Public Policy

Preparing for Growth: An Assessment of the Challenges to Expansion of Microfinance Services in India

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Microfinance has been a force of growing importance over the past few decades as a tool for grass-roots economic development. Each stage of development presents new challenges to expansion, and it is important for microfinance researchers, practitioners and policy-makers to fully understand these challenges when deciding where to allocate resources and efforts. Both changing legislation and an influx of money from commercial banks in India's microfinance sector present opportunities for expansion. However, practitioners should be aware of the most relevant challenges so that resources may yield optimal results. Based on open-ended interviews and closed-ended written surveys, both local-level microfinance administrators and national-level practitioners at support institutions agree that the need for regulatory reform and a lack of funds for infrastructure are there primary challenges, while differences between the responses of the two groups reveal some interesting implications about how solutions for these challenges should be addressed.

Microfinance and challenges in expansion

Global Microfinance

Microfinance (financial and social intermediation centered on providing loans to poor people for self-employment projects) has been growing exponentially in developing countries over the past three decades. The purpose of microfinance is to meet the financial needs of those populations excluded from formal financial services, especially the poorest of the poor. Microfinance has largely been an NGO-based initiative outside of the regulation of the government. Microfinance is not the definitive solution to end poverty, but it is a very important part. MFIs have the capability to lift the worlds poorest above the poverty line, and consequently, they provide a broad range of social benefits for their clients, including improved education, better health, women's rights, and human rights in general.

The global microfinance sector faces many challenges such as finding bankable funding, ensuring accountability and credibility, addressing their clients' needs, sharing best practices with other MFIs, integrating with the local and national government, and training employees. Infant sectors may struggle with issues such as safety and security for loan officers or, even more fundamentally, properly assessing the demand for microfinance services within the society. However, developed microfinance sectors have flourished and the much more advanced sector faces advanced challenges. For example, in Bolivia, the trend has been toward commercializing MFIs that were once NGOs into regulated commercial banks. The concerns of these more developed institutions shift toward questions of branding and upgrading technology systems in order to expand their businesses.

Within each country or region, it is important that researchers, practitioners and policymakers maintain awareness regarding the most relevant challenges to the expansion of microfinance services, if all three are to impact the sector positively and contribute to its development. Particularly in India where there is an anticipated influx of funds into the microfinance sector and subsequent rapid expansion of microfinance services in the coming years, maintaining this awareness is especially important. If researchers, practitioners, and policymakers understand the most relevant challenges to expansion, then they are more likely to administer programs for the sustainable growth of the sector.

In-depth Study of Challenges for India

India was selected for an in-depth look at current challenges to the expansion of microfinance because of two major developments in the Indian microfinance sector. Both of these developments will lead to a huge influx of funds into MFIs, namely (1) recently heightened interest of commercial banks in the microfinance sector as a market opportunity, and (2) very recent changes to legislation around funding MFIs.

The banking industry in India has historically been extremely consolidated, like many other industries in India. To illustrate, in 1999, the government-controlled State Bank of India alone held 94% of consumer deposits (McKinsey Quarterly 1999). Now that changes in legislation towards deregulation have opened India's banking industry, competition has increased and commercial banks have just recently started to turn towards microfinance clients as potential customers.

Commercial banks have started tapping into microfinance markets, using existing MFIs as distribution channels. Banks essentially give bulk loans to MFIs that in turn distribute these funds across tiny loans to clients, and then repay the loans to the banks (Anath 2005). This funding model is called the partnership-model and was pioneered by ICICI Bank (one of India's leading commercial banks). As this partnership-model gains more and more popularity among Indian commercial banks, the resulting influx of funds will greatly enhance MFIs' financial capacity to disperse loans.

The national government recognized this trend and has responded to facilitate increasing interest in funding MFIs. On January 25, 2006 India's central bank, the Reserve Bank of India (RBI), circulated an issue that now allows commercial banks to use "business correspondents" for the distribution of loans. The specific implementation of this issue means that banks will now use MFIs as intermediaries for disbursing loans to microfinance clients (Business Line 2006). This is a monumental event for microfinance in India, as the national government is encouraging the flow of funds from commercial banks through MFIs to microfinance clients.

The heightened interest of commercial banks and the national government's support of banks' involvement with MFIs suggest that funds will begin to flow into the microfinance sector in India at an unprecedented rate. It is important for practitioners to be aware of the most current and relevant challenges to the sector to utilize these funds optimally. That is the motivation for this study.

Methodology and data collection

Data for this study was obtained through open-ended interviews as well as through closed-ended surveys. Of the 25 interviews conducted, 12 were local-level microfinance administrators and 13 were national-level practitioners at support institutions. Of the 18 surveys conducted, 8 were from the local-level group and 10 were from the national-level group. (See Appendix A for a complete list of study participants.) Study participants were asked to describe their experiences as well as express their opinions on questions related to challenges in the expansion of microfinance in India.

Data was analyzed using standard qualitative research methods. The Microanalytic and the Holistic Approaches were used to analyze interview results, and Matrix-based Classification was employed to analyze survey results. The data revealed several interesting findings about the sector in general and also about each of the two participant groups, local-level and national-level.

Results of qualitative study

"What are the biggest challenges in the movement to expand the provision of microfinance in India?"

> "A major challenge is always of a legal form…the industry needs its own, better legal environment."
> Shiva Nageswara Rao
> Planning Manager at SHARE Microfin

> "Previously, resources were very scarce…. Now, there are a lot of funds, but partners [MFIs] have not matured."
> Daksha Niranjan
> Credit Program Head at Friends of Women's World Banking

> Although the microfinancing schemes started in an efficient manner by the professionalized NGOs and MFIs, now there are innumerable NGOs totally new to the microfinancing sector, which leads to duplication of programs sometimes and which ultimately causes the beneficiaries to be indebted. This is the biggest challenge.
> K. Loganathan
> CEO at Association for Sustainable Community Development

One-to-one Interview Results

The most common response focused on the need for investments in sector infrastructure and management information systems (MIS) to reduce MFIs' operating costs and inefficiencies (14 of the total of 25 respondents, 8 of the 12 local-level respondents, and 6 of the 13 national-level respondents expressed this view). There is a severe lack of use of technology in Indian microfinance practices. Most MFIs still operate with hard copies of their records, and only a handful of the largest institutions employ MIS software. Resulting high operational costs are then passed on in higher interest rates to clients.

Interestingly, several respondents (11 of the total of 25 respondents, 4 of the 12 local-level respondents, and 7 of the 13 national-level respondents) explained that, over the next decade, there is expected to be substantial or adequate funding for the disbursement of loans, but funding for infrastructure is expected to be lacking. The influx of funding described above is earmarked for loan disbursement rather than for the general development of the sector's operations and infrastructure.

Respondents also emphasized the need to expand the set of products offered by MFIs (9/25 of total respondents, 4/12 of local-level respondents, and 5/13 national-level respondents expressed this view). While current loan models may be successful, many financial service needs such as savings and insurance are left unmet.

Another challenge commonly noted by study participants as a significant hindrance to the expansion of the Indian microfinance sector was the need for regulatory reform, especially regarding the difficulties NGOs face registering as financial institutions and legal restrictions on offering savings services (7/25 total respondents, 4/12 local, and 3/ 13 national respondents expressed this view).

Survey Results

The survey mirrored the interview by asking respondents to rank the importance of various challenges to the Indian microfinance sector on a scale from one to five, with one indicating "almost no importance" and five indicating "great importance". The means, medians and modes of these scores were calculated (1) across all study participants, (2) local-level MFI administrators and (3) national-level practitioners at support institutions within the microfinance sector. These descriptive statistics were then used to rank responses according to importance-ratings assigned by study participants in each group. (See tables above for rankings.)

Local-level Respondents:

Response (in order of importance ranking)	Mean Importance Rating	Median Importance Rating	Mode Importance Rating
Need for regulatory and policy reforms	4.6	4.5	5.0
Lack of funding for infrastructure	4.2	4.5	5.0
Lack of technology infrastructure	4.2	4.0	5.0
Lack of training and capabilities of staff	4.0	4.0	4.0
Lack of sharing of best practices	3.6	3.5	3.0
Lack of funding for loan disbursement	3.1	3.5	3.0

National-level Respondents:

Response (in order of importance ranking)	Mean Importance Rating	Median Importance Rating	Mode Importance Rating
Lack of technology infrastructure	4.4	4.5	5.0
Need for regulatory and policy reforms	4.2	4.0	5.0
Lack of training and capabilities of staff	4.2	4.0	4.0
Lack of sharing of best practices	3.8	4.0	4.0
Lack of funding for infrastructure	3.6	4.0	4.0

For the local-level group, mean importance-rating scores revealed the most important challenge as "Need for regulatory and policy reforms" (mean importance rating of 4.6). "Lack of funding for infrastructure" and the "Lack of technology infrastructure" both had the second highest importance rating (4.2), based on the mean importance rating of participants in the local-level group.

The rankings of the survey responses are generally consistent with the interview responses, except that the mean scores in the surveys assigned somewhat greater importance to regulatory reforms than was the case with the interview results.

The national-level group's importance rankings showed "Lack of technology infrastructure" to be the most important challenge to the expansion of microfinance, according to the national-level group of study participants (mean importance rating of 4.4). "Need for regulatory and policy reforms" and "Lack of training and capabilities of staff" both had the second highest importance ranking (4.2).

The local-level and national-level groups both identified "Need for regulatory and policy reforms" and "Lack of technology infrastructure" as two of the three most important challenges to the expansion of microfinance in India.

There are also interesting differences between the two groups. The local-level group ranked "Lack of funding for infrastructure" second in importance (based on the mean score), whereas the national-level group ranked that challenge fifth in importance. Both groups ranked "Lack of technology infrastructure" as either highest or second highest in importance. However, the local group identified "Lack of funding for infrastructure" as close in importance to "Lack of technology infrastructure," whereas the national group did not.

The patterning of similarities and differences in the two groups' importance rankings suggests that the following processes may be operating: Both groups highlight the lack of technology infrastructure as impeding Indian MFIs. However, the national-level group highlights lack of staff training as a major problem, while the local-level group highlights lack of funding for infrastructure as a major problem. While national-level practitioners have observed the increases in funding for MFIs over time, local-level practitioners have observed a more detailed earmarking in those increased funds. They realize that whereas increased funding has flowed into MFIs for the purpose of loan distribution, an adequate level of funding has not been made available for technology and infrastructure.

While neither group ranked "Lack of sharing of best practices" among the three biggest challenges, the national group assigned greater importance to this challenge especially according to median and modal importance ratings. This difference in perspective may reflect that whereas formal or informal sharing of best practices happens at the local level, national-level practitioners are not aware of this sharing. Alternatively, local-level microfinance administrators may be more narrowly focused on their local situation. If this were to be the case, local-level microfinance administrators would attribute less importance to the sharing of practices across institutions and hence perceive the lack of sharing as a subordinate challenge.

Conclusions and Implications of Results

The results of this study reveal underlying themes of problems with both poorly aligned incentives and poorly understood perspectives.

According to research subjects, the most important barriers to the expansion of microfinance are the need for regulatory reform as well as improvements in and funding of sector infrastructure. These challenges are collective, affecting the sector as a whole, as opposed to private challenges affecting the operations of individual MFIs such as the training of MFI staff and funding for loan disbursement. Microfinance practitioners can have a direct impact on private challenges, but each MFI has less incentive to tackle collective challenges because the resulting benefits are less immediate and spread across all MFIs. No single MFI has a strong incentive to bear the costs of creating solutions for these collective challenges.

Therefore, in order to find solutions more rapidly, these collective challenges must either be solved collectively or turned into private challenges. There is evidence that India's microfinance sector is in fact heading in this direction.

For example, a national network of Indian MFIs called Sa-Dhan was recently established to create a common discussion forum for institutions and to serve as the collective voice of microfinance administrators. One of Sa-Dhan's primary goals is to facilitate regulatory reform. In this way, Sa-Dhan is attempting to solve the collective problem of need for regulatory reform by gathering Indian MFIs for collective action.

Additionally, as commercial banks become involved in microfinance, the challenges related to the lack of technology infrastructure have become more of a private interest rather than a collective one. A bank providing bulk loans to MFIs for micro-loan disbursement affects a much greater portion of the microfinance sector than any single MFI. This involvement has the effect of consolidating the interest in technology infrastructure, transforming it from a collective challenge into a private one. Technology infrastructure affects the viability of the banks' investment in microfinance as a market segment. Therefore, because the lack of technology infrastructure is becoming more of a private challenge, new efforts are developing to tackle this problem. ICICI Bank is one bank in India particularly active in this area. One of the primary initiatives of ICICI Bank's Social Initiatives Group is to plan and develop a common technology platform for India's microfinance sector (Ruchismita interview).

Thus, there is evidence of efforts to solve these collective challenges of regulatory reform and sector infrastructure by both creating collective action and transforming a collective challenge into a private one.

While current efforts in the sector address the incentive problem, this still leaves the problem of poorly understood perspectives.

Sa-Dhan currently has 139 MFI members of various sizes, and thus would seemingly have a good understanding of the perspectives and needs of local-level MFI administrators. However, according to the findings of this study, especially regarding the discrepancies between responses from local- and national-level practitioners, organizations with a national-level perspective such as Sa-Dhan have the potential to misrepresent local administrators. While the inconsistencies in responses were not major, it is critical that national-level decision makers clearly understand the intricacies and limitations of the MFIs they represent.

Commercial banks are partnered with a much smaller number of MFIs and hence have an even less complete view of the perspectives and needs of local-level microfinance administrators. Banks such as ICICI Bank working towards developing technology infrastructures solutions must be wary of this limited understanding. Without explicitly taking into account the perspectives and needs of local-level administrators, banks are at risk of creating technology solutions that are not applicable or useful to their MFI partners. For example, as operational costs of practicing microfinance are already burdensome, it is critical to develop low-cost solutions. Furthermore, interview subjects revealed the limited training and capabilities of MFI staff as an important challenge. Thus, technologies should be developed with these limitations in mind; simple solutions that do not require much training to learn are essential.

Any microfinance sector faces challenges according to its stage of development. In India, the primary challenges are related to a need for regulatory reform and improved sector infrastructure. Further analysis of these challenges reveals problems around poorly aligned incentives. These are collective challenges that must be met either by collective action or by transforming the challenge into a private one. Initiatives led by Sa-Dhan and ICICI Bank show some promise in addressing this incentive problem. However, any solutions will not be successful if they do not also address the problem of poorly understood perspectives. These national-level parties working towards regulatory reform and improved sector infrastructure must very closely communicate with local-level microfinance administrators to fully understand their needs and perspectives in order to achieve successful solutions and the sustainable expansion of microfinance in India.

Appendix A

List of Interview Subjects

Local-level administrators

- P. Sai Gunarajan (interview) is a Manager at BASIX, an MFI operating in Andhra Pradesh. Mr. Gunarajan's primary focus is the insurance business at BASIX.
- Keerthi Kumar (interview and survey) is a Research Consultant for Spandana, an MFI operating in Andhra Pradesh.
- K. Loganathan (interview and survey) is the Chief Executive Officer of the Association for Sustainable Community Development, an MFI operating in Tamil Nadu.
- Rewa Misra (interview) is the Policy and Research Manager at CARE India, an MFI operating in New Delhi.
- George V. Mathew (survey) is the Senior Manager of Operations and Human Resources at Krishna Bhima Samruddhi Local Area

Bank (KBSLAB), an MFI operating in Andhra Pradesh.
• P. S. Mukherjee (interview and survey) is the founder and Secretary General of DISHA, an MFI operating in Pune.
• Reema Nanavaty (interview) is the Director for Economic and Rural Development at SEWA Bank, an MFI operating in Gujarat.
• Prem Cheand (interview) is the Secretary General at Krushi, an MFI operating in Andhra Pradesh.
• V. Chandar Rao (interview and survey) was a Manager at BASIX, an MFI operating in Andhra Pradesh.
• G. Shiva Nageswara Rao (interview and survey) is the Head of Planning at SHARE Microfin, Ltd., an MFI operating in Andhra Pradesh.
• D. Sattaiah (survey) is the Associate Vice President at BASIX, an MFI operating in Andhra Pradesh.
• Rashmi Singh (interview) is an Area Manager at SKS Microfinance, an MFI operating in Andhra Pradesh.
• Reeva Sood (interview) is the Secretary General at Indcare Trust, an MFI operating in New Delhi.
• Santosh Vaidya (interview) was a Manager at BASIX, an MFI operating in Andhra Pradesh.

National-level administrators

• Rituparno Bhattacharyya (interview) is Chief Executive Officer and Secretary General of AHAN, a non-governmental organization with research and funding efforts within the microfinance sector in India.
• Puneet Gupta (interview and survey) is a Manager in the Social Initiatives Group at ICICI Bank, a commercial bank operating throughout India that is most active in funding Indian MFIs.
• Niket Kamdar (interview and survey) is a Manager in the Technology Group at ICICI Bank, a commercial bank operating throughout India that is most active in funding Indian MFIs.
• Jaidev S. Lohchab (interview) is a Manager at CRISIL, a corporate ratings firm that serves MFIs in addition to commercial corporations.
• Raj Kamal Mukherjee (interview and survey) is a Manager at Sa-Dhan, the national network of MFIs in India.
• Berenice de Gama Rose (interview and survey) is a Manager in the Social Initiatives Group at ICICI Bank, a commercial bank operating throughout India that is most active in funding Indian MFIs.
• Rupalee Ruchismita (interview and survey) is a Manager in the Social Initiatives Group at ICICI Bank, a commercial bank operating throughout India that is most active in funding Indian MFIs.
• Ashish Kumar Sahu (interview and survey) is a Manager at Sa-Dhan, the national network of MFIs in India.
• M. Sarat (interview and survey) is a Manager at Sa-Dhan, the national network of MFIs in India.
• T. Raj Sekhar (interview) is a Manager at CRISIL, a corporate ratings firm that serves MFIs in addition to commercial corporations.
• Daksha Shah (interview and survey) is the Program Manager of Credit at Friends of Women's World Banking, an international organization with economic development and other social programs throughout the developing world.
• M. Sudhir (interview and survey) is a Manager at Sa-Dhan, the national network of MFIs in India.
• Niyatendra Tripathy (interview and survey) is a Chief Manger in the Technology Group at ICICI Bank, a commercial bank operating throughout India that is most active in funding Indian MFIs.

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Valerie graduated in December 2005, concurrently conferring her BA in Public Policy and her MA in Sociology. Within both degrees, Valerie concentrated on the study and practice of social entrepreneurship and business. While at Stanford, she has focused her academic research on microfinance through two independent research trips abroad, to Bolivia and Argentina during summer 2003 and to India during fall 2005. Valerie aspires to build entrepreneurial companies with a positive social impact, especially in areas of economic development.