Enabling Sustainable Enterprises

# Way Ahead for Small MFIs in India

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Prelogue: The RBI has granted approval for setting up small finance banks to ten organizations. Eight of these are MFIs.

## Introduction

The microfinance sector in India has grown impressively over the previous ten years. This has ensured that millions of Indians now have access to institutional credit. The sector has traditionally been characterized by a diversity of institutional forms as well as operating models. Even in 2015, we have MFIs of diverse sizes as well as institutional forms who are providing financial services to the economically underprivileged.

MFIs that have reached a minimum scale and are in a position to generate surpluses, are well positioned to take advantage of the opportunities that have emerged in recent times[1]. However, for MFIs which are small – with a clientele of less than 50,000, the opportunities have also brought several challenges. Well capitalized MFIs which have the size and form to attract funding will be in a position to scale up their operations rapidly, sometime at the cost of small MFIs. Given this landscape, it is important to explore critical factors that will determine the sustainability of small MFIs and hence are factors that should guide their future roadmaps.

## Critical Factors Framework

This note takes a look at some of the critical factors building a case that factors such as *Value Proposition* and *Promoter's Commitment* etc. are basic and are like foundation, upon which higher order factors such as *Continued Access to Funds* can be built up, leading to institutional sustainability.

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## Foundation

Value Proposition: A small MFI which stands out on account of its unique value proposition for its clients has a high likelihood of success. Pricing efficiency leading to low cost credit to clients, innovative products and processes for a client segment which is still excluded, use of innovative technology that leads to value addition for clients are all examples of value propositions which MFIs may offer to clients. It is important here that the value proposition is not a mere idea and the MFI has demonstrated early success with it.

Promoter's commitment and interest: The commitment of promoters as well as their experience is another important foundation factor. In case of for-profit MFIs, the capital invested by the promoter himself/herself is an important determinant of his/her commitment and interest. In case of not-for-profit MFIs, the conviction, tenacity and reputation of the promoters towards their institutional cause become much more important.

Compliance: MFIs should be in a position to comply with regulations including those related to priority sector assets, code of conduct, as well as capitalization and capital adequacy. They need to have products and processes that ensure that they comply with existing regulations.

## Access

Small MFIs that have a strong foundation have a high likelihood that they will do well on "access" – to capital, onlending funds, technology and human resource.

Capital: Capital is required in order to meet investments related to start-up or operational expansion. It is also required to attract debt funding. Even under the BC model, MFIs are required to place a First Loss Default Guarantee (FLDG), which must come from its capital – the exception being guarantee arrangements which some institutional sponsors of not-for-profit MFIs provide. A small MFI needs to have sufficient capital to meet its investment and expenditure needs till it starts to accrue surpluses internally.

A not-for-profit MFI has to depend on grants to meet its capital requirements. Being strong on the "foundation" factors is especially important in order to generate donor interest given that donors do not expect financial returns on their investments.

A for-profit MFI may approach equity investors in order to augment its capital base. It needs to carefully select its investors so that there is an alignment between the MFI's objectives and the investors objectives. Also, the promoters need to be willing to reduce their stakes in favour of the investors. The experience in the sector so far has been in favour of those promoters who have not chased very high valuations and those investors who have given equal importance to risk management and growth.

Cooperative organizations can access member contributions as capital. However, they lack the ability to attract equity capital from private sources. While cooperatives which enjoy sound reputation have been able to successfully obtain grants, their ability to get grants too is constrained because of their for-profit nature.

On-lending funds: Small MFIs largely depend on funds from financial institutions to build their portfolio. The availability of on-lending funds for MFIs has increased with funding available under the BC model complementing funds from term loans and cash credit extended by banks against hypothecation of book debts. The launch of MUDRA ensures that more on lending funds will be available for MFIs.

The ability to leverage on-lending funds largely depends on the capital base. MFIs that are constrained for capital may seek guarantees against which they may be able to access on-lending funds. It needs to be mentioned here that *continuing* access to onlending funds is important for smooth functioning of MFIs. This requires that MFIs maintain cordial relations with their lenders and fulfil terms and conditions that are laid down in the agreements they have with the lenders. In particular, lenders may need diverse data regarding their portfolios and MFIs should be able to provide such information in order to generate comfort among their lenders.

Cooperative organizations may be in a position to access savings of their shareholding-members and use these to provide loans to their members.

There are several credit cooperative societies which have been running small scale microfinance programs and recovering their costs. However, the potential to scale up as a cooperative is limited given that equity capital is a constraint in cooperatives. There is also a high level of regulatory scrutiny on cooperatives. For this reason, banks and financial institutions are apprehensive of taking debt exposures in cooperatives (See Box below)[2].

## Credit Cooperative Societies face Scrutiny

The Central Registrar of Cooperative Societies had in 2014, written to the Registrar, Co-operative Societies of all states informing that RBI is of the view that acceptance of deposits from nominal members by credit co-operative societies may have to be construed as accepting deposits from public and carrying out banking activity. In February 2015, the RBI asked the Orissa government to take steps for stopping collection of deposits from the public on a larges cale by chit fund companies in the guise of multi-state credit cooperative societies. Also, in May 2015, a Supreme Court bench of Justices A K Sikri and Uday U Lalit restrained co-operative societies in Rajasthan from carrying out any 'banking activity,' as defined under the Banking Regulations Act, and further imposed restrictions on accepting deposits from general public. The court noted that several such societies accepted deposits from nominal members as well as from public without obtaining a license for a banking business from the Reserve Bank of India.

Human Resource and Technology: It is important for MFIs to have competent human resource in order to build sound operations. The staff members need to be motivated and adequately trained on technical as well as soft issues. Similarly the falling cost of technology gives small MFIs the opportunity to utilize technology to improve their service delivery.

## Sustainability

Beyond access, MFIs need to prepare for surprises that may affect their sustainability. For this on the one hand, they need to have sound risk management system, and on the other, they need to reasonably meet the expectations of their stakeholders.

Risk management: Risk management in MFIs is determined by their capacity to avoid, mitigate, control, tolerate and treat risks. Sound governance with oversight from competent directors, well defined institutional roles for Directors as well as managers, documented and disseminated processes are qualities that help organizations in developing sound understanding of their risk environment which in turn helps them avoid, mitigate and control risks. Additionally, for a given scale of operations, MFIs should target a capital base which gives them the capacity to tolerate the materialization of serious risk events.

Stakeholder expectations: MFIs have diverse stakeholders such as clients, the elected government, regulators, promoters, investors, lenders, managers, and operational employees. These stakeholders have diverse expectations from the

MFI. If the MFI is able to align its operations with the expectations of its stakeholders and can manage its relationships with various stakeholders well, it can be reasonably sure that it will receive continued patronage, loyalty and support from them.

## Conclusion

Bandhan in many ways is the most successful MFI in the country today. Starting modestly as an NGO in 2003, Bandhan has been able to establish a bank in 2015. Bandhan's microfinance methodology was different than the standard joint liability group methodology. While it gave loans to women who had to form into groups, it did not have a culture of assertive enforcement of joint liability. Further, it discouraged involvement of informal rent seeking agents right since its initial days. This allowed it to develop sound relationship with its clients. It proactively reduced its interest rates and its repayment terms ensured that clients were never put under undue stress. In order to scale up, Bandhan formed an NBFC and received equity support from SDIBI and IFC. Gradually it also adopted technology and ensured that its risk management systems could cope up with the expansion in its operational scale. Finally, it has been able to reasonably meet the expectations of its various stakeholders – the fact that it received a banking license provides sufficient evidence in favour of this.

Cashpor started its operations in the late nineties in eastern UP. This area was considered a tough terrain for any type of enterprise. In its initial days it suffered setbacks as its application for the grant of NBFC license was refused by the RBI. However, the commitment of its founder to the cause of serving the underprivileged in some of the poorest parts of the country ensured that it received grant support from institutional sources as well as high net worth individuals, ensuring in turn, that it had sufficient capital to reach a sustainable operational scale. Even as Cashpor continues to operate as a not-for-profit, it has enjoyed continued access to onlending funds both for the portfolio it carries on its balance sheet as well as portfolio under the BC model.

Both Bandhan and Cashpor illustrate that if small MFIs build their operations on a strong foundation they can continue to serve their clientele in a meaningful and sustainable manner.

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[1] In the emerging scenario, there is clarity in the regulatory environment for MFIs. The RBI has issued directions regarding priority sector classification of loans originated by MFIs. It has also created a specialised category of MFIs called NBFC-MFIs. The more recent Micro Units Development & Refinance Agency (MUDRA) set up by the Government of India, identifies MFIs as an important channel to disburse credit to microenterprises. Under the Business Correspondent model, banks are increasingly looking at MFIs to act as BCs to reach the unbanked. Overall also, the funding environment for MFIs has improved with investors and lenders taking a favourable view of the microfinance sector.

[2] http://indianexpress.com/article/india/india-others/rbi-asks-orissa-to-stop-deposit-collections-by-credit-societies/

http://indianexpress.com/article/business/business-others/credit-co-operatives-face-crackdown-sc-to-regulate-activities/