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FROM THE CANVAS OF INDIAN INCLUSIVE FINANCE MODELS: PROBLEMS OF HYBRIDISATION WITHOUT REGULATION

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Abstract: *In this research, the different inclusive finance models that has evolved in India, with diverse institutional logics is portrayed. With this backdrop, the context in which hybrid models emerge in a sector and the relevance of regulatory support for its welfare sustenance is discussed. It shows why theoretical models needs legal vigilance for effective practical implementations.*

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Introduction

In India, the inclusive financial system comprises of a continuum of financial institutions—commercial banks in the public sector and Non-Banking Finance Company (NBFC) - Microfinance Institutions (MFIs) in the private sector and Non-Governmental Organization (NGO) – MFIs, in the third sector. Among these players, Indian commercial banks have a competitive edge over the rest, in terms of its wide institutional coverage across the nation. Whereas, the private sector NBFCs and third sector NGO-MFIs have the advantage of the grass-root intelligence needed to reach out to the hitherto unreached. Among these NBFC-MFIs and NGO-MFIs, the latter third sector player has an additional competitive advantage of providing welfarist business development services to the poor, along with the provision of finance. Such welfarist services are much needed by the excluded micro-entrepreneurs, who avail financial services to run their ventures efficiently and sustainably.

However, when the sector developed the welfarist NGO-MFIs lost its sheen in the name of hybridisation of inclusive finance models and scalability of outreach to the poor.

This resulted in problems for the sector as a whole, specially in a scenario when it stood largely unregulated. It resulted in a crisis in September 2010. The crisis was allegedly due to the exorbitant interest rates and over-lending practices adopted by few NBFC-MFIs. Therefore, in the case of NBFC-MFIs, the central bank (Reserve Bank of India (RBI)) intervened and laid down stringent rules governing the quantum of microfinance loans, ceiling the number of loans per customer, interest rates and margins. Using this setting as a context, it is argued in the paper as to why social finance needs proper regulation in careful design of welfarist hybrid models, before advocating scalability in outreach.

It needs protection of the welfare intention and social logic of the institutions, though financing may still be a recovery based activity. Prior to discussing this need for protection of welfarist approach in social finance, we reflect on the prominent inclusive finance models used in India: the Internal Unit Model, the SHG[1]-Bank Linkage Model, the MFI Model, the Bank-MFI Partnership Model and the recent Banking Correspondent Models – to set our context. The researcher critically reflects on these models and its evolution to draw regulatory attention on the withering welfarist intent and the need for its protection.

Microfinance Models in India

The prominent models which aimed to address inclusion in finance are explained through the annals of Indian microfinance history.

Old Paradigm of Microfinance

Right from the days of India's independence, provision of institutionalized microcredit to rural poor, gained prime importance in the nation's microfinance policy reforms. With the unorganized sector dominating the microcredit scene[2], the presence of a formal institutionalized structure in microfinance, was felt imperative. Based on this observation, the State Bank of India (SBI) was set up in 1955, fourteen large commercial banks were nationalized in 1969, and the National Bank for Agriculture and Rural Development (NABARD) was created in 1982. Cooperative banks and Regional Rural Banks (RRBs) were set up, during the period 1950 to 1976, primarily to meet the agricultural credit needs. In early eighties six more banks were nationalized and more branch expansions were undertaken (Thorat, 2006; Leeladhar, 2007). Despite these efforts put in by successive governments to expand the reach of these formal financial intermediaries, the indented results did not materialize. Poor continued to access services from non-institutional sources to meet their financial exigencies.

The plethora of reforms[3] based on subsidized microcredit, were inherently incapable of providing sustainable financial services to the poor. Subsidized microcredit delivery could provide only limited volume of cheap loans, which often ended up being allocated to the local elite, who are more influential in bypassing the deserving poor. In addition to the misallocation, it resulted in high arrears[4] and losses to the service providers and funding agencies, depressing the viability of pro-poor financing programmes, in general and sustainability of microcredit ventures, in particular (Robinson, 1995).

In the early nineties, at the outset of the structural reforms, the microfinancing profile, remained far from satisfactory (Thorat, 2006).The financial sector reforms that ensued, swept a wave of competition and deregulation in the banking sector, as a whole (Narasimham, 1991).

[2]All India Rural Credit Survey (1954) conducted by Reserve Bank of India (RBI) portrays Indian rural poor to be dependent on local moneylenders, for more than 90 percent of their financing needs.

[3]Policy initiatives like directed credit programmes, subsidized interest rates, priority sector lending, lead bank scheme and service area approach, sufficed mainly to comply with the quantitative targets of poor-lending, much needed for projecting the social face of banking. See Sinha & Patole (2003) for details.

[4]Repayment rate of Integrated Rural Development Programme (IRDP), which delivered subsidized credit to 5.38 crore families through commercial banks, was as seen to be as low as 25-35 per cent. Though it was considered to be world's largest microcredit programme, it is reported to have resulted in huge losses for commercial banks. See RBI (1995) for more details.

With respect to microcredit, it did not bring much of a change in the competitive scenario[5] among the service providers. But it did set a new trend of autonomy in pro-poor financing. It liberalized the interest rates[6] for cooperatives and RRBs, relaxed the controls on poor financing, reworked the sub-heads under the priority sector credit and introduced prudential lending norms.

The reforms also initiated efforts to restructure and refinance the financially deteriorated RRBs. But a thorough overhaul of the flaws created by decades of bureaucratic slouch, mismanagement and distorted incentives systems in the co-operative credit institutions and RRBs required much more than refinancing. Recapitalization, without concomitant reforms in its operational design, often culminated in postponing failure, hampering the sustainability of these institutions (Vaidyanathan, 2004).

The post-liberalization scene resulted in mounting over dues for the banks. As on March 2004, priority sector lending constituted 47.5 per cent of the total Non Performing Assets (NPAs) of the public sector banks. Provisioning norms for NPAs, further deteriorated the banks, in the form of capital erosion. Negative spread on account of mismatch between lending rates and deposit rates proved to be a disincentive for savings mobilization. The loss on account of mismatch between lending rates and cost of financing, resulted in a fall of nearly 30 per cent of net profits for the banks (Basu, 2008). Thus in the old paradigm, banks internalized the notion that subsidized microcredit lending is a loss-making activity, to be undertaken as a mandatory social banking practice.

In the old paradigm the poor continued to resort to money lenders for their financial needs. Agrawal (2008) observes that even in cases where market supply of low cost microcredit was augmented through policy interventions in the old paradigm, poor preferred not to meet their entire financial demand from the formal financial sectors. Agarwal explains this anomaly by citing the price and non-price barriers associated with microcredit delivery. The non-price barriers like elaborate documentation and income assessments, makes the poor reluctant to approach the formal banking system. To by-pass these non-price barriers, and to economize their daily financial needs they seek the assistance of local moneylenders than the formal financial institutions. The behavioral justification given for the phenomenon is that financial exclusion is highly correlated with the social and self-exclusion traits, latent in the poor psyche (Sinclair, 2001). Rural Finance Access Survey (RFAS, 2003 as cited in Basu, 2008), further goes on to quantify the non-price barriers, like the high rates of bribes to be paid and extended time taken for accessing finance from formal sectors. Extracts from RFAS (2003) indicate that average

[5]Old paradigm was rooted in the belief that microfinance is best rendered via nationalization of banks than privatization. See Raj (1974) for more details.

[6]Deregulation of interest rates was an integral part of financial sector reforms, intended to ensure efficiency allocation of resources and better price discovery. As per this mandate, apart from interest rates on savings deposits and NRI deposits and export credit and small loans up to Rs. 2 lakh, all other interest rates have been made flexible. See Narasimham (1991) for details.

bribe rate for availing a loan from commercial bank comes to nearly 10 per cent of the loan amount and the documentation time is close to 33 weeks, with high loan rejection rates.

All this made financial access difficult under the old paradigm of microfinance, justifying the poor's act of approaching the usurious moneylenders. In the financial diaries of Ruthven (2001)[7] one of his respondents gave a thought provoking rationale for choosing non-institutional instruments, even if it meant paying usurious rates. "*When I go to a money lender, it's between him and me*. *I give my relatives no reason to talk"* (Ruthven, 2001:14). The message is thus clear—the convenience, speed and dignity conferred by close social circles in a locality, reduces the non-price barriers and transaction costs for the poor. The old paradigm of microfinance was unable to confer these benefits. However it marked the origin of a prominent model named as the Internal Unit Model. In this model, the commercial banks had an inclusive finance department internal to the instituion. The model is depicted below in Figure 1.

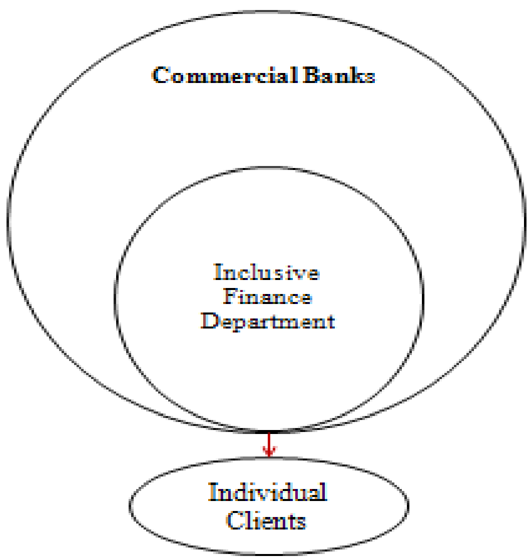

Figure 1: Internal Unit Model

Competitive Advantage of the Internal Unit Model

The positive impact of the policy efforts taken in the old paradigm of microfinance was that it resulted in a huge increase in the commercial banking branch outreach in India, as the average population covered by a branch fell from 64,000 to 13,711 (Thorat, 2007). This competitive advantage of these public sector commercial bank branches, with huge infrastructural base, networking and funding potential and legitimacy capital as the reliable banker for the masses, made it an eligible partner for the institutions that subsequently made entry in the new paradigm

[7]Ruthven (2001) used financial diaries to comprehend the financial instruments preferred by Indian poor.

of microfinance. Moreover as per mandate these banks are to keep 40 per cent of their loan portfolio as priority sector lending to the marginalised and economically weaker sections, which makes their participation in microfinance initiatives a requirement. The crystallisation of the Internal Unit Model in banks gave an institutional approach to lending.

New Paradigm of Microfinance

Indian Financial System did a lot of experimentations in the field of microfinance, before its transition to the new paradigm of microfinance. Lessons learnt about the non-price barriers in old microfinance paradigm and introspective assessments of informal group credit-lending methods like chit-funds devised by poor, gradually led to this transition.

Microfinance in the new paradigm had its modest beginning as a grass-root development movement among Non-Governmental Organizations (NGOs) in the early 1970s. The Self-Help Groups (SHGs) formed by these NGOs, were affinity groups of around fifteen to twenty poor individuals, mostly women with a homogeneous socio-economic background, sharing the willingness to improve their living conditions. The group members provided financial support to one another through internal credit assistance made from their pooled savings. This was an informal credit-lending method designed by the poor themselves to meet their consumption and productive needs. After inculcating financial discipline among themselves, these SHGs formed under the aegis of the NGOs, persuaded government to link themselves to formal financial institutions for sourcing additional funds and depositing their pooled savings. This when acceded to, paved way for the India's celebrated SHG-Bank Linkage Programme[8]. The SHG-Bank Linkage Model is depicted below in Figure 2.

[8]In the 1991 RBI Circular, an announcement for linkage of informal SHGs, with the existing banking system was made. In the following year NABARD launched a pilot project which linked 500 SHGs with commercial banks. These incidents formally marked the advent of the new paradigm of microfinance. Banks were permitted to classify such microfinance lending under its advances to weaker sections under the priority sector lending norms.

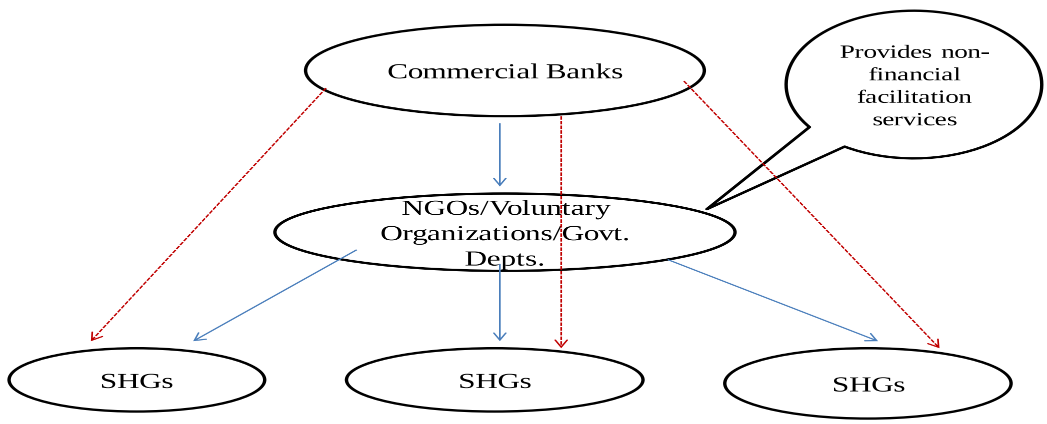

Figure 2: SHG-Bank Linkage Model

Later on some of the Indian NGOs, instead of merely performing the role of a facilitator or promoter for microcredit, transformed themselves to into specialized financial intermediaries called MFIs, constituting a niche industry with high growth potentials. The Indian MFIs assumed heterogeneous forms comprising of Non-Banking Finance Companies (NBFCs), societies, trusts and co-operatives. They organized the poor in to groups and catered to their financial needs, instead of linking them to the banks. In 1973, an MFI called Self Employed Women's Association (SEWA) was registered as a trade union in the district of Gujarat in India, to meet the financial needs of bottom of the population pyramid. This institution called the Mahila SEWA Co-operative Bank was the first MFI in India.

Thus gradually what lied dormant as an informal lending method among the poor, eventually initiated a new paradigm in Indian microfinance reforms. The MFIs overcame the non-price barriers experienced in the old paradigm of microfinance as it provided speedy financial access to the poor, within their local socio-economic circles using group lending credit-delivery models. Since the non-price barriers are low in a MFI model, the National Council for Applied Economic Research (NCAER, 2011) study on small borrowings in India observes the over-all cost for borrowings for the poor from an MFI to be least when compared to that of the costs associated with formal financial institutions, SHG-Bank Linkage Programmes and other informal sources[9]. This can be attributed mainly to the credit delivery model used by MFIs which operates at the grass-root level.

[9]The over-all cost of borrowing for the poor includes both the interest rate charged on loans and the cost of non-price barriers associated with obtaining a loan from a given source. The cost of non-price barriers included wage loss due to time spent in getting the loan approved (opportunity cost),cost of travel, money spent on food while travelling to the source of loan, charges paid for preparation of documents, additional charges (like stamp duty), payment of bribes and other charges associated with insurance.

The MFIs in India used two forms of group lending credit delivery models—the homegrown SHG model (discussed earlier in this section) and the Bangladeshi Grameen model for its credit delivery. Unlike the SHG model where groups are initiated by the poor themselves, in the grameen model, small sized groups of individuals are formed among the poor by the MFIs for the purpose of microfinance delivery. Weekly meetings are organized among the group members and saving is made mandatory for them. Credit is not given to all members simultaneously, but all hope to have their turn and all stand jointly liable for amount lent to each person in the group. The principle of joint liability is used as collateral for the loans they receive from the MFI (Ghatak, 2000). Repayment rate and efficiency was seen higher under joint-liability contracts as compared to conventional individual-liability contracts because the former exploits a useful resource that the latter does not—the information that borrowers have about each other. Thus repayment rates close to 90 per cent was reaped by these NGO-MFIs in the new paradigm of microfinance, which proved that lending to poor is not a loss making business (Thorat, 2006).

Later in the early 2000's, the NGO-MFIs began to establish their permanent footing in Indian financial system by transforming its informal non-profit legal status to formal pro-profit NBFC status. These informal NGO players and formal NBFCs comprised the two forms of private players working in Indian inclusive finance space. The snapshot of the share of poor clients served by the formal and informal MFIs in India is portrayed by Srnec (2007) as given below in Figure 3.

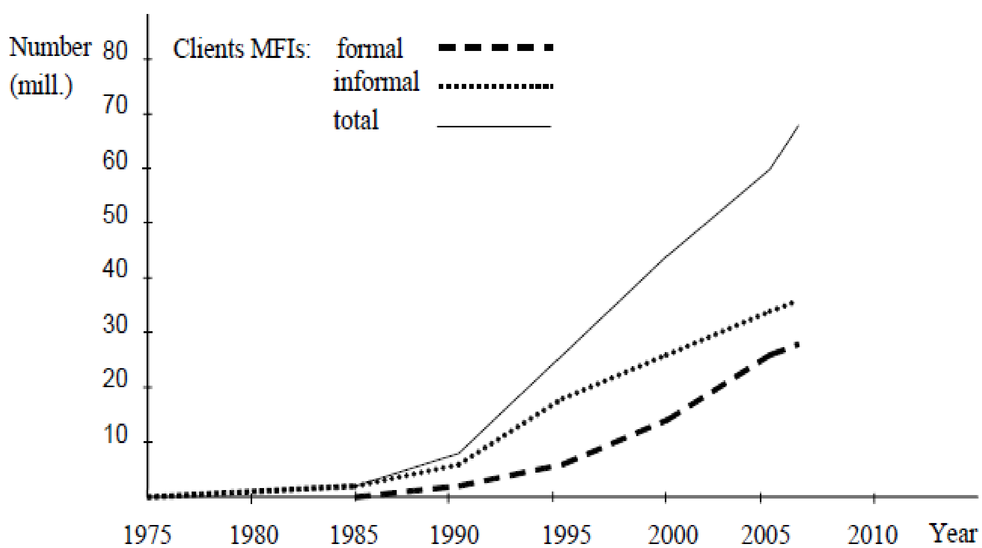

Figure 3 Comparison of Formal and Informal Microfinance Institutions in India

(Source: Srnec, 2007)

As per NABARD's statistics, after taking into account both these formal and informal MFI in India, there are close to 800 to 1000 MFIs operating in India, as on April 2011. Out of these 1000 odd MFIs, nearly 52 MFIs are regulated NBFC-MFIs and the rest are NGO-MFIs in the form of trusts, co-operatives and societies. As shown in Figure 1 together they serve close to 70 million poor and financially excluded masses in India as on April 2010. Sustaining the operations of these MFIs became crucial as the 70 million served by the MFIs constitute only a fraction of the 700 million Indian people who lack access to essential financial services like credit, insurance, and savings facilities, and therefore constitute the potential target client base for microfinance services (Intellecap, 2010).

The MFI model that emanated at this phase is depicted below in Figure 4.

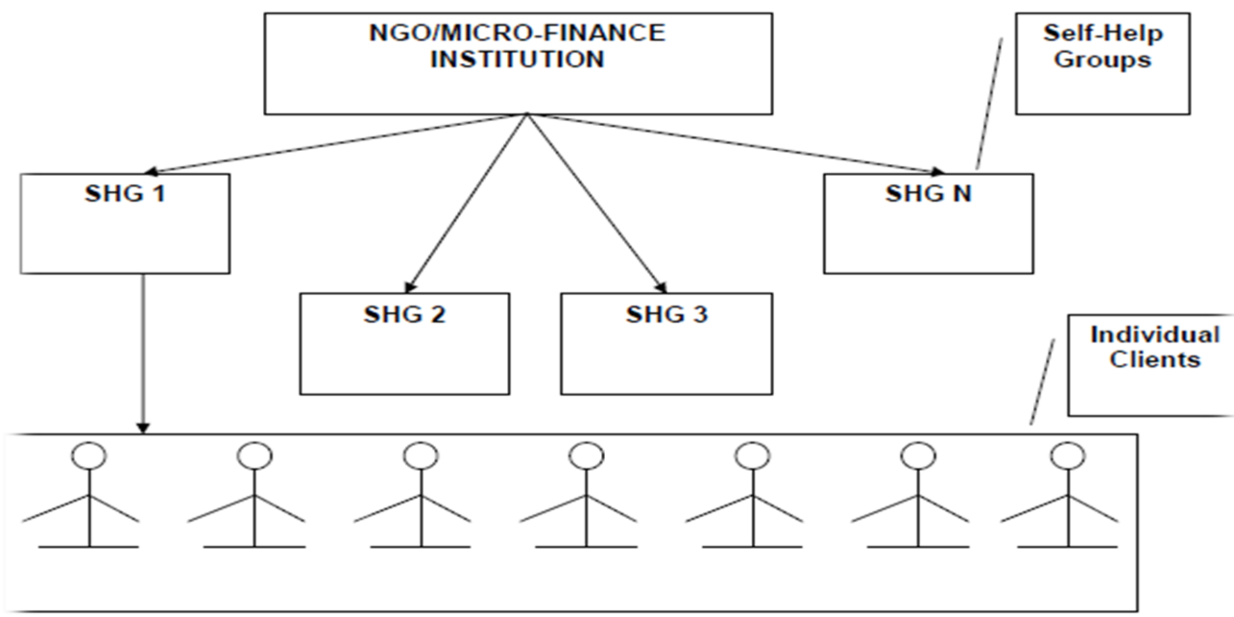

Figure 4: The MFI Model
Source: Micro-Finance Consulting Group.(MFC, 2007). MicroNed India Country Scan Study. Chennai: MFC.

Competitive Advantage of New Paradigm Microfinance Models

NBFCs and third sector NGO-MFIs are institutions, which have the advantage of the grass-root intelligence needed to reach out to the hitherto unreached. These institutions also have the additional competitive advantage of providing welfarist business development services to the poor, along with the provision of finance (Fisher & Sriram, 2002). Such welfarist services are much needed by the excluded micro-entrepreneurs, who avail financial services to run their ventures efficiently and sustainably.

But since these MFIs had constraints in getting funding to expand their outreach and scalability, they had to collaborate with commercial banks for financing their lending activities.

This led to the formation of a hybrid model called 'Bank-MFI Partnership Model'. For the banks it was the best means to fulfil their priority lending targets, without indulging in grass-root operations. Thus a partnership model which was a hybrid of public sector banks and private sector MFIs was formed. The details of this model are presented in the subsequent section.

Bank-Microfinance Institution Partnership Model: Advent Of Hybridisation

As the name suggests 'Bank-MFI Partnership Model' is a hybrid model, in which the commercial banks works in partnership with MFIs, to lend loans to the poor (Thorat, 2007). The MFI evaluates, recommends, originates the loans, helps in disbursal and, subsequently, tracks and collects the loans. But, loans are accounted for in the bank's books and not in the MFI's books. This model overcomes the constraints of capitalization of MFIs as the bank provides the funds for lending. For the services that the MFIs provide at the grass-root level, a service charge is collected from the borrowers by the MFI. In this model, banks also at times provide working capital assistance to MFI to meet cost of promotion during initial years. MFI repays the working capital loan from donor funds when available or from service charges.

The model is schematically depicted below in Figure 5.

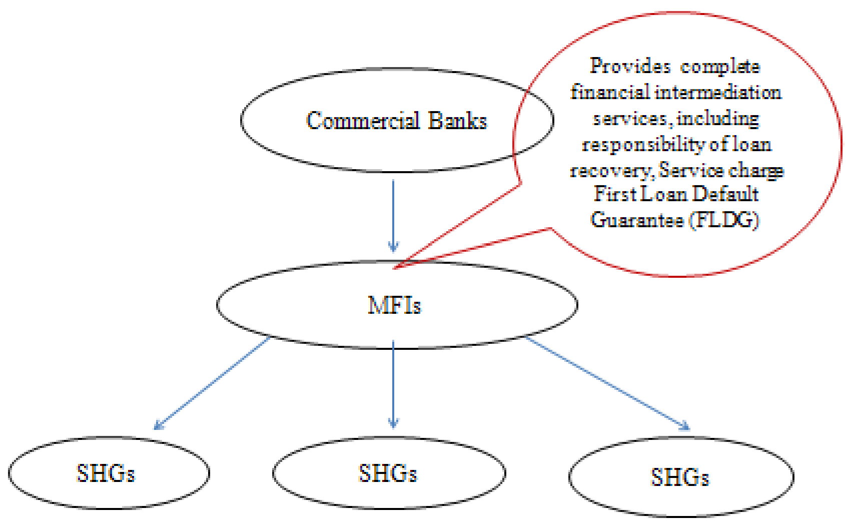

Figure 5: Bank-Microfinance Institution Partnership Model

The MFIs must bear defaults if any, to a certain degree i.e. it must provide a First Loan Default Guarantee to the bank to an extent of 8 to 15% of loans sanctioned, in the form of a security deposit with the bank so as to maintain its stake in the loan portfolio.

A sub - variation of this model is where the MFI, as an NBFC, holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables the MFI enlarged funding access.

The securitization model is schematically depicted below in Figure 6.

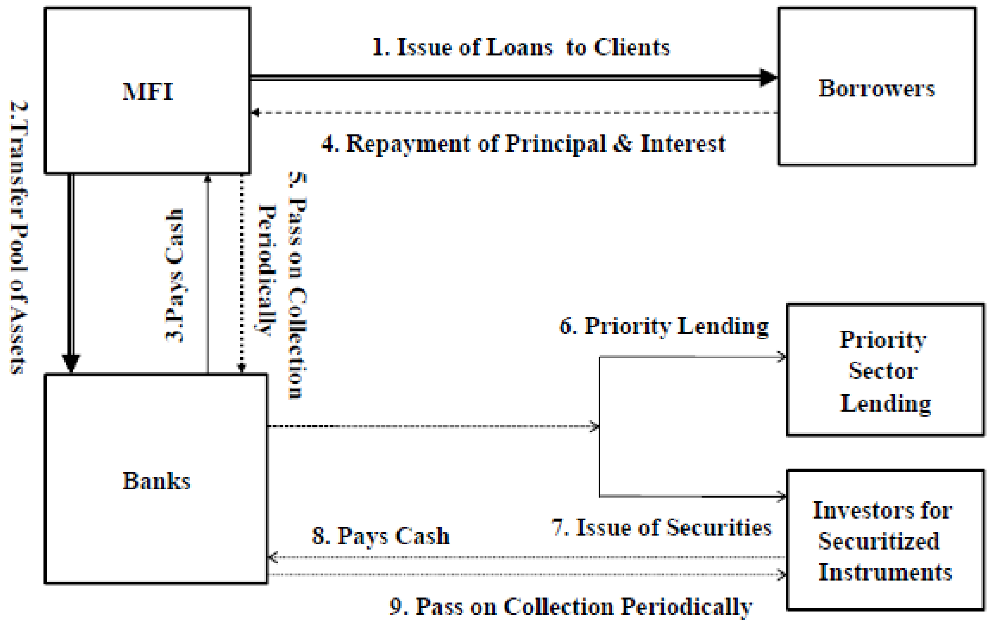

Figure 6: Securitisation Model

As shown in Figure 6, after issuing loans to the clients, the MFI transfers the loans to banks interested in a securitization deal. The bank which purchases the pool of assets then pays back cash at a discounted rate of interest to the MFI. The MFI will continue to service the sold out loans on behalf of the bank and will pass on the collections periodically to the bank. The MFI will be financially responsible for any losses on the sold out loans, up to a certain percentage as agreed at the time of the securitization contract. This clause is termed as first loan default guarantee in the contract.

Just as the MFI gets its loans liquidated, the bank too has an advantage in entering in such a deal. The bank can use this purchased loans to fulfil their priority sector lending requirements. It can also pool these assets and redistribute it as securities to new investors. For the investor, securitized microfinance loans are attractive as it mature much faster than other industry investments. The maturity period ranges from 6 months to 3 years and portfolio quality is generally high on microfinance loans. Thus securitization is a win-win deal for all the parties involved. But since there is no active secondary market for securitized microfinance instruments, usually the banks either use it to meet their priority lending requirements or resell it to other banks that face the similar need. So if the redistribution element in this model is not there, then it becomes a mere portfolio buy-out model between the MFI and the bank, with no issue of securities. Such portfolio buy-out models are mainly used by the NGO MFIs as securitisation is permitted only for NBFC-MFIs. But nevertheless, both securitization and portfolio buy-out models are good means to reduce the MFI's cost of funds (Parekh, 2012).

Also there were banking correspondent (BC) models - which used MFIs and other retail local agents as correspondents to enable banking with the poor. The correspondents were given commission and the model is depicted below in Figure 7 –

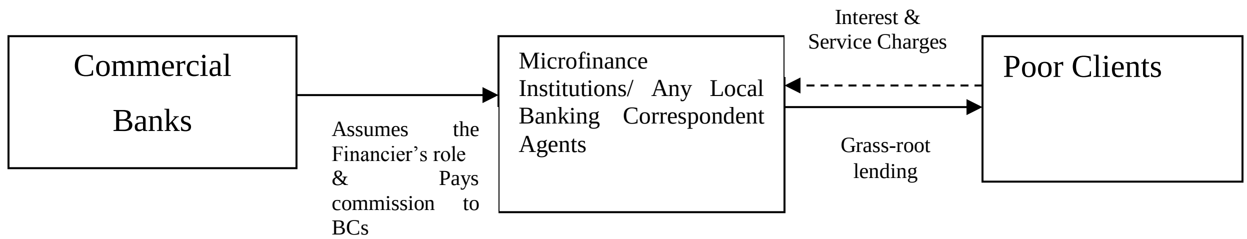

Figure 7: Business Correspondent Model

Together the different versions of the 'Bank-MFI partnership model' enable the MFIs who are adept in grass-root operations and implementations, to address its financing issues by framing hybrid models with public sector commercial banks.

Institutional Logics in Hybrid Models

With this hybridisation of model at its backdrop, we revisit the genesis of these institutional players. As seen from the originating history of the institutions that participate in this hybrid model, the players have diverse institution logics. The public sector banks and NBFC-MFIs have commercial lending logic and NGO- MFIs have social logic.

The public sector commercial bank chose to participate in the hybrid model, essentially to fulfil their priority sector lending mandates. For them the private sector NBFC MFIs are a low-cost hassle free medium for financial intermediation at the grass-root level. They outsource the cumbersome grass-root lending processes, which isn't their core competency and primary organisational goal, to the MFIs who are adept in group-lending operations.

On the other hand, for the MFIs entering into this hybrid model, this collaboration works as the best means to stabilise their funding and scale-up quickly, through the bank's resource base. In their view it also helps the MFIs to later on leverage on the customer base of the banks to cross-sell products. The legitimating effect of collaborating with a commercial bank, which has acceptance in financial sector as a reliable banker for the masses, makes the MFIs pitch easier to newer markets.It also adds to the credentials of the MFI when it launches and offers wider product ranges other than credit, like insurance and deposits. Customer's concerns associated with deposit safety and insurance coverage can be largely mitigated if the MFI can depict a strong partnership with a reliable public sector bank. Moreover, such partnership models help the MFI to address their client's aspirations for graduation. Poor clients aim to graduate from small loan sizes to higher levels and to enter into a reliable and consistent banking relationship, for their financial needs. This graduation becomes easier through bank collaborations.

However, contrary to these theoretical benefits, when the collaborations happened, the social element started withering. Most often the collaborators for the banks where the NBFC

MFIs, for scalability through them were found easier.. The NGO MFI were more welfare oriented and so could achieve breadth of outreach only slowly in comparison to NBFCs. This neglect of the NGO-MFIs resulted in some problems discussed in subsequent sections. In the first place, due to the scalability elements of the NBFC Model, many NGOs themselves began to transform into this status. This transformation is depicted in table 1 below.

Table 1: Source: Ashta & Assadi, 2010 and individual MFI websites

MFI Name	Present Status	Former Status
Bandhan	NBFC since 2007	Society Before
Spandana	NBFC since 2005	Society Before
SKDRDP	Trust since inception	Trust since inception
SHARE	NBFC since 2000	Society Before
Ujjivan	NBFC since 2004	NBFC since 2004
Equitas	NBFC since 2007	NBFC since 2007
Janalakshmi Financial Services Pvt. Ltd.	NBFC for investors as for-profit operating company and a Section 25 non-for profit holding company for social services since 2003	NBFC for investors as for-profit operating company and a Section 25 non-for profit holding company for social services since 2003
AML	NBFC since 2002	NBFC since 2002
SCNL	NBFC since 1990	NBFC since 1990
Cashpor MC	Section 25 co. since 1997	Section 25 Co. since 1997

Thus the hybrid model,though had the best of the intentions to work for the cause of microfinance and poverty alleviation, soon began to be skewed towards sustainability and scalability needs. Sustainability and scaling up was definitely the concern of the MFI too, but it was considered the means to fulfil their welfare-oriented social goal. But with the risks inherent in the partnership model, where subsequent funding has ties to good recovery performance, MFIs soon began to take welfare for granted. The guiding premise was that ‘more microfinance would lead to more welfare’ and therefore ‘growth for growth sake’ is justifiable. This rat race for achieving scale, resulted in mission drift (Panwar, 2011; Parekh, Olivares-Polanco &Ramanan, 2012).This was evident in the month of September 2010, when the industry was hit by a crisis. The crisis alleged Indian MFIs to be a new avatar of money lenders, who adopt coercive recovery practices, in the name of fulfilling the sustainability and scalability demands driving them. The model was driven by scale and therefore they often ended up assuming more risk than their normal risk-taking appetite. They began to comprise client-staff relationship for the sake of scale. Their policy was to incentivise their field staff for maximising scale and minimising defaults. Thus the culture of scaling up and zero-tolerance for delinquency rates crept in, spoiling the entire welfare-orientation envisioned in an MFI's operation.

Concluding Remarks

Against the background of the problems discussed above in the existing hybridisation models, we see the need for regulatory support to protect welfare interest in hybrid designs. As seen in the discussions, the NGO-MFIs which are more welfare oriented and equipped to use financial inclusion as a tool for poverty alleviation.

But in case of the case of these third sector NGO-MFIs, there is still no proper regulatory mechanisms in place. They are registered as Trusts, Co-operate Societies, Section 25 Companies and Mutually Aided Co-operative Society under their respective organizational acts and are mostly governed by State or Central Government laws. But these laws do not prescribe any governance norms and thereby make these institutions hard to source capital from commercial markets or enter in hybrid models easily. Therefore these third sector players though adept in grass-root credit operations and provision of welfare services, have regulatory limitations to scale their operations or source funds. Moreover because of their limited infrastructural, capital and asset base, they are bound by the regulatory mechanisms, to operate only as Non-Deposit taking Institutions (NDIs). On the contrary, the laws permit the public sector commercial banks to act as Deposit taking Institutions (DIs). The regulator is cited to have equipped these different players with differential deposit taking abilities, considering the systemic risks involved in the sector. But to do full justice to the cause of financial inclusion, there should be enough provisions in the regulatory space that enables players to form hybrid models that can leverage on the competitive advantage of different players. A hybrid model that can integrate the infrastructural network and asset support base of the public sector commercial banks with the grass-root intelligence and welfarist approach of the third sector NGO-MFIs, currently evades the regulatory design of Indian inclusive financial system.

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