Financial Inclusion – Micro Credit – Risk Management

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"Overcoming poverty is not a gesture of charity. It is an act of justice. It is the protection of a fundamental human right, the right to dignity and a decent life. While poverty persists, there is no true freedom." Nelson Mandela.

"*Poverty is the worst form of violence*." - Mahatma Gandhi.

Bernanke: "Helping people better understand how to borrow and save wisely and how to build personal wealth is one of the best things we can do to improve the well-being of families and communities." (Shri Vijaya Bhaskar, 2013)

"India's poor are more prompt in repaying loans and deserve access to more financial services. The poor in India, he said, were ethical and not bad borrowers, and asked banks and financial institutions to make extra efforts to lend more to those in the bottom of the pyramid" Finance Minister Chidambaram (Mr.P.Chidambaram)

"Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of credit, many other services such as savings, insurance, money transfers, counseling, etc" (RBI, 2011)

"UN Secretary General Kofi Annan during the launch of the International Year of Micro Credit (2005), mentioned "sustainable access to microfinance helps alleviate poverty by generating income, creating jobs, allowing children to go to school, enabling families to obtain health care, and empowering people to make the choices that best serve their needs" (Mr.Anand Sinha DG, 2012)

"Microcredit programs have brought the vibrancy of the market economy to the poorest villages and people. This business approach has allowed millions to work their way out of poverty with dignity" (Wolfensohn, 1996).

"….why I felt credit should be accepted as a human right, and how credit could play a strategic role in removing hunger from the world" (Yunus)

ABSTRACT: *Financial inclusion could be an important instrument for alleviation of poverty. Financial Inclusion would result in economic growth and lead to balanced development. Financial inclusion broadens the resource base of the financial system by developing a culture of savings among large segment of rural population and plays its own role in the process of economic development. Policy transmission of the central bank could be most effective only when the entire financial system is under the organized sector. Financial Inclusion would ensure that vulnerable sections of the society are not exploited by the usurious money. Micro credit is an important aspect of financial inclusion and provision of which would lead to efficient allocation of capital and uplift the downtrodden from poverty. MFIs which are engaged in this onerous task have to guard themselves against risk undertaken. The micro credits disbursed by them are without collateral and hence the onus lies on them to adopt proper risk management methods. MFIs are dependent on bank finance who deal in 'public funds' and hence would be responsible/accountable to the financial regulator. Therefore, it is imperative that*

MFIs put in place proper risk management system.

KEY WORDS: Microfinance, risk management, financial inclusion, micro credit, self-help groups, joint liability group

Introduction: "Financial inclusion may be defined as the process of ensuring access to financial services and timely and adequate credit where needed by vulnerable groups such as weaker sections and low income groups at an affordable cost" (Dr.C.Rangarajan, 2008).

"Financial Inclusion, broadly defined, refers to universal access to a wide range of financial services at a reasonable cost. These include not only banking products but also other financial services such as insurance and equity products" (Rajan, 2009).

Micro Finance: "Micro finance, involving extension of small loans and other financial services to low income groups, is a very important economic conduit designed to facilitate financial inclusion and assist the poor to work their way out of poverty.

It has the potential to fill the critical gap left by formal financial institutions in providing financial services to low income groups. *Mainstream institutions shied away from providing financial services to the poor considering them unviable owing to high costs involved in reaching out to the unbanked/under banked areas where there is not enough scale of operations due to low numbers and low value of transactions*. Other reasons cited for such exclusion are, perceived high risk and inability of poor borrowers to provide physical collateral for raising loans" (Mr.Anand Sinha DG, 2012).

Microfinance is an economic development tool whose objective is to assist the poor to work their way out of poverty. It covers a range of services which include, in addition to the provision of **credit**, many other services such as **savings**, **insurance**, **money transfers**, **counseling**, etc.

Micro finance is looked upon as means of credit-based poverty alleviation and financial inclusion. The basic principles of micro finance credit delivery are small amounts of loan, lack of physical collateral and emphasis on social collateral/peer monitoring.
Micro Finance Institutions (MFIs) can be important delivery channels for credit and furthering financial inclusion in the country. With appropriate incentives they could be the required instrument of change in the financial inclusion agenda. Economic growth could be uniform in the economy only if there is financial inclusion. Underbanked and underserved sections of the society need access to finance. This would increase economic activity, particularly in the rural areas, and thereby reducing inequality. MFIs can promote inclusive growth.

Micro Credit: While Microfinance is broad term which includes providing credit and also delivery of financial services like thrift, insurance, pension, money transfer etc, micro credit is narrow and deals with provision of low value credit to the underserved or vulnerable section of the society.

In the Second Quarter Review of Monetary Policy in November 2010, a Sub-Committee of the Central Board of the Reserve Bank (Chairman: Shri Y. H. Malegam) was constituted to study issues and concerns in the MFI sector. The Committee submitted its report in January 2011. In the Monetary Policy Statement 2011-12, it was announced that the broad framework of regulations recommended by the Committee has been accepted by the RBI. The financial sector regulator in its

circular issued on December 02, 2011 stated “It has been decided to create a separate category of NBFCs viz; Non Banking Financial Company-Micro Finance Institution(NBFC-MFI)”. This was the turning point in the MFI sector and microfinance was recognized as a sector and leading to a new asset class.

RBI defines micro credit (qualifying asset) and the principle among them are i.“loan disbursed by an NBFC-MFI to a borrower with a rural household annual income not exceeding Rs. 60,000 or urban and semi-urban household income not exceeding Rs. 1,20,000; ii. loan amount does not exceed Rs. 35,000 in the first cycle and Rs. 50,000 in subsequent cycles; iii. total indebtedness of the borrower does not exceed Rs. 50,000.

In other words, a credit can be classified as ‘micro credit’ if the quantum does not exceed Rs.50,000/- at a given point of time. The basic features of micro-credit is: a) The borrowers are from low-income groups b) The loans are for small amounts c) The loans are **without collateral** d) The loans are taken for income-generating activities or even for consumption, housing and other purposes e) The tenure of the loans is short f) The frequency of repayment of loans is high.

MFIs generally extend credit facilities in three ways. These are Self–Help Group (SGH), Joint Liability Group (JLG) or directly to individuals.

Self–Help Group (SGH): SGH’s are generally promoted by non-governmental organizations (NGOs). SGH is more popular in rural areas usually comprises 10–20 local women or men. It typically comprises a group of micro entrepreneurs voluntarily coming together to save regular small sums of money. They agree to contribute regularly to a common pool to meet their emergency needs on the basis of mutual help. They pool their resources to become financially stable and obtain loans from the money pooled by that group and by making everybody in that group self-employed. The group has a homogeneous social and economic back ground. Members are also imparted skill sets to which they are suited to enable them to become micro-entrepreneurs and self-employed. The NGO also impart training to maintain proper books of accounts. Use of collective wisdom and peer pressure ensure proper end-use of credit and timely repayment. This system eliminates the need for collateral.

Joint Liability Group (JLG)/Social collateral: In this method the borrowers make a group among themselves and the lender gives loan to that group. JLG is a lending model to enable group of individuals (usually five) to take a group loan wherein the responsibility of loan repayment is on all members. If any one person in the group defaults then the other group members will have to pay for that debt. In a JLG each individual is at liberty to use his credit best suited to him. There is no formal training in skill development or maintenance of accounts, hand holding etc which are prevalent in a SHG. Coming from the same neighbourhood, they know each other well enough to understand the cash flows and requirements of households, and have insight into the ability and willingness of the members to repay. Most low-income households have no collateral to provide. The model effectively replaces physical collateral with social collateral.

Direct Lending: This method is similar to the traditional lending wherein the borrower approaches the MFI directly to obtain a credit facility. Under this method since there is no guarantor like JLG and the borrower is not introduced by an NGO nor has the advantage of the being directed by the collective wisdom of the SHG the lender usually insists on collateral. However, non-collateral loans are also not uncommon, particularly in respect of

NBFC-MFIs where in RBI has mandated that "loan to be extended without collateral". (RBI circular dated December 02, 2011)

Micro Credit and Risk Management: Risks faced by any micro credit institution can be broadly classified as **Systematic risk, unsystematic risk and idiosyncratic risk.**

Systematic risk - The risk inherent in the market. These are non-diversifiable risk and affect the overall market. This type of risk is both unpredictable and impossible to completely avoid. It cannot be mitigated through diversification and can be managed only through hedging or by using the right asset allocation strategy.

Unsystematic Risk/ Idiosyncratic Risk – Company **-** or industry-specific hazard that is inherent in each investment. Unsystematic risk, also known as specific risk can be reduced through diversification. By holding securities such as Government bonds, highly rated securities investors will be less affected by an event or decision that has a strong impact on one company, industry or investment type.

E.g the risk that coal mining workers will go on strike and consequently coal company stock prices will be affected. This risk primarily affects the coal industry and the companies with whom the coal companies transact business. It does not affect the entire market system, so it is an unsystematic risk.

By diversifying the portfolio holdings like fast moving consumer goods, hospitality etc the portfolio would face less unsystematic risk.

Risk that is specific to an asset or a small group of assets is known as idiosyncratic risk. Idiosyncratic risk has no correlation with market risk, and can, therefore, be substantially mitigated or eliminated from a portfolio by using adequate diversification. Examples of risk that might be specific to individual companies or industries are business risk, credit risk, legal risk, liquidity risk, operational risk etc.

As it is known that MFI loans are non-collateralized (does not have security) and hence carry high risk it is essential that MFIs take adequate measures to identify, measure and control the risk adequately. MFIs are mostly dependent on commercial banks for raising debt for on-ward lending purpose. Banks would be comfortable to extend the 'public funds' mobilized by them to MFIs if the MFIs could provide necessary comfort to the lending institutions by ensuring proper risk management system at their end. It would be useful to understand how MFIs would put in place appropriate risk management.

Non-collateralized loans to individuals: With regard to JLG lending the lender could ensure that the JLG consists of individuals who have different income streams like a fisherman, tailor, flower vendor, construction worker, cobbler etc. The assumption is that the JLG will not fail as the probability of individuals with five different income streams defaulting is remote.

Credit Score: "A credit score is a numerical representation of the customer's credit profile and also predicts the probability of a customer going delinquent in the next 12 months. While retail customers of banks and NBFCs have been scored for some time now, the concept of a credit bureau is relatively new for the MFI sector. It provides predictive power along with credit attributes in a credit report of a customer. Both MFIs and their customers will benefit from a credit score. It would provide MFIs a better understanding of their customers' credit profile as well as a

predictive insight into customer behaviour. This will help them target their products and services more efficiently. As for customers, credit scores will help differentiate themselves based on their credit behaviour. It will enable them have gain broader access to products in this segment and possibly even credit at lower rates." (Srivats).

Credit scores are of recent origin in the country and are increasingly being used by MFIs to predict delinquency of the borrowers.

Credit Bureau:RBI mandates "it is reiterated that every NBFC-MFI has to be a member of at least one Credit Information Company (CIC), provide timely and accurate data to the CICs and use the data available with them to ensure compliance with the conditions regarding membership of SHG/ JLG, level of indebtedness and sources of borrowing" (Circular, 2014). Hence becoming a member of atleast one credit information bureau to obtain information of the borrowers before sanction of credit facility is a sine-qua-non from risk management point of view. Further RBI adds, "while the quality and coverage of data with CICs will take some time to become robust, the NBFC-MFIs may rely on self certification from the borrowers and their own local enquiries on these aspects as well as the annual household income". It is, therefore, mandatory on the part of NBFC-MFIs to obtain and take on record the required information to avoid credit delinquency on the part of the borrowers.

Local Feel and Local touch: MFIs are local institutions. In local institutions "the centre of decision making is close to the loan officer—he can get approval directly from the manager without the documentation, delays, and loss of information that would be incurred if he had to get approval from head office" (Rajan, 2009)

Experiences in US, Europe, the Philippines, and other countries in the creation of small and local financial institutions are a case in point. These institutions should be 'local' because someone who is part of the locality has much better information on who is creditworthy than someone who is either posted temporarily from a city, or someone who takes the bus everyday from the nearest town" (Rajan, 2009) .

Hence MFIs best strategy for risk management could be to gather information on who is creditworthy and who is not. As the staff recruited is also local they would know the pulse of the local area and hence should leverage on the information and local strength. This would enable them to ensure better recovery rates and low delinquency.

Micro and Small Enterprises (MSE) Loan: As MFIs also offer MSE loans they need to adopt proper financing methods in this regard. "High quality origination can help evaluate idiosyncratic risks well. A high quality local originator with geography and business specific information about such enterprises in the operational area will be able to evaluate and manage this risk well and will demand lesser traditional equity to be brought in by entrepreneurs. No amount of traditional equity is sufficient when the financier is uncertain about an enterprise selling anything at all in an environment where demand patterns and economic situations can change very quickly. A financier searches for cues to establish that the business has a current and future ability to service loans, even in an uncertain business environment. For small enterprises that have large number of cash transactions, poor record of sales, produce undifferentiated goods and lack known clients, assessment of systemic risk becomes very difficult. Such challenges can

be addressed through structures that allow financiers to trap cash flows, or by resorting to a stronger and well established sales pattern in a supply chain.

Supply-chain financing, where a supplier and a buyer with known balance sheets can be financed. For example, small enterprises that manufacture and supply jam to large players can be financed if their cash flows are trapped through bills, or by obtaining a collateral/guarantee/comfort letter from the company to which it supplies.

Obtaining the services of a local intermediary who can verify cash flows and income of the enterprise and finance them through relationship-based approach is another option.

Business-specific templates can be developed for each small enterprise. Innovation in product structuring is as important in addressing gaps in small enterprise financing. Innovative products such as equipment lease finance can help address the need for term debt, and products such as receivable financing, bills discounting and factoring could substitute requirements of working capital finance, addressing the unique needs of small enterprises" (Arun Kumar D)

Hence as far as MSE loans are concerned the financiers should be able to trap cash flows of the borrowers effectively. For this the MFIs local knowledge of the borrower's business, borrower's suppliers and to those whom the borrowers supply would be of great value. Business-specific templates, lease financing, bills discounting etc would also mitigate risk to a great extent.

Securitization: "Securitisation involves pooling of homogeneous assets and the subsequent sale of the cash flows from these asset pools to investors. The securitisation market is primarily intended to **redistribute the credit risk away from the originators to a wide spectrum of investors who can bear the risk**, **thus aiding financial stability and provide an additional source of funding"**(RBI Circular May 7, 2012).

RBI further mandates "Originators should retain a portion of each securitisation originated, as a mechanism to better align incentives and ensure more effective screening of loans. In addition, a minimum period of retention of loans prior to securitisation is also considered desirable, to give comfort to the investors regarding the due diligence exercised by the originators. Keeping in view the above objectives and the international work on these accounts, guidelines have been formulated regarding the Minimum Holding Period (MHP) and Minimum Retention Requirement (MRR)" (Circular, DBOD.No.BP.BC-103/21.04.177/2011-12 dated May 07, 2012).

"In a single-originator securitisation, microloans originated by a single MFI are pooled into an Special Purpose Vehicle. IFMR Trust Pioneer-II was the first rated single-originator microfinance transaction in India to be placed with capital market investors" (Blog).

Hence securitization of standard assets by NBFC-MFIs is an effective way of managing the risk to which MFIs are exposed. Securitisation would redistribute the credit risk from the MFIs to investors like large financial institutions who can bear the risk. With 'the skin in the game' concept introduced by RBI whereby the originating MFI would hold a minimum of 5 per cent and a maximum of 10 per cent and also hold the originating credit risk for a minimum period of three months would not only ensure better origination and risk management by NBFC-MFIs but also contribute to the developing an orderly and healthy securitisation market.

Multi originator securitisation in microfinance: "A securitised pool must have a minimum critical size in order to make these transactions financially viable. Given this constraint only large MFIs can access capital via the securitisation route. Smaller MFIs often find it difficult to provide a sufficiently large portfolio for a single originator securitisation transaction. The IFMR Capital's multi-originator securitisation allows small and medium sized MFIs to combine their microloan portfolios in a single pool to achieve the required critical size. Pooling loans across originators and geographies results in a well-diversified portfolio; this provides an attractive risk-return trade-off to the investor" (IFMR)

Therefore, securitization of microfinance loan portfolio **-** single originator as well as multi**-** originator transactions could be effectively used for risk management purpose by the MFIs.

Portfolio at Risk (PAR 30): One of the most important tools used to assess a Microfinance Institution's (MFI's) asset quality is Portfolio at Risk or PAR. It is a percentage (%), which represents the "proportion of an MFI's total gross outstanding loan portfolio that is at default risk."

The Formula for PAR is:

Sum of Unpaid Principal Balance of All Loans with Payments Past Due/Total Gross Outstanding Loan

(1 to 365 Days and more)

Portfolio (Sum of Principal

Outstanding of

All Loans)

PAR has desirable standards. Generally speaking, sustainable institutions have a PAR <= 2%. However, apart from absolute % values, two other factors are important while using PAR: **trends**, in terms of ***decreasing/increasing values*** as compared to the last (reference) period, as well as the **aged values** of PAR.

As far as trends for PAR is concerned, a decreasing Portfolio at Risk is positive.

Conclusion:

MFIs are localized institutions and do not undertake investment banking or trading. They are not dependent on bulk funding and money market. They have no exposure to forex markets. As a consequence the risk of contagion which is caused in an economy through the 'financial channel' or 'trade channel' does not affect the MFIs. The financial crises - internal or global- do not affect the MFIs. Hence, to this extent these institutions would be able to provide the regulatory comfort and would also contribute towards financial stability.

Financial inclusion broadens the resource base of the financial system by developing a culture of savings among large segment of population and has an important role in the process of economic development. Financial inclusion would lead to proper distribution of wealth and also result in balanced regional development. Financial inclusion is a poverty alleviation tool in the hands of the central bank and State. Financial inclusion would also enable proper policy transmission of the central bank and State and would ensure that vulnerable sections of the society are not exploited by the usurious money lenders.

Micro credit is an important vehicle for financial inclusion and provision of which would lead to efficient allocation of capital and uplift the downtrodden from poverty. MFIs which are engaged in this onerous task have to guard themselves against risk undertaken. The micro credits disbursed by them are without collateral and hence the onus lies on them to adopt proper risk

management methods by which they could safeguard themselves. Since MFIs are dependent on bank finance who deal in 'public funds' and hence would be responsible/accountable to the financial regulator. Therefore, MFIs need to put in place proper risk management system in place.

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