Much still to do: microfinance and the long journey to financial inclusion in India

Oxford Policy Management
and EDA Rural Systems

Briefing Note

Introduction

After the fireworks of demonetisation in November 2016, the reality remains that most people in India still rely on cash and the informal economy for their survival. Risks to micro-entrepreneurs are high but so are potential rates of return to their investment, and economic prospects hinge on being able to mobilise and manage liquidity. *Jan Dhan* accounts, *Aadhaar* identity cards and Mobile money may promise 'JAM' tomorrow, but an immediate responsibility falls on India's less fashionable but huge cadre of credit-led microfinance institutions (MFIs) to raise their game by combining growth, a poverty focus and an improving quality of service.

Under the 'Poorest States Inclusive Growth (PSIG)' Programme, the UK Department for International Development is working with the Small Industry Development Bank of India (SIDBI) to promote responsible microfinance and financial inclusion in the under-developed states of Uttar Pradesh (UP), Bihar, Madhya Pradesh (MP) and Odisha in north-central India. This briefing paper draws on a mid-term study of this six-year programme (2012–2018) to review the ongoing efforts in promoting access to financial services and inclusive growth across India.

The paper provides a brief overview of recent sector trends and initiatives, starting with regulatory responses to the Andhra Pradesh (AP) crisis in 2010, taking in the demonetisation saga, and looking ahead to the establishment of a new class of small finance banks. It then reports on findings from a concurrent evaluation of the PSIG programme. This confirms that MFIs have been growing rapidly in the poorest states on the back of often high rates of return to micro-enterprise investment. However, by relying too heavily on a limited range of products that are relatively inflexible and not fully aligned with business cash flow requirements, MFIs undermine the value of their services for low-income households. We conclude that more can and should be done to foster product adaptation and to strengthen the micro-business appraisal skills of MFI staff alongside the financial capabilities of their clients. Digitising payment systems and encouraging savings are important aspirations for financial inclusion but should not distract from the potential returns on improvements in credit services too. Likewise, improvements in aggregate measures of financial access (such as the proportion of people who have bank accounts) are a weak and inadequate indicator of the *quality* of financial services, and hence the costs and benefits of actually using them.

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Context: Microfinance sector trends and initiatives

Demonetisation. *The wider political economy*

On 8 November 2016, the Prime Minster of India suddenly announced the demonetisation of ₹500 and 1,000 notes; in a highly cash-dependent economy, 86% of cash lost its value overnight. The announcement caused widespread disruption, affecting everyone, with crowds of people outside banks trying to deposit their old notes and withdraw the new notes (₹ 500 and ₹ 2,000) as they slowly began to be issued; crowds gathered too outside ATMs that were not yet calibrated to the new currency notes. Small businesses faced an immediate demand shock, and struggled to manage their cash flow; wage labourers went unpaid, and even lost work. MFIs were directly affected: unlike banks, they were not authorised to handle the old notes. How could their clients repay?

Leaving aside the short-term costs and the variety of objectives attributed to the move, in terms of financial inclusion, demonetisation was a jolt to spread formal banking further across the economy, targeting those piling up cash to avoid tax but also pushing more people to use bank accounts and cashless means of payment. By the end of May 2016, '99.99% of households' in the country had a Jan Dhan account, reflecting the ambitious target of the programme announced by the Prime Minister in August 2014 (Pradhan Mantri Jan Dhan Yojana: PMJDY). Jan Dhan accounts can be zero balance, without charge, and linked to life insurance, a credit card and a small overdraft facility (₹ 5,000; around $80) depending on the use of the account. One issue with the Jan Dhan accounts prior to demonetisation, however, had been their lack of use (see **Table 1**). Demonetisation led to more money passing through these accounts, and it seems that some poorer people were able to pocket a margin from those with excess cash to deposit – thereby, perhaps inadvertently, fulfilling the Prime Minister's election promise to divert black money into these accounts.

Table 1 Progress in PMJDY accounts

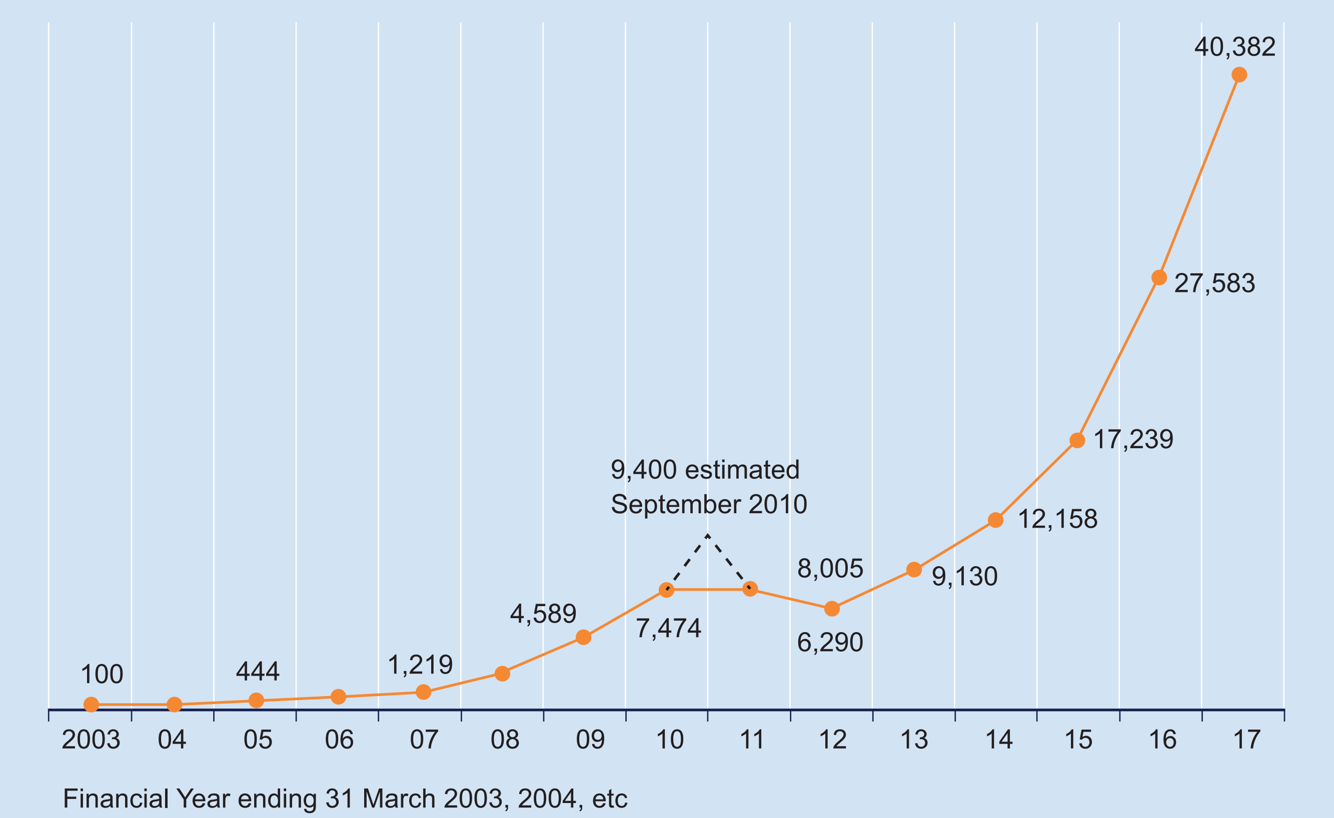
End Year	Number of accounts (millions)	Accounts with zero balance (%)	Avg deposit in active accounts (₹)
2014	104.48	73%	2,991
2015	198.38	32%	2,161
2016	262.02	24%	3,573

Source: https://www.pmjdy.gov.in/

Trends in MFI outreach: *Bouncing back dramatically from 2010*

Whilst the Government has been actively pushing for formal financial inclusion, it has tended not to look favourably on microfinance institutions (MFIs). The State Government ordinance against MFIs in Andhra Pradesh (AP) led to the crisis of 2010-12, which nearly brought the Indian sector to its knees. **Figure 1** shows the growth of the sector until 2010 and then a dip from a CRILEX index level estimated to be over 9,000 in September 2010 (days before the crisis) to 6,290 in March 2012 - after 18 months of decline that wiped out nearly a third of the sector's outreach. Since then, MFIs in India have resumed their dramatic expansion, growing over the next 5 years at a compounded rate of 45% per annum with the outstanding loan portfolio reaching a total of $10.7 billion, to 35 million households.

Figure 1 **Microfinance growth in India**
using CRILEX, M-CRIL's composite indicator of client outreach & portfolio growth

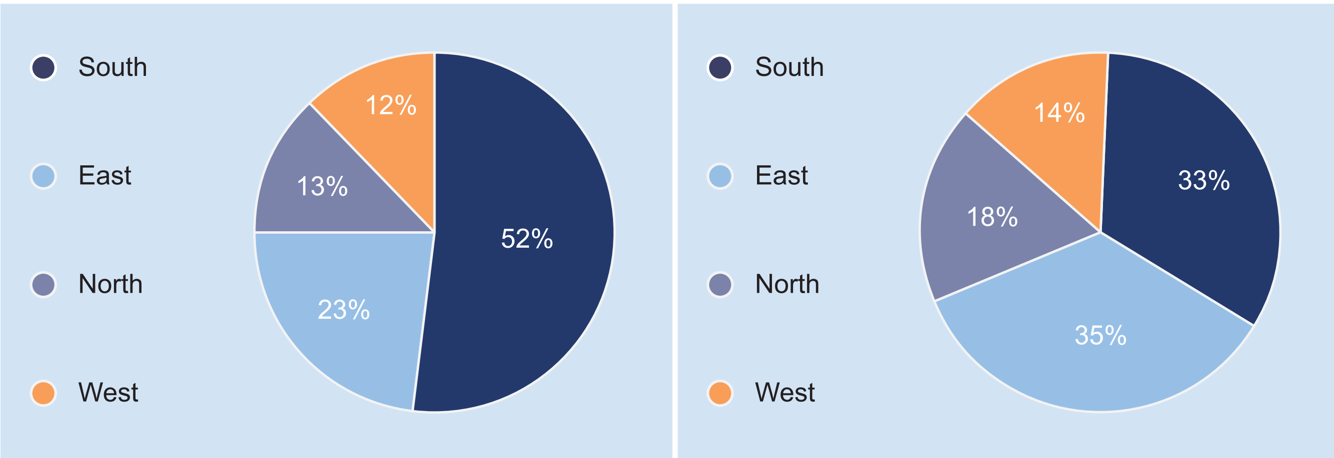


…with some of the empty spaces in the geographical landscape filling up

As is well known, the crisis in AP, then by far the largest state for microfinance, decimated MFI operations there, though the activity continued to flourish in other states in south India, especially in Karnataka and Tamil Nadu but also, latterly, in Kerala. As a result, the south still has 33% of the portfolio in 2016 (much diminished in relative importance from 52% in March 2011). But with the rise of Bandhan Bank it has been overtaken by the eastern region as shown by **Figures 2a & 2b**. In the poorer north and east, the pattern has now changed from the pre-eminence of West Bengal in March 2011 to substantially increased portfolios in UP and MP (in the north) and Bihar in the east. As a result, the north has significantly increased its share of total portfolio from 13% to 18% during 2011-16 and the west has also grown (especially Maharashtra). Significantly, the PSIG states that accounted for around a fifth of the portfolio in 2011 now have nearly one-third of the total. Another significant change in outreach, as estimated by industry watchers (in the absence of related data) is the change in market shares from rural (75% in 2011) to urban areas (around 60% in 2017).

Figure 2 **Regional Distribution of MFI Portfolio**

2a Gross Loan Portfolio, Mar 2011 = $4.8 bn | **2b Gross Loan Portfolio, Dec 2016 = $10.7 bn**



The tendency towards a regionally more balanced portfolio has been enabled partly by the growth of a handful of local MFIs in the previously under-served northern and eastern states, and - even more so - by the rapid multi-state expansion of larger MFIs. The largest 12 institutions account for some 90% of the total portfolio of just under $11 billion[1].

Apart from MFIs, some low income families in India access financial services from a range of other institutions. These include Self Help Groups (SHGs) for women, linked mainly to the public sector commercial banks, primary (village-level) agriculture cooperatives (mainly for men), and Regional Rural Banks (RRBs). Each of these sources, however, has faced significant challenges in recent years. RRBs are often at the forefront of the government-sponsored credit system for farmers and rural artisans, with the subsidies creating an institutionalised weakness in both their under-writing and their collection systems. The few well managed RRBs are unable to expand due to geographical limitations. All RRBs have now been turned into state-wide banks thereby diluting their intra-regional focus. Similarly, the cooperative system's endemic weaknesses due to government and political interference means that these continue to be part of the rural entitlement mechanism rather than a self-sustaining means of financial inclusion. Both RRBs and the cooperative system are dependent on periodic subsidy injections to offset capital erosion. Meanwhile, SHGs are limited in their services to intra-group deposits, small amounts of credit (average still around $100) and occasional micro-insurance outreach.

1. The West Bengal-based Bandhan (now a fully licensed commercial bank), Karnataka-based Janalakshmi, Ujjivan and Grameen Koota, the former SKS (now BFIL), Tamil Nadu-based Equitas, Delhi-based Satin and Kerala-based ESAF. Bandhan Bank alone, with its portfolio of $2.5 billion, accounts for around 25% of the overall portfolio in Indian microfinance. Janalakshmi (nearly $2 billion), BFIL ($1.5 billion) and Ujjivan ($1 billion) together dominate the industry along with Bandhan, although there are eight other banks with portfolios between $200 and 700 million as well.

However, MFIs may become a hostage to fortune

At the time of writing (in May 2017), MFIs have more or less successfully managed the defaults that immediately followed demonetisation, and picked up on lending. However, the environment has been vitiated by the announcement of a waiver in UP (the largest and politically most important state) of outstanding loans by banks to small farmers. There are similar calls for loan waivers in other large states like Maharashtra and Tamil Nadu. In practice, this has raised expectations among all small borrowers that their loans will be waived irrespective of the source of credit. The result is a weakening of the credit environment and a drastic decline in MFI portfolio quality, with reported MFI overdues of 10 to 30% in UP, and overdues of national-level MFIs rising from less than 1% to 6–8%[2].

▶ **Responsible microfinance, regulation and restructuring:** *Regulation was introduced under pressure*

For over 10 years, from the late 1990s until 2010, the Reserve Bank of India (RBI), the financial services regulator, resisted requests by the microfinance sector for regulation. This was largely due to the perception of microfinance as an unimportant component of the financial system – representing less than 1% of all financial assets. Then came the crisis, the dumping of around 6 million borrowers due to what amounted to a ban on the functioning of MFIs in AP, and the consequent loss of nearly $1 billion worth of financial assets by the banking system through its loans to MFIs (as almost the entire AP MFI portfolio became unrecoverable). The RBI finally realised that – if the AP ban was copied by other states – it was not simply under 1% of financial assets that was at stake but rather the lives and livelihoods of around 25% of low-income families in the country as a whole. Regulation was therefore rapidly introduced.

Briefly, microfinance regulation in India entails:

- All ‘for-profit’ microfinance companies being registered with and supervised by the RBI;
- A ban on offering deposit services in any form, including compulsory deposits; and
- Compliance with various other requirements including norms of management capacity, minimum capital, adequacy of capital relative to the risk profile and provisioning for bad debts.

Moreover, if MFIs want borrowings from commercial banks they must qualify for preferential (priority sector) status by ensuring that:

- At least 70% of their assets conform with the RBI’s definition of microfinance (currently, unsecured loans of less than ₹100,000 ($1,500) made solely for income generation to borrowers with family incomes less than IDR 160,000 ($2,500) per annum in urban areas or ₹100,000 in rural areas); and
- Interest rates comply with a 10% cap on the margin charged above their average wholesale borrowing rate from commercial banks, or the interest rate is no more than 2.75 times the average base rate of the five leading commercial banks. An additional loan processing fee equal to 1% of the disbursement amount is allowed.

As M-CRIL has argued elsewhere, the net effect of the margin cap requirement has been to create a stronger incentive to reduce operating expenses (as intended by the regulator) at the expense of the MFI’s relationship with clients (unintended)[3]. Essentially, with staff accounting for 55–60% of total expenses, MFIs realised that the best way to reduce operating expenses was to increase the number of borrowers served by MFI loan officers from an average caseload of around 230 in 2010 to over 400 today. The margin cap has also been an important factor in reorienting the focus of Indian microfinance from rural (more remote, low density)

2. The impact on the portfolio qualities of RRBs, cooperatives and SHG loans is not presently available but can be assumed to be much greater.

3. M-CRIL India Microfinance Review, 2014 www.m-cril.com/publications

to urban clients, thereby reducing the travel and supervision expenses incurred by MFIs. Loan officer caseloads in some urban areas are now of the order of 800. The net effect has been a speeding up of the loan under-writing and collection process, reducing the client interaction once regarded as an essential component of unsecured microfinance lending and now relying for maintaining credit quality solely on group collateral and the borrower's incentives to maintain his or her goodwill with the lender.

Apart from pricing, the other aspect of the client relationship of concern to the regulator is over-indebtedness, e.g. MFIs pushing borrowers to take loans from them despite existing debt with other lenders. The RBI has sought to address this by requiring registered MFIs to ensure they limit their lending to less than ₹100,000 ($1,500) and that no client receives loans from more than two MFIs. To ensure this, all registered MFIs are required to report to one of two credit bureaus and to obtain Know Your Customer (KYC) documents from borrowers to facilitate the credit bureaus' work. KYC has been greatly facilitated in recent years by the advent first of voter identity cards and, more recently, by the famous Aadhaar (the unique, biometric identity system). No MFI loan can be approved without a Credit Bureau enquiry about the client.

This has placed some restraint on over-indebtedness but there are nonetheless some gaps: there is no effective link with Credit Bureau information from banks, which has meant that there is often no cognisance of bank lending to their borrowers in the MFIs' under-writing process. Furthermore, cooperative, SHG and informal loans remain unaccounted for by any bureau and, therefore, also beyond consideration for under-writing purposes.

Though the current institutional churning could yet have a positive impact on responsible finance

Within the past two to three years, regulation has resulted in a new churning in the microfinance sector, resulting in other intended – and only partially intended – changes in the landscape accelerating the transition of MFIs into the fully regulated sector. First, apart from the transformation of Bandhan into a successful microfinance-oriented commercial bank, has been the introduction of innovative banking licences for 'small finance' banks (SFB). This is currently resulting in the transformation of eight of the largest MFIs, evenly distributed over the country, into banking-lite institutions able to offer deposit and some other banking services as well as credit in exchange for much stricter regulation than before. Six of these SFBs have now started operations. At the other end of the scale, the margin cap has forced some of the smaller for-profit MFIs, as well as not-for-profit MFIs, into seeking other business models. A number have switched fully to the role of business correspondents for commercial banks, originating and managing microfinance portfolios in the field with bank funding and earning a margin as a service charge. Others have simply been acquired by commercial banks that have seen the potential of microfinance clients as a precursor to larger business in the future and are therefore keen to expand their footprint among them[4].

As part of a more regulated financial landscape, this recent churn represents the positive change taking place in the Indian microfinance environment. With the establishment of three payment banks (and a few others, including a Postal Payments Bank, to follow) to facilitate the environment for payments and remittances, this churn could represent the revolution in microfinance services in the country that was the vision of some of the sector founders in the late 1990s and early 2000s. For the authors, the excitement is palpable; however, issues remain around access and quality for low-income households, and for women.

4. Among these are some well-known erstwhile MFIs, including Grama Vidiyal of Tamil Nadu, BSS of Karnataka and Swaadhaar of Mumbai. Even the former SKS, as the stock market-listed BFIL, is reported to be a target for a banking takeover.

2 Client-level findings from the PSIG mid-term research

Under the PSIG, UK Aid is supporting financial inclusion and women's empowerment in four states in northern India, through a number of channels and at different levels – policy, institutional and client. At policy level, the programme aims to engage with all financial sectors (including MFIs, SHG promoting institutions, RRBs and banking correspondents) and consciously aligns with government flagship financial inclusion schemes, including PMJDY, MUDRA and other schemes such as for pensions *(Atal Pension Yojana)* and loans to scheduled castes/ tribes and women *(Stand- Up India)*. Institutional funding with technical assistance is channelled primarily to MFIs, covering 29 MFIs and one apex partner for smaller MFIs, with a total outreach of nearly 8 million clients in the PSIG states. Equity investment has also been channelled to four MFIs under the Samridhi (social investing) fund of PSIG.

When PSIG began, in 2012, MFIs across the country were yet to recover from the loss of reputation – and bank funding – as a fall out of the AP crisis. PSIG funding – through SIDBI – helped to build sector resilience, with a focus on expansion in the underserved northern states, and linked to other initiatives for responsible practices (including a unified code of conduct, and use of Credit Bureau data). MFIs with different institutional models, from small, single state to large, multi-state, are supported. The programme aims to develop different financial products relevant to the poor, including credit, insurance, savings, pensions and financial literacy.

The evaluation of PSIG being conducted by Oxford Policy Management and EDA Rural Systems is concurrent, with baseline and midline phases completed, and the endline due to take place before December 2018[5]. The midline field work, on which this section is based, was completed in 2016 (before demonetisation), with a focus on in-depth qualitative investigations at household level.

Micro-credit and micro-enterprise returns

Microfinance in India still fundamentally means micro-credit, and micro-credit is primarily intended for economic investment. The aim is both developmental – to contribute to business opportunities for the client's household – and prudential, since business growth is expected to ensure repayment of the loan[6]. Our mid-term research was designed to investigate both these aspects:

- the *fit* of micro-credit (amount, timing, repayment options) to the financial needs of household businesses; and
- the *marginal returns to household businesses* relative to the cost of borrowing micro-credit.

Mixed results for different businesses on credit amount fit….

5. For the overall research approach, see https://beamexchange.org/evidence/evaluating-psig/
6. Of course, MFIs do now provide credit for other household needs and recognise that the instalments on these loans can be repaid from any household income source, including wages or remittances. In practice, loans may also be secured against cash flow from existing business activities, rather than cash flow generated out of new or expanded business activities. However, the main emphasis remains on credit for business investment – as stated in the RBI policy directive that non-bank finance company (NBFC) microfinance portfolios must be at least 70% for income generation / economic investment, with not more than 30% in other types of investment (such as housing or education).

How well do these credit terms fit the capital requirements and cash flows of the businesses that they finance? The responses from our sample are mixed, depending on the type and scale of the business.

Businesses financed by micro-credit range from ‘nano’ enterprises with total assets of less than $400 (such as, for example, tailoring, petty trade, snacks/tea stalls, small crafts, etc.) to micro and small enterprises with assets of at least $800 (such as garment businesses or beauty parlours) or $1,500 and more (scrap dealers, grocery shops, auto drivers, lease farming, etc.)[7]. Several types of business have fairly uniform requirements of capital with regular activities throughout all months of the year (e.g. snacks/tea stall, dairy, garment trade, driver/vehicle repairs), while other businesses have particular seasons of high demand – often linked to festivals or agricultural seasons, and also periods of low activity (two to four months) during the monsoon or other months when demand is low and there is a decrease in income. This applies to businesses such as food stalls, crafts-makers, builders and, of course, to the seasonal cycles of farming and allied businesses.

Given this variation in business characteristics, it is interesting that for around two-thirds of the businesses the amount of micro-credit obtained – albeit quite often from more than one MFI – was reported to suit the capital requirement. In just under one-third of businesses, however, the amount of micro-credit did not suit the capital requirement: it might not be enough (typically one MFI loan[8] is no longer enough to purchase a milch animal, or more is needed for a bulk purchase for trade), in which case the clients (or their husbands) turn to other sources, including moneylenders or suppliers; alternatively, the credit could be more than needed, and the ‘excess’ was used for other household purposes or even for savings or a form of insurance.

Mixed responses too on loan disbursement and repayment fit with cash flow

Was credit disbursed at the time it was needed? Just over half our sample said ‘yes’. For 44% of the sample, however, micro-credit disbursement had come a few months after they had planned to purchase additional stock or an asset.

Did the instalment frequency suit the cash flow of their business? Often, yes – particularly the monthly instalments, which many clients said they could easily plan for and if necessary adjust from different income sources. That said, some poorer clients, with daily sales, said they could manage small weekly instalments better, although not in the early weeks after loan disbursement. However, the requirement of regular repayment of equal instalments throughout the year emerged as a challenge. For businesses with seasonal lows – or closures – clients said that they either rely on regular inflows from other household businesses or employment or had to set aside their business earnings (or initial loan disbursement) for loan repayments; 10% said they have had to draw on group joint liability, but mentioned that the group cannot do this more than a few times, and sometimes other group members face difficulties at the same time. In eight cases (6.5% of the sample), clients had at different times had to borrow from a moneylender – at moneylender interest rates often 5% a month – to pay their MFI loan instalments.

So, the standard terms of micro-credit can disrupt financial management, which has a cost – in addition to the interest charged on the loan. MFIs in India typically charge declining interest in the range of 24% to 26%, with a processing fee of 1% of the loan. This is in line with the RBI guidelines. While the regulation thus allows for the additional costs

7. We applied the following classifications based on estimated assets (fixed and working capital):
Nano = < ₹ 20,000 (<$320), Nano+ = >₹ 20,000 – ₹ 50,000 ($320–800), Micro = >₹ 50,000 – ₹ 100,000 ($800–1,600), Micro+ = >₹ 100,000 – ₹ 300,000 ($1,600–4,800) and Small = >₹ 300,000 (>$4,800).
8. MFI loan amounts have historically been kept at the same level (₹ 10,000, ₹ 15,000, etc.) at different cycles, and have not kept pace with inflation.

that MFIs incur in micro-lending compared to banks, politicians and the public remain ambivalent about and indeed often suspicious of such rates and costs. This is lending to the poor after all… How can the poor afford this amount of interest, when the middle class pays less on their bank loans? To address this question, we looked more closely at the returns to investment in micro-financed businesses.

High returns to micro-financed businesses mean that credit cost is not the main issue

There is some evidence of high returns on investment (ROIs) in micro-enterprises from different parts of the world[9]. We wanted to explore ROIs for typical MFI clients in north India. In the PSIG midline interviews, we spent time with the person managing the business to go through the basic financial details – of fixed capital, current working capital, total expenditure and sales – to arrive at an estimate of annual profit, and the ROI in micro-financed businesses across the four northern Indian states[10].

The results are as varied as the type of business, but the pattern is clear. The minimum estimated ROIs are usually well above the rate of interest paid on an MFI loan: more than 100% in nearly all types of activity, averaging 200% and more (see Table 2 for an example of the calculations). The exceptions were in agriculture – in leased farming for grains and dairying (when the milking period was short), when the ROI was estimated at less than 30%. The exceptions also included nine micro-financed businesses (7% of the sample) that had closed.

Table 2 **Estimating the ROIs to a micro-financed business**
Example of a small grocery shop's annual balance sheet, income and expenses

Assets	Rupees	Liabilities	Rupees
Building/equipment (purchase value)	18,650		
Stocks	10,000		
Due from customers	1,000	Owned to suppliers	0
Cash in hand	400		
Total Assets	**30,050**	**Total Liabilities**	**-**
Income		**Expenses**	
Annual sales	3,24,800	Rent	0
		Tax/commissions	0
		Operating expenses (material, transport, electricity)	2,11,640
		Employees	0
		Loan repayments	27,900
		Depreciation (on own building /equipment)	1,250
Total Income	**3,24,800**	**Total Expenses**	**2,40,790**
Net profit	**84,010**		
ROI	**280%**		

Exchange rate taken as ₹63 = $1

9. See for example, Mackenzie, D. (2008) Returns to Capital in Microenterprises: New Experimental Evidence from Sri Lanka and Mexico, http://econ.worldbank.org/external/default/main?theSitePK=477894&contentMDK=21619823&menuPK=545573&pagePK=64168182&piPK=64168060

10. This was based on structured discussion, in the absence of written accounts of these businesses, or none that were shared. We did not include an estimate of self-employment earnings (or opportunity cost of time of family members involved in the business) as part of the expenditure since this would involve difficult assumptions about alternative employment opportunities. The business managers themselves involved in nano-/micro-enterprises seldom include their own/family time/earnings in expenditure.

The high ROI percentage is on a relatively low asset base, with estimated annual returns in the range of $1,100 to $4,000 for businesses that are the main household income source, or $380 to $1,500 for businesses that are a supplementary income source for the household[11].

Businesses run by women microfinance clients run at a smaller scale, and with lower returns, than businesses run by a husband or son

Our analysis looks at results separately for rural and urban areas (which show higher levels of assets and earnings in urban businesses, reflecting greater market opportunities). We also analysed the findings for women-managed businesses.

As the clients of MFIs, women are the borrowers in name. But they are not necessarily the primary decision-makers within their household (when it comes to how to use the loan, for example) nor are they always involved in the business for which the loan is used. In the midline interviews we explored in detail for the micro-financed businesses who it is in the family that actually takes the business decisions and manages the financial transactions (purchase of assets, sale of goods, etc.). We categorised businesses on this basis as 'woman-managed', 'jointly managed' or 'man-managed' according to what the woman client told us as well as evidence from the discussions about the business.

Woman-managed businesses are mostly home-based ('inside') activities that can be combined with domestic work, and often also involve women as customers; men in the household may assist in market linkages. Man-managed activities, where women are not involved at all, are service activities that are often located in an 'outside market' or require regular mobility. Jointly managed activities are usually home based (see below for examples).

Typical businesses that are…

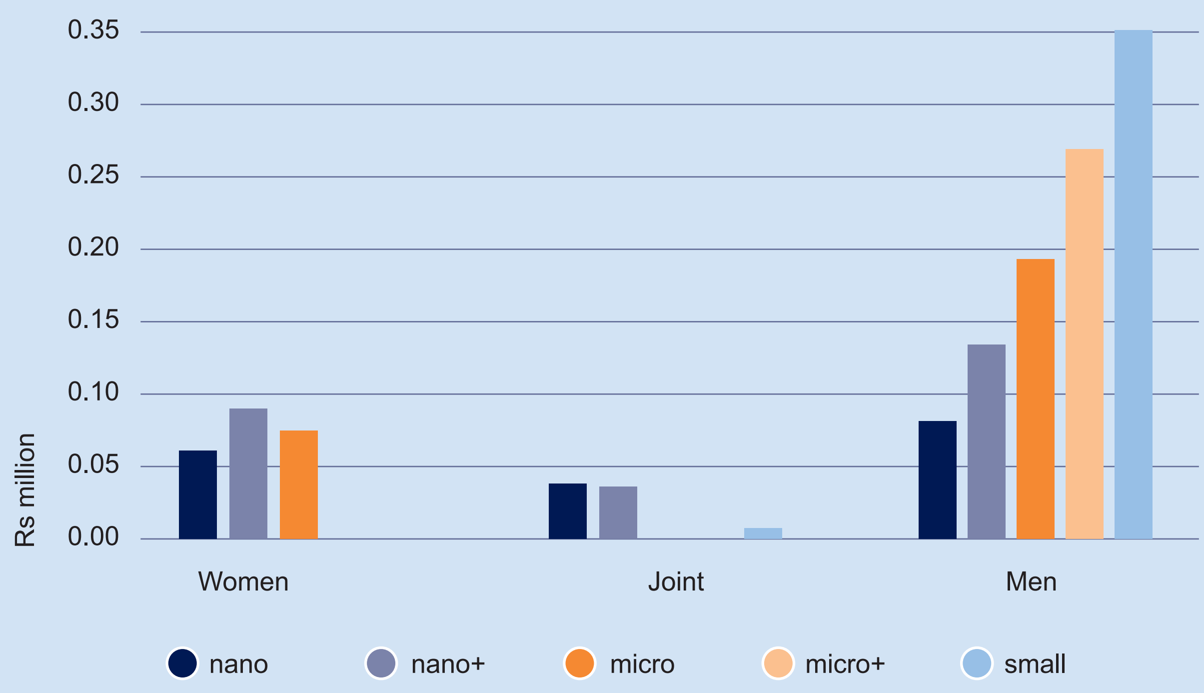
Women-managed	Jointly managed	Man-managed
Tailoring, beauty parlours, livestock/dairy, small trade	Snacks/tea stalls, grocery shops (especially if home based), dairy, agriculture	Building contractor, driver, carpenter, mechanic, barber, sign board or house painter

Overall, women are more likely to be business managers in urban businesses (41%) than in rural ones (25%). What is interesting is the pattern of lower capital and lower returns to women-managed businesses. Most of our women-managed businesses are 'nano' and 'nano+' and have similar levels of profitability, often providing a supplementary income source for the household. Men-managed businesses include nano and nano+ and larger businesses, with higher profits at the same scale as women-managed businesses, substantially increasing at the micro+ and small scale[12].

11. This compares with $1,430 per household/year as the estimated equivalent of the current international poverty line benchmark of $3.80 per person per day, at 2011 purchasing power parity. 50% of households in India are estimated to be living below this line (see Mark Schreiner, 2016, India 2011 Progress out of Poverty Index: Design memo. http://www.progressoutofpoverty.org/country/india

12. See footnote 6 for the asset categories.

Figure 3 **Estimated annual average profit of micro-financed businesses – by scale and business manager category**



Social/market limits to women's opportunities are reflected in the further finding that smaller first loans may be used for the woman client's business, but when the loan size has increased (to $500) this credit is often channelled into a husband or son's business.

Clearly, micro-credit is an input to the household: it is sometimes used by women clients to run their own businesses but market barriers and social norms continue to limit business opportunities for women.

Other financial services – access and quality

Clients of microfinance now increasingly have access to other parts of the wider financial ecosystem, with PMJDY reporting 'at least one bank account for every household' and banks using more agents – known as business correspondents (BCs) in India – to provide last-mile delivery of services.

The midline research was an opportunity to explore people's perceptions of the different financial services now on offer in the PSIG states. We conducted over 50 focus groups and key informant discussions in 13 villages and eight urban wards across the four northern states, interacting with women and men from different communities. The following is a summary of what they told us.

Bank account ownership is widespread…

Most households do now have bank accounts, as noted in Section 1. But it turns out that PMJDY is only a part of the story, which in fact started a decade ago under a previous government. For many years, payments under different government schemes (direct benefit transfers) have been linked to bank accounts. Nevertheless, people say that the very poor may still be excluded, due to lack of awareness and resources, as well as remoteness, with the

nearest bank branch often more than 10 km away, and BCs not active in these villages.
Mostly, households opened a PMJDY account in addition to an existing account, while some changed their existing accounts into a PMJDY account and very few have only a PMJDY account. So, this was not a clear case of the intended 'banking for the unbanked'. Many signed up for the PMJDY account hoping for substantial financial benefits being channelled into the account (including for the transfers of 'black money' promised by the Prime Minister during the 2014 election campaign).

People were mostly not aware that use of the account (at least once in the six months after opening) was a precondition of getting the advertised services (i.e. the insurance policy and the overdraft).

… but access has a cost

In reality, bank services may not be so low cost: opening an account is not difficult but it sometimes requires a 'commission' that goes to 'agents' outside the bank branch, to bank staff, even the bank manager – for assistance in filling the application form, opening the account or obtaining the passbook. People were aware of special bank credit schemes intended for low-income and scheduled caste households, but typical barriers remain in the form of paperwork, the costs of 'commission' and brokerage, as well as the collateral requirement. In nearly half the areas where we held discussions, people talked about the lack of helpfulness and the (sometimes) rude behaviour of bank staff, as well as the payment to brokers required to get anything done. Where bank staff are willing to help and to respond to questions directly, this was appreciated. ATMs are seen to be convenient, in both rural and urban areas, so long as cash is available, which is not always the case. Guidance in using the ATM – by bank staff or by the security guard – makes a difference.

Low-income households are interested in savings that are convenient and promise high returns. For many years, informal NBFCs or 'chit funds' have worked through local agents who canvassed their areas to enrol people in schemes to 'double their money in five years'. In four villages and two urban slums (i.e. six out of the total 22 study locations) men and women said that they signed on to save up to ₹ 500 ($8) a month. However, many of these schemes had turned out to be scams: the companies disappeared, there was no answer from the contact phone numbers in the pass books and these households lost substantial savings, which they are still asking about.

Micro-credit is still a significant resource

In this context – of formal financial services being not fully accessible or reliable, and prone to 'informal charges' and other transaction costs (such as travel to a branch/agent) – micro-credit is seen as important and valuable for poor and low-income households. There are no informal fees and collateral is not required; micro loans from MFIs are seen as an alternative to saving by the poor ('saving down' rather than 'saving up'), with small instalment repayments. SHGs offer internal savings and lending, access to larger bank loans, and mobilisation of women for group-based activities. However, SHG activity is variable – the groups are functioning in some areas but in others many SHGs are 'dormant' due in large part to a legacy of loan default under an earlier subsidised government scheme[13], as well as a continuing lack of clear rules for bank loan repayments.

Borrowing from more than one MFI enables flexibility for the customer

MFI credit appears to be more accessible and reliable, however, even if the loan terms are

13. Swarnajayanti Gram Swarozgar Yojna, the 'Golden Jubilee Rural Self-Employment Programme', which was launched in 1999.

relatively inflexible. Nevertheless, borrowing from more than one MFI in an area introduces a degree of flexibility. Given the relatively small amount of credit provided by an MFI, clients say they have borrowed from more than one when they needed more credit – for example, to support the capital needs of their businesses at different times (or for other purposes not stated in the loan application). Indeed, one MFI may provide a monthly repayment option and the other a fortnightly option, for example.

The presence of a number of MFIs catering to the same target market in an area is a matter of concern in the sector, due to the risk of clients borrowing beyond their capacity to repay, perhaps from one institution to repay another. The Credit Bureau check, limiting a borrower to two MFIs, is designed to address this risk. Clients are aware of the Credit Bureau checks and the reason for them but this does not stop women borrowing from more than two MFIs, since they say they can submit different KYC documents with different names to different MFIs (and other group members do not stop them). Their view is that, when MFIs only provide small loans, the issue is not the number of loans borrowed but rather client capacity to repay.

However, high-cost informal credit still fills a gap

In most of the areas we visited, rural and urban, informal moneylending continues to fill a gap. Despite their high costs (5–10% a month, which is much higher than MFIs), informal loans continue because they give credit at the time it is required in the amount needed and for any purpose. People repay such loans as soon as they can, to reduce the accumulation of interest[14]. If they cannot repay them quickly, then they are in trouble. It is a well- known principle of finance that it is the most expensive loan with the highest penalties that is repaid first. Resultantly, the subsidised government loan with negligible penalties is the least likely to be paid and, perhaps, therefore, the least likely to be productively deployed. Policy-makers need to consider the implications of this for promoting subsidies on credit as well as promoting choice for the consumers between the formal and informal sector.

14. The All India Debt and Investment Survey of 2014 reports incidence of moneylender debt in around 13% of rural households and 6% of urban households. The FinScope Consumer Survey of 2015 for the PSIG states reports similar levels. Given the fast turnarounds on moneylender loans, however, such figures may understate the role of informal moneylending.

3 Conclusions and Implications

Policy-makers face a big challenge in steering rapid but responsible expansion of financial services for low-income, excluded individuals and households. Some of these dilemmas are not dissimilar to those facing rapid scale-up of service delivery in education, health or water supply while simultaneously fostering innovation and improvements in service quality. The excitement about financial inclusion is also driven by users' perceptions of value added and therefore ability and willingness to pay for these services. This has demonstrated potential for sustainability of provision, and attracted private capital into the sector.

The field interviews and detailed analysis of borrowers' diverse business activities highlighted market fluctuations and seasonality, sometimes further complicated by emergencies and shocks to the informal household-level economic portfolios within which they are embedded. The most successful MFIs will be those that rise to the challenge of offering financial products better adapted to these conditions in terms of size of loan (too much or too little is not helpful), duration (over how long), predictability (e.g. working capital loan received in time to buy raw material available), and matching repayment amounts and frequency with cash flows (issues around seasonality of the returns). This assumes a much higher level of product flexibility, diversification and innovation, as well as client/business assessment, than is possible using conventional methodologies for very small loans, often delivered through the group mechanism. Achieving flexibility at scale is an immense challenge, and this explains why delivery on product innovation is such a lively area of discussion. The more flexibility MFIs want to offer to their clients, the greater they have to strengthen internal systems, tools and processes (including staff training and incentives, ability to segment different types of customer, IT/MIS, appraisal protocols, early identification and analysis of clients going off track and risk management).

MFIs need a much better understanding of their customers, that goes beyond the regulated minimum KYC requirements, because a better understanding of client opportunities and constraints can help shape and improve their product design and delivery. More flexible and larger individual loans may be appropriate. The application of data to develop models of cash flow for different types of livelihood is also relevant, along with including the real effects of women's or men's management of different businesses.

Interest rates charged to MFI customers often provoke strong reactions but what needs to be compared is total cost to the customer including not only what the different financial services providers directly charge but also the other direct and indirect costs customers incur to access the services. The latter include frequency of repeat visits, transport, time, documentation, 'informal fees', stress and possible losses from unpredictability. This research also confirms that most small businesses derive returns which are more than adequate to pay for financing costs.

For many households, credit helps them to seize and invest in economic opportunities (in assets, expanded businesses or to facilitate migration, for example). However, they equally need financial services to deal with external or internal shocks (such as lack of work or family illness) and smooth variable or seasonal incomes and expenditures. In the light of the limited financial services available, they adapt and sometimes opt for inefficient/more expensive solutions (e.g. borrowing instead of savings withdrawal or insurance pay-outs).

Finally, while a broader view of financial inclusion is important (including promoting savings and digitising payment systems), this should not distract from less novel aspects of microfinance, that nevertheless remain crucial to the experience of many clients. There will always be pressure to embrace new fads and fashions, but the potential pay-off to improving incrementally the availability and quality of proven micro-credit services too should not be neglected.

About the authors

OPM has partnered with EDA Rural Systems to conduct the concurrent evaluation of UKAID's PSIG programme in north India.

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