cooperatives or other MFIs. Rampant informal lending sector still exists in all locations.</td>
<td>Mainly informal sources. Growing number of microfinance players and banks.</td>
</tr>
<tr>
<td>» Collateral</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Guarantee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Hybrid-Collateral and Guarantee</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Mortgage</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Line of Credit</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>INSURANCE</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Life</td>
<td>Yes. / Little access, particularly to products other than life insurance.</td>
<td>Life Insurance Company. Other insurance companies entering through Business Facilitator route.</td>
</tr>
<tr>
<td>» Livestock</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Crops</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Asset</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Health</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Weather</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>MONEY TRANSFER</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Demand Draft</td>
<td>Yes. / Poor quality access through inefficient or informal methods.</td>
<td>Mainly Post Offices. MFIs and banks wish to enter through Business Facilitator route.</td>
</tr>
<tr>
<td>» Cheque</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» ATM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Money Order</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>DERIVATIVES</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Commodity</td>
<td>Yes, especially farmers. / Very limited access.</td>
<td>Recently, PepsiCo offered a futures contract for potato in Jharkhand.</td>
</tr>
<tr>
<td>» Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>FINANCIAL INVESTMENT</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>» Debt</td>
<td>To be determined / There are no formal avenues to make such investments.</td>
<td>Informal avenues such as investing in relative’s business are available.</td>
</tr>
<tr>
<td>» Equity</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>PENSIONS</strong></td>
<td>Yes. / Virtually no access.</td>
<td>UTI recently launched a product for SEWA Bank clients in Ahmedabad.</td>
</tr>
<tr>
<td><strong>FOREIGN EXCHANGE</strong></td>
<td>No.</td>
<td>None.</td>
</tr>
<tr>
<td><strong>FINANCIAL ADVICE</strong></td>
<td>To be determined. / No access</td>
<td>Scope for future opportunities.</td>
</tr>
<tr>
<td><strong>GUARANTEE CERTIFICATE</strong></td>
<td>Yes. / MFIs act as aggregate guarantors in the partnership model.</td>
<td>MFIs.</td>
</tr>
<tr>
<td><strong>REFINANCE</strong></td>
<td>Yes. / MFIs act as re-financers if the first loan pays off past debt.</td>
<td>MFIs.</td>
</tr>
</tbody>
</table>
## Annex 2

### Legal Form and Type of Microfinance Services that can be Legally Provided

<table>
<thead>
<tr>
<th>Legal Form</th>
<th>Suitable for Financial Intermediation</th>
<th>Services that can be Provided</th>
<th>Credit</th>
<th>Savings</th>
<th>Insurance</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td>In-House</td>
<td>Ext. Link</td>
<td></td>
</tr>
<tr>
<td><strong>Not-for-profit MFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Societies</td>
<td>Yes. Scope of activities limited as Business Correspondent (RBI 2006)</td>
<td>Yes, but may result in contravening IT and other Acts.</td>
<td>Yes, may collect savings on behalf of a bank. (RBI 2006)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Trusts</td>
<td>Yes. Scope of activities limited as Business Correspondent (RBI 2006)</td>
<td>Yes, but may result in contravening IT and other Acts.</td>
<td>Yes, may collect savings on behalf of a bank. (RBI 2006)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Section 25 Companies</td>
<td>Yes there is legal sanction to do Financial Intermediation.</td>
<td>Yes but must be careful on how much interest is to be charged and what it is to be called.</td>
<td>Yes, may collect savings on behalf of a bank. (RBI 2006)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>Mutual Benefit MFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>State Cooperatives</td>
<td>Yes, there is legal sanction to do Financial Intermediation but can be superseded.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>National Cooperatives (Central Act)</td>
<td>Yes, there is legal sanction to do FI and lesser Govt. Control but requires multi-state operations.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Mutually Aided Cooperative Societies</td>
<td>Yes, there is legal sanction to do FI and less Govt. control but can be incorporated within a state only.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Urban Cooperative Banks</td>
<td>Yes, there is legal sanction but Registration under State Coop Act and with RBI required. Difficult to get Registration today. Is applicable for only Urban and peripheral areas.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td><strong>For-profit MFIs</strong></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Non-Banking Finance Companies (NBFC)</td>
<td>Yes there is legal sanction but registration required with RBI, which is very difficult and also capital and norms required are very stringent.</td>
<td>Yes</td>
<td>Strict restrictions*. Can collect savings for a bank. (RBI 2006)</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Local Area Banks</td>
<td>Yes there is legal sanction but registration required with RBI, which is very difficult and also capital and norms required are very stringent. The RBI has not abolished the legal form but has stopped issuing licenses to establish new LABs.</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

* The MFI must receive a recommended level credit-rating from CRISIL/M-CRIL for 3 consecutive years, should have a minimum stipulated net-owned fund; maturity of deposits is limited to 1-5 years; there is an interest rate ceiling; deposit mobilization is possible only in the province of registration and they have to open branches or have agents to collect deposits. Only two NBFC-MFIs in India satisfy all norms for deposit-taking and yet don’t – possibly because of all these stipulations.

Source: Ramesh Arunachalam, Consultant. Updated by Centre for Microfinance.
Annex 3

Financial Performance Figures

Figure 1\(^{25}\): Sustainability by Scale

<table>
<thead>
<tr>
<th>Scale</th>
<th>Return on Assets</th>
<th>Return on Equity</th>
<th>Operational Self-Sufficiency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Large</td>
<td>2.3%</td>
<td>21.0%</td>
<td>123.0%</td>
</tr>
<tr>
<td>Medium</td>
<td>0.7%</td>
<td>26.0%</td>
<td>104.8%</td>
</tr>
<tr>
<td>Small</td>
<td>-4.3%</td>
<td>-56.6%</td>
<td>83.7%</td>
</tr>
</tbody>
</table>

Figure 2: Efficiency and Productivity by Scale

Figure 3\(^{26}\): Capital Adequacy of Indian MFIs

<table>
<thead>
<tr>
<th>Portfolio Size in Rupees</th>
<th>Number of MFIs</th>
<th>Capital Adequacy Ratio (CAR)</th>
<th>MFIs with CAR</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td></td>
<td>Average</td>
<td>Median</td>
</tr>
<tr>
<td>0-50 lakh</td>
<td>41</td>
<td>49.8%</td>
<td>51.6%</td>
</tr>
<tr>
<td>50 lakh-1 crore</td>
<td>20</td>
<td>18.7%</td>
<td>8.7%</td>
</tr>
<tr>
<td>1-5 crores</td>
<td>32</td>
<td>20.6%</td>
<td>10.0%</td>
</tr>
<tr>
<td>5-10 crores</td>
<td>9</td>
<td>25.9%</td>
<td>22.9%</td>
</tr>
<tr>
<td>&gt;10 crores</td>
<td>8</td>
<td>13.8%</td>
<td>11.5%</td>
</tr>
<tr>
<td>Total</td>
<td>110</td>
<td>18.4%</td>
<td>17.3%</td>
</tr>
</tbody>
</table>

\(^{25}\) Figures 1 & 2 from MIX Market 2004 data as of October 18, 2005. Data presented are averages.

\(^{26}\) Figure 3 from M-CRIL Technical Note.
Annex 4

Microfinance Stakeholders in India

Apex & Regulatory Institutions
1. National Bank of Agriculture & Rural Development (NABARD)
2. Small Industries Development Bank of India (SIDBI)
3. Reserve Bank of India (RBI)
4. Ministry of Home Affairs, Government of India
5. Registrar at Societies and Trusts
6. Registrar of Cooperatives State/Central
7. Registrar at Companies
8. Central Board Direct Taxes
9. Insurance Regulatory Development Authority
10. Ministry of Finance, Government of India

Microfinance related legislations in India
1. Society Registration (Various Acts) and same for Trusts
2. Foreign Contribution Regulation Act FCRA (1976)
3. BR Act—Banking Regulation Act, 1949
4. BCA Act—Banking Companies Acquisition Act, 1970 and 1980
5. NBFC Regulations—Non-Banking Finance Company (NBFC) Regulations till date
6. RBI—The Reserve Bank of India (RBI) Act (1934) and amendments till date
7. FCRA—Foreign Contribution Regulation Act (FCRA), 1976 and amendments
9. Companies Act, 1956
10. IRDA Act, 1999
11. State Cooperative Acts (several)
   i. Multi State Cooperative Act
   ii. Parallel Cooperative Acts (Like Mutually Aided Cooperative Societies Act (MACs) ACT etc)

Capacity Building, Consultancy Services & Technical Support
1. Centre for Micro Finance (CMF), Institute for Financial Management and Research, Chennai
2. EDA Rural Systems
3. Intellecap [Intellectual Capital Advisory Services Pvt. Ltd]
4. M-CRIL
5. MicroSave India
6. Sa-Dhan
7. District Rural Development Agency [DRDA]
8. Bankers Institute of Rural Development [BIRD]
9. COMAT
10. Indian Grameen Services [IGS]
11. Media Lab Asia
12. n-Logue
13. Rural Innovations Network [RIN]
14. Development Alternatives
15. Appropriate Rural Technology Institute [ARTI]
16. Banking With The Poor
17. ARAVALI [Association for Rural Advancement through Voluntary Action and Local Involvement]
18. All India Association for Micro Enterprise Development [AIAMED]
19. Credit and Development Forum [CDF] India
20. Credit Watch India

Donor/Funding Agencies
1. ACCION International

Microfinance in India: Current Trends and Challenges
2. Action Aid
3. Acumen Fund
4. Asian Development Bank [ADB]
5. AlterFin
6. Bill & Melinda Gates Foundation
7. CARE India
8. Consultative Group to Assist the Poor [CGAP]
9. Department for International Development [DFID]
10. FiNCA International
11. Ford Foundation
12. Freedom from Hunger
13. Friends of Women World Banking
14. GTZ
16. Okiocredit
17. PlanetFinance
18. Shell Foundation
19. Shorebank Advisory Services
20. Social Initiatives Group
21. USAID
22. Unitus

**Venture Capital Funds**
1. Aavishkar
2. Bellwether
3. BlueOrchard Finance
4. Lok Capital
5. Grameen Capital India [GCI]

**Research institutions & colleges offering courses focused on development / microfinance**
1. Centre for Development Studies
2. Centre for Micro Finance, Institute for Financial Management and Research, Chennai
3. EDI India [Entrepreneurship Development Institute of India]
4. Indian Institute of Management, Bangalore - Microfinance Incubator
5. Indian Institute of Management, Ahemedabad
6. Indian School of Microfinance for Women
7. Institute for Development Policy and Management
8. International Food Policy and Research Institute [IFPRI]
9. Institute of Rural Management, Anand
10. Xavier Institute of Management, Bhubaneswar
11. Indian Institute of Forest Management, Bhopal
12. Overseas Development Institute [ODI]
Annex 5

*Microfinance Marketplace in India*\(^\text{27}\)

[Diagram showing the microfinance marketplace in India, including various stakeholders and channels of lending.]