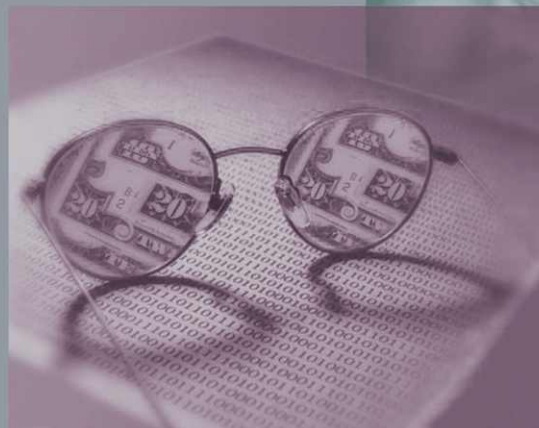


BUSINESS & ECONOMIC DEVELOPMENT RESEARCH PROJECT

Report on The Finance Sector in India



BUSINESS & ECONOMIC DEVELOPMENT RESEARCH PROJECT

REPORT ON THE FINANCE SECTOR IN INDIA

Project in Association with
**ACCOUNTABILITY & BUSINESS FOR
SOCIAL RESPONSIBILITY**

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1.0 SUMMARY

This research, conducted by the UK- and India-based **Centre for Social Markets (CSM)**, forms Phase II of the research programme on “*Business and Economic Development: The Impact of Corporate Responsibility Standards and Practices: Insights from Recent Experiences*”, launched by **AccountAbility** and **Business for Social Responsibility**. It addresses the following research question:

How well does the finance sector, and its key players, understand the economic impacts¹ of its activities and act to manage them to ensure desired outcomes and enhances corporate impacts on low income, excluded and disadvantaged communities?

Unlike previous research addressing the question of the economic development impact of business, CSM will be using a *product/service-based* approach to understand the economic impact of the micro-finance service providers in question.

Microfinance aims at providing access to financial instruments for persons hitherto excluded from the mainstream formal financial system. Those excluded tend to be the worst off sections of any society – the poor, and particularly women, amongst them. These are predominantly in the informal sector, living mostly in rural areas, and now increasingly in urban slums. Thus, microfinance attempts to cover critical gaps in the formal financial systems in order to address a specific aspect of poverty – access to financial instruments – in a manner sensitive to the needs of the poor and consistent with gender equity.

Microfinance, once considered a risky enterprise by many governments and donors, is now considered a highly propositional sector. It is most successful when designed with a tight and mutually reinforcing fit between the larger financial environment, the mechanism of service design and delivery, and the particular needs of the poor that microfinance institutions serve. Traditionally, an operation of non-government organisations followed by microfinance institutions, microfinance is now being increasingly adopted by private financial service providers. The sector appears to be as much in a transition phase as in a high-growth phase.

In the larger context of poverty and economic development, financial companies provide significant socio-economic benefits through the impact of financial products and services on the financial stability of beneficiaries. This is through employment creation, distribution channels, return to investors and donors, community capacity building, and investment projects. Microfinance institutions are said to contribute positively to the economic development of the society, and this is to a certain extent validated by various impact assessment studies. However, the assessment studies are by themselves narrow in their definition of ‘impact’. When viewed in the larger context of economic development impact, the contribution of the financial institutions serving the poor might shrink.

¹ Economic impacts take many forms. Direct impacts include monies paid to employees, suppliers, investors, governments, while indirect impacts relate to how those monies are used in subsequent decisions by those actors. At the broader level, CSM will assess the extent to which companies understand and/or report on their economic impacts in terms of their *direct* economic impacts – payments to employees, suppliers, investors, government; efforts to understand and report on their *indirect* impacts or supply multiplier, which are the second round impacts of that expenditure – such as employment created in supplier companies; and a step further, their *induced* impacts or income multiplier which measures the subsequent impacts. Having an understanding of companies direct, indirect and induced impacts may be useful to make comparisons across sectors and regions.

AccountAbility and Business for Social Responsibility (BSR) have developed a methodology by which institutions can identify significant economic impacts, designed to align with business decision-making processes or 'domains' of business activity. This methodology aims to provide a means by which institutions might begin to articulate their economic impacts and research has focused on product-related economic impacts as well as provide a basis from which to explore where institution impacts and responsibilities converge.

This study focuses at the institutional level on the economic impacts of financial products and services – specifically product development and the distribution channels in making them accessible – on the communities that use these products. The economic impact of microfinance includes the following: impact of micro credit on the level or depth of indebtedness; impact on interest outgo for the clients; transition from debt to credit; the extent that micro credit has ensured relief from the usury; impact on smoothening consumption; change in the savings habit and amount saved; impact on asset building; intended and unintended benefits in the quality of life.

As with the entire voluntary sector, the social responsibility of microfinance institutions is assumed to be a given. However, this should not be blithely assumed by the different stakeholders involved in this area as aspects of social responsibility such as regulation, governance, transparency, and accountability, are as critical for microfinance institutions, as they are for commercial organisations. Furthermore, the social responsibility issue becomes all the more relevant with the entry of private financial service providers into the microfinance sector. It is important for private players to measure the impact of their social responsibility 'realisation' on their customers. This will then inform how they can best direct their financial products to the poor, manage and optimise the impact of their business activities and accountabilities, and ensure that business decisions on this issue are an effective and sustainable investment, both with respect to the financial institution's internal and external stakeholder interests.

A key consideration in understanding economic impacts is in understanding the following:

- Which economic impacts are significant?
- On whom does the impact occur?
- Which economic impacts are financial institutions responsible or accountable for - and are these alone or with other players?
- What are the regulatory and policy enablers and disablers in different markets? And how do they impact on product development and delivery options?

Public policy settings affecting microfinance institutions and even the private players – banks and insurance companies – are critical in the success or otherwise of microfinance contributing to socio-economic development. Financial institutions are likely to have the most beneficial and sustainable economic impacts where the programmes deliver improved infrastructure, education, and employment for the poor.

Asking questions about the institutional level economic impacts will help institutions determine the point at which their economic impacts, responsibility, and accountabilities intersect, and provide a further entry point for constructive discussion about the link between business decision-making and broader societal issues and expectations.

This report is not an original research study but a review of selected impact assessment and credit rating studies conducted in India in the recent past. The review indicates the inherent strengths and weaknesses of microfinance impact assessments in India in terms of economic development impact with gender mainstreaming.

2.0 RATIONALE

To understand the impact of corporate responsibility standards and practices in the finance industry in India, this research focuses on microfinance and covers issues related to its accessibility, affordability, and availability, current impact assessment studies, and broader social, and public policy contexts.

The rationale for the choice of the financial services rests on the fact that India has a sizeable population that does not enjoy widespread social security coverage. To date, key players in the provision of financial services in India have included – to varying degrees - the public, voluntary and private sectors. The *government* has provided a variety of financial services to disadvantaged groups over the years – including through the state-run banking system - but these have been far from adequate and suffered from lack of reach. The *voluntary sector* – largely in the form of support NGOs and independent micro-credit agencies – have been pioneers in the field of micro-credit servicing the needs of poor populations in urban, peri-urban and rural environments. The latest entrants to this field include *private sector* financial entities – including large foreign commercial banks – seeking to tap into the poor as a potential market.

This study will explore, using case studies, how these sectors are beginning to understand, monitor and measure their developmental potential and the impact of their products and services on poor and disadvantaged communities with a view to their positive economic impact.

The overall objective of the research is to normalise Economic Development as an aspect of business performance and outcomes.

Background & Research Question

This research forms Phase II of the research programme on *“Business and Economic Development: The Impact of Corporate Responsibility Standards and Practices: Insights from Recent Experiences”*, launched by AccountAbility and Business for Social Responsibility, and will look more closely at the following research question:

How well does the finance sector, and its key players, understand the economic impacts of its activities and act to manage them to ensure desired outcomes and enhances corporate impacts on low income, excluded and disadvantaged communities?

Unlike previous research addressing the question of the economic development impact of business, CSM will be using a *product/service-based* approach to understand the economic impact of the micro-finance service providers in question.

Public Policy Considerations

As noted above, we will also be looking at public policy considerations, which cut across the areas of focus identified. The rationale is that while businesses are and should be accountable for their economic impacts, they share responsibility with other social actors, including governments. Policies can be shaped to support and enable corporate responsibility with respect to their economic impacts and we would be interested in exploring the extent to which businesses perceive the necessity for government support on this front.

METHODOLOGY & RESEARCH PHASES

CSM has conducted this research in three phases and actively outreached to relevant stakeholders and partner organisations at each stage to ensure their valuable input.

Phase One: Information Gathering & Consultative Meetings (Period: Nov 2003 – Feb 2004)

Information gathering involved desk research as well as telephone and direct interviews/consultative meetings with key companies and organisations, and other stakeholders. The consultative meetings comprised both one-on-one meetings as well as seeking responses to a detailed questionnaire largely focused on assessing organisational policies.

Phase Two: Case Studies (Period: Feb – March 2004)

CSM conducted three case studies on three companies – ICICI Bank, TATA AIG Insurance, and SHARE Microfin - providing micro-finance products and services in India.

The case studies provided the stakeholders with a practical look at industry best practice and illustrated how these organisations understand, manage and measure their influence on a community's economic development. The case studies described and assessed key aspects of organisational policies such as product and service packaging, pricing, access, and public policy engagement. The case studies will be incorporated into the *Finance Industry Benchmark Briefing on Managing Economic Impacts* published by AA and BSR in 2004. The case study findings will also be reflected in the Final Report of the Business and Economic Development project.

Phase Three: Public Dissemination & Advocacy (Period: April 2004)

CSM's research findings were launched at a multi-stakeholder convening to be held in New Delhi on 7 April 2004. The objectives were to disseminate the research results and to discuss how a broader outreach strategy to engage companies to actively manage their economic impacts in this particular field may be advocated.

The convening included senior business (company and industry) representatives from the finance sector; policymakers; and key influencers and stakeholders from standards organisations, regulators, NGOs, the investment community, the donor community and media.

3.0 MICROFINANCE IN INDIA

Microfinance offers some hope to policymakers and development practitioners who look toward financing innovative programs that will help curb the growth of poverty. But this is only if policymakers and development practitioners understand the services that the poor demand, and if they can learn from the experience of government and non-governmental programs that have promoted innovation and been informed by the specific finance needs of the poor.

Microfinance, once considered a risky enterprise for many governments and donors, is now considered a highly propositional sector. It is most successful when designed with a tight and mutually reinforcing fit between the larger financial environment, the mechanism of service design and delivery, and the particular needs of the poor that microfinance institutions (MFIs) serve.

It was once assumed that the poor needed no financial services, or perhaps needed only credit. Yet the conditions under which the poor live suggest the contrary. For poor people managing and coping with risk is a part of everyday life. Research and experience have shown that borrowing helps households achieve food security and alleviate their poverty. But borrowing alone is not enough to pull households out of poverty. Poor people also require savings services to help them better manage their resources over time and to enable them to plan and finance their investments. The poor also need access to insurance to reduce risk impact in situations such as an earning member falls ill, crops fail, or prices for their products decline. In actual fact, the demand of poor households for microfinance services has been significantly underestimated. The poor should not be shut out of financial services because of the risk they bear; on the contrary, the poor need additional services to mitigate that risk.

Availability of finance for the poor in India²

Lack of all forms of reasonably priced finance remains an obstacle to the poor.

- Banks in India were not willing to lend to MFIs as such lending was not counted towards their obligation to the priority sector until the year 2000. Since then, after the rules were changed, it has risen to a cumulative outstanding of about \$200 million.
- MFIs were not allowed to source funds from abroad. With requisite policy changes, foreign lending to MFIs in India rose to \$10 million by 2002. There is also an equity investment, in BASIX, of \$2 million by the IFC, Triodos-Hivos and Shorebank.
- Banks were allowed to lend to self-help groups (SHGs) of women and such lending counted towards priority sector lending. Yet, they were unwilling to do so due to lack of understanding and transaction costs. Sustained educational efforts were needed to persuade them to do so. It has begun to pay dividends. Such lending has crossed a cumulative of \$450 million by March 2003 - from nothing in 1995. Over 350 banks have lent to 700,000 SHGs with 12 million members.

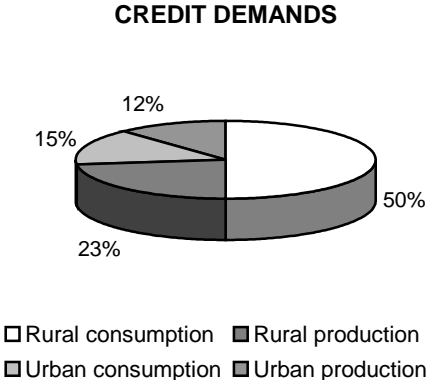
Meeting the Credit Demand

Almost 27 percent of India's one billion people live below the poverty line. Out of the 60 million households that live below the poverty line, only 20 percent have access to credit from the formal sector³. Various estimates put the requirements of micro-credit at Rs. 150

² Various articles from BASIX and SA-DHAN

³ www.basixindia.com/micro_finance_in_india.asp

billion to Rs. 500 billion (\$3.26 billion to \$10.87 billion) per year⁴. The estimated credit demand breaks down along the following lines (also see pie-chart): 50 percent is for rural consumption, 24 percent is for rural production, 15 percent is for urban consumption and 12 percent is for urban production. The estimates also confirm that nearly two thirds of the demand for credit is for short-term consumption purposes, and that 75 percent of production needs are met by the formal financial sector while nearly all consumption needs are met by informal sources⁵.



Despite the impressive progress as seen above, timely availability of adequate finance for the poor remains an ongoing challenge. According to some estimates based on surveys, annualised credit usage by the nearly 40 million poor households in India from all sources is about USD 10 billion, of which over half to two-third is at usurious rates of interest from moneylenders and traders. According to *The Census of India 2001*, only about 30 percent of rural households have access to bank accounts - mostly for savings, not loans.

The Census of Enterprises, 1998⁶, showed that only about four percent of all enterprises in the informal sector accessed any credit from a bank or any other formal financial institution. This is despite various mandates and exhortations to Indian banks to lend to the “weaker sections” and all of this lending counting towards the “priority sector” (including agriculture, diamond, road transport and exports) obligation of 40 percent.

Savings for Tough Times

Savings facilities are necessary because many poor households are not in a position to take advantage of credit for investing in human or physical capital to increase and diversify their incomes. Other households require additional services besides credit to manage the household budget and risks. In many cases households are too poor and the fluctuations in their incomes and the risks they face are too high for them to rely on borrowing strategies alone. Currently, the poor in many parts of the country pay enormous transaction costs in their efforts to save. Yet many MFIs offer no savings services at all.

⁴ The difference in estimates is due to the per-household need for credit. While the practitioners take the amount as Rs. 6000 as the credit demand for the households, EDA Rural Systems estimates the annual credit need as Rs. 2000.

⁵ www.censusindia.net

⁶ The Census of Enterprises, 1998

Ample evidence exists that the poor save to build assets for future planned activities, such as children's education or marriage. Savings may also decrease the amount of credit a household has to seek at high cost from informal lenders and reduce the sale of assets at low cost during times of distress.

Moreover, poor people can save in the form of human capital by improving their health, nutritional status, and education. MFIs, governments, and donors need to recognise that this form of saving can produce real future benefits by raising productivity and speeding development.

The poor also save to help smooth their consumption in the face of possible income shocks or expenditure increases, due to illness, for example. Downturns in income or shocks can have severe consequences for households that are struggling to subsist. Even households whose income is adequate on average may face transitory food insecurity or the risk of it. Savings are needed to simply maintain adequate consumption.

Households in the lowest third of the income scale at times spend as much as 91 percent of their consumption budget on food⁷, yet they often still go hungry. For the poorest people, one large shock or a series of small ones can lead to major reductions in food intake, which can lead to permanent disability, especially of children, and lasting impoverishment of the entire household. The poorer, more risk-averse and vulnerable a household is, the more important precautionary saving becomes.

The demand for savings services is estimated to be even higher than the demand for credit. Irregular cash flows taken with small amounts available for savings often deter the poor from using the services of banks. For this reason, poor and low-income households save through post offices and a few specialised savings institutions. However, the need for safe and liquid savings is not met adequately⁸.

The Unmet Demand for Insurance

In addition to borrowing and savings services, the poor need insurance to protect themselves from uncertainty. In the absence of insurance, the poor often avoid risky but potentially profitable economic activities and enter into informal insurance arrangements or rely on precautionary savings.

The World Bank (2002) estimates that one-quarter of all Indians fall into poverty as a direct result of medical expenses in the event of hospitalisation⁹. One of the important challenges facing Indian health policy experts is how to convert the predominantly private out-of-pocket spending into health insurance premium whereby this amount is collected from a much larger group of insured individuals rather than from the limited number households affected by illness. Another important challenge is how to provide health insurance to the people who cannot afford to pay full or part premium.

⁷ www.censusindia.net

⁸GTZ had commissioned a study in two states of India to quantify poor people's demand for savings services and their present saving mechanisms. Apart from this, there have not been any other major studies.

⁹ The World Bank (2002) comes up with some other startling observations: that, on average, the poorest quintile of Indians is 2.6 times more likely than the richest to forego medical treatment in the event of illness; that more than 40 percent of individuals who are hospitalised in India in a year borrow money or sell assets to cover the cost of health care; that hospitalised Indians spend more than half of their total annual expenditure on health care.

The poor face two types of risk: personal misfortune such as illness, accident, or theft, and misfortune that afflicts the entire community, such as drought or flooding. Whereas a personal misfortune would affect only a few people in a village at the same time, a drought or flood would affect almost everyone. Because of these characteristics, providing insurance services is fraught with special difficulties. The existence of insurance may cause people to engage in riskier behaviour that ultimately imposes higher costs on the insurer. Or, if an entire community is affected by drought, an insurer may have difficulty in meeting all of its commitments to pay out simultaneously. Public support for innovations that address these problems will ultimately lead to higher public and private returns on investments.

Some MFIs have begun to offer insurance products from public and private insurance companies. Some NGOs act as intermediaries between a formal insurance provider and the insured community (e.g. SEWA in Ahmedabad and ACCORD in Nilgiris) and some NGOs provide insurance to the target community. Where an NGO itself insures the target population, the NGO may itself be the health service provider (e.g. Sewagram Hospital) or may have an arrangement with the health service provider (e.g. Tribhuvandas Foundation). Yet examples such as these are relatively rare and MFIs have yet to tap the potential for innovation in providing sustainable insurance services. Of the three financial services mentioned here, the largest gap between demand and access is for insurance.

Where an NGO itself provides insurance to the target community, insurance sector reforms do not directly affect formation of such schemes, though appropriate regulatory changes designed to encourage such grouping may positively affect their formation¹⁰. On the whole, providing insurance to the poor is not profitable and insurance companies are unlikely to take up this moral obligation of their own volition. Furthermore, even public insurers that have mostly entered into such commitments may no longer be willing to do so as competition in the market intensifies. The current social and rural sector obligation imposed by the Insurance Regulatory and Development Authority (IRDA) is on the insurance business in general and does not specifically apply to health insurance. Furthermore, this obligation does not require insurance companies to subsidise premium. This obligation is just to ensure that some amount of insurance activity also moves to rural areas and does not remain confined to big cities and towns.

Studies (Girija and Ramesh, 2001¹¹) have shown that the demand for health, old age pension and asset insurance is high among women who are major clients of MFIs in India. Similarly, accident, life, health and asset insurance are a high priority among men. Though there are many low premium options for loss-of-life, accidents and loss of assets, there appears to be a low level of awareness among the poor that these exist along with little incentive for agents/facilitators like NGOs to market the plans. The end result is often a mismatch between insurance plan designs and the requirements of the poor.

¹⁰ A well known international expert on health insurance, William Hsiao, who examined IRDA regulations, commented that these regulations are written only for for-profit organisations and do not recognise the fact that insurance could also be provided by not-for-profit organisations such as NGOs involved in CBHI schemes. Not-for-profit organisations play an important role even in market economies like that of the US.

¹¹ Srinivasan, G and Arunachalam R, "The Indian Micro-Insurance Sector - Lessons and Recommendations of Good Practices, 2001

Perhaps the most important factor to consider in increasing access to financial services to the poor is that programs must fit the specific context of a particular area and its population. Blindly replicating successful programs will not work, as there is no blueprint for success. A lending approach that succeeds in one context may not bring positive results in another. For example, the poor generally lack traditional forms of collateral, so microfinance institutions must find collateral substitutes based on local conditions to greatly improve credit access. Likewise, repayment arrangements should be based on local production cycles. Although group lending and joint liability have ensured high repayment rates at low cost in absolute terms, may not be effective in the real sense at the grassroots level. Peer monitoring may not function well for various socio-economic reasons, and there may be social costs to applying peer pressure. Joint liability may cause some members to default based on unwillingness, not inability, to repay. In fact, in many cases groups actually perform better when they do not expect joint liability to be enforced.

Supply of Micro Financial Services

Banks in India provide micro credit to Self-Help Groups (SHGs) of poor and low-income households under the linkage-banking program. There are also specialised MFIs that provide micro financial services.

Linkage Banking

In February 1992, NABARD¹² began to support microfinance with a pilot project to test the Self-Help Group (SHG) Bank Linkage Approach designed to cover 500 SHGs¹³. The intent was to harness the large banking network already in place rather than create special MFIs. Under the linkage banking approach, SHGs are formed by NGOs and linked to formal financial institutions.

Usually an NGO forms the groups and then links it with a bank, but recently some of the branch managers of banks have started forming SHGs. The NGOs can be simple facilitators or act as financial intermediaries. NABARD refinances up to 100 percent of the loans made by banks to the groups at the interest rate of 7 percent. On June 1, 1999, the rates that banks charge to the NGOs or the SHGs, the rate the NGOs charge to the SHGs, and the rate the SHGs charge their members were completely deregulated. The SHG-bank linkage programme now has over 11 million poor households accessing banking services including micro-credit through their 700,000 SHGs. Over 2800 NGOs and 30,000 branches of 500 banks are associated with the programme. Cumulative disbursed to SHGs as on 31 March 2003 was Rs. 20487 million (\$427 million)¹⁴.

NGOs may absorb SHGs into federations for a variety of reasons. These federations may act as financial intermediaries, as in the case of federations promoted by the DHAN Foundation in Madurai. Some of the federations act only as non-financial organisations working towards strengthening the groups, providing business development services, and other services. An

¹² In July 1982, the Indian Government created the National Bank for Agricultural and Rural Development (NABARD) as an apex bank to provide credit for agricultural and rural development. It also emerged as a major institution to support institutional development, to regulate and supervise financial institutions, and to develop and implement programs for channelling credit, often at subsidised interest rates, into agricultural and rural activities.

¹³ Small homogeneous groups of rural poor coming together to save small amounts regularly and mutually contribute to a common fund to be lent to individual members per group decisions. SHGs are neighbourhood groups with 15 to 20 members. The members pool their savings and use them to make loans to other members. Upon successful completion of six months of activity, these groups are eligible to be linked to banks.

¹⁴ www.nabard.org

example of these types of federations is that formed by MYRADA. In the long run, the federations expect to take over the role of the NGOs in nurturing and monitoring the groups.

Since bankers find it difficult to deal with such a large number of SHGs, there are expectations that future federations will play the intermediary role of routing funds from banks and other apex financial institutions to their member SHGs. While the SHGs are financially self-sustaining, there are very few federations that have demonstrated financial sustainability¹⁵. However, the linkage banking remains the popular model of dispensing micro loans; nearly 70 percent of the ground level disbursements for micro loans have been through this model.

Microfinance Institutions

Specialised microfinance organisations (MFIs) have been functioning in India since the 1970s, and at present there are about 400 MFIs¹⁶ of varying sizes in the country. Microfinance institutions include the following types: NGOs that act as financial intermediaries; Grameen Bank replications such as SHARE Microfin; for-profit new generation institutions like BASIX and SEWA Bank; and federations of SHGs and Mutually Aided Cooperative Societies (MACS). Many of them are hybrid institutions and are very small in size. MFIs, which have medium-sized operations, number about 100. As per the discussions with major players and support service organisations, there are as few as 10 MFIs that are professionally managed, five of which are operationally sustainable.

These institutions provide financial services and credit to the poor. They mobilise loans from apex organisations like SIDBI Foundation for Micro Credit (SFMC), Friends of Women's World Banking (FWWB), *Rashtriya Mahila Kosh* (RMK) and others. Some of them also borrow from the promotional grants of NABARD. Private sector commercial banks have also forayed into financing wholesale and some for profit retail MFIs.

¹⁵ This is primarily due to the fact that most of them are in the formation/stabilisation stages. Areas of concern are the organisational sustainability of these federations in the long run, especially their management by poor, illiterate women, their ability to recruit and retain professional and competent staff, and increasing outreach.

¹⁶ The national level data on microfinance is very limited. NABARD tracks certain indicators like the number of groups linked to banks, amounts of bank loans and refines support for self-help groups. There is no reliable information on some basic but essential details, such as: a) number of organisations acting as facilitators and financial intermediaries; b) Number of groups formed, number of defunct groups, and delinquent groups; and c) qualitative data on the performance of financial intermediaries including banks such as outreach, portfolio quality, efficiency of operations and sustainability.

4.0 HELPING THE POOR?

Experience shows that micro finance can help the poor to increase income, build viable businesses, and reduce their vulnerability to external shocks. It can also be a powerful instrument for self-empowerment by enabling the poor, especially women, to become economic agents of change.

Since poverty is multi-dimensional, by providing access to financial services, micro finance plays an important role in the fight against the many aspects of poverty. For example, income generation from business helps not only the business activities expand but also contribute to household income and its attendant benefits on food security, children's education, etc. Moreover, for women who, in many contexts, are excluded from the public sphere, transacting with formal institutions can also build confidence and empowerment. The poor are more vulnerable to shocks such as illness of a wage earner, weather, theft, or other such events than the non-poor are. These shocks produce a huge claim on the limited financial resources of the family unit, and, absent effective financial services, can drive a family so much deeper into poverty that it can take years to recover.

When is Microfinance NOT an appropriate tool?

Microfinance increasingly refers to a host of financial services - savings, loans, insurance, remittances from abroad, and other products. But the fact of the matter is that most people take "micro finance" as being one thing: micro credit.

Micro credit is only useful in certain situations, and with certain types of clients. As noted earlier, a large number of the poor, especially the poorest of the poor, are excluded from micro credit as it is currently designed. Extremely poor people who do not have any stable income - such as the very destitute and the homeless should not be micro finance clients, as they will only be pushed further into debt and poverty by loans that they cannot repay. As currently designed, micro credit requires sustained, regular, and often significant payments from poor families. At some level, the very cause of poverty is the lack of a sustained, regular, and significant income.

Even though a family may have a significant income for extended periods, it may also face months of no income, thereby reducing its ability to enter into the type of commitment demanded by most MFIs. Some people are just too poor, or have incomes that are too undependable to enter into loan products. These extremely poor people at the bottom percentiles of those living below the poverty line need safety net programs that can help them with basic needs some of these are working to incorporate plans to help graduate' recipients to micro finance programs.

Often, governments and aid agencies wish to use micro finance as a tool to compensate for some other social problem such as flooding, relocation of refugees from civil strife, recent graduates from vocational training, and redundant workers who have been laid off. Since micro credit has been sold as a poverty reduction tool, it is often expected to respond to these situations where whole groups of individuals have been made poor. Frankly put, this is simply unrealistic. Running a program with substantial default rates undermines the very notion of credit and destroys credit discipline among those who could repay promptly but look foolish given that many do not.

Micro credit best serves those who have identified an economic opportunity and who are in a position to capitalise on that opportunity if they are provided with a small amount of ready cash. Thus, those poor who work in stable or growing economies, who have demonstrated an ability to undertake the proposed activities in an entrepreneurial manner, and who have demonstrated a commitment to repay their debts, are the best candidates for micro credit. The universe of potential clients expands exponentially however, once the broader concept of micro finance is taken into account.

It is also important to design background interventions that build the market for micro finance clients. Such interventions can range from building infrastructure to opening up new markets for the produce of the poor to providing business development services. Often these interventions will create conditions and opportunities for micro finance and not the other way round. What needs to be avoided, however, is the directional use of microfinance to solve developmental challenges in situations where the basis of peoples' livelihood is destroyed.

Why high interest rates?

Providing financial services to poor people is expensive, especially in relation to the size of the transactions involved. This is one of the most important reasons why banks do not make small loans. For example, a Rs.100 loan requires the same personnel and resources as a Rs. 2,000 one, thus increasing per unit transaction costs. Loan officers must visit the client's home or place of work, evaluate creditworthiness on the basis of interviews with the client's family and references, and in many cases, follow through with visits to reinforce the repayment culture. It can easily cost Rs. 25 to make a micro loan. While that does not seem unreasonable in absolute terms, it might represent 25 percent of the value of the loan amount, and force the institution to charge a high rate of interest to cover its cost of loan administration.

The MFI could subsidise the loans to make the credit more "affordable" to the poor and indeed many do. But subsidy-dependent programs are always fighting to maintain their levels of activity against budget cuts and seldom grow significantly. They are not sustainable, especially if other micro credit operations have shown that they can provide credit and grow on the basis of high rates of interest and along the way serve far greater numbers of clients.

Evidence shows that clients willingly pay the higher interest rates necessary to assure long-term access to credit. They recognise that their alternatives are even higher interest rates in the informal finance sector (through moneylenders, etc.) or simply no access to credit and are much less attractive for them. Interest rates in the informal sector can be as high as 20 percent per day among some urban market vendors. Many of the economic activities in which the poor engage are relatively low return on labour, and access to liquidity and capital can enable the poor to obtain higher returns, or to take advantage of economic opportunities. The return received on such investments may well be many times greater than the interest rate charged.

Moreover, the interest rate is only a small part of their overall transaction cost of credit, and if MFIs offer credit on a more accessible basis, substantial costs in terms of time, travel, paperwork, etc. can be reduced, thus benefiting the poor. A long series of studies has shown that many programmes that charge subsidised interest rates end up using rationing mechanisms to distribute credit in response to excess demand. These mechanisms cause the

borrower to have to jump through hoops, increasing the time and money they must put out to get the loan. In fact, these transaction costs are frequently higher than the interest costs, which take away the advantage to the borrower of the interest rate subsidy. However, while increased access to credit for the poor on a long term and sustainable basis can bring significant benefits, MFIs must continue to work to improve efficiency levels, and to increase scale. This will bring down the cost of providing loans, and the benefits transferred to the poor in terms improving loan products, better access to loans, and lower borrowing costs.

This model of scale and efficiency is reflected by SHARE Microfin's success. (See Case Study 1)

CASE STUDY 1 - SHARE Microfin Limited

SHARE Microfin Limited (SML) began its microfinance operations as a two-year action research project funded by a recoverable grant from the Asia Pacific Development Center and a soft loan from the Grameen Trust.⁵³ Soon, two branch offices were operating in Kurnool and Guntur Districts. Within a year, the original targets for the program were met, and SHARE continued to expand its activities. By 1996, four branches were in operation, and another six branches opened in 1997. The Dachapalli branch in Guntur District achieved operational self-sufficiency in 1996 and financial self-sufficiency in 1997, covering all operational expenses, including the cost of funds borrowed, with income earned.

In its attempts to achieve overall financial self-sufficiency, SHARE has been constrained by Indian laws which do not permit the society to leverage net worth or equity or to earn a profit. To complicate matters further, because Indian tax law did not recognise charitable institutions carrying out microfinance activities, SHARE's tax-exempt status was also often challenged.

As a result SHARE Microfin Limited (SML) was ultimately registered as a public limited company and as a Non-Banking Finance Company (NBFC) with the Reserve Bank of India. This structure allows SML to access commercial funds, thus facilitating future growth. The existing SHARE microfinance branches were taken over by SML between 1999 and 2001, and all branches opened since then are operated by SML.

SML has an authorised capital of US \$3.3 million, of which US \$1.2 million consists of contributions by 26,034 poor women clients. SML's clients have also contributed 99% of total equity; only 1% is owned by outside sources. Two representatives of the shareholders, or the clients of SML, sit on the Board of Directors.

The Indian rating agency, M-CRIL, has declared SML as an a+(Alpha plus) MFI with a Composite Score of 79%. This rating indicates strong organisational, management and financial performance by the company and declares it highly recommended for investments. Another rating agency, CRISIL, ranked SML at "mfR3" on a scale from mfR1 (being the highest rating) to mfR10 (being the lowest rating).

By November 2002, SML had 99 branches operating in 18 districts in India, with 229,814 members, all of whom are poor rural women forming 45,538 borrower groups. In total, over US \$65.6 million has been disbursed by SHARE and SML since 1993 with a repayment rate of 100%. SML targets its programs at the poorest rural women in Andhra Pradesh. Services are

available to the bottom 50% of women living below the poverty line. A housing index and asset holding criteria are used to select clients. In order to be eligible, a woman must have total asset holdings of less than US \$500 and per capita family income of less than US \$7.50 a month. SML's operational self-sufficiency stands at 111% and its financial self-sufficiency of 109%. By March 2006, SML plans to have served 300,377 women at 150 branches with total loan disbursements of US \$64,919,564.

SML management views micro-credit as the single most critical input for poverty reduction. Its perspective is as follows: the poor have been excluded by the formal financial system; they have no physical or financial collateral; government sponsored programs are largely subsidy-based, attracting people for one-time benefits; the poor are driven to local money lenders where credit is exorbitantly priced, ensuring that the borrower never comes out of poverty. The poor are therefore unable to utilize their skills for lack of capital. Regular access to micro-credit on reasonable terms with simple procedures, quick disbursements with full and frequent (weekly) repayments, is seen as the critical input for poverty reduction.

Accordingly, SML offers access to micro-credit to enable households to use their skills in income generating activities and help them generate surpluses. The intention is to support clients to slowly expand into multiple activities (e.g., keeping buffaloes with a small shop and fruit trade) with additional loans and own resources, thus countering seasonal and activity based risks. There is perceived to be a good fit between the immediate needs of poor households and the services provided by SML, resulting in full co-operation from women members and their husbands.

A study conducted by the International Food Policy Research Institute (IFPRI) found that 85% of SML's clients are in the bottom 20% below the poverty line, reaffirming that the institution effectively targets the poorest of the poor. A UNDP study on the empowerment of women found that SML clients have become much more active in making family decisions, sending their children to school, and practising proper hygiene.

An impact assessment study undertaken by external experts, found that 76.8% of SML's mature clients have experienced a significant reduction in poverty. For example, when they began using SML's services, 64% of its clients had been considered as Very Poor, and the remaining 36% as Moderately Poor. Three to four years later, only 7.2% remained Very Poor. The majority (56.8%) were classified as Moderately Poor. The remaining 36% of clients had improved household incomes enough to be classified as Non Poor.

Having more income earners in the household is of course a function of children growing up – changing from mouths to feed into hands to earn. But grown children of new client households simply join their parents doing daily labour. Mature clients are able to borrow from SHARE to create self-employment for themselves, and increasingly for other members of their households.

Diversification of the source of household income is also strongly related to poverty reduction. Some 82% of client households with three or more sources of income had experienced significant reduction in their poverty compared to only 47% of households with one source of income. Although raising buffalo for milk is a dominant activity in the first years of borrowing, by their third and fourth year, SHARE Microfin clients demonstrated no less

than 17 different combinations of sources of household income, with none being clearly dominant. Some combined buffalo and tea shops, some petty trade, oxen for ploughing and cultivation of chillies on leased land.

Some had goats and grocery shops and sent their sons out for daily labour. It is clear that in the context of rural India, spreading one's risk among several enterprises and types of work is a better strategy for escaping poverty than growing one business.

The key challenges that SML has had to overcome during its early stages include the following:

- Mobilising financial resources
- Opposition from money lenders and the rich
- Staff dropout in the initial years
- Effect of Government Development programmes—e.g. subsidy and loan write off melas (fairs)
- Clients—undertaking collective responsibility for repayment
- Lack of mobility/public transport system to reach clients' villages which are 30 km from the branch
- High salary costs
- Inter-personal problems, accommodation and entertainment issues related to staff
- Field staff spending more time on paper work at office than in the field
- Lack of client confidence in SHARE activities
- Migration of villagers for employment

Sources:

www.sharemicrofin.org,

www.undp.org.in/report/wkspscImblizn/casestudyofSML.htm

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How do the Various Sectors Fare in Providing Microfinance?

The financial services industry is highly fragmented with little integration and overlap between the formal, semi-formal and informal markets of credit, savings, insurance and various non-banking financial services. The key constraints to integrating the formal, semi-formal and informal markets for financial services are as follows:

1. an overall lack of confidence among all intermediaries
2. poor legal and regulatory system
3. problems in institutions that combine to undermine an environment for secured transactions

The formal sector is still technically and legally placed to mobilise deposits, pool risks by intermediating over larger areas and individuals and finance larger investments. The areas of disadvantage in the formal sectors are precisely those in which the semi-formal sector claims advantage. These include broad and deep outreach effective screening and enforcement in the absence of formal collateral and lower transaction costs.

The semi-formal sector is constrained from taking advantage of these potential new areas of business due to lack of experience in issuing and managing diversified financial instruments and lack of adequate prudential oversight structure to accept voluntary deposits and contractual savings.

The informal sector shares similar advantages with the semi-formal sector. The informal sector is able to keep transaction costs and risk at lower levels than either the formal or semi-formal sector.

Knowledge of local needs and circumstances also mean that it is in a much better position to identify new markets, products and process. The main disadvantage of this sector is its limited ability to increase the scale of its operation. To do so would be to undermine the very nature of its key factor for success: trust and personalised knowledge of individuals and their needs and a sensitive understanding of the local environment.

Chart 2: Comparative Analysis of Microfinance Services offered to the Poor¹⁷

| Parameter | Money Lender | Commercial Banks | Govt. Sponsored Programs | Financial products of MFIs |
|---------------------------------------|---------------------------|---|---|--|
| Ease of Access | High | Low | Low | High |
| Transaction cost of Access | Low | Very High | Very High | Low Medium |
| Lead time for Loans | Very Short | Extremely Long | Extremely long | Short |
| Repayment Terms | Fixed and Rigid | Fixed and Easy | Fixed and Easy | Flexible |
| Interest Rates | Exorbitantly High | Low and very Affordable | Low, Affordable and Subsidised | Reasonable and Affordable |
| Incentives | None | None | None | Repeat and larger loans, Interest Rebates |
| Repeat Borrowing | Possible | Possible but not likely | Possible but not likely | Stream of credit is assured |
| Loan Access Procedures | Very Quick | Extremely Time Consuming and complicated | Extremely Time Consuming and complicated | Simple and Quick |
| Loan Application Procedures | Informal but exploitative | Exhaustive and Complex | Exhaustive and Complex | Simple and Informal |
| Collateral and Demand Promissory Note | Mandatory | Required but hypothecation of asset may suffice | Not required although a charge on the asset becomes automatic | Not required social collateral is used for physical collateral |

¹⁷ Arunachalam, R. (1999) Alternative Technologies in the Indian Micro-Finance Industry. New Delhi: Action Aid

Linking Development & Finance

Microfinance is evolving in impressive ways, incorporating into its practice social and economic development concepts, as well as principles that underlie financial and commercial markets. This combination has led to the creation of some sustainable MFIs around the country. As microfinance continues to evolve as a development strategy, it will only be successful if it is able to strike the right balance between two frameworks – development and finance – that underlie its practice.

Microfinance practitioners should recognise that the answer to the capital needs of marginal populations is based on innovative efforts focused on the three intersections between microfinance and development: reaching the poor, building institutions, and deepening the financial system's reach. All three characteristics must be present for the MFI to reach both its development and financial goals.

A discussion of these three dimensions of microfinance, however, does not imply that there are trade-offs of one over the other. All are equally important. Without them, the strong points of intersection between microfinance and development will diminish and microfinance will become either a set of highly profitable financial institutions that have abandoned their market, or a set of insignificant donor-dependent and localised credit programmes. Keeping the collective eyes of microfinance professionals on these intersection points is a huge challenge for this field today.

Reaching the Poor

The first point of connection is microfinance's objective to alleviate poverty at the client level. Indisputably, microfinance, at its core, combats poverty. Urban clients of microfinance institutions are poor city dwellers housed in slums or squatter settlements, often living in appalling overcrowded settings, lacking access to basic services, such as health care. Their survival tool kit lacks education or skills that are essential to enter the mainstream economy.

Many of them are women, poorly trained and playing dual roles of provider and caregiver. These poor people are more exposed to the threats of contamination, bad sanitation and disease than the rest of the population. When disaster strikes, in the form of inflation, earthquakes or other outside forces, they are the most exposed.

Rural clients are landless or land poor. Their land is often unproductive or lies outside irrigated areas. Many farm in arid zones or on steep-hill slopes – land that is ecologically vulnerable. Opportunities for off-farm employment are few, and must be self-generated, with many of the rural poor mixing many earning activities to generate the cash they need to survive. They live in large households. Their children are especially susceptible to disease and many suffer from malnutrition. Many depend on their children for work, and must weigh the opportunity cost of sending children to school against present benefits of keeping them at work.

Microfinance enables poor people who start their own small businesses to create capital, to protect the capital they have, to deal with risk, and to avoid the destruction of capital. It

attempts to build assets and create wealth among people who lack them. For the very poor, microfinance becomes a liquidity tool that helps reduce their level of vulnerability¹⁸.

At a subtler but no less important level, which is much harder to measure, increasing material capital strengthens the sense of dignity a poor person possesses, and contributes to empowering them to participate in the economy and society. With a source of income, a person can provide for the family, improve the household's access to basic needs, and plan for the future. When these conditions are present, a person who was part of the marginalised sector of the society becomes better equipped to be an active citizen.

Building Institutions

The second point of intersection between microfinance and development occurs at the institutional level. Microfinance proposes to create private, sustainable (i.e., self-sufficient), permanent institutions that specialise in delivering financial services to the poor. Against a broader development backdrop, these institutions become a means to an end, not an end in and of themselves. They constitute part of the not-yet-attained and long-sought-after vehicles needed to incorporate the poorer sectors into the economy. They put capital in the hands of those who otherwise would not have it to employ immediately in productive ways, and they enable people with few assets to save.

It is for this reason that institutional sustainability becomes so crucial to microfinance. If microfinance institutions are not financially solid, able to cover their costs, and capable of delivering financial services over the long term, they become a transitory means of reaching the poor, and lose their power as a component of a broader development strategy. Moreover, only by becoming financially self-sufficient and ultimately, profitable, will these institutions be able to continue accessing the private capital markets, the only resource large enough to address a problem as immense and endemic as world poverty. This major link between finance and development begins to unravel unless microfinance institutions attain self-sufficiency in their operations.

MFIs need to strengthen themselves to implement innovative strategies that both increase the efficiency of their internal operations, and address the unique nature of their target micro enterprise markets through new product development. Among the innovations that they need to develop to maximise efficiency include cost management schemes, reengineering efforts, and creative uses of technology (e.g., smart cards, credit scoring and Palm Pilots). (See Case Study 2: ICICI Bank)

Deepening the Financial System's Reach

The final intersection between microfinance and development occurs when a MFI becomes a regulated institution that is part of a country's financial system. This connection is made possible by the increasing recognition in the last decade that healthy financial systems are an important piece of the development puzzle, and that financial sector improvement and reform should be a priority in all developing countries.

¹⁸ These findings are emerging from the work conducted by Jennefer Sebstad and Monique Cohen, "Microfinance, Risk Management and Poverty," prepared for the World Bank's World Development Report 2000 on Poverty, 1999. Data from four countries – Bangladesh, Bolivia, the Philippines, and Uganda - demonstrates that finance, for the poor, serves to reduce their risk, especially when they face personal emergencies.

When MFIs become part of the financial system, they can access capital markets to fund their lending portfolios, allowing them to dramatically increase the number of poor people they reach. They can also capture savings, providing another important financial service to the poor, and access these deposits as another source of lending funds.

The opportunities for successful microfinance to tap into international capital markets include the issuance of paper backed by the portfolio of the world's leading MFIs. By inserting themselves into the financial systems of their country, these MFIs deepen dramatically the reach of financial systems to populations previously excluded from banks and other financial institutions. One essential means of alleviating poverty becomes the creation of a broader and deeper financial system that does not restrict the allocation of capital to a tiny group of elite, but instead integrates the poor as a market segment and reallocates resources from other sectors.

Deepening the reach of the financial systems is, in relative terms, a recent one for microfinance. It is made possible only after attaining the second intersection, the creation of financially viable institutions. Only after it was demonstrated that MFIs could manage risk effectively, and that they would not become a systemic risk, could their incorporation into financial systems become possible.

When microfinance intersects with development at the three points – reaching the poor, building institutions and deepening the financial system's reach – it has the capacity to create structural changes in how capital is made available to people previously excluded from the financial mainstream. It is addressing the seemingly intractable problem of creating the infrastructure to reallocate resources and to create wealth among poorer sectors. Moreover, it is changing the dimensions of a system within an economy – the system that moves and reallocates capital in the economy. Many MFIs are not able to complete these three points of intersections, either because they have not become sustainable, or because they operate in an unfriendly regulatory environment. Microfinance operates at its best when it intersects with development on each of these three points.

5.0 ENCOURAGING SIGNS FOR SUSTAINABLE MICROFINANCE

Private Sector Involvement

1. The world's largest micro-finance securitisation deal of \$4.3 million has been completed between ICICI Bank and SHARE Microfin. Grameen Foundation acted closely with the two parties and helped successfully conclude the deal. Prior to this, Grameen Foundation had provided SHARE Microfin with \$322,000 in rupee denominated loans.

Under the securitisation deal, ICICI Bank has purchased \$ 4.3 million of SHARE Microfin's outstanding loan portfolio. Grameen Foundation in turn provided \$325,000 as cash collateral deposit that accounts for 93 percent of the guarantee required by ICICI Bank. It also provided ongoing technical assistance. Under the terms of the agreement, ICICI Bank will receive payment from individual micro credit borrowers with SHARE Microfin acting as the collection agent. The \$ 4.3 million received by SHARE Microfin will enable it to meet its growth projections. Its expansion plan for the first quarter of 2004 calls for reaching 25,000 new female clients. Its long term goal is to provide one million of India's poorest with microfinance services by 2007. (*The Economic Times*, 24 February 2004)

2. Grameen Foundation, in conjunction with ICICI Bank, is in the process of incorporating a finance company in India that will structure transactions similar to the ICICI-SHARE Microfin deal and help Indian MFIs access capital market funding. The Citigroup is also expected to participate in the venture. The outfit will also function as a credit enhancement company in supporting microfinance transactions.

This new organisation, due to be operational in the second quarter of 2004, will be christened Grameen Capital India Pvt Ltd. Grameen Foundation's current partners in India, apart from Microfin include Activists for Social Alternatives – ASA (Tamil Nadu), Cashpor Financial and Technical Services – CFTS (Uttar Pradesh), Sneha (Andhra Pradesh), and Swayam Krishi Sangam – SKS (Andhra Pradesh). (*The Economic Times*, 24 February, 2004)

CASE STUDY 2 - ICICI Bank

ICICI Bank in India

ICICI Bank is the second largest bank and the largest private bank in India. It has subsidiaries in life insurance, general insurance, investment banking, and venture capital that are market leaders in their respective segments. This case study profiles the ICICI Bank's development efforts through its micro-finance provision of credit and insurance through ICICI Bank's Social Initiatives Group (SIG).

No information has been provided or publicly available on how company resources are used and budgeted for broader economic development or how impacts are measured and managed.

(i) Micro-credit – ICICI Bank

ICICI Bank funds a dedicated not-for-profit group, the Social Initiatives Group (SIG). The SIG focuses on early child health, elementary education and micro financial services. The SIG's microfinance practice aims to maximise access to basic financial services for the poorest of the poor in India.

The SIG's programs and projects seek to generate measurable outcomes with minimum quality requirement. With limited resources, their efficient use is imperative if they are to generate a positive impact on the maximum number of people.

ICICI Bank's micro-finance channels include direct lending to individuals, MFIs and NGOs. Reaching 0.18 million members with an asset size of over US \$14 million and deposits of US\$ 55 million accessible through 200,000 outlets. This makes it the fourth largest micro-finance portfolio in India. Its micro-finance services include banking services, micro loans, home loans, two-wheeler finance, insurance, savings, and remittance. The Bank has been recognised by the National Bank of Agriculture and Rural Development (NABARD) for its SHG-Bank Linkage programme and continues to design and develop new products specifically for the micro-finance sector.

The key elements of its micro-finance strategy are low cost outreach, partnerships for risk sharing and mitigation, and group lending approach (joint liability as collateral). Low cost outreach is through shared networks model leveraging existing channels that include MFIs, NGOs, cooperatives, trade/ dealers and distributors, and new networks such as Internet kiosks.

The SIG is supporting the development of a low cost ATM in the range of Rs. 30,000-Rs. 50,000 (US \$6650-1000) per unit. A biometric-based authentication mechanism is under development at the Indian Institute of Technology in Chennai, to and is hoped will enable access for illiterate customers. Another relevant project is the SARI Project which attempts to provide connectivity through a new technology, corDECT Wireless in Local Loop, capable of providing both telephony and Internet connectivity simultaneously. The plan is to establish one hundred kiosks in the first phase of the project. The second phase will seek to provide a number of applications over this network including in areas such as education, health, micro-finance, rural banking and e-governance. The DHAN Foundation, a local NGO, is partnering with the SIG to establish 50 kiosks through its SHG members. The project is planned to be commercially sustainable to ensure scalability of Internet access for rural India.

(ii) Insurance – ICICI Prudential Life Insurance Company & ICICI Lombard General Insurance Company

ICICI Prudential Life Insurance Company has had a presence in India's rural areas since 1999. The company offers services to low-income populations in partnership with NGOs, corporates, MFIs, and rural Internet kiosk networks. Some of its products include:

Mitr is an endowment product. It includes savings, life cover & protection and caters to both a young and middle-aged clientele with low but regular income.

Suraksha: This product provides protection of the family in case of death. On death, the sum assured is paid to the beneficiary. There are no maturity benefits, however, so in case of survival till maturity, the policy terminates without any returns. The plan is available for both regular and single premium modes. In specific cases, the policy can be assigned to the Lending Institution, which becomes the beneficiary, to cover the loan amount. This product is targeted at people seeking a high cover product with a low premium.

ICICI recognises that in a country such as India, micro-finance is often the only means for poor people to provide essential financial cover for their families. Given the amount of

financial support needed in a country the size of India, a more sustainable alternative to government and NGO efforts (typically reliant on foreign aid) was needed. For the ICICI Group this situation presented an opportunity to use its nationwide reach and local expertise to expand access to financial services for underserved communities.

ICICI Bank's Social Initiatives Group (SIG) focuses on scalable initiatives. Scalability implies the ability to draw upon important elements of a program and adapt them to suit the needs of a specific situation. Even if the program itself is not directly scaleable, it should be possible to take away significant lessons from it in order to enrich work in other settings.

The SIG measures and analyses the short- and long-term impacts - primarily social - of these initiatives. It assesses how an initiative is performing in terms of predetermined goals and in comparison to alternatives. The SIG assigns greater value to programs/ organizations that carefully examine the short-term and long-term implications of their actions.

In its research work and impact assessment, the SIG often works in partnership with academic institutions such as the Institute of Rural Management, Anand; Massachusetts Institute of Technology; Tata Institute of Social Sciences; University of California, Berkeley and the University of Southampton.

ICICI Bank continues to face challenges such as high serving costs, poorly functioning commodity markets, insufficient collateral, high dependence on rainfall, regulatory issues, and issues related to individual customer capacities such as health and education. Serving costs remain high due to geographically dispersed and small unit sizes, high cash handling requirements, and moral hazard and adverse selection. Commodity markets continue to function poorly due to poor price transmission mechanisms, weak linkages between markets, no systematic cleaning, grading, and sorting facilities, and inadequate transportation, warehousing and cold chain facilities. Section (8) of India's Banking Regulation Act 1949 prohibits banks from buying, selling, and bartering goods otherwise than as realisation of security given to or held by it. Branch licensing norms and capped interest rates comprise other regulatory issues that present a challenge for the Bank.

(Sources: www.worldbank.org, "Micro Finance Products", ICICI Bank, December 2003, www.icicisocialinitiatives.org)

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3. Allianz Bajaj Life Insurance has launched "InvestGain", a life insurance plan where sustenance of income is combined in the same plan that also pays a lump sum. The most significant benefit of InvestGain is the monthly Family Income Benefit. This benefit sustains the family by compensating the loss of income due to death or accidental permanent disability by paying one percent of the sum assured every month. It is guaranteed for a minimum period of 10 years, which allows the family to cope with loss of regular income. The InvestGain Plan is available in four packages offering protection up to four times the basic sum assured. Moreover, the plan participates in the profits of the company and therefore, grows with time.

4. Royal Sundaram Alliance Insurance Company, with its corporate office in Chennai, offers two policies - Shakthi Health Shield and Shakthi Security Shields - which are designed

exclusively for the poor women and their family. Shakthi Health Shield is specifically designed to provide health insurance to women and their family members at an affordable cost. The unique feature of this, apart from health cover, is that it also covers maternity expenses. For a family of four - self, spouse and two children - the premium works out to Rs.380 to 480 depending on the age group. The policy is offered on the basis of group coverage subject to certain guidelines. Shakthi Security Shields is specifically designed to provide Personal and Property insurance to women and their family members at an affordable cost.

5. CASHPOR Financial & Technical Services (CFTS) has registered a new company - CASHPOR Micro Credit (CMC) - that is collaborating with ICICI Bank in Chandauli District, eastern Uttar Pradesh, with the dual objectives of breaking-even financially within four years and providing nearly 50,000 households below the poverty line with microfinance services. CFTS will provide the social intermediation, assist with the financial intermediation and charge an upfront administrative fee of 5 percent. ICICI Bank will provide the loan funds and take the risk on the loans. A memorandum of understanding (MOU) for the initial four-year collaboration has been signed, and work commenced in April 2003.

6. Aviva Life Insurance has three insurance products – Amar Suraksha (term insurance with premium back), Jana Suraksha (pure term insurance plan), and Anmol Suraksha (simple savings cum protection plan) for the rural sector.

For targeting specific social groups, Aviva has associated with Basix, a micro finance institution and Rajasthan Co-operative Dairy Federation (RCDF). With Basix, Aviva has covered over 50,000 lives. Aviva claims to have focused customers in the interiors of the country who have not had access to life insurance previously. By tying up with Basix, the company has reached artisans, self-employed women and other weaker sections of the society and provided life insurance to them.

Aviva also uses its Bancassurance distribution network to reach some of these sections of the society. Through its association with The Lakshmi Vilas Bank, Aviva distributes its Jana Suraksha product. The scheme provides them with an individual life cover at a very low premium. Through its Canara Bank relationship Aviva is distributing the Amar Suraksha product, a term insurance policy with premium back. Aviva achieved 10,000 policies against a target of 6200 policies, and covered 61,000 lives against the target of 8880 lives, set by the regulator for the company for the fiscal year 2003-04.

For the rural areas, Aviva has adopted a differentiated approach, which focuses on the special needs of the customer. It includes introduction of special products, which are easy to understand, do not require medical tests and have simpler documentation. The approach also involved setting up of a special distribution network of four rural branches exclusively set up for these areas with Financial Planning Advisors (FPAs) recruited from the local population using simple communication to convey the need for insurance as well as create awareness about Aviva through wall paintings, vans, association with local events and *melas* (fairs) in local languages.

Joint collaborations like this one may be the answer to reducing the capital constraint. If instead of trying to establish their own formal financial institutions or transforming themselves into such an institution, non-governmental MFIs can collaborate with banks to provide

microfinance to large numbers of poor households, then significant poverty reduction could be achieved. Such collaborations eliminate capital requirements for leveraging non-lending funds because the collaborating bank provides them. Also they reduce working capital needs, as no loan loss provision needs to be made by the MFI. Significant reduction of the capital constraint to growth in the micro-finance industry should make possible the provision of micro-finance services to many more poor women throughout Asia.

SRI in Microfinance

Socially-oriented investors in developed countries have long been interested in social investing in developing countries, but have seldom had viable vehicles through which to make such investment. Still fewer options have existed for investing in MFIs. There are several reasons for this. The most important being that social investment itself is a relatively young sub-sector of the financial industry and has mostly focused on domestic, large capital stock corporations. Although a relatively new phenomenon, socially responsible investment (SRI) is growing significantly. SRI also continues to grow despite three years of declines in equity markets worldwide, with inflows of new money to retail SRI mutual funds totalling over \$1.5 billion in 2002, in contrast to the outflow of over \$10 billion from conventional funds that same year¹⁹. However, SRI growth has largely been limited to the markets of developed countries. Only very recently have emerging markets become a topic of focus among social investment practitioners.

The modest amount of social investment in emerging markets belies a high degree of interest in MFI investment opportunities. Various studies of social investment professionals suggest significant latent demand among both individual and institutional social investors for high impact social investments in MFIs and SMEs.

However, questions remain. Given the order of magnitude of potential demand, why are so few funds invested in emerging market high impact investment? It appears that lack of adequate financial intermediation is one answer. SRI professionals see a range of interrelated issues combining to make emerging market high-impact investments difficult to make. The greatest concern among SRI professionals is the lack of comprehensive information on emerging markets. This is followed closely by the need to have strong emerging market and high impact investment fund management capacity, and the need to have social and environmental impact measures that can be benchmarked against other investments. Oddly, risk and return are the second-least noted concern, followed by the availability of a regulated investment vehicle.

Venture Microfinance

In many developed economies, particularly the USA, the venture capital industry has been for been growing over the past five decades and helped create many successful global and local ventures. However, the phenomenon of venture capital-supported entrepreneurial growth is largely limited to urban areas. Despite the realisation of the need of venture capital in bridging the urban-rural and rich-poor income and growth divides, the availability of non-traditional venture capital is hamstrung by many constraints.

In India, the venture capital industry emerged in the second half of the 1990s, and the funding has been largely for software and ICT ventures and bio-technology in the last couple of years.

¹⁹ Centre for Social Markets, "Socially Responsible Investment in India", 2003

There have been no formal directional attempts to channel venture capital into socially responsible ventures and development activities.

While few dollars still continue to chase too many ventures, Aavishkaar India Micro Venture Capital Fund is perhaps the only fund to finance socially-relevant, commercially viable and environmentally friendly enterprises that do not have access to loan or equity forms of project financing from mainstream financial institutions. Aavishkaar India is a pioneering concept in India and one that is funded purely by individual investors.

Changes in the regulatory and banking sectors facilitating flow of funds to development oriented venture funds are required to strengthen their financial foundation and catalyse sustainable growth.

CASE STUDY 3 - TATA AIG Life Insurance

TATA AIG Life Insurance Company Ltd is a deemed public joint venture between the TATA Group with 74 percent stake and AIG with 26 percent stake, providing various life insurance schemes in India. Their annual turnover for December 2002-November 2003 was Rs 113 crore (1cr = 10 mn) and have a staff of approximately 400 employees.

The Insurance Company is not into any reporting of economic impacts though some of the TATA group companies do so. However, responding to our questionnaire, the Company indicated that life insurance activity in India by its regulatory nature is developmental. Market share, number of policies and premium collected should be some indicators for micro insurance.

TATA AIG Life Insurance considers the following as important drivers of its business efforts to understand the economic impact of its insurance products and services on the market:

- Internal (culture, values)
- Context (sector, company, geography, stakeholder)
- Standards (risk and corporate governance, litigation)
- External pressures and circumstances

Market share, net sales, new product development, intangible assets such as brand reputation, operational impact on community, and responsible marketing practices, are the most important pressure points for the Company's insurance products and services.

Tata AIG Life Insurance has launched 'Project Micro Insurance' aimed at spreading insurance awareness, and providing insurance cover to all irrespective of their economic status.

This project intends to provide life insurance cover to the poor in the state of Andhra Pradesh. This initiative of the company is to provide financial reforms and other means for the upliftment of the poverty stricken areas of the state. This project also aims to initiate investment through insurance, so that it can provide for education of the people. It also aims to set up a cost-effective delivery and servicing channel for insurance in the rural market.

This project is aided by the FDCF (Financial Deepening Challenge Fund) established by the UK Department for International Development (DFID) and currently operational only in Madhya Pradesh and Andhra Pradesh. FDCF and Tata AIG will fund this joint venture, of which the Rs 65 lakh will be contributed by FDCF, while Tata AIG will chip in Rs 75 lakh.

For TATA AIG Life Insurance, market penetration of micro insurance is currently marginal, and does not measure market share separately. Direct benefit of insurance to the customer is in terms of protection and vehicle for long-term savings as well as employment and livelihood to the people engaged in the distribution. With increased penetration it would indirectly benefit in the infrastructural development expenditure that insurance proceeds help fund. While there is no estimation of cost of non-availability of insurance products and services, it is perhaps the opportunity cost that could be perpetuation of poverty in a country like India where social security is not State sponsored. The Company suggests that on the face of it there may not be any social cost of providing the products and services, perhaps though, channelling funds out of unorganised sector could be one.

Micro insurance was particularly not available before TATA AIG Life Insurance and other companies got into the market, primarily in response to the regulatory mandate. However, the positive side is that some markets were not addressed earlier. Innovative methods to address certain processes, that is distribution, servicing, are also outcomes of the initiative.

Most of the buyers of the policies of TATA AIG Life Insurance are consumers though in some cases organisations, affinity groups, etc sponsor the purchase. The consumers, many illiterate, come from lower and lower middle socio-economic strata of the rural population with an annual household income from Rs 15,000 per annum and upwards. The price for consumers is Rs 72 per annum to Rs 200 per month depending on the policy take.

Among its competitors are other financial products and services both in unorganised and organised sectors at a generic level though risk management products are far and few. The competition is based on price, quality, brand, distribution reach, awareness creation initiatives, etc.

TATA AIG Life Insurance provides after purchase services to its consumers at no additional service charge since it is included in the purchase price itself. Currently it is taken into account into mortality only for lack of adequate experience.

The Company's insurance products and services impact on community in terms of creating infrastructure, income/ wealth stability, new business opportunities, and additional purchasing power; and the employees in terms of skill levels, etc.

The insurance products and services are different depending on market needs and these could change with time. All income groups are targeted with differential focus but through one rural strategy. Consumer needs, alternate solutions, regulation, fiscal policy impact, company mission, plans for growth and profitability are the key drivers for product specification in the market.

TATA AIG Life Insurance's business strategy for different market segments takes cognisance of the adaptations required. For instance, its micro insurance strategy takes cognisance of

poor rural infrastructure, affordability, relevance of insurance, awareness issues, vernacular needs, irregularity of income flows, etc. Micro insurance generally engages the informal sector. In the process of engagement, benefits are livelihood. Risks are high cost strategy as yet unproven in terms of long-term servicing, collection risks, etc, and the Company has control mechanisms in place.

Like other private players, TATA AIG Life Insurance is governed by the regulatory requirements on rural and social sector penetration for life insurance companies in India. Its micro insurance programme however has been evolved to meet the spirit of the regulation as an enhancement of their Corporate Social Responsibility and is therefore not limited to meeting the numbers requirement alone.

Source: Company response to CSM questionnaire

7.0 MEASURING IMPACT

MFIs have emerged as one of the main channels for providing financial services to poor and needy. In response to regulations, private banks and insurance companies are collaborating with MFIs and NGOs to provide their products and services designed to meet various demands of the poor. There is a large number of the NGOs or other organisations in purveying microfinance outside the orbit of the banking system. Most of these NGOs thrive on foreign donors and charity organisations. NGOs are not subject to any mandatory supervision and regulation. In fact, RBI in their recent policy initiatives has encouraged MFIs to be organised as self-regulatory organisation (SRO). Further, banks should deal with NGOs or MFIs that are members of the SRO and have better track record.

Given the above features of NGOs, for-profit MFIs, and the private sector's entry into microfinance sector, an assessment of all becomes imperative. Rating agencies are involved in assessing particularly the MFIs, M-CRIL, CRISIL, and Planet Finance being the frontrunners in India. The assessment of MFIs is broadly divided into two broad approaches:

1. Impact assessment and capacity building of MFIs and evaluating them in terms of social or economic impact at the client level.
2. Assessment of MFIs to enable them to approach financial markets, donors and other lending agencies for raising funds.

Scale and sustainability are the two pillars of success for MFIs. Some of the problems faced by MFIs in this context are:

- Weak institutional capacity
- Lack of viable and sustainable delivery system
- Relatively small financial base and huge investment requirements in staff training and client orientation
- Resource crunch to reach a greater number of the target clientele in an effective and client orientation
- Current dependence on donations and subsidies are unsustainable in the long run

While impact or credit assessment studies by donors, credit rating agencies, and groups of MFIs point to the above problems of MFIs, these assessment studies have their own shortcomings in measuring the impact. Also, virtually every issue included in the accountability and social responsibility of financial institutions catering to the development sector is ignored. We first look at the gaps in the assessment studies and then move on to the social responsibility issues.

The most comprehensive impact assessment studies involve comparing information on clients against national household survey data. However, they rely on information already collected by the MFIs, which often represents an under-exploited database.

The selection of the MFI by credit-rating agencies is based on the availability of detailed information on borrowers and their families collected in the credit evaluation process for individual loans.

- Not all MFIs have such detailed information available;
- The reliability of the information collected by the credit evaluation process is questioned by many.

- Since the national surveys are not recent and their reliability is questioned, comparison with national-level household surveys is difficult.

It is vital to know how the poverty level of MFIs' clients compares to the poverty level of the general population. If the analysis deals with all the clients, what conclusions can be drawn? If they are richer, does it come from a selection of richer people or from a positive impact of financial services? If they are poorer, does it come from a selection of poorer people or from a neutral or even negative impact of the financial services?

Thus most of the frameworks only focus on poverty assessment and do not provide a full picture of social performance. Poverty outreach is only one aspect of social issues. Moreover, it relies on data that are not easily available or reliable, viz. information on clients entered in the MFI database and national household survey data.

Many development projects seek to reach the poorest via the provision of agricultural inputs, extension, credit, education, and many other services. However, low-cost and reliable methods for assessing whether a project reaches the poor are lacking at present. An operational method was designed during a two-year research project from 1999-2001 by IFPRI (International Food Policy Research Institute) with the support of CGAP. The objective of the research was to develop and test a new method that could be later used by development practitioners to assess the poverty level of beneficiaries of development projects that target the poor in relation to the general population in the intervention area. The method constructs a poverty index using principle component analysis, and is based on a range of indicators that describes different dimensions of poverty for which credible information can be quickly and inexpensively obtained. To ensure the method's usefulness to a wide number of countries and projects, the method was tested in rural and urban areas in four countries: Nicaragua (urban and rural), Kenya (urban and rural), Madagascar (rural), and India (rural). The results are summarised in Zeller et al (2001). The method has potential for monitoring and evaluation purposes of development organisations. Since 2001, the method has been used in over 20 assessments of MFIs. However, the main focus of the tool remains poverty and ignores other aspects of responsibility of organisations, which are integral part of sustainability when viewed from a larger development perspective.

Taking a sustainability perspective

The two primary areas where financial institutions need to evaluate Impact relate to the setting and reaching of clear goals around enterprise profitability, and to providing employment and skill development opportunities to disadvantaged populations. Hence, the definition of success therefore has a double bottom line; success is achieved if both the clients and the enterprise itself are able to develop paths towards self-sufficiency.

Success in providing financial products and services needs to be analysed within the Sustainable Livelihoods framework, an asset-based approach that provides a useful context from which to specifically address where clients are now, where they want to go and how they can get there. Increasingly, impact assessment studies point to the lack of assets – financial, social, physical, and natural – as a key indicator for why certain groups slip into and/or cannot move out of poverty.

From a **social outcome** perspective, real Impact is realised if after the financial support beneficiaries are able to secure that next opportunity and continue to develop a path for both financial self-sufficiency and personal growth. Transitioning into that next opportunity however could also occur within the financial institutions providing support. In that respect, financial institutions will develop more permanent employment positions, depending on the nature and needs of the target employee group.

From a **financial outcome** perspective, Impact will be achieved if after the start up, stabilisation and growth periods, cash flow from the business is able to cover all associated costs while continuing to generate employment opportunities for the target employee group.

According to the Global Reporting Initiative, the economic dimension of sustainability concerns an organisation's impacts on the economic circumstances of its stakeholders and on economic systems at all levels. Economic impacts can be divided into direct and indirect impacts.

Broadly speaking, economic performance encompasses all aspects of the organisation's economic interactions, including the traditional measures used in financial accounting, as well as intangible assets that do not systematically appear in financial statements. Financial indicators focus primarily on the credit-worthiness of an MFI for the purpose of informing its management and donors. By contrast, economic indicators in the sustainability reporting context focus more on the manner in which an organisation affects the stakeholders with whom it has direct and indirect economic interactions. While financial performance indicators are well developed, indicators of organisation-level economic performance need to be evolved.

The main dimensions in measuring economic development impact in business evaluation are:

- Business ethics: contractual agreements, transactions with donors and clients, etc.
- Community initiative: relationships and communication with clients, contribution to their local economy, building their wealth and skills, etc.
- Governance: transparency, accountability, etc.
- Human rights: child labour, forced labour, non-discrimination, etc.
- Workplace: wages and benefits, education and training, financial and job security, etc.
- Corporate philanthropy: donations, etc.
- Social impact of products: the contribution of products and services to social welfare, equity, and the meeting of basic needs such as food, shelter, water and health care.

MFI, NGOs and private players in this sector are primarily concerned to demonstrate that they are making progress in creating employment opportunities for the underprivileged, strengthening social safety nets, and ensuring the health and safety of communities. These are just a few of the complex and ambitious issues they tackle but find difficult to access.

The Role of Responsibility Standards in Measuring, Reporting, and Managing Economic Development²⁰

Most responsibility standards address only one of the three elements – social, environmental, and economic - of sustainable development to any great extent. Of these three, the economic

²⁰ "Business and Economic Development: The Impact of Corporate Social Responsibility Standards and Practices", A Report by AccountAbility and Business for Social Responsibility, June 2003

component tends to be a poor relation of the other two. Several international efforts address economic development to some extent, including the APEC Code on Business Conduct, the Ethical Trading Initiative, the Global Reporting Initiative, the Global Sullivan Principles, OECD Guidelines for Multinational Enterprises, Sigma, and the United Nations Global Compact. But even these efforts and the norms they seek to establish have limitations when it comes to the economic development dimension. Firstly, most standards fail to distinguish adequately between the financial (which would include staff remuneration) and the economic (which would include a living wage for poor workers). Financial issues and economic issues are quite different (see Box below). Secondly, no framework adequately defines who the impacts are measured for – i.e. everyone, or only the poor and disadvantaged? Clearly, additional clarification of the economic dimension is needed.

Box 1: Differentiating between 'economic' and 'financial'

The terms "economic" and "financial" do not mean the same thing. According to Tuppen and Zadek, financial refers to the market valuation of a company's transactions. In contrast, economic refers to activities beyond the boundaries of a single organisation, taking into account social and environment activities, and ultimately, outcomes for stakeholders at large. Yet the economic element of sustainable development has generally been taken to be synonymous with financial performance. Bannock et al (1987) define the financial as the provision of money when and where required. In contrast, the economic refers to the production, distribution, and consumption of wealth in human society.

Need for Measurement

Some kind of common measurement framework for the sector as a whole is critical in order to establish a link between performance and funding. This link is second nature in the mainstream commercial sector. Those companies that can consistently generate superior returns on investment for their investors will continue to attract more financing; those that generate inferior returns go bankrupt. The critical feature that permits this to happen is a common accounting measurement framework - however imperfect - that facilitates the comparison of companies. The result is that good companies thrive and bad ones do not.

The link between performance and funding is not second nature in the social development sector because a common measurement framework that allows easy comparison of the performance of one social service agency to another does not exist. Consequently, it is difficult to determine who most worthy of support is and inevitably the sector is much less efficient. This is because there is no invisible hand to ensure that those agencies doing the best work are the ones that are financially supported and thrive. Also in the social responsibility claims by private companies are till date largely anecdotal and it is time they start measuring the Business and Economic Development Impact (BED Impact) to (im)prove themselves.

In the first stage of the evaluation of BED Impact, which includes social performance (as applied to MFIs), the focus should be on core social issues such as the relations of the MFI with its employees, beneficiaries and communities.

The distinction between BED Impact and 'in vogue' Impact assessment, does not mean that the credit ratings and measurement of poverty outreach are not important. But it is also

important to emphasise that social performances cannot be reduced to poverty outreach. Poverty outreach is one aspect of BED impact assessment and looks at a broader picture of sustainable development.

Participating financial institutions have different objectives and constraints. One may focus more on reaching women, another on scale, another on reaching remote areas, another on empowerment, etc. BED Impact assessment should take into account these different dimensions of social concern.

To achieve BED Impact assessment that can be used by a wide range of financial institutions, including the MFIs, two points must be taken into account:

- BED Impact assessment system derives its legitimacy and relevance from the underlying value system. It should rely on "universal" values: eradicating poverty, equality, voice for the excluded, etc. These different values should be included in BED impact assessment.
- Data availability: the type of information available is closely related to the type of institution, particularly its lending technology. The indicators must be based on "universal" information, which are easily available for all financial institutions or can be captured through rapid surveys/interviews.

In the broadest sense, Return on Social Investment (ROSI) is an attempt to quantify the economic and social value being generated by an organisation as a result of its products and services. ROSI is proposed as an evaluation strategy to determine what financial institutions and their products and services are delivering the 'best' economic and social returns. It is defined as a "return" because it is a result of resources (financial and human) invested. ROSI's distinguishing feature compared to the more traditional "return on investment"(ROI) is that the units being measured encompass the three components of sustainable development.

The total economic value generated from the work done in the social development sector, including the financial institutions, is largely unknown. A significant need exists to develop and utilise frameworks that attempt to define and measure BED Impact of products and services provided by the financial institutions. A ROSI analysis could be just a part of BED Impact assessment.

Undoubtedly establishing a common measurement framework is a much more difficult task in the social development sector than the mainstream commercial sector. Many would argue that any attempt to establish a methodology to quantify success in this sector - when so many aspects of the work can only be judged qualitatively - would actually be counter productive. However, while acknowledging that it is much more difficult and complex to do, the benefits of a common measurement framework - encompassing both quantitative and qualitative measures - would ultimately lead to a more productive sector and outweigh the costs of figuring out how to do it.

This is based on the following perspectives:

1. Disadvantaged populations that get employed with continued access to relevant support services such as capacity building will generate improved social outcomes for themselves through increased financial self-sufficiency, creating access to other employment and/or educational opportunities and developing capacity for lifelong learning.

2. MFIs with feasible and scaleable business ideas that help disadvantaged populations have the ability to become self-sufficient and exist without external grants over a certain period of time.
3. Access to employment and training will contribute to the decreased need of individual target employees to rely on specific social services over time, which eventually translate to cost savings to society.

Our overarching challenge in this whole process centres on developing a BED Impact assessment framework and ultimately a system that will be an integral tool to guide strategic development of financial institutions, particularly the MFIs. The process in setting up a BED Impact assessment needs to be valued by all key stakeholder groups in order to be useful.

8. CONCLUSIONS

For the finance sector in India measuring its economic development impact remains largely uncharted territory. Social consciousness and current impact assessment studies of private companies, and those emerging from the non-profit backgrounds, are not sufficient to articulate their contribution to societal objectives. Institutional understanding of their business' economic impact on identified poor sections of the society will require linking micro level impacts with desired macroeconomic outcomes.

Most of the impact assessment studies conducted so far focus only on poverty assessment and do not provide a full picture of social performance. Poverty outreach is only one aspect of social issues. Moreover, they rely on data that are not easily available and reliable: viz. information on clients entered in the MFI database and national household survey data.

Success in providing financial products and services needs to be analysed within a Sustainable Livelihoods framework, an asset-based approach that provides a useful context from which to specifically address where clients are now, where they want to go and how they get there. Increasingly, impact assessment studies point to the lack of assets – financial, social, physical, and natural – as a key indicator for why certain groups slip into and/or cannot move out of poverty.

This is not to suggest that players in the microfinance industry do not appreciate the contribution their products have on beneficiaries or that there is a tendency to ignore any such attempt. However, if they know the specific impact made, companies can best justify resource allocation decisions to both internal and external stakeholders and make the best possible contribution to those they seek to serve.

A BED Impact assessment system derives its legitimacy and relevance from the underlying value system. It should rely on "universal" values: eradicating poverty, equality, voice for the excluded, etc. These different values should be included in BED Impact assessment.

While the financial institutions, and other key stakeholders, debate the issue of regulating microfinance, it is also important for them to at least voluntarily begin measuring their own impact at a broader level. Credit rating agencies can take a lead on this immediately. Such steps would enable donors and other partners in deciding the all-round worthiness of an institution rather than merely its credit worthiness.

Matters can be taken forward by enlightened MFIs, banks, insurance companies, credit rating agencies, industry associations, donors, and regulators. The CSM-organised multi-stakeholder consultation²¹ on 7 April 2004 in New Delhi was a start and players from the abovementioned institutions should meet to discuss the practical aspects of adopting the BED Impact assessment framework and mainstreaming it.

If the industry is to have a significant impact in shaping debate in this area, then understanding its business and economic development impacts will provide a constructive and dynamic platform for discussion with stakeholders in the short term, and eventual success in overall BED performance in the longer term.

²¹ Report available from CSM upon request or directly from our website: www.csmworld.org

In terms of next steps, CSM work so far recommends that follow-up studies to this project go further in-depth and attempt to measure the BED impact for a handful of successful pilot MFIs, banks and insurance companies. The next stage of research should also go beyond micro-credit to cover a variety of other microfinance products such as insurance.

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FINANCE MEETING REPORT



CSM BUSINESS & ECONOMIC DEVELOPMENT SEMINARS

THE FINANCE INDUSTRY, CORPORATE RESPONSIBILITY & ECONOMIC DEVELOPMENT IN INDIA

Presentation of Results of CSM Research Project

In association with AccountAbility & Business for Social Responsibility

WEDNESDAY, 7 APRIL 2004
INDIA HABITAT CENTRE
NEW DELHI

1. BACKGROUND & OBJECTIVES

This meeting was organised by the UK- and India-based **Centre for Social Markets (CSM)** to share the preliminary findings of research we conducted on the subject in association with the UK-based Institute for Social & Ethical Accountability (**AccountAbility**) and the US-based **Business for Social Responsibility (BSR)**. The meeting programme is attached. (Details on CSM's research activities can be found on our website: www.csmworld.org)

The meeting was an invitation-only event bringing together a small group of experts and practitioners active in the financial sector with a particular interest in micro-finance products intended for disadvantaged or marginalised groups. (Details on this research project can be found in CSM's **Information Memo** on the subject on our website.)

The meeting's objectives were as follows:

1. publicise the **findings** of CSM's research with a small peer group;
2. invite **feedback** from the peer group on the report to flag areas for further improvement;
3. discuss a possible **advocacy** strategy to take forward some of the recommendations contained in the report – particularly with the industry in question – in both the Indian and, where relevant, the international context; and
4. identify **next steps** –ideally in partnership with participating organisations.

2. MEETING SUMMARY & MAIN POINTS RAISED

The Finance Convening started with approximately 32 participants from micro-finance institutions (MFIs), NGOs, donor agencies, private banks, insurance companies, multi-lateral agencies and rating agencies bringing expertise from various segments of the broad world of micro-finance.

After the presentation of the findings of CSM's study on India's micro-finance sector, the floor literally split into two. The micro-finance players took a broad stance against any sort of 'additional' impact initiatives, while the private players (and some micro-finance intermediaries) supported the requirement for impact measurement presented.

This spilt emerged right from the panel itself where the two discussants took divergent views and was reflected in the discussion with the floor. Efforts were taken to keep the discussions focussed on CSM's BED impact research and not stray into other areas of micro-finance. Digressions into other areas did occur occasionally, however, and led to an emotional debate about the social development role and efforts of MFIs.

This report summarises the presentations made by the two discussants that were broadly reflected and reinforced by other participants at the consultation:

Discussant 1: Ms Vijayalakshmi Das, Chief Executive, Friends of Women's World Banking

- 1.0 **Defining 'MFIs'**: it is important to define who exactly the MFIs are. A narrower definition, limited to legally identified MFIs can leave out many institutions and organisations such as NGOs and community-based organisations (CBOs) that provide micro-finance as intermediaries. For example, PRADAN, DHAN Foundation, CASHE Care India, etc. Secondly, there are other financial institutions such as co-operative banks and regional rural banks (RRBs) that provide various micro-finance products and services. The successful ones are those that provide a basket of services to the poor beyond finance and fulfil their broader needs.
- 2.0 **Defining 'poor'**: It is necessary to consider the target audience: who exactly are the 'poor' that we intend to reach and measure the impact on. For example, there are vulnerable groups that move Above Poverty Line in case of good monsoons, and slip Below Poverty Line in case of a drought for two years. Then there are the poorest of the poor that remain underserved even by MFIs.
- 3.0 **Cost of delivery mechanisms**: The interest rates charged by the MFIs are high essentially due the high costs of bringing micro-finance products and services to the poor. In addition, there are the costs of creating delivery mechanisms at the community level (which are not included in determining the interest rates). Then there is the cost of creating and setting the client base for micro-finance products and services. These costs are difficult to integrate into the calculations of interest rates.
- 3.1 **Regulation**: There are regulatory constraints for MFIs and NGOs to provide savings products as a result of which they cannot mobilise additional money through savings and forward the same as credit. If such regulations were relaxed, MFIs and NGOs could bring down their interest rates and make credit more affordable.
- 4.0 **Entry of private players**: It is perhaps only because of the regulatory mandate that private banks and insurance companies have entered the micro-finance sector with new credit and insurance products. This has resulted in new partnerships and a variety of products with some customisation. However, there are still gaps in terms of products offered and the needs of the poor. For example, BASIX and ICICI Lombard have worked out weather insurance (quoted in CSM's report) which apparently is for the poor. However, it is meant only for land-owning farmers and not the landless farmers, since the landless do not have assets and capacity to afford the insurance product. The consequence is that in case of a drought, while the weather insurance protects the land-owning farmers, the landless are still dependent upon their employers to maintain their living. This gap needs to be bridged. Products should be customised to the real needs of all types of poor people. Only then there will be a wider impact of micro-finance and private participation.
- 5.0 **Consumption vs. production loans**: 60-70% of MFI loans are for consumption. This means that there are no multiplier effects in terms of generating employment or adding on to national product. Thus the resulting impact gets limited. Further, high interest rates also affect the takers of production loans. There is a gestation period of about 3-5 years for the new micro-enterprises to stable down and determine the impact. Not that high interest rates are justifiable; they have to come down and there are sufficient market forces even in the rural areas to force them down.
- 6.0 **Partnership with private sector**: MFIs and NGOs are concerned about getting into partnerships with private banks and insurance companies. Various concerns arise basically from striking a balance between business and service to the poor. Partnerships with private players work best

when the terms on using the money are not dictated but left to the MFI/ NGO to decide on and all relevant information is disclosed and transactions as transparent as possible.

- 7.0 **Case studies:** The case study selection is disappointing since there are much better initiatives on appropriate technology, housing, etc.
- 8.0 **Impact:** This does not become visible with smaller amounts of Rs 2000-5000 loans in the first two years and often not even in a sufficiently longer period. The impact becomes visible only when the loan size gets bigger and when there are opportunities for borrowers to invest those incomes into income generating opportunities with employment options. Again every borrower is not an entrepreneur. Hence new income earners are not added with every loan disbursed.
- 9.0 **Urban vs. rural poor:** The urban poor have more opportunities compared to the rural poor who are left with just one or two income generating options. There are also constraints on infrastructure and market linkages. The BED Impact assessment is ahead of its time and one should not be in a hurry to measure it. One should also realise that it takes 5-10 years to make an impact.
- 10.0 **Social impact:** While it is good to extend the economic impact beyond financial impact assessment, assessing social impact is more critical. In a society divided on caste lines, improvements in the economic situation of a low caste individual or family does not necessarily improve their acceptance in the community. Similarly, in terms of the status of women, micro-finance does not necessarily improve the social impact on a female borrower.
- 10.1 Micro-finance support can also lead to negative impact on borrowers. For example, credit taken to buy new cow(s) results in more workload for the woman in the house, which does more harm than good.
- 11.0 **Cost:** Impact assessment is expensive. It should be cost effective, simple, and easily measurable.

Discussant 2: Ms Moumita Sen Sharma, Vice-President & Head Micro-finance, ABN Amro Bank

- 1.0 **Sustainable Development:** Micro-finance is seen as the financing of sustainable development by ABN Amro Bank and is part of the bank's sustainable development agenda. Thus defining impact to include various factors beyond just finance and poverty centric measurement makes considerable sense and is apt. Till now the micro-finance basket has not reached a scale to make it a viable business for banks to get into it and be profitable. It is, therefore, out of their social initiatives that they are offering these products and services for the poor.
- 2.0 **Demand for common standards:** MFIs and NGOs cannot do away with common standards of transparency and accountability. Banks now need to pay a great deal of attention to governance and transparency. But this is not the same for MFIs and NGOs who need to be more attentive to issues of transparency. They may be less transparent due the manner in which MFIs and NGOs have grown. Run by social entrepreneurs, they have not been able to institutionalise and make operations transparent. Common standards on transparency and accountability will make them attractive to private players for partnerships.
- 2.1 **CSM Research Timely:** The dialogue that this research seeks to begin is timely. A few large MFIs are just graduating beyond their basic survival stage and some are adopting pragmatic ways of increasing outreach, productivity and profitability, often resorting to various legal engineering and compromising transparency. Therefore, by laying down standards for wider social impact measurement, it may be possible to direct growth in the desired direction.
- 3.0 **Cost of measuring impact:** The cost of making a BED impact assessment possible (by maintaining/ accessing data necessary data) should not make the service delivery prohibitively expensive. Also, most MFIs are still at an economically vulnerable stage. The cost of incorporating the necessary "values" within their operations at this point of time may make them financially unviable.
- 4.0 **Regulation:** a reluctance to regulate MFIs is discouraging private banks to get further into partnerships and move down the channel to reach customised and affordable micro-finance

products to the poor. This reluctance is perhaps because the government wants to justify its own rural network of banks that are extensively promoting self-help groups (SHGs), which are not sustainable in the long-run.

4.1 **Policy issues:** the policy prohibits MFIs and NGOs from savings mobilisation, which results in high interest rates being charged by them. However, in order to withstand competition and provide competitive rates to the poor, some MFIs are mobilising savings by resorting to legal engineering creating structures that may not be standing in long-term. Private players are uncomfortable partnering with such.

5.0 **Broader package offered:** The MFIs should be one-stop-shops selling a variety of financial products and services, not just limited to credit or insurance. This would ensure lower transaction costs, lower interest rates, and long-term sustainability of the MFIs.

3. CONCLUSIONS & NEXT STEPS

The meeting concluded that there is certainly a lot of information on micro-finance and its impact on the poor, and that ever-greater numbers of private players are beginning to venture into the sector.

Participants noted that some key questions and concerns would need to be addressed. Specifically, what information is important to share in order to measure impact when private banks and insurance companies partner with MFIs/ NGOs to reach the poor? Furthermore, it is important to identify exactly which impacts are sought to be reported as this will determine what information will be relevant.

In terms of concerns, the major one referred to issues of trust, transparency and accountability in this sector. As both foreign and domestic banks become more interested in the poor as a new market, they will seek partnerships existing MFIs and NGOs but this will require a greater deal of attention to professionalism and accountability by these players.

CSM's draft study – the subject of discussion at this meeting - concluded that by and large companies in India do not measure the economic development impact of their putatively pro-poor activities. However, the consultation revealed that many private banks and insurance companies are indeed supportive of the need for such impact assessments and that CSM's research needs to now extend from case studies to actual collaboration on the 'hows' of such measurement and assessment. The business case for impact assessment will be easier to make if the practicalities of it are also made clear in a step-wise and cost-effective manner for the key market players.

CSM's final report will now incorporate the views expressed and the information shared at this consultation and make recommendations for specific next steps accordingly.

For more information, please contact:

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PROGRAMME

CHAIR: Dr. Uddesh Kohli, Chairman, Consultancy Development Centre

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| 8.30 – 9.30 | Coffee & Registration | |
| 9.30 – 9.45 | Welcome & opening remarks | Uddesh Kohli, Chairman Consultancy Development Centre |
| 9.45-10.00 | Introduction to BED research | Helen Campbell, Senior Researcher AccountAbility |
| 10.00 – 10.30 | Introduction to research & key findings | Sachin Joshi, Researcher Centre for Social Markets |
| 10.30 – 11.00 | Response by 2 expert discussants followed by open discussion | Moumita Sen Sharma, Vice President & Head of Microfinance ABN Amro Bank Vijayalakshmi Das, Chief Executive Friends of Women's World Banking |
| 11.00 – 11.30 | Coffee/tea | |
| 11.30 – 12.45 | Open discussions (continued) | |
| 12.45 – 13:00 | Concluding remarks | Helen Campbell. Senior Researcher AccountAbility |
| 13.00 – 14.00 | Lunch | |

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