Innovative Approaches to Developmental Microfinance in India

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Executive Summary

Though microfinance in India has grown phenomenally in the last decade, there has been a problem with increasing the geographical reach and impact of the same. The reasons for less reach are multifold but primarily, lack of continuous capital and little state & regulatory support to the sector. To address the problem of capital, the first part of this study focuses on which funding source suits the industry the most given its mission to alleviate poverty, in order to create commercially sound and sustainable organizations. Here, the case of LOK capital, New Delhi, India, which invests solely in the microfinance sector, is discussed using both primary and secondary research. The second part of this study focuses on increasing the impact which microfinance can create on the lives of the poor, by innovatively using the channel of microfinance to provide increased access to education to the poor. Here, the case of Indus Academy chain of schools, an innovative tie up between a microfinance institution and education service provider, is discussed using both primary and secondary research methods. Empowerment through education will be a key in any efforts to improve the quality of rural life and the welfare of the next generation in developing countries.

Last part of this study focuses on the way ahead for the microfinance sector which demands a host of policy and regulatory changes on the part of the government. The state governments need to clearly define the role of microfinance as supplementary channels in providing financial services to the underserved population in India.

Also, since microfinance has a vast distribution channel, it can be increasingly used to provide allied services such as education and healthcare, the former has been covered in depth in this study.

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Chapter 1 Introduction

Poverty in the 21st Century: An Enduring Dilemma

Currently, India is home to one-third of the world's poor: 456 million people, roughly 42 percent of the country's population, live below US $1.25 per day (World Bank, 2005). The number of India's population living in poverty (with incomes of $1.25 per day or less in 2005 PPP) has increased in recent years, from 421 million in 1981 to 456 million in 2005.[1]

MFIs are specialized financial entities that offer very small amounts of business credit to the financially excluded[2]. Since MFIs offer a new approach to alleviating poverty, their importance is growing. In fact, their growth has been nothing short of spectacular. At the end of 1997, MFIs had 13.5 million clients. As of December 31, 2007, 3,552 microcredit institutions reported reaching 155 mn clients, 106 mn of whom were among the poorest when they took their first loan[3]. Of these poorest clients, 83.4 percent are women. The United Nations declared 2005 the International Year of Microcredit. In addition, the Nobel Peace Prize for 2006 was awarded to Muhammad Yunus, microfinance pioneer and Founder of the Grameen Bank.

The broader shift toward the profit model began in the nineties, when Acción International, a network of Latin-American institutions, concluded that commercialization was the only way microfinance could serve large numbers of people, because commercial enterprises could tap the capital markets for the funds they needed to grow.

The idea of reaching billions of the poor by achieving "scale"—a word invoked ceaselessly in the microfinance community—has enticed foundations, rich individuals, even investors into channelling millions into microfinance. The $1.2-billion Michael and Susan Dell Foundation—

[1] Although the percent of India's population living below the poverty line has decreased from 60 percent in 1981 to 42 percent in 2005 (The World Bank, 2007).

[2] See Bhatt (1997)

[3] Daley-Harris 2009 Microcredit Summit Campaign

established by the founder of one of the world's largest computer manufacturers—has begun making grants to microfinance institutions in India, a country of 1.1 billion people, most of whom have no access to financial services. In October, 2005, Google established a philanthropic entity called Google.org, with seed money of about a billion dollars, to fight disease, global warming, and poverty; microfinance is expected to be a key component of its poverty portfolio. And last April the Bill and Melinda Gates Foundation announced that it would devote an undisclosed amount of money to expanding financial services for the poor in developing countries[4].

This conflict, between pure do-gooders and profit-minded do-gooders, has come to define the current debate in the microfinance world.

[4] See Connie Bruck Millions for Millions The New Yorker 2006

Fortune at the Bottom of the Pyramid

The Indian population (over 1.1 billion) spread in rural & urban centers, is served by[5]

- 50,000 commercial bank branches
- 12,000 co-operative bank offices
- 15,000 regional rural bank branches (RRBs)
- 100,000 primary agriculture credit societies (PACS)

As per the study undertaken by LOK capital, New Delhi, India, despite this high branch density, the infrastructure has not been able to deliver financial services to low income households due to:

- High fixed & operating costs resulting in high delivery cost
- Lack of sales incentives in cooperatives and regional rural banks
- Lack of products suited to the rural poor
- Lack of formal employment/ steady income and absence of collateral makes them unsuitable for a banking product (at times because of regulatory constraints)
- Illiteracy in general & the lack of financial knowledge
- Lack of accessibility & reach of the traditional bank branches – Long distance and high cost of visiting a bank is a prohibiting factor, as it leads to loss of daily wage for a borrower
- Absence of private sector banks – operating model not feasible

"Due to these hurdles", says Tyler, an associate with LOK capital, New Delhi, India, "India has over 150mn households which lack access to formal financial services". Here's where Microfinance Institutions and the Self Help Groups play an important part. India's Microfinance institutions reached 76.6 million against last year's 59 million, according to the "State of the Sector Report" released as part of the annual Microfinance India Summit 2009. At present, the microfinance industry is hugely concentrated in the southern region of India, which has been a host to a huge Self Help Group (SHG) network since many years. The successive governments in

[5] http://www.lokcapital.com/market-opportunity.html

the states like Andhra Pradesh have played a major role in promoting microfinance in a big way as instruments of poverty alleviation and empowerment. The state government had also undertaken a massive SHG formation drive under the World Bank-supported poverty alleviation program called Velugu. The rise of SHGs and more formal SHG Federations coupled now with SHG Bank Linkage have made SHG a dominant form of microfinance in addition to microfinance institutions (Reddy & Manak, 2005).

Though the business model of MFI's and SHG's have proven effective in alleviating millions of poor people out of poverty in India, yet only some states have developed these further than others. This need gap provides a huge opportunity to all the stakeholders of microfinance namely poor people, investors, government and the society at large.

Problem Statement and Research Objectives

Limitation of Reach

Microfinance has been doing great work in adding to the income generating capacity of the poor. In doing so, it has dramatically improved the local economies of developing countries and has provided dignity and self respect to the poor. Though the demand in India for the financial services through the microfinance route is of 150 mn people, presently only 90mn are being served. To increase the reach, it is mandatory to attract more capital to this industry.

Funding and capitalization strategies take place within the context of a sector transforming from one driven primarily by a social mission ethos to one that also responds to the needs and interests of private capital. The transition to private capital is well underway and some MFIs are mostly or entirely funded by private capital. But the transition has been slow and difficult as many MFIs lack the management capacity to attract and absorb private capital. To make the transition to private capital, MFIs will have to play by a new set of rules - those of the private sector. These rules are numerous, but all revolve around profit making, an objective that has not entirely entered the poverty focused lexicon of microfinance. Achieving funding goals also require *structured, professional funding strategies*. Some MFIs have such strategies, unfortunately most rely on rather informal and *ad hoc* approaches to funding. As MFIs grow, adopting professional strategies becomes all the more important, because growth is heavily contingent upon access to funding, which is increasingly only available from the private sector. In the absence of a clearly defined funding strategy, MFIs typically drift toward the sources they know best, which are often non-commercial in nature.

Limitation of Impact

In order for micro finance to cause a greater impact on the lives of the poor in developing nations, it is essential to not only give them access to financial services but also a chance to empower themselves through education under a regulatory environment. This will also help alleviate fears of '*Mission Drift*' by the proponents of not-for-profit enterprises[6]. If you give the poor a loan and don't see that their other needs are met, perhaps they are worse off. They have a debt to repay, but still they have no sanitation, no health care, and no education.

[6] World Bank Microfinance Meets the market 2008

Significance of the study – Innovative approaches to developmental microfinance

This research aims to study how the above two limitations of microfinance at present could be addressed.

Firstly, I agree that though profit seeking private investment is important, alignment of the philosophy of investors with the social mission of an MFI is equally important for the promoters and founders of MFI. Here, we study the case of *LOK* capital of India, a private equity organization dedicated to investment solely in the microfinance space, which acts as a catalyst to create socially responsible but commercially viable microfinance institutions. In addition to the capital requirements, *LOK* capital also provides other things like best practice knowledge, stronger sector associations, etc. to the partnering MFI's.

Secondly, the case of Indus Academy chain of schools in the Andhra Pradesh state of India is discussed. Indus Academy is a tie up between SKS Microfinance, Andhra Pradesh, India (one of the biggest MFI's in India) and Career Launcher (Asia's leading education service provider with presence in over 130 locations across India, Middle East and the United States). The primary education in India is afflicted with problems of lack of quality, reach and facility of education loans for poorer households. Indus Academy provides an innovative way to address some of these in an efficient manner.

Organization of the study

This study is divided into two seemingly distinct areas both of which innovatively contribute towards comprehensive developmental strategies for microfinance – in terms of reach and impact.

The first chapter emphasizes the state of poverty in India and the role played by microfinance in adding to the income generation capacity of the poor. Here, the problem statement of the study and significance of this study in the research area are mentioned.

The second chapter reviews the related literature to provide an expanded understanding of the subject area. The research methodology is divided into two parts, both involving a case based approach. Part-I talks about increasing the reach of microfinance through socially responsible private equity investments in the sector using the example of *LOK* capital, New Delhi, India. Part-II talks about using the channel of microfinance to provide for allied underserved services like education using the example of SKS Microfinance, AP, India.

The third chapter lists the various methods of researches used and why the particular type of research was used for the purpose of this study.

The fourth chapter carries an in-depth study of the two cases of LOK capital and Indus Academy of India. Primary research, in terms of the discussions with the founders and people working in these organizations, has been used along with the secondary research done for both the areas.

The fifth chapter summarizes the research based on the findings of the two cases. Here, the limitation of the current research and the scope for further research is stated. Based on the study, some policy recommendations for the different stakeholders of the microfinance industry have been recorded.

Chapter 2 Literature Review - Towards Comprehensive Development Strategies

The literature review is divided in two parts. The first part discusses the relevant literature on the importance of private capital for the microfinance industry in India. The second part discusses the available literature on current state of education in India and the importance of microcredit in education.

Need for private sources of funding – Increasing the reach of microfinance

Why have we not been able to enlist the power of microfinance to reach more poor families? And beyond that, what can we do to remove those whys, and shatter those barriers. Vikram Akula of SKS Microfinance attributes this question to three primary reasons[7]:

1) Lack of access to capital
2) Lack of capacity to build scalable models
3) Prohibitive costs of widespread operation

To combat these opportunities, Vikram proposed three ideas he believes are imperative. Respectively, they are:
1) Profit model to access commercial capital
2) Learn from scalable business models that have been successful (think Starbucks, McDonalds, Coke)
3) Use technology to automate manual processes to dramatically lower transaction cost

Microfinance is not only serving a significant proportion of credit worthy urban poor but also the rural poor in many developing countries. At present, majority of the funding to the microfinance

[7] http://www.socialearth.org/microfinance-20-conference-day-1-vikram-akula-on-the-wins-opportunities-future-of-microfinance

sector is in the form of domestic and international debt and savings. Very little is in the form of equity and even little comes from developmental agencies. Microfinance industry is not much regulated which also hampers its market credibility to raise more debt. All this puts limitations on the capital available for capacity additions and growth investments since retained earnings are also used mostly for portfolio financing.

In a paper by USAID 2005 to describe, compare and contrast MFI funding strategies (Deposit, Debt and Equity Strategies)[8], the author says that most MFI's are only partly attracting private capital at present. Best practice liability management is still not completely understood and most MFI's even lack the formal systems to access private capital. There are 'like-minded' investors in the private space too who are inclined to integrate microfinance in the formal financial system. Moreover, the industry knowledge, network and experience of the investors will also help institutionalize the MFI's.

The microfinance industry understands the need to scale operations geographically but still hasn't been able to completely appreciate the need for private sources of funding. In order for the sector to attract commercial capital and make it attractive for conventional venture investors, there is a need to innovatively blend the social missions of MFI's with the interests of the investors, which may not necessarily be only profit seeking. To achieve increased level of outreach in a sustainable way, the industry will need a combination of savings, debt and equity. Without consistent access to private sources of financing, it is unlikely that the microfinance industry will grow significantly or achieve broad-based profitability.

Now, that the need of private sources of funding in microfinance is called for, the first part of this research studies how private equity investment is much more suitable for this sector than other forms of funding. Moreover, the expectations of the leaders in the microfinance industry in India have also been taken into account based on secondary research. The criteria, which investors like private equity look for while investing in MFI's, are discussed by primary data collected using an in-depth interview with an associate with *LOK* Capital, New Delhi, India.

[8] MFI Financing Strategies and the Transition to Private Capital – USAID June 2005

Need for integrating microfinance with education - Increasing the impact of Microfinance in India

Education in India

India reveals particularly persistent underinvestment in schooling, chiefly among the poor. Furthermore, India's population is incredibly young—the median age is 24 years (Census data, 2004)—making the task of educating this population of emerging adults especially challenging and all the more critical to the nation's future economic and social welfare.

Children's schooling is essential to sustainable economic growth and poverty alleviation at both the individual and the macroeconomic level. The United Nation's Millennium Development Goals outline the achievement of universal primary education as critical to long-term development, and target educational indicators directly in seven out of the eight established goals to reach by 2015. At the household level, enrolling children in school, or investing in human capital, increases the household's potential for future earnings and amplifies its capacity to break the intergenerational transmission of poverty; at the community level it amplifies social cohesion and political participation, discourages violent crime, promotes health, increases labor productivity, and reduces birth rates (Shafiq, 2007).

Karnani (2007) argued that unless the children are educated enough and rural youth skillful enough, the rural poor will never be able to emancipate itself from the spiral of poverty.

There is an extensive literature on the additional socio-economic variables that influence schooling decisions across Asia, and particularly in India. It is found that educated heads of households (as a continuous variable—number of years of education) are more likely to emphasize the education of their sons and daughters (Khan and Ali, 2005; Jayachandran, 2002). Parental participation in the workforce has been found to increase the likelihood that the children will be sent to school, and household income levels have been found to have a positive and highly significant effect on child school attendance although the relationship between income and schooling is ambiguous for households lower down on the poverty line (Jayachandran, 2002). Household size tends to have a negative impact on child enrollment, especially for girls, indicating that larger families are more likely to pull their children out of school to tend to household needs (Hazarika and Sarangi, 2007). Males are much more likely to be sent to school, although gender bias has been shown to decrease with school accessibility and household size in India (Shafiq, Najeeb, 2006; Khan and Ali, 2005; Jayachandran, 2002).

The issue of child employment is especially critical in India. Despite strict labor legislation, the Government of India itself estimated that 12.6 million children under the age of 14 (roughly 13 percent) were working in 2001 (Census data, 2001), though some NGOs suggest that this number is closer to 50 million. The International Labor Organization (ILO) states that the principal reason cited by children of why they entered the workforce is due to the "the suggestion of parents", while parents said the main reason was that their working children contributed at least 20 percent of household income, followed by "help in the household enterprise" (International Labor Organization, 1996). This relationship between household-owned business and demand for child labor is critical, as in addition to severe health and safety risks posed to children in the workforce, child labor can have a devastating effect on education outcomes (see Ravallion and Wodon, 2000; Rosenzweig and Evenson, 1977). There is a vital need to further investigate the capacity for development interventions to inadvertently catalyze demand for child labor.

Microfinance and Education

There is not much consensus on the effect of credit on schooling decisions. While available evidence shows an overall positive effect on household education (Meyer, 2002; Littlefield, Morduch, and Hashemi, 2003; Goldberg, 2005), these results differ greatly across countries and programs. Given the rising importance of microcredit in international development financing and the growing role of credit programs in government expenditure, further analysis of the effects of microcredit on human capital is crucial to understanding the long-term, intergenerational implications of access to credit.

Several researchers highlight the sustainability implications for microcredit as a vehicle for poverty reduction, asserting that for poor households, access to even small amounts of credit facilitate investments in projects—such as education—that would otherwise be impossible or ignored (Bebczuk and Haimovich, 2007). New income that results from microenterprise can facilitate the direct costs of schooling as well as any opportunity costs associated with child labor. Loans can also provide the opportunity for consumption smoothing, reducing the tendency for children to drop out of school in times of income shocks. Reducing income barriers and smoothing consumption, therefore, provide two ways in which microfinance can be a vehicle for increasing educational attainment of children in developing countries. However, as will be discussed further, the relationship between credit and education is not explicit, especially in light of constraints on the demand for education and the increased need for child labor as a result of activities funded via credit.

In order to further explore the overall impact of access to credit on education, a deeper understanding of the channels through which this influence works is needed. Maldonado and Gonzales-Vega (2008) shed some light on five key factors that affect how microfinance can affect human capital development.

To begin with, the income effect, or increased household income generated through access to credit, combined with a positive income elasticity of demand for education, should generate greater schooling expenditures for families participating in microfinance programs. However, extreme poverty levels can further complicate the effect of credit on education—families lower down on the poverty scale are likely to have lower initial demand for education and therefore are less likely to send their children to school despite an increase in income (Maldonado and Gonzalez-Vega, 2008).

Secondly, risk-management plays a crucial role in potentially increasing the demand for education; families who are able to borrow money in times of emergency have diminished income volatility due to consumption smoothing. Access to credit can therefore increase the capacity for families to allow their children to stay in school due to the fact that they are in less dire need of the child's labor output and because of an increased capacity to pay school fees, even in times of economic shock.

Thirdly, the role of gender plays a pivotal role in microfinance. A large number of programs across the globe specifically target women as clients because they are more traditionally excluded from formal credit and labor markets, and because research shows that women "are the most important members of society in order to generate family development and therefore social development" (Velasco and Saiko, 2006). Specifically, females show stronger preferences for investment in their children's education than males (Behrman and Rozenweig, 2002), and Pitt and Khandker (2003) reveal that loans to women have a greater positive effect on measures of consumption, education, health and nutrition than loans provided to men.

A fourth channel through which credit affects education decisions is through the information effect. In particular, parental education levels affects decisions regarding children's education, concluding that if microfinance programs provides information regarding labor opportunities for graduates and increases the demand for an educated population, this gives added incentive for parents to send their children to school (Lillard and Willis, 2004). (Some programs, such as

CRECER in Bolivia, leverage borrower meetings as a platform to spread information about health and education; while India's Swayam Krishi Sangam's educational program facilitates early-education and tutoring programs across the country).

Lastly, the demand for child labor may play a critical role in determining the effect of credit on schooling outcomes. Considerable theoretical research emphasizes the uncertain nature of this relationship. On one hand, the opportunity cost of sending a child to school instead of working is lower when household income is increased through credit—the opportunity costs associated with keeping a child in school are higher for poorer families due to both higher marginal utility of each additional unit of income and the labor-supply potential of children Maldonado and Gonzales-Vega (2008). On the other hand, access to credit for the purpose of microenterprise can create additional productive activities requiring further demand for child labor through newly-formed microenterprise tasks, more extensive farm and livestock obligations, household chores needed due to a working parent, etc. Obtaining loans for the purpose of production as opposed to consumption or investment in human capital, therefore, may induce households to pull children from school in order to work.

Paltry disbursement of credit on education

Studies for the impact assessment of microfinance on poverty have found paltry disbursement by MFI's for education as a percentage of total credit disbursements (Ahmed 2009). Academic literature has little to say about integrating microfinance with education. In some developing countries like India, education forms part of the priority sector to which banks have to compulsorily lend[9]. Though MFI's have come to be known as financial institutions for the poor, there are no such mandates for them.

Thus, education still allures a majority of the population in India. Though microfinance has the distribution to facilitate increased education access to the poor, it is not being done at present. The second part of this study will focus on how educational services to children of rural poor can be provided using the marketing and distribution of microfinance. Here, in-depth interview with the founder of Indus Academy chain of schools is discussed. Indus Academy is a tie up between SKS Microfinance, Andhra Pradesh, India and Career Launcher.

[9] http://www.rbi.org.in/scripts/FAQView.aspx?Id=8

Chapter 3 Research Methodology

Case Based approach of the study

I chose the case based approach since I wanted to focus on specific and interesting cases namely that of Lok Capital and Indus Academy of India. The study demanded an in-depth investigation of both organizations and a case based approach helped gain a sharpened understanding of the topic. Single case based approach was used for both the parts of this research study namely, LOK capital and Indus Academy chain of schools. The case based approach allowed flexibility in taking new directions during the course of the study and drawing conclusions unlike simply trying to prove or disprove a hypothesis.

Both primary and secondary research was conducted for the study. Primary research includes in-depth interviews conducted with the stakeholders of both organizations. Secondary research includes data from information published on the internet, proprietary online sources and company report. The study is divided in two parts. The first part of the Chapter 4: Discussions & Findings, talks about increasing the reach of Microfinance via private sources of funding using the case of *LOK* Capital. The second part talks about increasing the impact of Microfinance via integration with education using the case of Indus Academy.

Pros & Cons of case study research design

The case study produces the type of context-dependent knowledge that research on learning shows to be necessary. Also, case study approach offers flexibility to change the course of study based on interim findings rather than proving or disproving a hypothesis as is done in statistical studies. A case study provides more realistic responses than a purely statistical survey. The argument between case study and statistical method also appears to be one of scale. Whilst many 'physical' scientists avoid case studies, for psychology, anthropology and ecology they are an essential tool. A case study cannot be generalized to fit a whole population or ecosystem.

Finally, one minor point is that, when informing others of your results, case studies make more interesting topics than purely statistical surveys, something that has been realized by teachers and magazine editors for many years. The general public has little interest in pages of statistical calculations but some well placed case studies can have a strong impact.

The case based approach also has few disadvantages. Critics of the case based approach believe that since the number of cases studied in a case study approach is limited, it is difficult to generalize the findings and ascertain reliability. Also, since few cases are generally studied in detail, the possibility of biases cannot be ruled out. Some dismiss case study research useful only as an exploratory tool and helpful in establishing only the first stage of the hypothesis.

The truth probably lies between the two and it is probably best to try and synergize the two approaches. It is valid to conduct case studies but they should be tied in with more general statistical processes.

Chapter 4 Discussions & Findings

Part 1: Increasing the reach via private sources of funding – The Case of LOK Capital

The way in which MFIs search for private capital is significantly different from the way the MFIs attract donor funding. MFI's, which haven't yet appreciated the importance of managing the liability side of the balance sheet, have now realized the need for the same. This is as true for debt and deposit management as it is for equity capital, each of which demand distinct, but somewhat overlapping strategies.

As discussed in the literature review, without consistent access to the private sources of funding, it is difficult for the microfinance industry to scale or increase profitability. At the same time, the social inclination of the investors and alignment of the financial inclusion philosophy with the founders of the MFI's is equally important though the investment may be for profit purpose. Such socially responsible investment is done at present by *LOK* capital of New Delhi, India. *LOK* capital's mission is: "To promote inclusive growth by supporting the development of social enterprises to deliver basic services to serve the BOP segment in a scalable, affordable and commercially viable manner. LOK seeks to partner with talented and visionary entrepreneurs to help take these social enterprises in India to a new level of sustainability, scalability and professionalism."

LOK Capital team has a deep understanding & working knowledge of India, including its complex regulatory environment and investment culture. The management at LOK capital comprises of highly qualified individuals with prior experience as investors, consultants for MFI's and other rural initiatives across US, Europe and Asian companies. For example, Donald Peck, one of the founders of LOK, has around 30 years experience investing in emerging markets with Actis (where he was a founding partner), IFC and Morgan Grenfell, including over 10 years in India building and heading the Indian private equity business of Actis. He has become a social investor pursuing a range of interests from Indian microfinance through education to biodiversity projects. Venky Natarajan, Managing Director, is an MBA from Cornell University and has acted as an operational consultant to various MFI’s in India. Melanie Bowen, Senior Advisor, responsible for new initiatives at LOK including education and healthcare, has over thirteen years of experience with Revolution Health, Discovery Communications, McKinsey & Co and Price Waterhouse Coopers spanning the US, Asia, Africa and the Caribbean. He is a JD from Harvard Law School and BA from Dartmouth College. Tyler Bolender, Associate, has three years of experience as operations analyst with TransUnion in the US and fellowship assignments with leading MFIs in South Asia including the Grameen Bank in Bangladesh and KAS Foundation/Jagannatha and Spandana in India. He holds a BA in Political Science and minor in Economics from California Polytechnic Institute. For the purpose of this study, I’ve conducted an in-depth interview with Tyler over LOK capital’s investment philosophy and how LOK capital is different from other private equity players.

Strategic importance of private equity in Microfinance

LOK Capital has concluded that any intervention intended to help microfinance sector should aim to:

- Retain and nurture managerial talent
- Help increase for-profit equity capital into the sector
- Contribute towards institutionalizing microfinance industry

These three aims being very similar to the objectives of investors in early stage companies, LOK believes that a “venture capital approach” suits the needs of the Indian microfinance sector.

In a *LOK* capital initiative called ‘Face to Face 2008’, several industry leaders from the leading Microfinance Institutions of India such as SKS Microfinance, Basix, Janalakhshmi Financial Services, Spandana, Satin Credit Care etc. as well as noted Indian journalists like Swaminathan Aiyer participated. The aim of this initiative was to bring together the different stakeholders working in the field of financial inclusion. The experienced leaders brainstormed on several areas like: challenges facing the microfinance sector, expectations from the investors pouring in private capital and development of strong institutions which ultimately are able to deliver on the inclusion front but with commercially sound foundations.

Samit Ghosh, CEO & MD Ujjivan Financial Services, claims that the industry understands the aim of MF is not just to give loans but alleviate poverty. This will happen only when the scale on which microfinance operates increases. India’s microfinance has primarily focused on Andhra Pradesh which has prevented them from extending the financial services to other parts of India. When I conducted an interview with Tyler Bolender, associate at LOK capital, he says “If microfinance industry wants to expand, it needs capital beyond the present meager grants (on an average less than 1 % of the total assets) it receives and beyond the capacity of the commercial banking structure to provide the same.”

Private Equity offers an alternative source of funding to the Indian microfinance sector, which has so far relied on commercial bank funding to drive operations. Due to such excessive reliance on bank funding, MFI’s have developed high leverage (debt-to-equity) ratios.

Availability of PE could help MFIs increase their equity, resulting in more sound leverage levels.

The funding from PE could enable MFIs to build scale, reducing their average costs. With more funding, MFIs can invest in cost reducing technologies, which in turn may lower lending rates. Increased availability of funds may result in strategies based on lower effective lending rates, and may spur MFIs to offer new products to their customers. In addition, PE investors could bring international expertise in finance and technology to the microfinance sector.[10]

All said, some skepticism rules as far as investment from profit seeking private equity firms is considered. PE's typically seek extraordinary returns and are seen as aggressive, non-transparent, difficult to regulate and uninterested in the broader social aspects of businesses they invest in. Here's where *LOK* capital stands as a differentiator.

As per H P Singh of Satin Credit Care, MFI's look for the following when an investor wants to invest.

I Investment assured by the investor

N Need of the investment

V Value added in terms of guidance & long term planning

E Experience of the investor in the microfinance field

S Strength of the investor

T Transparency maintained by the investor

O Whether there is alignment of interests - common objectives shared

R Relationships

LOK shares an understanding with each of its partners as to why they are doing what they are doing. It considers itself as a catalyst or facilitator to create financial inclusion. Rajiv Lall, Founder of LOK, advises its partners to think of social responsibility when it comes to strategy & product design in a sector as sensitive as microfinance and as politically charged. *LOK*'s aim

[10] http://www.microcapital.org/news-wire-india-private-equity-in-microfinance-will-have-pros-and-cons/

when it was started was to create a business model such that business interests are complimentary to the wider purpose of financial inclusion.

The Case of *LOK* Capital

Historical View

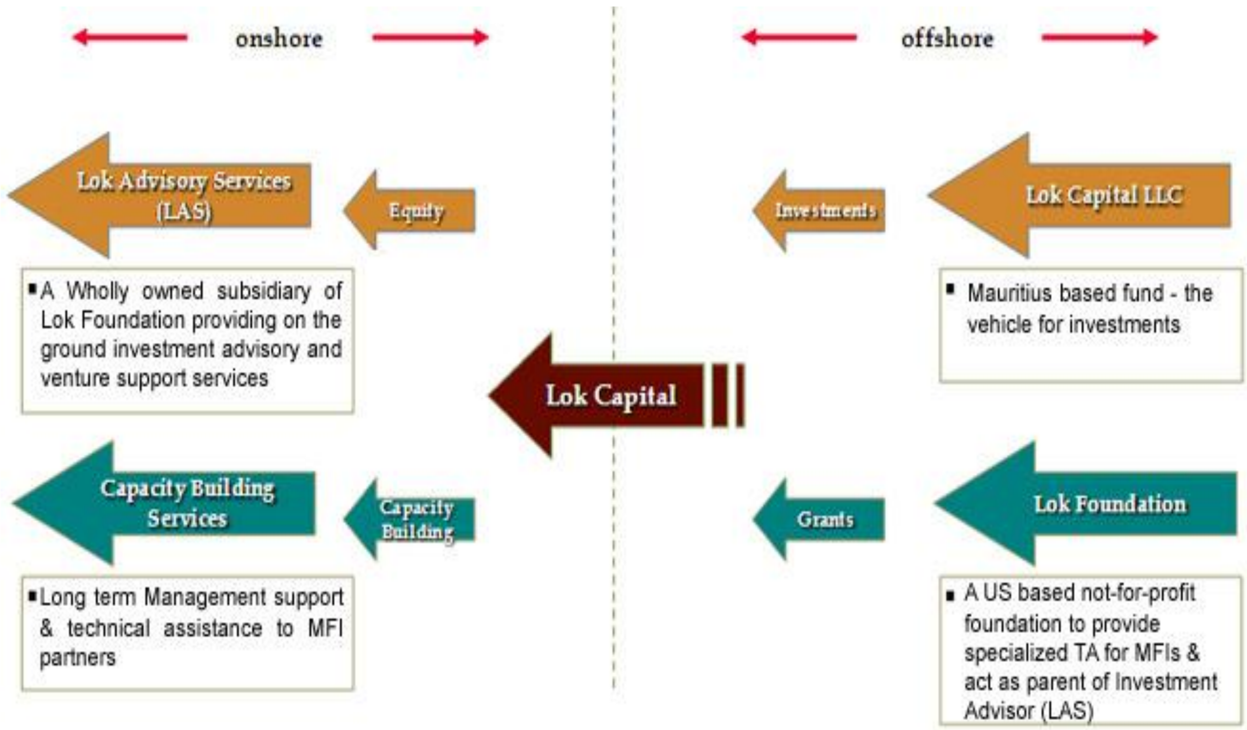
The *LOK* Capital Group represents an innovative partnership between for-profit and not-for-profit entities aiming at delivering not just equity capital but also technical and strategic advisory to Indian Microfinance Institutions. *LOK* seeks to partner with visionary and talented entrepreneurs and managers who are keen to take microfinance in India to a new level of sustainability, scalability and professionalism.

LOK Capital's mission is "To promote inclusive growth by supporting the development of social enterprises to deliver basic services to serve the BOP segment in a scalable, affordable and commercially viable manner. *LOK* seeks to partner with talented and visionary entrepreneurs to help take these social enterprises in India to a new level of sustainability, scalability and professionalism."

LOK consists of a Mauritius based venture fund called LOK Capital LLC, which is dedicated to making long-term equity investments in Indian MFIs. LOK also has a not–for-profit US foundation called LOK Foundation, which provides grants and volunteers for capacity building in investee MFIs. The fund and its investee companies are advised by *LOK*'s founders and a team of professional advisors based in Delhi, India.[11]

[11] www.lokcapital.com

Source: http://www.lokcapital.com/our-approach.html



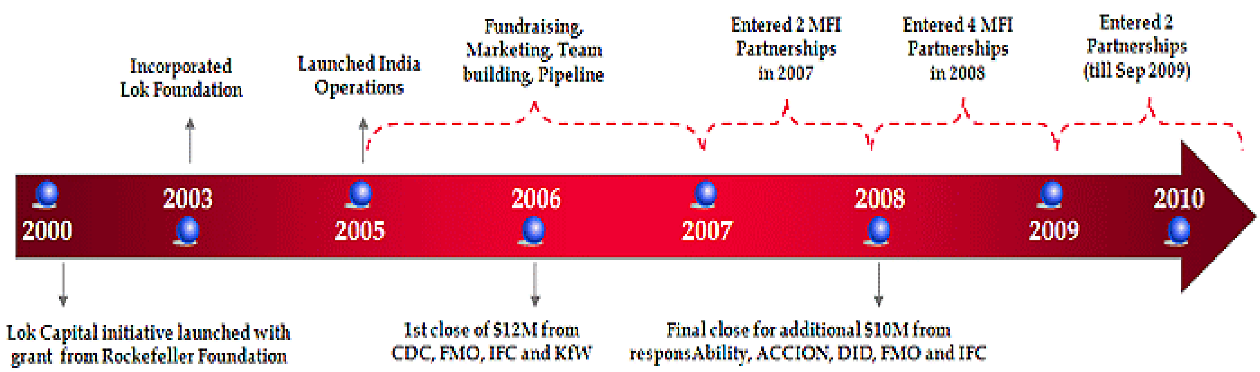
LOK Foundation was set up in 2003 to fulfill the following objectives:

- "To Act as a catalyst for directing risk capital to MFIs"
- "To help build scalable businesses that provide affordable financial services to the unbanked"
- "To act as a platform for sharing knowledge and best practices in the Indian microfinance industry"
- "To provide management support to visionary entrepreneurs running social enterprises whose abilities were limited to running 'development focused', non-scalable organizations"

India was chosen as the target for the *LOK* Capital initiative for two reasons.

First, high failure rate in the schemes intended to improve access to credit for the poor. There is tremendous scope for commercially viable micro-lending to urban and rural poor as compared to the demand for microfinance at present. In other words, the Indian MFI sector is still underdeveloped.

Second, the *LOK* Capital team has a deep understanding & working knowledge of India, including its complex regulatory environment and investment culture.



Source: http://www.lokcapital.com/history.html

Business Model of LOK Capital

LOK was the first international fund dedicated to microfinance in India and backed by institutional investors including several reputed development finance organizations. Indian microfinance is now proven to be a compelling opportunity from the point of view of both financial and social returns. Entrepreneurial leadership and innovation combine with strong social and commercial motivation of management into a very powerful force which makes Indian microfinance different from microfinance elsewhere and is spinning off new ventures of many kinds. *LOK* invests in microfinance businesses at all stages of their development taking a multi-faceted hands-on venture capital approach to developing new business strategies with the founders of their portfolio companies and their management teams.

Investment

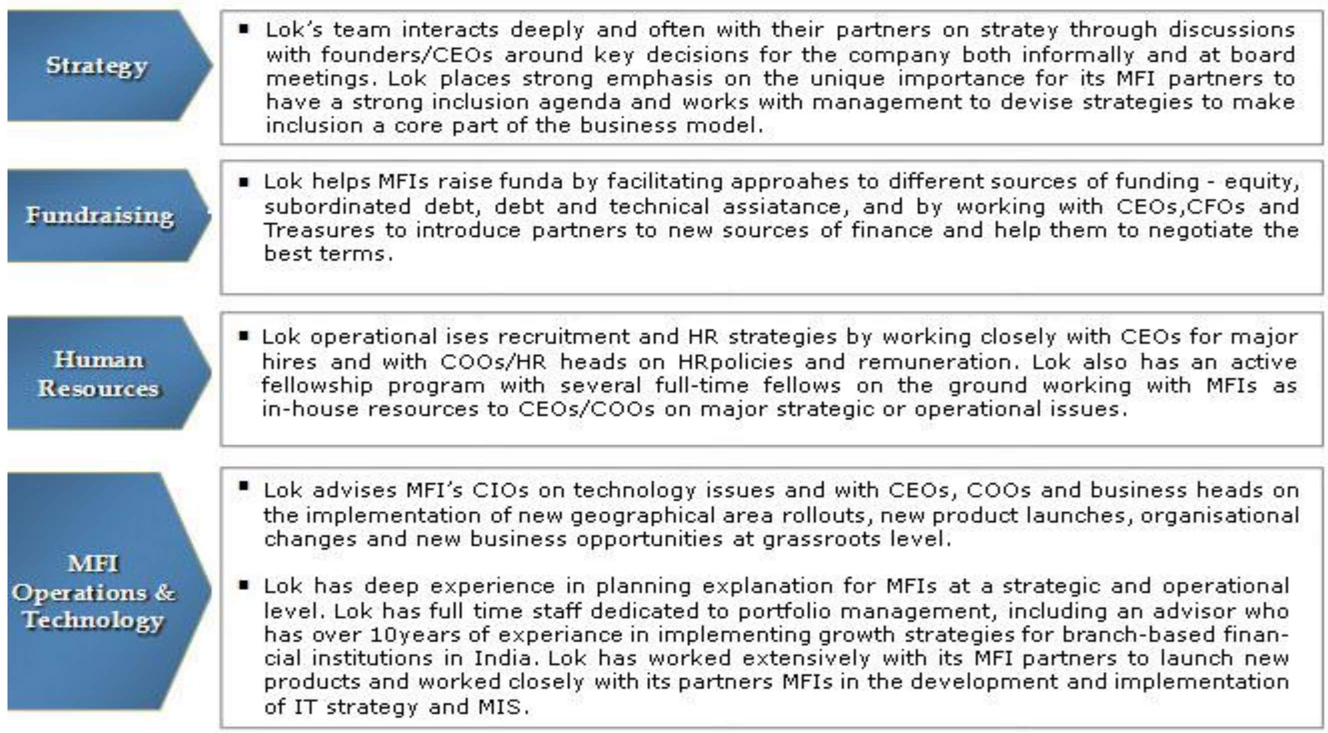
LOK Capital adopts the venture capital approach, acting as a catalyst for growth of microfinance, and is structured to deliver a broad range of services with specialized guidance suited to the specific needs of its partners. To invest in an MFI, LOK leverages:

- Its Extensive industry relationships
- Brand value of *LOK* and institutional investor backing
- Strong market intelligence by a very experienced and networked team
- Investment team with cross sectoral PE and VC experience. For example, the founders Rajiv and Donald have over 50 years of combined experience and are key figures in the Indian financial services market, combining skills in financial strategy, debt, FDI, foreign and domestic private equity, asset management companies and regulatory/policy environment for financial services in India.

Managing the portfolio

LOK Capital's eight MFI partners are well diversified with respect to geography, business model, rural/urban exposure and size. They include some of the largest and most well known MFIs such as Basix, Spandana and Ujjivan as well as regionally focused early-stage service providers like Arohan, Asirvad, Janalakshmi and Satin. As of June 30, 2009 *LOK*'s MFI partners collectively reached more than 4 million clients, had portfolio outstanding in excess of US$ 650 million and a distribution footprint across the country, with over 1,500 branches spread among 19 states and Union Territories of India.[12]

Once, LOK invests in an MFI, it uses a value add approach to manage its portfolio with dedicated portfolio management resources. LOK founders work closely with partners to develop and execute strategy.



Source: http://www.lokcapital.com/value-adds.html

Inclusion Agenda

LOK invests with partners who share their approach to social inclusion. One of the prime concerns which founders of MFI's share is that of profit seeking organizations, like private equity, investing in microfinance only for profits. PE firms stay invested in companies they invest in for short term gains. LOK capital, on the other hand, is a long-term investor and expects to remain invested in each company for a period of 4-7 years.

[12] www.lokcapital.com/images/Lok%20Capital%20Brochure.pdf

Factors considered at LOK for a successful investment

In an interview with Tyler Bolender, I asked him about the factors LOK capital looks at before investing in an MFI. Tyler is an associate at LOK with three years of experience as operations analyst with TransUnion in the US and fellowship assignments with leading MFIs in South Asia including the Grameen Bank in Bangladesh and KAS Foundation/Jagannatha and Spandana in India.

Tyler said, *"LOK* capital looks at primarily 3 areas while investing in an MFI:

Firstly, promoters. Whether the promoters understand the business, the challenges based on the geographical area and other socio-political risks. The kind of relations the promoters share with the staff and whether there is an alignment of philosophy with them.

Secondly, the strength of the management team since it'll be primarily responsible for taking day to day decisions regarding the future of the MFI

Thirdly, how strong are the processes within the MFI. How well are the Management Information Systems maintained, use of technology, checks in place before giving out loans and the processes followed when a loan goes bad. Also, the operational efficiency ratio is an important part of *LOK* Capital's assessment of any MFI."

MFI's have been repeatedly accused of charging high interest rates in Andhra Pradesh as well as other parts of India. So much so that, when Chandrababu Naidu provided state wide support to the SHG's in early 2000's, he promised to reduce interest rates. When Late Rajashekhar Reddy came in, he promised to reduce it further.

When asked about the high interest rates MFI charge to their clients, Tyler responded "MFI's generally have average 13% cost of borrowing from banks + 10% operational cost (min) + 1% costs of bad loans + Profit Margins. Hence, the high interest rates as compared to formal banking rates. Of these four factors contributing towards the interest rates, the one which helps compare MFI's with each other is the operational efficiency ratio given by:

Operational efficiency ratio = (Operational cost – Cost of funds) / Total Portfolio Size

In India, around 12% operational efficiency ratio is considered to be standard"

Tyler says, "Apart from the above well defined parameters considered for investment in a prospective MFI, LOK also considers following areas before investing:

- Profitability of the MFI
- Since *LOK* Capital looks for a relatively long term investment as compared to other private equity players, it looks at growth prospects for the next 5-7 years
- Differentiation factor for an MFI which helps it in long run
- Geographical reach of the MFI
- Group vs Individual loans
- Collection rate – Daily, Weekly, Biweekly"

Limitations of Private Equity investment in Microfinance

The availability of PE funds could well lead to aggressive lending by MFIs. Such a situation was witnessed in Andhra Pradesh in 2005, when there was a saturation of certain areas with too much micro credit, leading to over-indebtedness of borrowers and attendant problems. This suggests that excessive lending by the microfinance sector without considering the use of such credit and repayment capacity of the borrowers is counterproductive.

Involvement of PE firms may lead to undue attention to peri-urban areas, as it is easier to attract skilled manpower and the transaction costs of lending are lower. Moreover, as bigger loan sizes tend to reduce transaction costs, lending policies may lead to targeting of more well-off segments of the population who can service bigger loans. These developments may negatively impact RBI's financial inclusion goal. The time horizon of the PE investors may be an important factor in determining their impact. On a long-term basis, innovations that benefit the MFI customers are likely to yield positive returns, given the size of the Indian microfinance sector.[13]

However, a short-term view with excessive emphasis on profits could result in undesirable lending practices. MFIs should, therefore, seek PE investments with a longer time horizon. The large MFIs have special responsibilities in ensuring that PE investments do not lead to mission drift, as the positive and negative impacts of such investments will be felt by the whole sector

[13] http://www.microcapital.org/news-wire-india-private-equity-in-microfinance-will-have-pros-and-cons/

Part 2: Increasing the impact of Microfinance via Integration with education – The Case of Indus Academy

The SKS-Career Launcher tie-up – INDUS Academy Chain of Schools

Although the Indian Government stated its commitment to "free, basic education as a fundamental right guaranteed by the State" as early as 1950 and most notably in the Parliament's 83rd amendment in 1997, access and quality of education is poor and varies greatly by location, gender, income group and social category (World Bank, 2004). Literacy rates in Andhra Pradesh are similar to the national average, at 61 percent. Data shows that literacy rates among males are at 71 percent, while only 51 percent of females are literate (although this is a dramatic increase from 12.3 percent in 1961) (UNICEF, 2006). While 2006 primary net enrollment rates are reportedly high (87 percent of girls and 90 percent of boys aged 6-14 are enrolled in primary schooling), these numbers do not reflect low attendance rates and high dropout rates (UNESCO Institute for Statistics).

In its Strategy Paper on Poverty Eradication, the government of Andhra Pradesh has stated that the state's education indicators are of "serious concern" and has committed to achieving universalization of enrolment and retention by 2020.

SKS Microfinance believes that the most important way to improve the lives of the poor is through economic development. It is the foundation on which other human development - such as education and health - can be built. SKS is proud of improving the lives of more than 5 Million members through microfinance, which in turn fosters economic development. Microfinance enables people to earn income and build assets, which mean families eat better, they can afford health care, and children are more likely to attend school.

In a 2005 study targeted at the parents of households participating in microfinance programs provided by Swayam Krishi Sangam (SKS) in Andhra Pradesh, 87 percent of parents stated that their children's' education was of primary importance, although 25 percent of these people admitted that declining business or a bad harvest could change this prioritization. Central reasons for not being enrolled in school were lack of financial resources (83 percent) and the need for child labor (67 percent). In addition, parental fear that their daughter's dowry would increase if she achieved higher levels of education was reported to be a constraint to demand for child education (Quaegebeur and Srivatsa, 2005).

Career Launcher chain of schools and SKS Microfinance jointly launched SKS-CL Academy in 2008 to set up English medium schools in rural Andhra Pradesh. The Academy set up 10 schools in Nalgonda, Khammam, Rangareddy and Medak districts in the State in the pilot phase to provide primary education till third standard using the national open school syllabus with special emphasis on technology. *While Career Launcher managed and run the schools, Hyderabad-based SKS Microfinance took care of marketing through its well established loan distribution channel and provided education loans to students.* "It is the acute lacuna of quality education in rural areas which made us opt for this venture," Mr R. Satyanarayanan, Chairman, Career Launcher Group, said in a release according to a report in the Business Line. SKS-CL Indus Academies focus on providing excellent education to children of rural villages at a low cost price. The schools only charge INR 175 rupees per month and provide children with a complete English medium education. Unlike other rural schools Indus Academy focuses on providing children with an interactive and practical curriculum through a specially developed "play way method" which will prepare them for a bright future.

Marketing of the Indus Academy Chain of schools through SKS Microfinance

In an in-depth interview with ***Nandini Sood, Program Director of Indus Academy,*** I asked her what was the thought process before the tie up with a microfinance institution was thought about. To this Nandini says, "Career Launcher schools namely Indus World School has presence in big cities in India including Hyderabad, AP. We thought if we could work out a model where the education content and other resources required by our rural schools can be routed through these Indus World schools in cities, the quality to our rural schools can be delivered at reduced costs."

But the bigger problem was still reaching out to the poor families, explaining the importance of education to them and building credibility for our rural schools. For this, a tie up with a microfinance institution like SKS helped a lot.

SKS Microfinance has a presence amongst over 5 million clients in thousands of villages in Andhra Pradesh. At SKS, once the potential clients are officially accepted as SKS members, weekly meetings are held to conduct financial transactions. It was during these meetings that the awareness regarding importance of education for clients' children was spread. SKS also spread awareness regarding Indus Academy chain of schools and availability of education loans through SKS. Nandini says, "This solved the problem of marketing for us as well as building some credibility for Indus Academy to begin with."

SKS emphasized to the clients that when children stay out of school, they are bound to grow up to become unskilled workers, unable to earn a decent living and provide for their children, which also means: their children in turn do not go to school. This is the challenge of the cycle of illiteracy and poverty, as illustrated here.

Source: http://www.clef.in/challenges.html

Before starting operations in a particular area, staff at SKS conducts village surveys to evaluate local conditions like population, poverty level, road accessibility, political stability and means of livelihood. This knowhow enabled the Indus Academy readymade access to information on the demographics in the area. In addition, local knowledge and reach of SKS helped Indus Academy overcome the hurdles of diversity of language, culture and geography.

Design of the school

When I asked Nandini if there were any apprehensions before starting these rural schools, she responded "Of course, there were since it takes around 10 million rupees in India to set up a school. We were keen to maintain a high quality school but such costs were definitely prohibitive. Hence extensive research and innovation was carried out to come up with a model of low cost quality schools"

As per Nandini, the schools were targeted at SKS's clients' children since SKS has a wide presence in AP. This made it easier to establish credibility for the academy and also spread awareness about the importance of education. Nandini goes on to say, "Indus Academy created 'School in a box' solution through intensive research and innovation. Each school is equipped with over 200 items of teaching-learning material aggregated from best publishers across the country. In addition, the schools have a library with over 100 books, national Award winning Children's films, musical instruments, over 125 games for Math teaching, games for motor skills/ spatial reasoning, sports material, games for language development, TV sets and DVD players. Each school is also equipped with a laptop & broadband connectivity. Total set up expense per school 1.5 lakhs only. The schools use standardized NCERT curriculum through the National Book Trust which ensures scalability of the number of schools."

Recruitment and monitoring of mentors

Indus Academy has redefined the role of a teacher- to that of a mentor. It employs rural women and men as mentors with HSSC as the minimum education requirement but have a lot of spunk and enthusiasm. Nandini says, "We don't care if a person has holds a graduate degree or not if he/she has the passion and the potential to teach. A few of them come from economic backgrounds that are BPL (Below Poverty Line) for sure. Indus Academy conducts standard written test for the selection of teachers followed by a group activity and personal interview." Nandini stresses that love for teaching and children are the primary traits which are looked at and not a graduate degree. Indus has so far selected and trained 46 mentors.

When asked about the monitoring of mentors across 10 schools spread across 200 kms, Nandini responds “We developed a culture of ownership, accountability & enterprise. We do not police our mentors, we enable them.” Monthly micro schedules included a systematic plan for each day of the week with respect to which classes have to be conducted, manner in which these have to be conducted, etc. Local available props are used to supplement learning practically with the theory. The mentors are not micro managed but are evaluated on the basis of a monthly coordination report which included the number of new admissions, number of classes conducted, whether schedule followed or not, leaves taken and even the response of the children to various activities is recorded.

Incorporation of Technology at the schools

Each school is equipped with a laptop and broadband connection which is used for VOIP based trainings of spoken English for the mentors and for providing web resources, E-learning software in Telugu to the children. Indus Academy also has an ERP based platform to capture student, parent details, and mentor’s daily attendance.

Thus, Indus Academy was able to create these 9 low cost schools with high focus on quality in Andhra Pradesh. The schools not only helped the rural poor children access to good education but also provided employment to the rural youth willing to teach.

Limitations of the SKS-Career Launcher tie up

- The interest rates on education loans were much less than the interest rates on other loans of SKS Microfinance. There was not enough incentive for the staff at SKS to lend for education only. On few occasions, the staff asked education loan seekers to first become a member of SKS and then to give away education loans. As a result, the repayment rates of schools did not increase significantly with the availability of education loans.
- In order to make the current model of Indus Academy sustainable without grants, it is mandatory to use the school space for income generating activities after the school hours. But parents who worked as daily wage laborers till late evening wanted their children to be in school even after the school timings. This prevented Indus Academy to use the school space more efficiently.

In order to overcome the above limitation, Indus Academy aims to transform each school into a Community Enabling Centre where it delivers training enabling to all stakeholders in the community. In order to turn around the Indus Academy model into one of self sustaining, Nandini plans to use the current school space for rural youth skill development as well as telemedicine. Nandini Sood views Indus Academy as an R & D project that calls for a whole lot of innovation in order to make it viable as well as scalable. It is a worthy project that attempts to solve the problem of capacity building for India by blending schooling with employability training in rural parts of the country.

Chapter 5 Conclusions & the Way Ahead

Summary & Key Findings

Microfinance in India has come to a stage where though the growth rate has been phenomenal, a number of challenges face the industry ranging from capital funding, people training, technology, access to capital market, and continued threat from political environment. This study proposed two innovative ways for the development of financial and allied services for the poor.

First innovation focuses on increasing the reach of financial services to the poor in the form of microfinance by boosting private sources of funding to the sector. Since, a venture capitalist stays with an MFI for the longest possible time, benefits & limitations of private equity in microfinance were studied using the case of LOK capital, New Delhi, India. LOK capital, one of the only private equity firms to invest solely in microfinance institutions has been successfully driving private capital into the industry in a socially responsible way. The management at LOK is not only infusing capital into the sector but is also helping MFI's institutionalize themselves by incorporating the best practices of the corporate sector.

Second innovation in the sector focuses on increased access to the rural poor children through the channel of microfinance. Only better education will empower the rural poor and help them come out of the vicious cycle of poverty. For this, a working model Indus Academy was studied. Indus Academy, which is a tie-up between SKS Microfinance, Andhra Pradesh, India and education service provider, Career Launcher, uses the marketing and distribution channel of SKS microfinance in Andhra to provide educational services to the rural poor. SKS microfinance helps building awareness regarding education and Indus Academy and also with providing loans for the poor children's fees. Career Launcher takes care of running and managing the schools.

If microfinance in India reaches a critical scale where it is delivering such vital services to an important segment of society which is politically significant and the services are widely appreciated, the growth effect would be spiraled.

Limitations of Current Research & Way Ahead

For the private equity in microfinance, this research studies LOK capital. LOK has been able to gain the trust of the leaders in microfinance space in India on account of its socially inclined investment philosophy. Other private equity players may not share the same ideology as LOK. Hence it is important to study the perception other private equity players carry as far as investment in microfinance is concerned.

When asked about the social relevance of investment in microfinance, an associate with one such private equity namely, Avigo Capital, New Delhi, India, responded "We are not interested in the social importance an MFI carries. We just look at their growth plans for the next 3-5 years their profitability". Hence, a single case of a socially inclined private equity may not be a good enough indicator to prove that venture capitalist approach suits the microfinance space the best. For this, a multiple case study approach need to be adopted. This could not be done through this research paper on account of time constraints.

For the integration of microfinance with education, only qualitative research was considered by discussing the case of Indus Academy. As discussed in literature, credit has a significant influence on the education decision of rural households. Hence, a quantitative research to understand whether the availability of loans from SKS Microfinance of Andhra Pradesh really helped the poor with increased access to education would help supplement the academic literature. This could not be carried out on account of location constraints.

Policy Implications – Lessons for the Business & Government

In order for microfinance institutions to expand its geographical reach, it is important to understand what plans the government is undertaking in their particular area of operations and what interest rates govt. is setting, etc. In the last decade, microfinance industry has focused primarily in the southern region of India and amongst it, in Andhra Pradesh state. This has exposed the industry to political risks time and again. Hence, it is imperative to spread out geographically and not rest the complete portfolio in a single state. Also, the high interest rates charged by this sector have caused a lot of backlash from political circles. This has made it mandatory to raise transparency in reporting in this sector than companies in other sectors. In order to reduce the operational costs, best practices need to be adopted from the corporate sector and the benefits of reduced costs can then be passed on to the clients in the form of lowered interest rates.

For the state governments, it is important to realize that the commercial banking system may not be able to meet the needs of the poor despite the resources and the networks such as SHG-Bank linkages. In fact, the SHG-bank linkage program reaches only about one-third of potential borrowers and one-tenth of the estimated demand for credit. There is also a huge imbalance in the spread of the program across states.[14] Hence, MFI's, with their NGO background, act as supplementary channels and can provide access of financial services to the poor in a much better way. The need of the hour is to clearly define the role of microfinance institutions by creating flexible regulatory norms. The government needs to be proactive in institutionalizing microfinance. A good regulatory framework for MFI's will help reduce the transaction costs as well and increase transparency and the much need accountability.

The model studied in this paper, that of a tie up between microfinance and education service provider will be a win-win for both only when there is an incentive for microfinance institutions

[14] See Shylendra 2006

to lend for education. Banks in India have a mandate of lending to priority sector and education is a part of priority sector. Though MFI's have come to known as the 'banks for the poor', still so far there are no such mandates for them. Hence either regulatory norms of priority sector lending be applied to MFI's or incentivize them to do so. Rating agencies like M-Cril rate MFI's on financial and social parameters. If education lending can be made a part of the social rating parameters, MFI's may lend more. Better ratings would also enable MFI's to increased access to cheaper funds (as found out by interactions with some of the private equity investors of microfinance); benefits of the same would pass on to the poor in the form of lower interest rates.

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