

# Microfinance 01

Introduction

**MIT India Reading Group**

Kaustuv De Biswas , Sept 24, 2009

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## Microfinance

It refers to the provision of **financial services** to **low-income** clients.

Credit  
Savings/Deposits  
Insurance Plans  
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## Microfinance

It refers to the provision of **financial services** to **low-income** clients.

**Household Financial Goals**

**Microfinance Products**

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Source: Brett Matthews, Mathwood Consulting Company.

## Microfinance

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Purchasing power parity in U.S. dollars	Tier	Population in millions
> \$20,000	Tier 1	75 – 100
\$1,500 – \$20,000	Tiers 2-3	1,500 – 1,750
\$1,500	Tier 4	4,000
< \$1,500	Tier 5	4,000

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**Purchasing Power Parity (PPP)**  
 based on the **law of one price**: the theory states that, in ideally efficient markets, identical goods should have only one price.

## Bottom Of the Pyramid

It refers to the provision of **financial services** to **low-income** clients.

**world's 4 billion poor—people who live on far less than \$2 a day**

< \$1,500

Tier 5

BOP

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## Bottom Of the Pyramid

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C. K. Prahalad and Stuart Hart, *The Fortune at the Bottom of the Pyramid*, *Strategy + Business*, Issue 26, 2002

**There Is Money at the BOP**  
*The dominant assumption is that the poor have no purchasing power and therefore do not represent a viable market.*

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## Price you pay to be at the Bottom

Item	Dharavi	Warden Road	Poverty Premium
Credit (annual interest)	600–1,000%	12–18%	53.0
Municipal grade water (per cubic meter)	\$1.12	\$0.03	37.0
Phone call (per minute)	\$0.04–0.05	\$0.025	1.8
Diarrhea medication	\$20.00	\$2.00	10.0
Rice (per kg)	\$0.28	\$0.24	1.2

**The Poor and High-Cost Economic Ecosystems**

Source: Reprinted with permission from Harvard Business Review. "The Poor and High Cost Economics Ecosystems." From "Serving the World's Poor Profitably" by C. K. Prahalad and Allen Hammond, September 2002. Copyright ©2002 by the Harvard Business School Publishing Corporation, all rights reserved.

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**Causes**

- Transaction costs
- Distribution costs
- Lack of scale and competition
- Misconceptions of suppliers

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### There Is Money at the BOP

*The dominant assumption is that the poor have no purchasing power and therefore do not represent a viable market.*

### Access to BOP Markets

*The dominant assumption is that distribution access to the BOP markets is very difficult and therefore represents a major impediment for the participation of large firms and MNCs.*

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## Shakti Amma and the Avon Ladies

It refers to the provision of **financial services** to **low-income** clients.

One such experiment, **Project Shakti at Hindustan Lever Ltd. (HLL)** in India, is a case in point. HLL created a direct distribution network in hard-to-reach locales (markets without distribution coverage through traditional distributors and dealers). HLL selected entrepreneurial women from these villages and trained them to become distributors, providing education, advice, and access to products to their villages. These village women entrepreneurs, called Shakti Amma ("empowered mother"), have unique knowledge about what the village needs and which products are in demand. They earn between Rs. 3,000 and 7,000 per month (U.S. \$60–\$150) and therefore create a new capacity to consume for themselves and their families. More important, these entrepreneurial women are increasingly becoming the educators and access points for the rural BOP consumers in their communities.

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### **Access to BOP Markets**

*The dominant assumption is that distribution access to the BOP markets is very difficult and therefore represents a major impediment for the participation of large firms and MNCs.*

### **The BOP Markets Are Brand-Conscious**

*The dominant assumption is that the poor are not brand-conscious. On the contrary, the poor are very brand-conscious. They are also extremely value-conscious by necessity.*

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## Bottom Of the Pyramid

It refers to the provision of **financial services** to **low-income** clients.

The poor also spend their earnings in ways that reflect a different set of priorities. For example, they might not spend disposable income on sanitation, clean running water, and better homes, but will spend it on items traditionally considered luxuries. Without legal title to land, these residents are unlikely to invest in improving their living quarters, much less the public facilities surrounding their homes. **For example, in Dharavi, 85 percent of the households own a television set, 75 percent own a pressure cooker and blender, 56 percent own a gas stove, and 21 percent have telephones.** In Bangladesh, women entrepreneurs with cell phones, which they rent out by the minute to other villagers, do a brisk business. It is estimated that the poor in Bangladesh spend as much as 7 percent of their income on connectivity.

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### **The BOP Markets Are Brand-Conscious**

*The dominant assumption is that the poor are not brand-conscious. On the contrary, the poor are very brand-conscious. They are also extremely value-conscious by necessity.*

### **The BOP Market Is Connected**

*Contrary to the popular view, BOP consumers are getting connected and networked. They are rapidly exploiting the benefits of information networks.*

### **BOP Consumers Accept Advanced Technology Readily**

*Contrary to popular belief, the BOP consumers accept advanced technology readily.*

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## ITC E-Choupal

It refers to the provision of **financial services** to **low-income** clients.

The spread of wireless devices, PC kiosks, and personal digital assistants (PDAs) at the BOP has surprised many a manager and researcher. For example, ITC, an Indian conglomerate, decided to connect Indian farmers with PCs in their villages. **The ITC e-Choupal** (literally, "village meeting place") allowed the farmers to check prices not only in the local auction houses (called *mandis*), but also prices of soybean futures at the Chicago Board of Trade. The e-Choupal network allowed the farmers access to information that allowed them to make decisions about how much to sell and when, thus improving their margins.

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## BOP and Financial Services

It refers to the provision of **financial services** to **low-income** clients.

### 1. High Risks

#### The poor are not creditworthy

The real causes probably had more to do with the **mechanisms of service** provision and inadequate regulation.

The poor's **lack of collateral** can be overcome with **joint liability** within a group of borrowers, and this has resulted in very high repayment rates in micro credit over the last three decades.

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## BOP and Financial Services

It refers to the provision of **financial services** to **low-income** clients.

### 1. High Risks

### 2. High Transaction Costs

#### The programs need to be subsidized

Failed government initiatives work on the premise that the poor households **cannot afford to borrow at high interest rates**. Costs would quickly mount and programs would quickly get bogged down, giving little incentives for any expansion.

The experience of Bangladesh's Grameen Bank turned this around and now a broad range of **alternative microfinance models** are in place.

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## BOP and Financial Services

It refers to the provision of **financial services** to **low-income** clients.

**1. High Risks**

**2. High Transaction Costs**

**3. Finance falls lower in the 'hierarchy' of needs for the poor, below health, education etc.**

Empirical research shows that the poor use many financial instruments frequently, but due to absence and unsuitability of formal mechanisms, they have to rely mainly on unreliable informal service providers.

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**4. Credit is the only financial service required by the poor**

Poor need a range of services such as a) **risk mitigation** mechanisms, for example insurance, to protect against exogenous shocks; b) **savings facilities** to smooth consumption and get reasonable returns even on small amounts; and c) **investment/risk management mechanisms** that allow for wealth creation and diversification of risk

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## BOP and Financial Services

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1. High Risks
2. High Transaction Costs
3. Finance falls lower in the 'hierarchy' of needs for the poor, below health, education etc.
4. Credit is the only financial service required by the poor
5. The poor are not sophisticated in using financial services, so access to finance may end up damaging their livelihoods.

Due to the absence of well-designed formal services, they end up creating a complex mesh of informal financial mechanisms around their lives. It seems this is the only way they can meet multiple needs using informal instruments. For example, financial diaries of the poor show how they creatively use a variety of loan sources to deal with the irregularity in their incomes and expenditures.

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## Bottom Of the Pyramid

It refers to the provision of **financial services** to **low-income** clients.

### Market failures in credit markets

- Limited liability
- Imperfect information on borrower's **Risk** (adverse selection) and **Actions** (moral hazard)

### Traditional solutions

- Collateral raises costs of default to borrower
- Costly monitoring and information gathering.

### Barriers in serving the poor

- Lack of collateral due to:
  - Absence of formal title to property
  - No formal employment status
- High administrative and monitoring cost relative to size of loan

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## Capitalism for the BOP

Addressing the **unmet needs of the BOP is essential to raising welfare, productivity, and income**—to enabling BOP households to find their own route out of poverty. **Engaging the BOP in the formal economy must be a critical part of any wealth-generating and inclusive growth strategy. And eliminating BOP penalties will increase effective income for the BOP.**

- Moreover, to the extent that unmet needs, informality traps, and BOP penalties **arise from inefficient or monopolistic markets or lack of attention and investment**, addressing these barriers may also create significant **market opportunities for businesses.**

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## Characteristics of Leading Programs

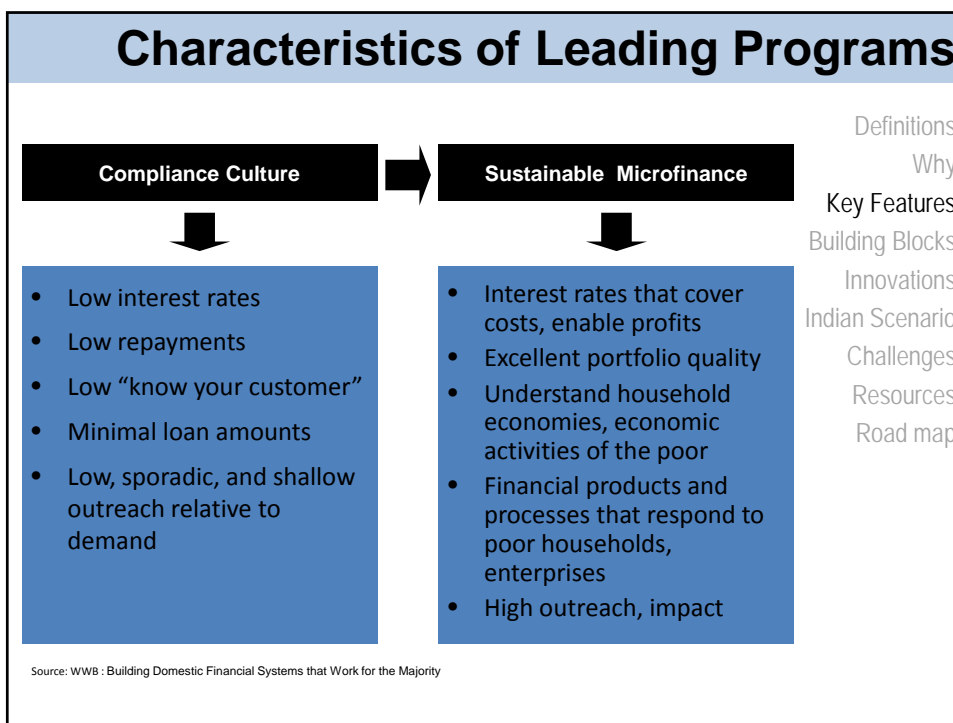
CHARACTERISTICS OF SELECTED LEADING MICROFINANCE PROGRAMS

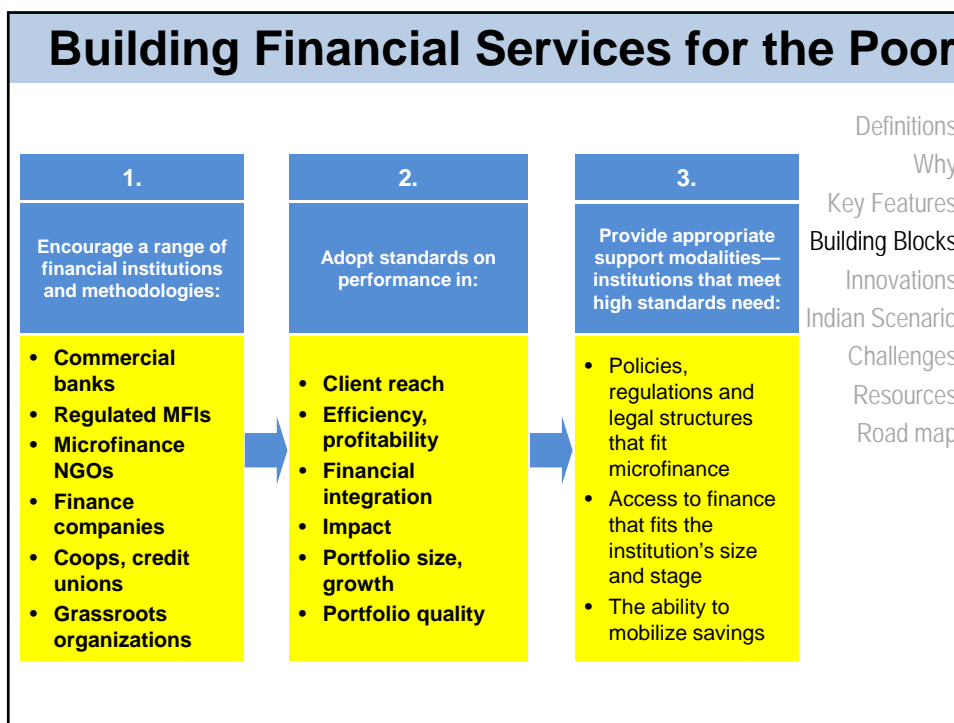
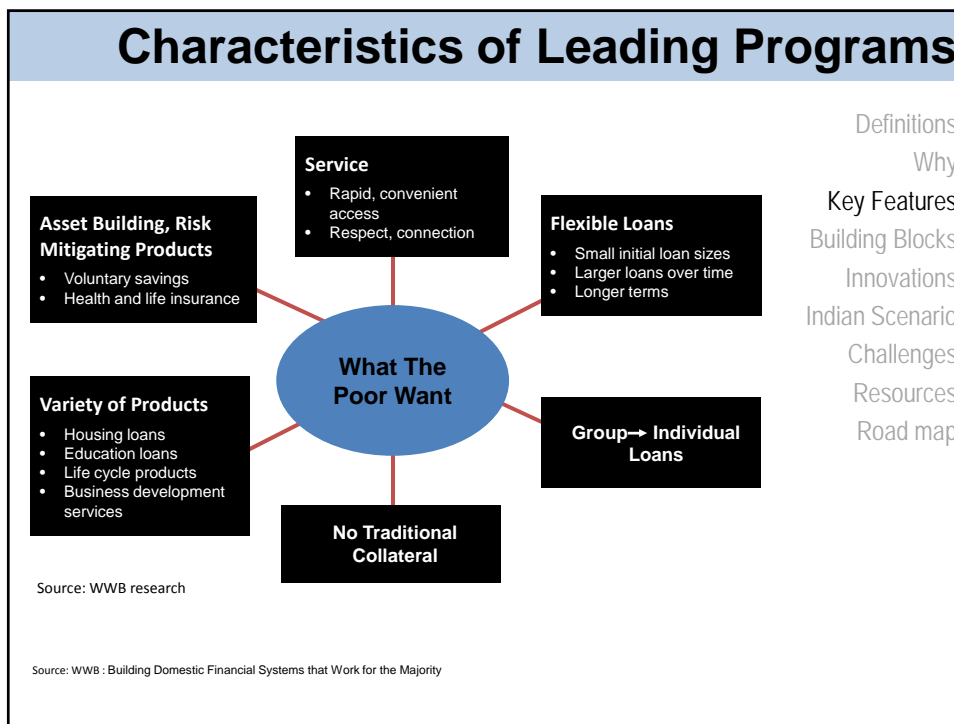
	Grameen Bank, Bangladesh	Banco-Sol, Bolivia	Bank Rakyat Indonesia <i>Unit Desa</i>	Badan Kredit Desa, Indonesia	FINCA Village banks
Membership	2.4 million	\$1,503	2 million borrowers; 16 million depositors	765,586	89,986
Average loan balance	\$134	\$909	\$1007	\$71	\$191
Typical loan term	1 year	4-12 months	3-24 months	3 months	4 months
Percent female members	95%	61%	23%	—	95%
Mostly rural? Urban?	rural	urban	mostly rural	rural	mostly rural
Group-lending contracts?	yes	yes	no	no	no
Collateral required?	no	no	yes	no	no
Voluntary savings emphasized?	no	yes	yes	no	yes
Progressive lending?	yes	yes	yes	yes	yes
Regular repayment schedules	weekly	flexible	flexible	flexible	weekly
Target clients for lending	poor	largely non-poor	non-poor	poor	poor
Currently financially sustainable?	no	yes	yes	yes	no
Nominal interest rate on loans (per year)	20%	47.5-50.5%	32-43%	55%	36-48%
Annual consumer price inflation, 1996	2.7%	12.4%	8.0%	8.0%	—

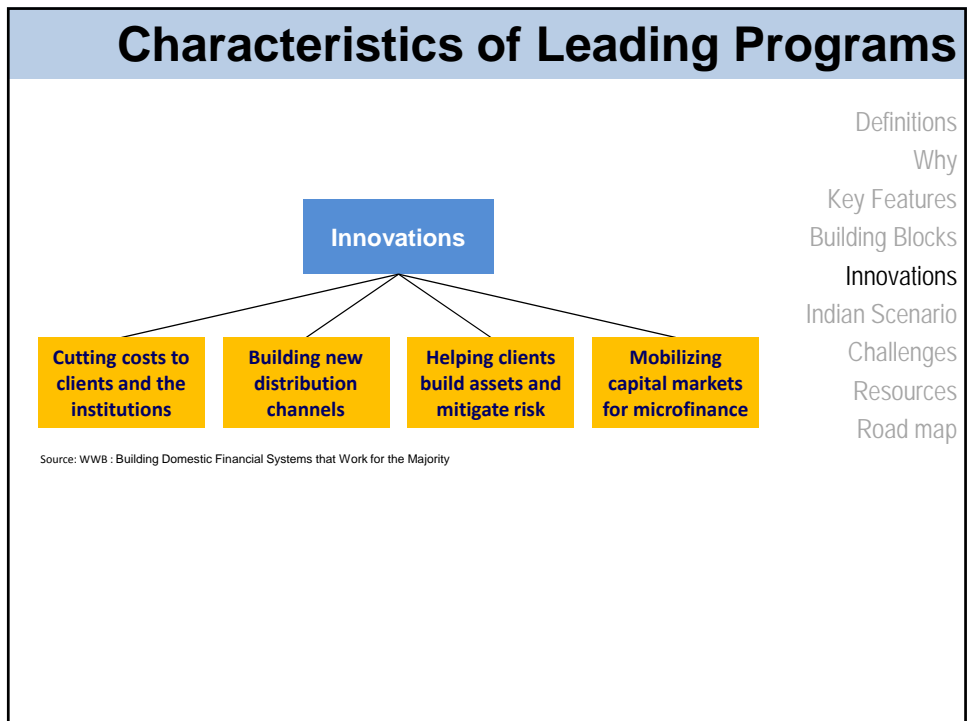
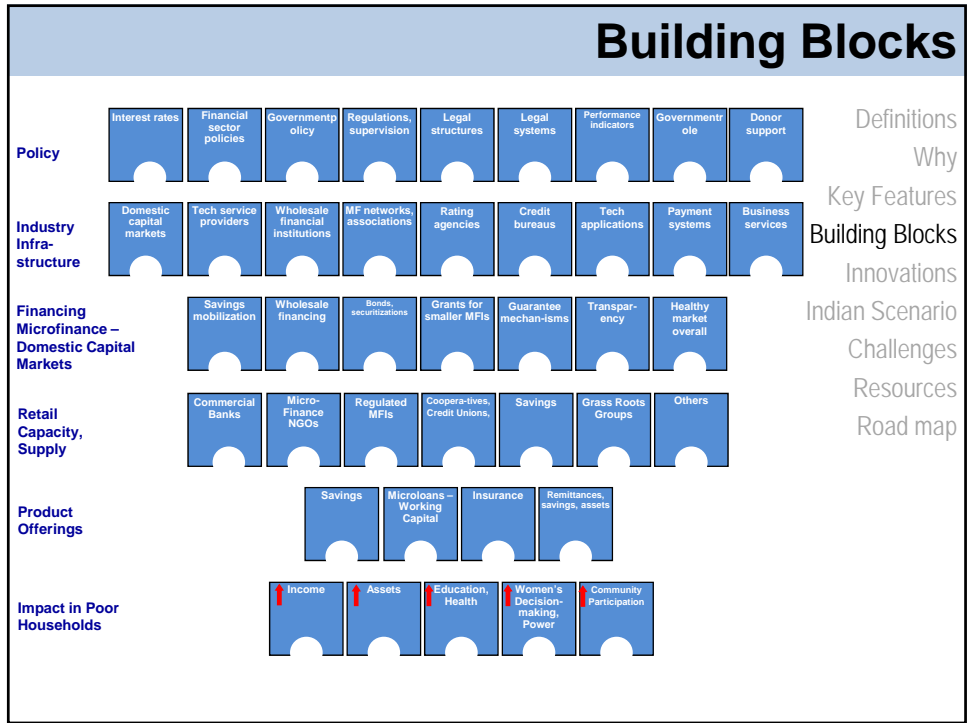
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Repayment Rates: > 90%

Source: Journal of Economic Literature, Vol XXXVII Dec'99 pg 1574.







## Indian Scenario

### Evolution of Microfinance in India

- 1904** Microfinance has been in practice for ages ( though informally). Legal framework for establishing the **co-operative movement** set up.
- 1934** **Reserve Bank of India Act** provided for the establishment of the **Agricultural Credit** Department.
- 1969** **Nationalisation of banks.**
- 1975** **Regional Rural Banks** created.
- 1976** Grameen Bank, Yunus
- 1982** NABARD established as an **apex agency for rural finance.**
- 1995** Passing of **Mutually Aided Co-op. Act** in AP in 1995.

Source: Doug Johnson, The Geographic Distribution Of Microfinance Services In India 2007

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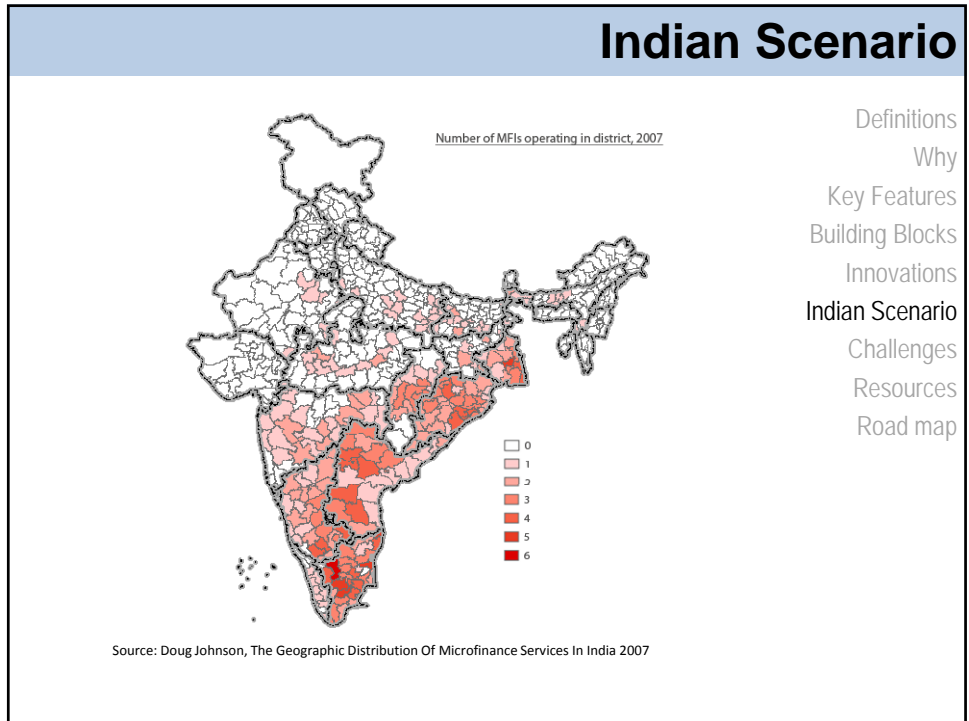
## Indian Scenario

Number of MFIs operating in district, 2006

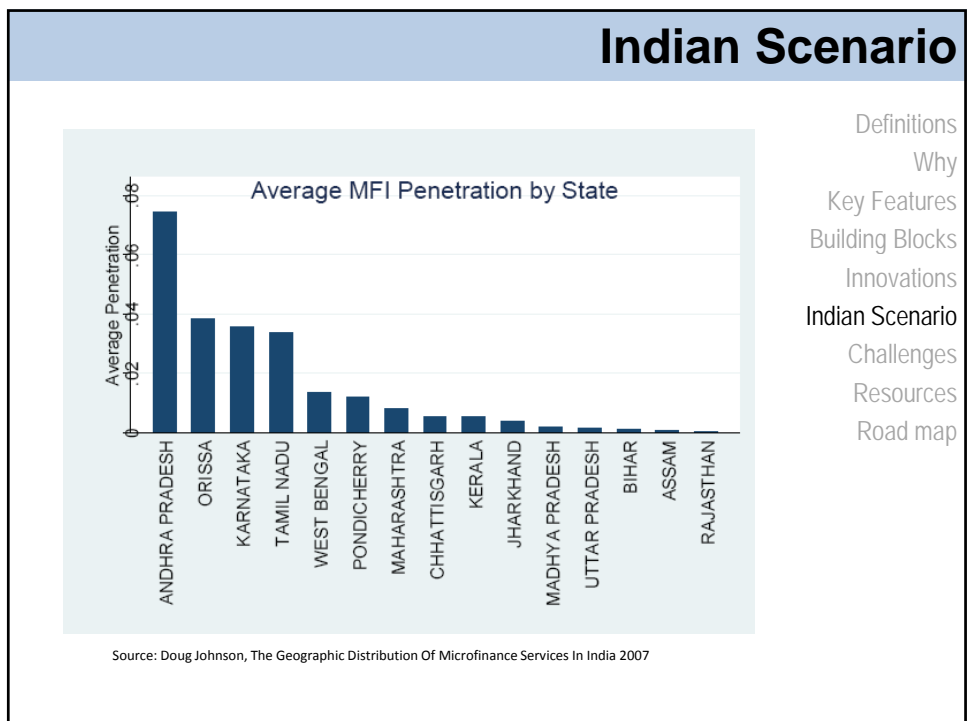
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Source: Doug Johnson, The Geographic Distribution Of Microfinance Services In India 2007

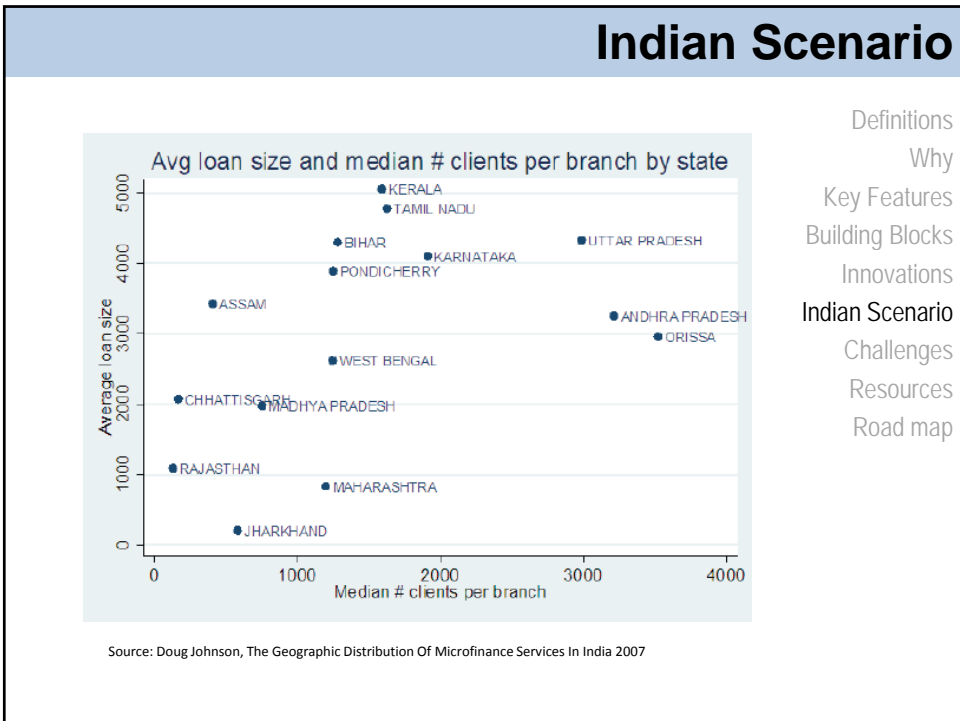
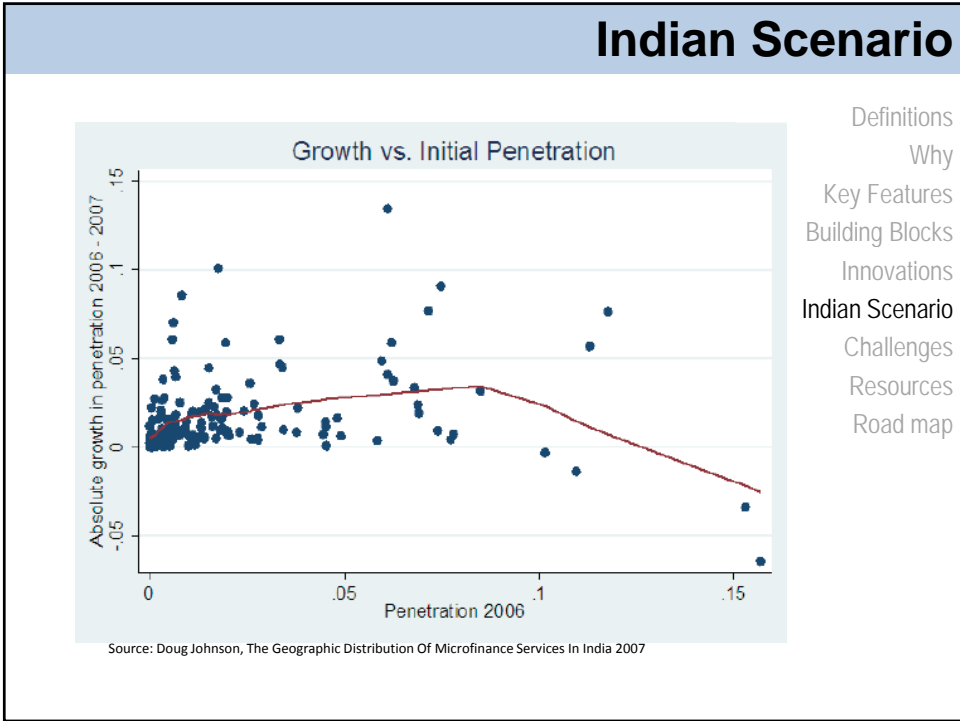
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## Indian Scenario

### Top 10 India MFIs by Number of Active Borrowers

<i>MFI*</i>	<i>Total # of Active Borrowers (2007)**</i>
Spandana	916,261
Share	826,517
SKS	513,108
Bandhan	449,304
AML	416,829
Microcredit Foundation of India (MFI)	410,329
KAS	394,462
Cashpor	201,692
BISWA	200,912
BASIX	

Source: [http://ifmr.ac.in/cmfi/map/notes\\_on\\_data.html](http://ifmr.ac.in/cmfi/map/notes_on_data.html)

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## Indian Scenario:Profile

Estimated that 350 million people live Below Poverty Line  
This translates to approximately **75 million households**.

Annual **credit demand** by the poor in the country is  
estimated to be about **Rs. 60,000 crores**.

Only **about 5 % of rural poor** have access to microfinance.

Source: <http://www.microfinance.in/presentation/sou.ppt>

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## Indian Scenario : Status of MF

**Considerable gap between demand and supply** for all financial services

Majority of poor are excluded from financial services. This is due to, inter-alia, the following reasons:

- Bankers feel that it is fraught with **risks and uncertainties**.
- **High transaction costs**
- Unfavourable **policies** like caps on interest rates which effectively limits the viability of serving the poor.

While MFIs have shown that serving the poor is not an unviable proposition there are issues that have constrained MFIs while **scaling up**. These include

- Lack of an appropriate **legal vehicle**
- **Limited access to equity**
- Difficulty in accessing **low cost on-lending funds** (as of now they are unable to offer savings services in a legitimate manner).

Source: <http://www.microfinance.in/presentation/sou.ppt>

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## Indian Scenario : Status of MF

**About 56 % of the poor** still borrow from informal sources.

**70 % of the rural poor** do not have a deposit account

**87 % have no access** to credit from formal sources.

**Less than 15 %** of the households have any kind of insurance.

Negligible numbers have access to **health insurance** (0.4 %) and crop insurance (0.2 %).

Source: <http://www.microfinance.in/presentation/sou.ppt>

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## Indian Scenario : Projections

Annual growth rate of **about 20 %** during the next five years.

**75 % of the total poor households of 80 million** (i.e. about 60 million) will be reached in the next five years.

The loan outstanding will consequently grow from the present level of about **1600 crores to about 42000 crores**.

Source: <http://www.microfinance.in/presentation/sou.ppt>

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## Indian Scenario : Challenges

Appropriate **legal structures** for the structured growth of MF operations

Finding **adequate levels of equity** for the new entities to leverage loan funds

**Ability to access loan funds** at reasonably low rates of interest.

Ability to **attract and retain professional** and committed human resources.

Design of **apt MIS** including user friendly software for tracking accounts and operations.

Appropriate **loan products** for different segments.

Source: <http://www.microfinance.in/presentation/sou.ppt>

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## The Microfinance Revolution

- Started in Bangladesh, 1976: Grameen Bank
  - Nobel Peace Prize 2006, *Muhammad Yunus*
- 10,000+ Microfinance Institutions in 60 countries
- Reached 82 million households by end 2006
  - Target for 2015: 175 million households
- Repayment rates around 97%
  - Citibank (1995): 93.7%
  - Government Institutions serving the poor: 70 – 80%
  - Traditional Banks serving the poor (Bangladesh, 1980): 51.6%
- Annual rate of growth worldwide: 30% (World Bank estimates)

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