Round Table On:
Accelerating Financial Inclusion through Microfinance- An Interface with Banks/FIs

19th December, 2013

Organized by:

ACCESS-ASSIST

Venue:

Bhubaneswar, Odisha

Summary of Proceedings

Supported by DFID, the Poorest State Inclusive Growth Programme (PSIG)is being implemented by SIDBI to enhance the income and employment opportunities of poor households in underserved states in India including Uttar Pradesh, Bihar, Madhya Pradesh and Odisha. The key purpose of the program is to improve income and reduce vulnerability of poor people and small producers by expanding their access to finance and markets. The PSIG programme it is envisaged to benefit the poor and vulnerable people, especially women, in the above low-income states, providing financial access to 12 million poor by way of capacity building of MFIs, facilitating technology led models, product development and roll-out, setting up risk funds etc. ACCESS-ASSIST, a specialised affiliate of ACCESS Development Services for Financial Inclusionhas been assigned the task of implementing the critical policy and enabling environment component under the programme.

One of the identified priorities within PSIG policy mandate is to undertake initiatives leading to enhanced flow of funds from banks to microfinance, for both the MFI and the SHG channels. As a part of the programme mandate, ACCESS-ASSIST has been organizing various thematic workshops, roundtable discussions, consultative meetings etc. at both national and state levels, involving different key stakeholders and facilitating constructive and forward looking discussion specifically between banks and MFIs for increased funds flow to the microfinance sector.

The first such consultation under PSIG initiatives in Odisha was organized at Bhubaneswar on 19th December2013. This proceeding is prepared based on the deliberations held in the above Roundtable.

1. Context and Objectives

Adequate and timely funding support plays a critical role for the growth and sustainability of microfinance program and facilitates greater financial inclusion in the process. The major sources of funding for microfinance service providers including MFIs in India have traditionally come by way of debt from apex lenders and banks, social and commercial equity financing from donors and investors and savings deposits from clients (in case of Cooperatives). In the initial years of development, MFIs were essentially an extension of the formal banking channel led by the SHG-bank linkage program. As bank lending to MFIs for on lending to SHGs, JLGs and individuals were recognized as part of priority sector lending, the banks increasingly provided loans to MFIs for this purpose, which also helped to fulfil their priority sector lending targets.

In line with the national level trend, the microfinance sector in Odisha continued to grow, peaking during 2007-2009. Both the local and the national level MFIs having operations in Odisha have contributed well in providing access to microfinance services to the low-income people and bringing SHGs, JLGs and individuals under the fold of the MFI-Bank Linkage.

However, post the Andhra Pradesh crisis in 2010, the fund flow from banks to MFIs across the country, including in Odisha, was severely affected. While banks have resumed lending since 2012, in Odisha the fund flow is still affected, due to high NPAs in 2-3 state level MFIs. In the absence of any potential funding, many MFIs in Odisha had to reduce their microfinance operations and some small MFIs had to discontinue their microfinance operations. This is evident from the fact that there were 32 MFIs operating in the state in 2009-10 which got reduced to 27 in 2010-11 and to 22 in 2013. Similarly, with regard to loan portfolio, there was significant decrease from Rs.12,980 million in 2009-10 to Rs 11,436 million in 2010-11 and Rs.9, 529.7 million in 2011-12 respectively. The microfinance portfolio of the MFIs in the state further got reduced and reached to a level of Rs.6, 320[1] in 2013. However, most of the bigger MFIs, especially NBFC, although affected by the funding crisis, were able to continue with their operations. The above negative trend had its bearing on the microfinance sector and financial inclusion process of the state.

In this context, ACCESS-ASSIST and SIDBI organized a Roundtable on **"Accelerating Financial Inclusion through Microfinance-An Interface with Banks/FIs"** on 19th December'2013 at Bhubaneswar, Odisha, under the PSIG programme. The key objectives of the Roundtable were to;

- identify the key concerns and constraints that banks face in context of lending to MFIs in Odisha
- facilitate consultative deliberations among stakeholders including rating agencies, credit bureaus, consulting organizations, industry bodies etc. to strengthen further the MFI channel by re-establishing the credibility of the MFIs in the state
- explore possible collaborative efforts among various stakeholders for supporting the microfinance sector and enhancing fund flow from banks to MFIs

2. Participants

The Roundtable was inaugurated by the Regional Director, Reserve Bank of India (Odisha). The meeting was attended by stakeholders such as the officials from public and private sector banks, representatives from MFIs, delegates from apex development finance institutions including NABARD and SIDBI, Funding organisations (DFID), Rating Agencies, Credit Bureaus, Consulting organizations, technical resource agencies including ACCESS-ASSIST. A list of participants is provided as **Annexure 1**.

[1](Source: Bharat Micro Finance Report-2012&2013 –Sa Dhan)

3. Summary of discussions

The day-long deliberations in the Roundtable were held mainly on the following key areas;

- Sector Overview - Challenges & Opportunities
- Risk Perception and mitigants to enhance Lending to MFIs and increase their creditworthiness
- Innovative Financing Models

3.1 Sector Overview - Challenges & Opportunities

The Indian microfianance is considered to be the largest in the world. It has got also a reasonably better quality of portfolio and depends least on the grant component to run the programme. Over the years the sector was growing well, but experienced a downtrend in 2010 by the crisis in AP. The crisis not only seriously affected the growth of microfinance in AP but also impacted other states. MFIs' approach and service delivery mechanism came under lens and funds flow to MFIs got affected across India. Banks and investors viewed it risky to on-lend MFIs. Along with good governance, transparency, accountability, fair practices, ethical behaviors, clients' protections etc were stressed, especially by the regulatory body to be practiced in the sector. Among other support organizations, DFID & SIDBI through PSIG initiatitives started strengthening responsible financing in the sector.

Re-Building the Sector – Moving towards Responsible Microfinance

As an apex level regulatory body, RBI took serious note of the situation and set up Malegam committee to examine the issues and make recommendations. It issued the revised PSL guidelines; MFIs specified as eligible avenue for priority sector lending. RBI also created a separate Category of "NBFC-MFIs" in December 2011 with specific guidelines and made it mandatory to adopt the Fair Practices Code. Financial Inclusion of poor has been taken up by RBI on a priority basis. All the banks in the country are being advised to plan and carry out their FIP, despite the infrastructure constraints, especially in the rural areas. The RBI is also equally committed to strengthen the microfinance sector in the country as that helps greatly to reach out to the poor in the remote areas. As the financial sector is quite vulnerable, RBI expects that all stakeholders including MFIs need to ensure greater accountability, integrity, transparency while delivering the services. This led to the growing focus of all stakeholders on Social performance of MFIs. MFIN and Sa-dhan (industry networks) announced the Unified Code of Conduct for MFIs. Concept of Responsible Finance was stressed and the Responsible Finance Forum set up. Microfinance Credit Bureaus becomes operational with 95 Million Micro Credit Records with High Mark and Equifax, which is the fastest Credit Bureau adoption in 24 months. In view of prospects of issue of new bank licenses, top MFIs raise their hope and aspirations for becoming mainstream FIs and have applied for bank licenses.

With an intention to promote Responsible Finance, SIDBI commissioned a series of Code of Conduct Assessments for MFIs for better compliance along with other processes such as Portfolio Audits, Process Mappings, Social Performance assessments etc. Altogether 15 Code of Conduct Assessments (CoCAs) conducted in 2011-12 and 33 in 2012-13. Out of 31 NBFC assessed 12 scored over 80% .None of the MFIs scored below 60% implying overall satisfactory performance. The outcome substantiates the fact that although the microfinance sector was passing through a crisis, the re-building measures to strengthen the governance, systems and procedures, client protection, risk management, integration with social performance etc. were carried out to engage MFIs in the Responsible Financing processes.

Govt. of India too established India Microfinance Equity Fund with SIDBI with a corpus of Rs 100 Crores and also initiated to bring the Microfinance Development and Regulation Bill in 2012. Additionally, SIDBI through its DFID assisted PSIG programme also has started providing both financial and technical assistance to several MFIs in the four focus states of UP, MP, Bihar and Odisha.

Insights from the Chief Guest – Mr. P K Jena, Regional Director, RBI, Bhubaneswar

Addressing some of the above issues, Mr. P K Jena, Chief Guest of the Roundtable, Regional Director, RBI stressed that there are many unbanked section of people, for them survival is a major concern. MFIs can address this noble issue where dealing with inadequate staff capacity banks are yet to reach or concern about their own survival as the growing NPAs has been an insurmountable problem for the banks. It has been more than three years since the AP crisis, the bigger MFIs do not have serious problem in attracting funds, and the small MFIs are mostly suffering the credit crunch. The situation demands the small MFIs to work more rigorously on improving their policies and practices and communicating effectively with banks for pitching their proposals. Understanding the prevailing issue of multiple/repeat financing among clients, he advised Banks/MFIs have to be proactive as it is their responsibility to monitor the flow of funds to clients in addition to managing delinquency. As far as supporting the financial inclusion in the state is concerned, there is an urgent need to establish good supporting institutional structures like SHG cooperatives/federations which can only be successful through structured approaches by the MFIs/NGOs. Expressing the RBI's commitment to strengthen microfinance and achieving greater financial inclusion through that, the Chief Guest assured cooperation from the regulatory agency for the microfinance fraternity in the state.

3.2 Risk Perception and mitigants to enhance Lending to MFIs and increase their creditworthiness

For a balanced and organized growth of the sector and financial inclusion process, adequate focus is required in supporting the MFIs as they strive to reach millions of poor clients in a sustainable manner.While banks are lending to MFIs in Odisha, the demand in terms of business potential and growth plans of MFIs far exceeds the supply of funds. This session was focused on identifying key risks perceptions and concerns of banks in lending to MFIs in the state, perspectives of rating agencies and credit bureaus, issues faced by MFIs in sourcing loans from banks and possible recommendations for way forward in overcoming the constraints.

Risks in MFI lending – Perspectives of banks and technical agencies

Banks acknowledged that MFI lending is an important business opportunity for them, both in view of fulfilling PSL commitments and otherwise, and that the recovery of MFI loans is good (except some NPAs that resulted due to closure of state level MFIs post crisis). However, banks have concerns in two critical aspects of Governance and Internal audit systems of MFIs, especially of smaller institutions. MFIs loan proposal is quite different from other industry proposals as the operation of MFIs largely target the unorganized sector, this gives rise to the problem of adherence to KYC guidelines. The rating agencies supported these aspects and emphasized that MFIs need to further strengthen the following in order to attract bank funds:

- Governance – Composition of Board as well as Governance practices
- Transparency including avoiding related party transactions
- Equity
- Internal controls – Documentation of procedures and demonstration of translation into practice
- Capital structure – nonprofit legal forms not appropriate for financial services and will continue to face problems in mobilizing funds
- Socio-political risks

The quality of data reporting by MFIs to credit bureaus has significantly improved over the past two years and most MFIs are submitting data to two bureaus – Equifax and Highmark. Sa-Dhan and MFIN need to ensure reporting by all members.

Perspectives of MFIs:

MFIs mentioned that while transparency and governance are issues that can be fixed internally, capital needs external support and MFIs have not been able to raise adequate equity owning to reduced interest of investors. Also, MFIs raised the issue of banks requiring collateral – both in the form of cash security of 10-20% as well as personal guarantee by promoters and asset mortgage. These are difficult to fulfill by MFIs because of their poor asset structure. Closing down three large MFIs and resulting rise of NPAs has impacted the bank lending to other good institutions in Odisha. MFIs felt that the RBI guidelines acknowledge MFIs as a separate category of institutions, some bank officials at state and regional level do not fully understand and appreciate MFIs' operations and guidelines and therefore expect similar standards as other industries. Bank officials should also make field visits to better understand the realities of MFI operations as part of the due diligence process. Also, the investments being made by MFIs on Responsible Finance practices and client protection measures should be understood and valued by banks. MFIs suggested that as part of the credit appraisal weightage to credit plus services should also be given and weightage on equity for non-profits should be relaxed. While appreciating the role played by the Rating and consulting agencies, the MFIs expected concrete suggestions and practical recommendations from them as part of the rating reports. MFIs urged that SIDBI should give special concession to Odisha MFIs in equity funding. MFIs also emphasized the need for capturing SHG loan details as well as direct loans by banks through microfinance credit bureaus since the issue of multiple loans with clients will not be resolved in absence of complete indebtedness data.

Insights from the Apex lender - SIDBI

The objective of India Microfinance Equity Fund (IMEF) is to help small MFIs in underserved states/regions leverage the equity from SIDBI to raise more capital, both debt and equity, from banks and other sources. However, unfortunately, many IMEF investees have not been to achieve leverage at expected levels. It was believed that banks are more positive for lending to MFIs that have received funds from SIDBI, but this has proved true for last couple of years. SIDBI continues to be committed to supporting the development of microfinance sector. SIDBI has recently commissioned a study on benchmarking of MFIs to assess their viability in the current context. SIDBI is also open to the possibility of conducting joint appraisals with other banks based on annual plan of MFIs. On one hand this will potentially optimize fund flows to the institutions across the year through different banks and on the other will save cost of lending by sharing of due diligence reports, system audits, LPA and other information among banks.

3.3 Feedback on RBI guidelines for NBFC-MFIs

This session was devoted to discussing issues in the current RBI guidelines for MFIs in view of submitting feedback and suggestions to the RBI Regional Office. The summary of discussions is provided in **Annexure 2**.

3.4. Innovative Financing Models

With a view to meet the increased credit demand of the clients in the sector, microfinance services providers including Banks and MFIs have been constantly trying to devise and adopt new approaches to deliver the services. The session focused on Financing models of two banks to provide learning and discuss opportunities for MFIs to partner with such initiatives.

Credit led BC Model of YES Bank:

This is initiated in September 2011 and is currently operational in Odisha and Rajasthan. The Bank appoints NGOs with microfinance experience as BC partners in order to leverage on the local know-how of the partner agency. The bank does not have any specific criteria on size of operations of the NGO/MFI, however, good governance and management practices are the important parameters for identifying potential NGOs as partners. NBFCs are not allowed as BCs by regulation and in case of sister NGOs of NBFCs, it is ensured that same institutional infrastructure is not used by the NGO. As per the agreed arrangements 5-10% risk has to be borne by the BC and therefore equity capital is an important criterion. Credit rating reports of MFIs provide ready information and are useful for due diligence. The bank provides loan to clients at an Interest rate of 15-26% with 2% to 10% commission for the BC. The Regulatory and political risks are low, since this is a mainstream banking model. On the other hand this allows equity can be leveraged 10-20 times which is much higher than in case of lending by MFI. So far YES bank has achieved a Pan India outreach of 250,000 clients with a Portfolio of Rs 350 crores, of which Odisha accounts for 50,000 clients being reached out through 5 BC partners.

HDFC Bank's Sustainable Livelihoods Initiative

Having experienced some failures through BC model, HDFC bank has now been directly intervening in the microfinance sector through its Sustainable Livelihood Initiative (SLI) since 2010. The bank lends directly to individual clients through Joint Liability Groups after assessment of the track records of the group and members. The average loan size is Rs. 10,000 per borrower at an interest rate of 26%. Repayments are received at the branch level and the HDFC field officers are involved in the collection. HDFC Bank currently has a portfolio of Rs. 23 Crores under this model. In addition to credit, the bank also offers a Zero balance bank account, Recurring deposit scheme, to inculcate saving habit among members, along with complimentary capacity building of the groups through livelihoods training and market linkages.

3.5. Recommendations

This section summarizes the recommended action points for enhanced funding from banks to MFIs.

- Sensitization and exposure programmes for state and regional level bankers covering MFI operations as well as responsible finance initiatives such as code of conduct compliance, client protection measures, social rating and audits, credit plus services etc
- Periodical interface between banks and MFIs to discuss the issues on lending
- Advocacy for issue of an advisory for banks by RBI to relax collateral requirements for MFIs and also advise them to lend across the financial year (avoid excess funding in last quarter of the year)
- Facilitate Joint due diligence to encourage banks to lend in a strategic manner; regional/state level lenders' forum can be a mechanism for facilitating this
- Expansion of credit bureau coverage to SHG data- A feasibility study followed by a pilot project can be the initial steps in this regard
- Submit recommendations to RBI on MFI regulations