BLOGTALK

Excerpts from the INDIA DEVELOPMENT blog*

SCALING UP MICRO FINANCE

While 'scaling up' has great potential to supply micro finance services to a larger number of clientele and to achieve institutional sustainability, there is the concern that it could lead to a drift away from the micro finance institution's original mission. In other words, scaling up could lead to a tendency to pay less attention to poorer clients (the ideal clientele for micro finance).

Recently, I had the opportunity to visit 'Hand-in-Hand' (HiH), a well-known NGO-MFI in Tamil Nadu that also promotes itself as an NBFC. HiH is in the process of scaling outward to expand its services to new clientele. During my visit to HiH, I learnt that in the course of expanding into new areas, the organisation uses a well-defined process to identify potential clientele. The process, a high-value orientation exercise to select future clientele, is called 'participatory identification of target households' (PITH).

PITH is conducted in three different phases at the village/hamlet level. The first phase is a transect walk, the second is social mapping, and the last phase is the introduction of poverty score cards at the household (HH) level to identify poorer households currently not served by micro finance programmes.

Posted by Amulya

Read more here: http://www.indiadevelopmentblog.com/2009/04/well-calculated-step-to-address-mission.html

MF INTEREST RATES

Several months ago, I attended a micro finance (MF) conference in which practitioners, academics and regulators had substantive discussions on a variety of issues that confront the sector as it matures.

Towards the end of the conference, an eminent government official gave a speech on the state of the sector from the State's viewpoint. Nearing the end of his speech, the official made a statement similar to the following: "And don't forget about high interest rates; this is still an issue as far as regulators are concerned." My immediate reaction was a quizzical and deflated, "Really? High interest rates?"

It has been my opinion from studying the issue over several years that MF interest rates in India are absolutely NOT an issue. Comparing the Indian MF sector to others in the world, and understanding the massive operational costs of micro finance institutions (MFIs), it seemed to me that not only were MF interest rates in India not a problem, they were comparably quite low. And thus, any effort by the government to instate an interest rate cap on MF would almost certainly be counter-productive by limiting the ability of MFIs to sustainably provide loans to those unable to access formal banking services. It was my view that any government official who supported interest rate caps was either being irresponsibly populist, or was simply uninformed.

But it is always worth reassessing one's opinions, and I recently came across a research paper and Internet discussion that allowed me to do just that. In February 2009, CGAP published *The New Moneylenders: Are the Poor Being Exploited by High Microcredit Interest Rates?*. This is a detailed and fair report done by a group of authors who are proponents of for-profit micro finance but have been critical of MFIs… The paper does essentially affirm my prior beliefs…

Posted by Dan Kopf

Read more here: http://www.indiadevelopmentblog.com/2009/03/exploitative-interest-rates-in-indian.html

Maintained by research staff of the Centre for Micro Finance (CMF), Centre for Development Finance (CDF) and Centre for Insurance and Risk Management (CRM). Views expressed in the blogs do not necessarily reflect the views of these institutions, IFMR Trust, or IFMR

ANNOUNCEMENT

Micro insurance training in association with Wharton School

CIRM, in association with The Wharton School of the University of Pennsylvania, and International Sector Experts is offering a training programme on 'Scaling Micro Insurance in Developing Countries', in Chennai, on April 20-26, 2009. The training is available for 'risk-carriers' and product designers from developing countries to enable them to write contracts with more appropriate pricing. Download the programme flyer here: http://ifmr.ac.in/cirm/downloads/SMIDC_CIRM_Wharton_TPF.pdf.

About IFMR Trust Advocacy Unit

IFMR Trust Advocacy Unit's (ITAU) mission is to ensure that every individual and every enterprise has complete access to financial services. Advocacy is the core strategy of ITAU and we pursue our mission by advocating for changes in policy and practice that will lead to total financial inclusion.

AN IDEA WHOSE TIME HAS COME?

Money market mutual funds for rural India

Financial services help households mitigate risks and allocate resources efficiently, so that capital is put to productive use. However, the majority of households in rural areas of India are not only denied access to credit at affordable terms but also financial services such as a safe and remunerative savings option; most rural households do not have a bank account and relative to the need, bank branches are few.

An innovative way to get around this problem and provide a safe and remunerative 'micro savings' alternative could be to offer households access to money market mutual funds. These products offer a high degree of safety and the track record so far is that returns are better than interest earned from savings accounts in banks.

ITAU's partner, IFMR Holdings, is piloting such an initiative. Pudhuaaru Kshetriya Gramin Financial Services (PKGFS), a company promoted by IFMR Holdings in rural Thanjavur, offers its customers ICICI Prudential Liquid Plan-Growth Option with a micro SIP facility (PKGFS is an agent of IFMR Holdings, which is a channel partner of ICICI Prudential Asset Management Company). To provide the liquidity of a savings account, PKGFS provides bridge finance to customers on redemption requests. Thus, the product can be used for investment, as well as to meet immediate cash needs. Read a detailed technical note on this subject by Anil S G and Nitin Chaudhary at <http://www.ifmrtrust.co.in/fieldreports/mmmf.php>.
If you have any comments or queries, write to us at: <advocacy@ifmrtrust.co.in>.

Synthesis is the quarterly newsletter of **IFMR Trust Advocacy Unit,** produced for private circulation only. Information provided in this newsletter is subject to change without notice. Content may be reproduced with due acknowledgement of source.

Published by IFMR Trust Advocacy Unit
Designed and printed by
PACE, Chennai 600 018

Editorial consultants: InfoChange

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IFMR Trust Advocacy Unit

APRIL 2009

Ideas and Updates from IFMR Trust Advocacy Unit and its Partners

SYNTHESIS

OTD and the future of financial systems design

"A well-developed, smoothly functioning financial system facilitates efficient life-cycle allocation of household consumption and efficient allocation of physical capital to its most productive use."

— **Robert C Merton**
Nobel Prize-winning financial economist

Financial systems help individuals and enterprises manage risks and move resources across time and locations. They also facilitate a household's interaction with the larger economy by providing payment and settlement systems, transmitting price information through the economy, and intermediating between those with surplus capital and those with better ideas to deploy the capital productively.

Building on this understanding of the importance of access to finance, IFMR Trust Advocacy Unit (ITAU) is working towards ensuring that every individual and every enterprise has complete access to financial services. As its name suggests, ITAU's core strategy is advocacy. It seeks to advocate for changes in policy and practice that lead to total financial inclusion. Our advocacy efforts are appropriately supported by demonstrations by associated organisations and the research findings of partners.

From the institutional perspective, ITAU envisages three well-functioning pillars of the financial system — most of our work feeds directly and indirectly into efforts to test and make this financial system model work.

Our first pillar is *origination*, which refers to delivery of services like loans and insurance to clients. We envisage high-quality origination even in remote rural areas, with continuity, flexibility, reliability and convenience being the keywords. Origination can best be done by localised entities embedded in the community and well-positioned to understand the needs and risks.

Secondly, the financial system must ensure *orderly risk transmission*. Given their small size and local orientation, local financial institutions are not in a good position to hold certain kinds of risk. So, risk needs to be aggregated by a well-capitalised, diversified entity that is able to manage it efficiently.

Thirdly, the financial system should have a well-developed *risk aggregation capacity*, done either by well-capitalised institutions or dispersed through capital markets to a range of institutions with an appetite to hold the risk.

In financial parlance, this three-pillar model is called the Originate-To-Distribute (OTD) model. The model has come under intense scrutiny lately, in the wake of the ongoing global financial crisis.

Against this background, on March 13, 2009, ITAU, along with IFMR Capital and Dun & Bradstreet (D&B), organised a conference on 'The Originate-To-Distribute Model of Credit Provision and Future of Financial System Design'. The objective of the conference was to bring together academicians, market participants and regulators to debate ways to strengthen the originate-to-distribute model, particularly for rural finance, and the process of securitisation for scaling up Indian financial services.

After opening remarks by Manoj Vaish, CEO of D&B India, Nachiket Mor, President of the ICICI Foundation for Inclusive Growth and Chairman of IFMR Trust's Governing Council, introduced the subject and set the ground for the day's discussions. Anurag Gupta of Case Western Reserve University (USA) presented international experiences with the OTD model; Sona Varma, Senior Advisor, ITAU, made a presentation on the Indian experience with the model. Sucharita Mukherjee, CEO of IFMR Capital, presented a case for the relevance of the OTD model for micro finance as an asset class. Prasad Koparkar, Head of Structured Finance Ratings at CRISIL, presented the rating

(Continued on page 2)

At the conference (l to r): Dr Sona Varma (Senior Advisor, IFMR Trust Advocacy Unit), Anurag Gupta (Associate Professor, Case Western Reserve University, USA), Dr Nachiket Mor (Chairman - Governing Council, IFMR Trust; President, ICICI Foundation for Inclusive Growth), Dr Manoj Vaish (CEO, Dun & Bradstreet Information Services India) and Prasad Koparkar (Head - Structured Finance Ratings, CRISIL)

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OTD and the future of financial systems design

(Continued from page 1)

agency's perspective on the OTD model.

The presentations were followed by a panel discussion in the afternoon. Participants included Anurag Gupta, P G Apte (IIM-Bangalore), Arvind Rangarajan (Director, Deutsche Bank), Ashish Sable (Senior Vice President, SBI Caps), and Ashwin Ramanathan (AZB Partners). The discussion was moderated by Nachiket Mor.

Advantages of the OTD model

Most speakers stressed the importance of realising the advantages of the OTD model, whilst also learning from what has gone wrong. Manoj Vaish argued that the process of OTD allows transfer of risk, creation of assets that appropriately meet the risk requirements of investors, and freeing up the originator's capital so that business can grow. Nachiket Mor agreed with Vaish in asserting that OTD was not a new idea, and that while some versions had worked well, others hadn't.

The insurance industry has been using the OTD model, and risk transfer has been used for exchange rate risks and interest rate risks for a long time now, Mor pointed out. He emphasised the need to discuss what aspects of the model were worth preserving, and which ones should be cause for alarm. Arvind Rangarajan stressed that OTD was an essential banking model.

Anurag Gupta listed a range of merits of the OTD model for risk originators as well as for aggregators of risk. Risk originators get benefits like:

- Freeing up of capital.
- Increasing fee-based loan originations where they have a comparative advantage.
- Increasing ROA and ROE.
- Effective mechanisms for risk diversification.
- Easier management of asset liability.
- Improving liquidity of the balance sheet.

Aggregators of risk can make up for lack of origination resources or skills. OTD opens up investment opportunities for non-banking financial institutions like mutual funds, and offers diversification opportunities.

Gupta also highlighted advantages of the OTD model from the borrower's perspective, like lower cost of borrowing and increased access to debt capital.

Speakers brought out differences between the Indian and global (particularly the US) experience. Both Manoj Vaish and Sona Varma reminded the audience that the size of the market in India was quite small, structures were fairly simple, and Indian banks had been quite careful in credit assessments. Mor and Varma also highlighted the fact that the OTD model was not new for India and must not be confused with securitisation alone. Both of them cited the example of cooperative banks as essentially working on the OTD model. Mor commented that India has had its own version of the sub-prime crisis because of the continuous refinancing of under-performing portfolios of cooperative banks.

Learning from the past

Most presenters and discussants talked about lessons from the past, particularly the recent past. Vaish stated that use of the OTD model in terms of understanding and pricing of risk had gone wrong, and that misalignment of employee incentives had added to the problem. Anurag Gupta presented research findings that seemed to show that securitisation may be leading to lax screening of borrowers, and that banks may be 'cherry picking' loans — selling off just the ones where they have negative private information about the borrower. He also warned that diminished monitoring of borrowers could be leading to sub-optimal investment and operating decisions, causing value destruction.

Gupta suggested that if banks were required to hold at least a certain percentage of the loans they originate, some of the problems could be alleviated. Also, additional disclosure requirements at the time of loan sale would reduce adverse selection. He recommended a loan trading exchange with a clearing house, which could help achieve these objectives. He emphasised the fact that some institutions in the US had become investors instead of intermediaries by holding a good portion of collateralised debt obligations created with the assets originated by them. He also blamed poor governance, misaligned employee incentives, and guarantees such as deposit insurance for the debacle in the US. There is need for greater transparency at every level, he concluded.

Other issues relevant to the future of the OTD model also came up for discussion. Some debated the role of regulators in ensuring that the model is not misused. Most speakers agreed that there needs to be more regulatory oversight; the extent and nature of such oversight was discussed extensively. According to Gupta, the rules should be at the macro level and should not restrict micro-level activities.

Role of rating agencies

As the role of rating agencies has come in for a lot of criticism in the wake of the sub-prime crisis, Prasad Koparkar's presentation was an important one. He focused on clarifying and explaining the role and methodologies of structured finance ratings at CRISIL. He reminded the audience that a rating agency gives advice, which has to be used appropriately by the investor. Gupta also stressed the fact that ratings only reflect credit risk, not market risk. If non-credit risks are poorly managed, ratings cannot be of much help. He argued that incentives and compensation schemes of rating agencies needed to be carefully thought through.

Inevitability of the model

During the presentations and discussions, participants stressed the inevitability of the OTD model. Nachiket Mor argued that in many contexts, like rural finance and small and medium enterprise financing, there was no alternative to OTD as, here, traditional banking was not likely to work. He said that large, capital-rich institutions would have to go to specialised entities that originate the risk and buy the risk from them. Sona Varma's presentation highlighted the importance of the OTD model in the future of financial systems design, particularly in the context of rural finance where there is no credible alternative. Sucharita Mukherjee's presentation focused on using the OTD model to link micro finance institutions to mainstream financial markets.

SPOTLIGHT

Don't reject structured finance

The global financial crisis has put a dampener on the originate-to-distribute model, a widely practised variation of traditional financial intermediation. In an article which appeared recently in *Mint*, Sona Varma and Suyash Rai of ITAU argue that the model itself is sound, and can play a key role in scaling up financial services delivery in India. "The case for the OTD model is most compelling in rural finance," the authors argue. Read the article here: http://www.livemint.com/2009/04/09205842/Don8217t-reject-structured.html?h=B.

UPDATES FROM PARTNERS

CENTRE FOR MICRO FINANCE

Financial inclusion

Smart cards and no-frills accounts

The Centre for Micro Finance (CMF) at IFMR recently completed three studies on various aspects of financial inclusion.

Use of smart cards

A case study by Doug Johnson on 'The Use of Smart Cards to Deliver Government Benefits in Andhra Pradesh' looks at delivery of payments from the National Rural Employment Guarantee Scheme (NREGS) and Social Security Pensions (SSPs) to beneficiaries in Andhra Pradesh through a platform based on smart cards and mobile smart card readers. The platform has been operational since late-2007, in collaboration with Financial Information Networks and Operations (FINO) and a number of banks. Johnson's report describes the payment system and analyses its impact on beneficiaries. It also looks at efficiency of delivery. The analysis shows that the smart card payment system offers greater convenience and helps reduce fraud.

Smart cards offer convenience and safety

No-frills accounts

A study by Minakshi Ramji aimed at understanding implementation of the 'No-Frills Account' drive in Gulbarga district, Karnataka. The study finds that the number of households with bank accounts doubled over the duration of the drive. However, 36% of the sample remained excluded from any kind of formal or semi-formal savings account. Further, bank accounts had been opened typically to receive government assistance, mostly under the NREGS. Usage and awareness of accounts remain low, the study found. Savings in self-help groups is still the most popular form of saving. The study concludes that while government programmes have the potential to include large numbers of low-income households, access to bank accounts does not often lead to usage. More needs to be done in the realm of financial literacy and marketing to ensure that bank accounts are optimally utilised.

Likewise, a study by S Thyagarajan and Jayaram Venkatesam highlights some of the major gaps in implementation of the 'No-Frills Account' drive in Cuddalore district, Tamil Nadu. A significant percentage of households (25%) were left out of the banking system even after the drive. The study also shows that only 15% of customers were operating their accounts; the bulk of accounts hadn't been used even once, a year after the drive was over. Analysis of operating accounts showed a steady increase in balances, more than a year from the date of opening the accounts.

The study stresses that one of the main reasons for non-operative accounts was lack of financial literacy, apart from things like distance from the branch, etc. The average cost of opening and maintaining no-frills accounts was estimated at INR 50.45 and INR 13.40 respectively. At current levels of transaction and average balances, the study says, maintenance costs would be recovered but not account opening costs. Recommendations emerging from this study include:

- Financial literacy at the time of opening an account.
- Incentives for branch managers delivering on socially responsible schemes.
- Documentation of best practices.

CENTRE FOR INSURANCE AND RISK MANAGEMENT

Crop insurance

Implications of NDVI

The Centre for Insurance and Risk Management (CIRM) is working on two projects related to the Normalised Difference Vegetative Index (NDVI) and its application in crop insurance.

In collaboration with the National Remote Sensing Centre, a part of the Indian Space Research Organisation, CIRM is working on a project to establish a correlation between NDVI and crop growth. The findings could help design better risk hedging solutions for low-income households and develop decision support systems. Such solutions are expected to be superior to normal weather-index-based products. A pilot study is being conducted on the wheat crop in four tehsils of Nagpur district in Maharashtra. Similar studies will be carried out throughout the country in the coming years.

CIRM and IFFCO Tokio General Insurance Company also plan to launch a crop insurance product based on NDVI in four districts of Andhra Pradesh and Chhattisgarh, after a thorough quantitative and qualitative analysis of potential consumers. Consumer expectations will be directly reflected in the product and process designing of the product. The research findings will be used to design scaleable solutions based on NDVI for low-income households. CIRM will play a key role as an academic and policy advocacy partner in this effort. The Microinsurance Facility of the International Labour Organisation (ILO) has agreed to partially fund the project under its Research Grant Programme.

EVENT

'Micro Finance: From Research to Practice'

Second annual conference

The Centre for Micro Finance (CMF) and College of Agricultural Banking, Pune, recently hosted their second annual conference on micro finance. Called 'Micro Finance: From Research to Practice', the conference was designed to engage micro finance practitioners and policymakers with research outcomes. Themes at the conference included 'Impact of Micro Finance', 'Financial Inclusion', 'Optimising Micro Finance Distribution Channels', 'Financial Literacy', and 'Emerging Issues'. Experts in micro finance attended and presented their research findings.

Rajalaxmi Kamath (IIM-Bangalore) discussed her study on multiple borrowing amongst micro finance clients, and Raghab Chattopadhyay (IIM-Kolkata) explained the results of the weather insurance study he was part of, with CMF. The conference gave CMF the opportunity to receive candid feedback and questions from practitioners, a mechanism that helps refine the research process. Among those present were luminaries from the micro finance sector such as Sanjay and Frances Sinha, Sankar Datta and Stephen Rasmussen of the Consultative Group for the Assistance of the Poor (CGAP).