Fresh Inclusive Growth Models for Microfinance Institutions

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Abstract: **Microfinance for the poor/ people below poverty line (BPL) is a niche industry that requires special market and operational Knowledge. However, around the world just 3 percent of the Micro-Finance Institutions (MFI) serves more than 80 percent of the total number of these kinds of members. Market demand for microfinance services is estimated at more than US$300 billion, while market supply is only US$15 billion. Presently MFIs are facing various Internal and External problems e.g. poor administration, lack of innovativeness, fluctuating state policies, lack of awareness in the institute and even to needy, lack of entrepreneurial support from the banks and rich business houses due to less profitability, etc. Hence, reaching out to the poorest and gaining financial stability are the biggest challenges the MFIs have to overcome. Future prospects of not all the Non Governmental Organizations (NGO) will be sustainable. In the long term, commercial banks shall be more involved.**

We are keeping the track on the existing models of Grameen Bank of Bangladesh, which has won the Noble Prize for Peace in 2006, and on the model of National Agricultural Bank for Rural Development (NABARD) of India. We have been analyzing them to understand their pioneering and innovative efforts for microfinance. In view of long-term objective a new 8-factor model is suggested which is based on customer engagement dialogue and collaboration. The factors include:

1. **Vision,**
2. **Raising Capital,**
3. **Product,**
4. **Delivery and Distribution mechanism,**
5. **Repayment mechanism,**
6. **Investment,**
7. **Promotion, and**
8. **Monitoring Progress.**

Every factor has been tried to link with some existing example to visualize its validity. Moreover some inventive ideas like intermediating the private sector, daily repayment model and investing in rural entrepreneurs, have been mentioned along with the experimental solutions like use of capital markets and implementing market segmentation. With such models adopted judiciously, future of MFIs may look brighter than ever.

Finally the evolutionary success story of Mohammad Yunus, and his Grameen Bank of Bangladesh, with Noble Prize in its belt, is highly influential, hence this effort to reach poor and needy around the world through this magical revolution and evolution in credit finance called microfinance.

I. Introduction

Around the globe there are 2.8 billion people, approximately 560 million families, who are considered poor, living on less than US$2 per day purchasing power parity (PPP). Of those, 1.2 billion people live in abject poverty; the "poorest" surviving on less than US$1 per day PPP. Despite recognition of microfinance as a proven poverty reduction tool, fewer than 18% of the world's poorest households have access to financial services. In fact in India there are 52% of people working in unorganized sectors, who do not have access to Bank accounts and who do not understand the concept of microfinance and various MFI schemes due to their total illiteracy and hence inability to understand the details. Still, market demand for microfinance services is estimated at more than US$300 billion, while market supply is only US$15 billion.

Microfinance for the poor is a niche industry that requires special market and operational knowledge; especially the ability to make them understand, wining good faith and making them prosper through your microfinance help.

Present status of microfinance institute: The world of MFI is highly concentrated. 3 percent of the MFIs serve more than 80 percent of the total number of members. The IFPRI database of MFIs from 85 developing countries shows 1,478 institutions. They reach 54 million members, 44 million savers, and around 23 million borrowers. Total volume of outstanding loans is US$18 billion. Total savings volume is US$12 billion. MFIs are also quite diverse in terms of size: 49 percent of MFIs have fewer than 2,500 members, 73 percent have 10,000 members or fewer, and only 7.5 percent have more than 100,000 members.

Classification of MFI: So far there has been no fixed classification of MFIs. Cécile Lapenu et.al., 2001 tried to classify MFIs based on the technology they used and their Legal status as follows:

a. By Technology: The MFIs have been classified into five major types, according to the main technology they use to provide financial services:
   i. Cooperatives,
   ii. Solidarity groups,
   iii. Village banks,
   iv. Individual contracts, and
   v. Linkage models.
   vi. Some MFIs combine different approaches, e.g., individual and solidarity group models. These are classified as *mixed*.
b. By Legal Status: MFIs have been classified by legal status:
   i. They may be NGOs,
   ii. Cooperatives,
   iii. Registered banking institutions,
   iv. Government organizations (GO) on projects.

II. Problems

Broadly speaking problems can be Internal or External. Internal problems arise due to conflicts in the internal operations of the MFI while External problems arise due to change in policies of the government or international community, or change in the market scenario.

a. Internal: General internal problems are related to administration, staff management, non adherence to norms and lack of innovativeness. Large MFIs suffer mostly from staff and administration problems due to their bulky size. Whereas smaller NGOs can have flexibility to try innovations. But such NGOs lack adherence to norms and generally work with an atmosphere of informality.

b. External: External problems generally include fluctuations in the state policies, inflation, global market and trading scenario. MFIs require stable macroeconomic and political environments to develop. That is the reason that unstable countries are still out of reach of the international world of microfinance e.g. Algeria, Somalia, Angola, or Afghanistan.

Case Study

Some of the known examples of failure include govt. banks of Bangladesh (1980s) and BNDA in West Africa.

The low repayment rate was one of the most visible failures of the state-owned development banks. These institutions were not sustainable and relied more and more on subsidies. A closer look at the impact of the development banks also revealed that they generally did not reach small farmers. Several points explain these failures. Political interference and lack of responsibility among bank staff led to biased selection of borrowers and arbitrary loan waivers, which led to decreasing repayment rates.

III. Challenges

1. Outreach: Reaching the target customer is a big challenge esp. in case of absence of a banking structure. E.g. in Madagascar, where microfinance institutions try to fill the gap of the deficient banking structure, shows that in spite of the interesting and innovative experiences of the microfinance network, the total number of members reached is around 25,000 i.e. a national rural outreach of less than 2 percent.

2. *Financial Sustainability:* Currently, 150 MFIs are sustainable without donations. With a total market between 2,000 to 8,000 MFIs, this is not a very high success rate. The amount of private capital is pretty low; most capital is still in donations. The challenge for the industry has been its traditional approach to raising financing.

3. *Understanding customer behavior:* MFIs need to understand the socio-economic condition of their clients. For example, they work with clients who have low literacy levels. Their low incomes mean that they cannot afford to travel to distant branch offices. That is why conventional village lenders are still very much popular. E.g. The majority of poor rural households in Bangladesh continue to be served by a vast number of informal lenders who, because of their superior information, are able to provide a range of financial services especially tailored to their clients.

4. *Interest rate:* Fixing down the interest rate is another challenge. MFI needs to look up for myriad of factors like government policies, market conditions, customer behavior, expected repayment rates etc. before fixing down the interest rate. Moreover it can not be frequently changed and is expected to remain stable for quite some time.

5. *Collateral basis:* The poor mostly lack traditional forms of collateral, so microfinance institutions need to find collateral substitutes. Many innovative approaches have been tried out such as peer-monitoring, joint liability but their success rate depends on the local socio-economic conditions.

IV. Prospects

To support future growth, it will be necessary to support MFIs in their efforts to find demand-oriented products to broaden their clientele and to innovate in cost-efficient service delivery systems, so that they can have sustainable increase of their scale in terms of number of clients, volume of activity, and relative poverty level of clients.

Efficiency in depth of outreach can come from three main strategies:

1. Huge institutions, such as the Bank for Agriculture and Agricultural Cooperatives in Thailand or the Bank Rakyat Indonesia may only have a low percentage of poor among their clients, but on the whole, they can reach more poor households compared with tiny non-govt organizations that struggle to target specifically the poorest but that have no means to grow in scale.
2. Some solid, self-sufficient institutions, which first concentrate their efforts on institution building and financial autonomy, can develop direct services or links for reaching the poor.
3. Some institutions clearly focus their services on the poor. They target actively and rely on specific organizations to compensate for the specific costs and constraints faced in reaching the poor. This last category of MFIs generally

grows more slowly and takes more time to reach self sufficiency.

Prospects for NGOs and commercial banks: In spite of their growing importance in the field of microfinance, NGOs cannot be the only vehicle for microfinance services, following the example of Bancosol and FIE in Bolivia or K-Rep in Kenya. This is not the objective for most of them, and they cannot have enough capacity in terms of banking skills, security, or human resources. In the long term, commercial banks should be more involved. They can offer physical infrastructure, well-established information systems, sound governance, important resources for funds and strong ability to offer financial services.

V. Existing Models

1. *Grameen Bank of Bangladesh Model:* Perhaps the most successful model so far. Grameen Bank (GB) has reversed conventional banking practice by removing the need for collateral and created a banking system based on mutual trust, accountability, participation and creativity. GB provides credit to the poorest of the poor in rural Bangladesh, without any collateral. At GB, credit is a cost effective weapon to fight poverty and it serves as a catalyst in the over all development of socio-economic conditions of the poor who have been kept outside the banking orbit on the ground that they are poor and hence not bankable. As of July, 2004, it has 3.7 million borrowers, 96 percent of whom are women. With 1267 branches, GB provides services in 46,000 villages, covering more than 68 percent of the total villages in Bangladesh. Grameen Bank's positive impact on its poor and formerly poor borrowers has been documented in many independent studies carried out by external agencies including the World Bank, the International Food Research Policy Institute (IFPRI) and the Bangladesh Institute of Development Studies (BIDS). The efforts of Mohammad Yunus, the founder of Grameen Bank, Bangladesh, received the Noble Prize in 2006.

2. *NABARD Models:* There are number of models working in India.

Model 1: SHGs (Self Help Group) are formed by NGOs and other formal or government agencies, but directly financed by the bank. This is the original and most common model and, in 2002, accounted for about 75 percent of SHGs. NGOs receive financial support from NABARD to form SHGs and link them to bank branches.

Model 2: SHGs are formed and financed by banks. Under this model, the banks themselves take up the work of forming and nurturing SHGs, opening their savings accounts, and providing loans. In 2002, this model accounted for 16 percent of SHGs.

Model 3: SHGs are financed by banks using NGOs and other agencies as financial intermediaries. Under this model, banks do not directly lend to SHGs, nor do the SHGs have any savings accounts in the bank. Instead, the bank provides loans to another NGO that acts as an intermediary. This model is especially practiced in areas where the bank does not have a branch. In 2002, this model accounted for 9 percent of SHGs.

Women credit groups have been particularly successful in providing traditionally secluded women a non-intimidating and socially acceptable platform from which to learn and conduct business outside the house. They have also provided a critical launching pad for women to increase and exchange knowledge and assert themselves as visible and important partners in the community.

VI. New Model Formation

An eight factor model has been conceptualized. This model aims at meeting the challenges mentioned earlier and tapping the maximum potential, keeping in mind the future prospects.

Assumptions

1. Applicability of the model: No model can be applicable for every situation. Thus this model aims more at highlighting the major focus areas and strategies rather than providing a specific solution.
2. Number of Intermediate layers: Number of middle tiers in the model will increase with increase in the expected Risk factor. This will help in distributing the risk.
3. Role of customer: The new model needs to be a 'connect and collaborate' model rather than being a 'command and control' one i.e. it should rely on customer engagement dialogue and collaboration. e.g. ITC e-choupals employs collaborative strategies particularly for designing products and services. Their sanchalaks, who are at the front-end of the network, interface with customers and personalize their needs.

Factors of the Model

1. Vision

MFI had been so far thought only for charity work but sustainability can't thrive for long on charity. For attaining independence, an organization needs to earn profit and grow. Profit should be seen as a means, not an end. Profits attract investors and allow old investors to exit. So profit remains the means for assembling the project, expanding the services, and rewarding investors. Adam Smith through his article on the "Invisible Hand" argued that under certain conditions profit maximization automatically leads to the common social good.

Profit making organizations are in disadvantage, for government policies are always in favor of the Non-Profit organizations. But this is more than compensated by a better support from the capital market.

2. Raising Capital

For microfinance to continue growing at average rates of 15 to 30%, US$2.25 to US$5 billion in new portfolio financing and US$300 to US$400 million in new equity will be required per annum. For abridging this supply-demand gap there can be two major options:

a) Capital Market

Capital markets have the resources readily available to close the supply-demand gap. Several such experiments have been tried out but still this has not being that successful due to the non-profit making and high risk scenario of the MFIs.

A number of pioneering transactions have taken: a US$15 million bond issue by Compartamos in Mexico; a partnership between ICICI, and CASHPOR; a US$4.3 million securitization SHARE's loan portfolio, again with ICICI; and a US$40 million bond issue by Blue Orchard Microfinance Securities I in the international capital markets.

b) Intermediating Private Firms

Private sector is showing great interest into rural market these days. E.g. Reliance's farm-to-fork operation, ITC e-choupal, rural supermarkets by Tatas and Shrirams. Such companies are highly interested in penetrating the rural market especially the remotest ones where they haven't reached so far. Here the MFIs that have already established in such markets can act as intermediators or facilitators. These MFIs can play lead roles in functions like financing the local distributors and/ or retailers, offering savings schemes and providing insurance coverage. Even they can go beyond that in channelizing venture capitalists to rural entrepreneurs. Moreover MFIs can help such companies in implementing various innovative financial instruments/tools. E.g. Triveni, a sugar group pays cane dues directly in farm bank accounts, and issues debit cards so that farmers can travel without cash to markets, a boon in gangster-ridden Uttar Pradesh.

3. Product

The conventional products offered are Credit, Savings and Insurance. What matters the most is the way these products are shaped and presented in accordance with the customers' environment.

Major considerations before designing a product are:

- Simple products work best because they are easier to administer and easier for clients to understand. Adding riders is fraught with difficulties. Even small riders may have large consequences.
- To get the product right, MFIs have to know what clients need and are willing to pay for.
- The target market is heterogeneous, so it is wise to offer a couple of different product options as long as they do not overly complicate the marketing message.
- MFIs need to conduct a costing analysis to determine how much they need to earn in commission to cover their administrative expenses.

Besides the important question of what risks to cover, organizations also have to decide whether they want to bundle many different benefits into one basket policy, or whether it is more appropriate to keep the product simple. For example, SHEPHERD, has been developing a multitude of products, which may be difficult to manage. In contrast, SPANDANA has focused on a few products and prioritized institutional efficiency over comprehensively meeting clients' needs. This prioritization has allowed SPANDANA to grow quickly, at the expense of not meeting as many articulated social needs.

Micro-Insurance, for instance, : instead of insuring crops (because very high uncertainty) provide instruments for Medical, house and personal insurance. This may also help in gaining tie-ups with medical institutions, builders/contractor etc also.

e.g. Yeshaswini Health Insurance Scheme started by Dr. Shetty. The model for this Scheme, is very low premiums with a very large number of participants.

Approach:

i. Communicating the scheme to the farmer
ii. Creating a system to collect premiums
iii. Issuing identity cards for participants.

Results:

By the end of the first year of operations, a total of 9039 surgeries had been completed valued at a total of Rs.105.3 million. From an accounting standpoint, the scheme turned a profit. The total premiums paid by 1.6 million subscribers were Rs 144 million (~$ 3.2 million). After administrative costs, the program generated a surplus of Rs. 18.6 million (~$406,000) which was carried forward for the second year of operations.

4. Delivery & Distribution mechanism

The delivery & distribution system has to be designed considering two major challenges viz. *Outreach* and *Risk*.

Broadly speaking there can be two types of delivery & distribution systems:

a. Direct: Without any intermediary organization or group. This will help the MFI to maintain full control over the process itself. Other major advantages include:

i. No sharing of the profit with any intermediary.
ii. Flexibility in making its own decisions and strategic changes.
iii. Better knowledge about the end customer.

But direct system suffers from many disadvantages too:

i. Limited outreach.
ii. Distractions by side issues (that contributes insignificant to its growth). This makes it very difficult for the MFI to focus on the core issues or core competencies.
iii. Very high risk: an active risk-management department is required for handling it.

Therefore such system can be used by institutions that have the capability to independently handle these issues. Such institution needs to be big enough in size to maintain robust operations. At the same time it will be required to have sufficient flexibility to handle high uncertainties.

b. Indirect : It is dealing with the end customer is not direct rather channelised through some intermediary organization such as cooperative groups, NGOs and local group of influential people. In effect it overcomes demerits of a direct system but is unable to provide latter's merits. To start with, this system requires fewer resources to build upon. But it is less flexible, required to share the profit with the intermediator, can not have full knowledge about the customer behavior and the most important, lacks full control over its operations.

Therefore such system is advisable esp. for startup MFIs with less available resources and knowledge about the target market.

c. Mixed: Provides few services directly while others indirectly. Hence this system can avail advantages of both the other systems while disowning their disadvantages. But it might not be an easy choice to decide upon which services to go by what system. Therefore for its implementation an efficacious strategic plan is required with suitable flexibility to adapt as per the changing market conditions.

d. Repayment mechanism (Daily repayment model): One of the biggest problems faced by MFIs is the low repayment ratio and the resources to be employed for handling it. In rural scenario customer is more bothered about the absolute value rather than the percentage rate. The traditional money lenders lend money usually for very short periods from one month to as small as one day. The debtors happily repay interest rates even as high as 70% per annum since the absolute amount repaid is small. For example, the money lender lends Rs. 200 for a day and will easily get a repayment of Rs.201 by the end of the day. This amounts to more than 180% p.a. of interest rate ({1/200}*365*100) which is unimaginable in a typical yearly lending scheme.

Implementation of such small duration instruments is very cumbersome for an institution. That is why Reserve Bank of India (RBI) is now exploring the option of letting banks use the money lender to reach out to the farmer. The reason being money lenders can reach where no bank can. However the money lenders have to be regulated so that they do not overcharge farmers. For proper implementation, the MFIs may look out for two options:

i. Lend money to the lenders.
ii. Use them as agents on commission basis.

The choice will depend upon various factors like the place, people, MFIs operations etc.

e. Investment: MFI should invest in the entrepreneurs and businesses aimed at generating more jobs in the rural market. This not only helps MFI in stabilizing its own portfolio but also in providing a sustainable development platform for the target population.

For example the GrameenPhone, Bangladesh, has allowed local entrepreneurs, mostly women, to buy cellular handsets with loans from Grameen Bank and then rent the phones, with airtime, to neighbors. Iqbal Quadir, founder of GrameenPhone in an interview said, "Its most important feature isn't the phone system itself but the microloans that mobilize an army of individual entrepreneurs to profitably meet an unsatisfied need".

f. Promotion (Marketing aspect): The concept of organized financing may be completely new to the target customer. Thus it will be required to educate & inform the customer about the concept and to build up a trustworthy image in their minds. For them to appreciate the benefits of it, the MFI has to implement a proper marketing and promotion strategy. The major elements to be looked upon to conceptualize such a strategy are:

I. Market Segmentation

The MFI needs to focus on one few particular market segments else it won't be able to develop any expertise or competitive advantage. Various major market segments for microfinancing can be:

i. Gender based i.e. Women Vs Men
ii. Occupation based i.e. Farm Vs Non Farm sectors
iii. Income based i.e. Poorest Vs Poor Vs Middle Vs Rich

It is not possible to predict that which sector will yield more profit. Thus which sector to focus will depend on the institution's policies, capacity and expertise. E.g. ASA mainly finances off-farm enterprises for women only whereas BRAC lends to women and men for both agricultural and non-farm activities.

II. Additional Value Addition :

Attaching extra benefits with your product helps in giving a better competitive advantage i.e. an edge over the competitors. e.g. NABARD also provides consultancy in the sphere of agriculture, rural development etc. through its subsidiary NABCONS (NABARD Consultancy services). Such services gelled with its products make it much more useful for the customer.

g. Monitoring Progress:

Benchmarking and tracking the performance is essential for an MFI. This will help it to adopt itself or change as per the changing market requirements. But it should not solely rely on financial performance data rather also on parameters like client-level impact. That is why new tools such as Poverty Progress Index of Grameen Foundation and the work of Sa-Dhan on measuring client satisfaction are now trying to address this gap.

VI. Revolutionizing the Evolution of Micro-financers to Small Scale Financers and Financing:

It is like evolution of a micro-credit holder. He repays to the society and leaves the legacy. Thus, a person tries to climb the value and earning chains would contribute to the society. From, Rs. 100/= per week, he will walk up to Rs. 1000/= per week then up and up. Government must encourage allowing every up in the earning chain to micro-credit down in the ladder. Thus, a person "A" earning Rs. 1,000,000/= per day will micro-credit 100 "C", persons earning less than Rs. 100/= per day, and so on. Person "B" earning Rs. 10000/= per day will Microcredit 10 "C", people earning Rs. 100/= per day. A→ C also B→ C and thus millions would be benefited. A tax exemption would be an added encouragement to this evolution with revolutionary implementations. It will help develop small scale finances and thus allow the needy people to develop small scale ventures.

There are two models possible:

Model 1:

A→ C

B→ C

Thus, both person A and person B earn significantly more than C. They both micro-finance the needy person C.

Model 2:

And other would be

A→ B→ C→ D→ E→ F→ G→ H→ I → J.

Pi(1,000,000,000)→ Pii(100,000,000) → Piii(10,000,000) → Piv(1,000,000) Pv(100,000) → Pvi(10,000) → Pvii(1,000) → Pviii(100) → Pix (10) → Px (1) .

Pi is up in terms of financial condition while earning one billion than Pii to Px, and thus he is micro-financing any body down in his ladder from Pii to Px. Similarly others in the ladder are doing so. Thus, everybody get benefited.

Here, government should give tax benefit to these kinds of micro-financers and thus will benefit the microfinance ventures.

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