



Microfinance - The crucial link in inclusiveness in Eastern India

January 2018

KPMG.com/in



Contents

Message from Association of Microfinance Institutions – West Bengal (AMFI-WB)	2
Message from KPMG in India	3
Macroeconomic overview of Eastern India’s economy	4
1. Agriculture and industry outlook	4
2. Emerging Bharat	5
3. Dependency on informal sector	5
Role played by MFIs in catering to financial services needs in Eastern India	6
1. Credit gaps in Eastern India	6
2. Role of MFIs in fulfilling the credit gaps	7
MFIs in Eastern India - Growth drivers and key challenges	8
1. Growth drivers	8
2. Key challenges	9
Emerging themes for MFIs in the current environment	10
1. Future of MFIs	10
2. Collaborations and partnerships	12
3. Digital – Enabling change	14
4. Risk management	17
Conclusion	19
About KPMG in India	20
About AMFI-WB	20
Acknowledgments	21

Message from Association of Microfinance Institutions - West Bengal (AMFI-WB)



Ajit Kumar Maity
Chairperson, AMFI-WB



Chandra Shekhar Ghosh
Former Secretary, AMFI-WB



Kartick Biswas
Secretary, AMFI-WB

The 3rd Eastern India Microfinance Summit 2018 is titled 'Microfinance - The crucial link to inclusiveness'. This paper highlights the critical role played by Microfinance Institutions (MFIs) in delivering financial services in Eastern India and their continuing relevance.

In the last couple of years, we have witnessed sweeping changes, both in the way microfinance is conducted and the manner in which technology is adopted and deployed for greater customer engagement, improve process efficiency and support increasing compliance requirements. As a dimension, regulatory compliance has also kept pace with the need to address the challenges posed by a complex financial eco-system.

As we move into the 3rd Eastern India Microfinance Summit 2018, it is interesting to note how the technology interface with microfinance institutions has undergone a huge transformation. Technology enablement has helped improve operational efficiency and reduce operational costs for MFIs. Most of the large MFIs have benefited from embracing technology through sizeable investments.

As far as the banking industry is concerned with regard to effective partnership with microfinance industry, the next few years promise greater excitement. The banking space is being redefined by the entry of newer players, emergence of newer businesses models and participation of innovative start-ups.

This document provides an insight on the way forward on how the microfinance industry should remodel itself is an attempt to stay in if not ahead of other players in the market. The fund flow situation, both for equity and debt, is now

comfortable for the industry. The present growth rate in the industry points to the trend of higher funding by banks to NBFCs but little for the non-NBFCs. This is still a challenge.

MFIs have also been able to penetrate rural areas and reach out to the unbanked locations of India with the help of technology, piggy backing on the reach and penetration of hand-held/mobile devices in the rural hinterland.

In regard to human resources management mechanism by the microfinance industry, building a robust and long lasting institution is a challenging task for the top level management as well as for the HR department. But HR is the most neglected function in Indian microfinance sector and HR planning is mostly run on ad-hoc basis though quantitative in nature and used mostly for determining new recruitment or promotions to estimate the salary expenses. The most critical issue in HR planning is finding right people for different functions of MFIs and their willingness to compensate adequately for people with relevant experience.

With this development as backdrop, AMFI-WB and KPMG in India have put together this report which showcases the microfinance industry as it is today and possible roadmap ahead to take a quantum leap with technology as its springboard.

We are sure this report will stimulate further thought and dialogue, spurring a rich exchange of ideas. We hope this report is helpful and we welcome any thoughts you may have.

Message from KPMG in India

Eastern India economy, which is driven largely by agriculture and mining sectors, plays a prominent role in India's growth story. Fuelling this progress are the region's Micro Finance Institutions (MFIs) that have facilitated in bringing formal finance to the bottom of the pyramid. MFIs have traditionally helped bridge the credit gap in the Eastern economy which has lower banking penetration as compared to the rest of the regions.

Over the past two years, some of the key trends that have impacted MFIs in India are changing ownership/structures (conversion to banks, SFBs or acquisition by banks), leveraging technology to drive operational efficiencies, challenges on employee productivity and retention, enhanced focus on risk management practices due to concerns on portfolio quality.

Innovative product offerings and practices that leverage customisation and flexibility have been met with tremendous success in developing economies. Indian MFIs would do well to take a cue from these successes and embark on the path of innovation. With rising digitisation,

analytics based rule engines can help predict consumer behaviour and can play a key role in better customer acquisition and risk management. Forging collaborations with telecom firms, fintech companies and firms providing clean energy and water, MFIs can utilise their strong distribution network to not only help rural areas improve the business environment but also tap into the strong cross-sell potential of these areas. Digitisation will be an active change enabler in the sector. While improvements in digital infrastructure will play a key role in defining success for MFIs, Government initiatives will strengthen the digital ecosystem, and developments in mobility could further ensure connectivity and reduce the operational costs.

This report discusses the key imperatives around future-focussed innovation-led strategies, digital, alliances and partnerships, and robust risk management for MFIs to remain competitive in the changing market landscape.



Mritunjay Kapur
National Head,
Markets and Strategy
Head - Technology,
Media and Telecom



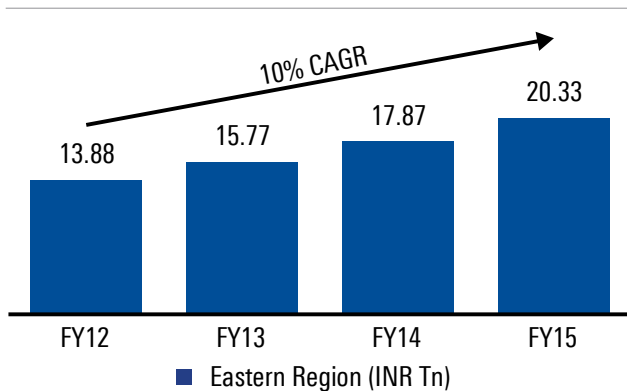
Narayanan Ramaswamy
Office Managing Partner,
Kolkata

Macroeconomic overview of Eastern India's economy

The Indian economy is expected to be the fifth largest economy in the world in dollar terms in 2018 and the third largest economy by 2032 with projected Gross Domestic Product (GDP) growth estimated at 7.7 per cent by 2019.¹

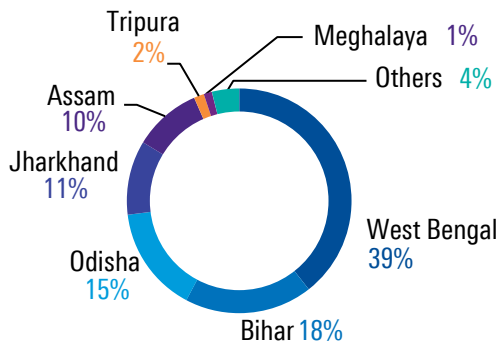
The eastern region (comprising West Bengal, Bihar Odisha, Jharkhand, Assam and other north-eastern states)² is home to 27 per cent of India's population and contributes 16.5 per cent to India's GDP. In the next 20 years, the eastern region is expected to contribute at least 25 per cent to India's GDP to become a INR195 lakh crore³ economy by 2035.⁴

Figure 1: Eastern and north eastern states Gross State Domestic Product (GSDP) (INR lakh crore)⁵



West Bengal, Bihar, Odisha, Jharkhand and Assam together contribute 93 per cent to the eastern regions GSDP⁶

Figure 2: Eastern region state-wise GSDP split⁷



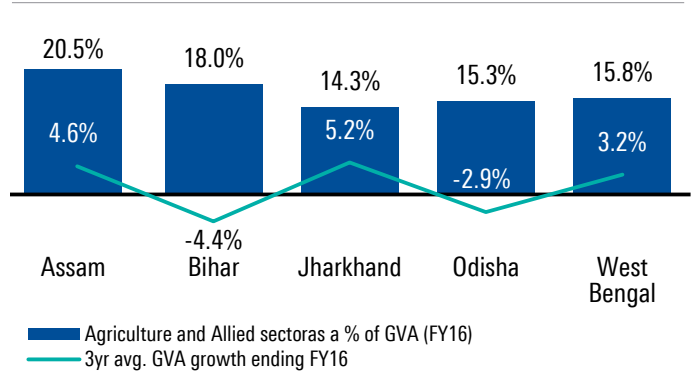
Agriculture and industry outlook

With 55 per cent of total employed persons in India dependent on agriculture for their livelihood, the sector contributes 17.3 per cent to India's GVA (Gross Value Added) (as of FY17).⁸

The eastern region has a direct influence on over 30 per cent of Index of Industrial Production (IIP) by weight and 57 per cent of core industries.⁹ Agriculture contributed towards 12 per cent of the eastern region's total GSDP (as of FY15).¹⁰ The north-eastern states, in particular, are heavily dependent on agriculture, with the average contribution to GSDP from agriculture at 25 per cent. To harness the natural endowments and extensive international borders of north-eastern states, the government of India aims to spend INR45,000 crore towards development.¹¹

Key industries driving Eastern economy are Jute, Leather, Tea, Locomotives, Steel and Mining. Eastern India contributes to more than 20% of the national output in each of these industries. Bihar and Odisha have witnessed a 4.4 per cent and 2.9 per cent respective decline in the share of agriculture, a proportion of GSDP in the three years up to FY16.¹² While Bihar witnessed a sharp growth in its mining industry (~165 per cent in the years up to FY16), capital investment subsidies and incentives in the services sector led to this change.^{13,14}

Figure 3: GVA growth and agri-contribution to GVA in the eastern region¹⁴



1. Indian economy to be the 5th largest in 2018: World Economic League, IBEF, December 2017, last accessed on 9 January 2018

2. North Eastern states include Arunachal Pradesh, Assam, Manipur, Meghalaya, Mizoram, Nagaland and Tripura

3. USD1 = INR65

4. Is West Bengal ready for a \$3Tn opportunity? SMERA Ratings Agency, January 2016, last accessed on 2 January 2018

5. Nominal GSDP series, MOSPI (Ministry of Statistics and Programme Implementation) data, last accessed on 29 December 2017. Gross State Domestic Product (GSDP) is defined as a measure, in monetary terms, of the volume of all goods and services produced within the boundaries of the State during a given period of time, accounted without duplication.

6. Is West Bengal ready for a \$3Tn opportunity? SMERA Ratings Agency, January 2016, last accessed on 2 January 2018

7. Nominal GSDP series, MOSPI (Ministry of Statistics and Programme Implementation) data.

8. Handbook of Indian Economy 2016-7, Reserve Bank of India.

9. Is West Bengal ready for a \$3Tn opportunity? SMERA Ratings Agency, January 2016, last accessed on 2 January 2018

10. Nominal GSDP series and state fact sheets, MOSPI (Ministry of Statistics and Programme Implementation) data, last accessed on 29 December 2017

11. Infrastructure Sector In India, IBEF, December 2017, last accessed on 3 January 2018

12. Is West Bengal ready for a \$3Tn opportunity? SMERA Ratings Agency, January 2016, last accessed on 2 January 2018

13. NCAER State Investment Potential Index (N-SIPI 2017), NCAER (2017), last accessed on 29 December 2017

14. NCAER State Investment Potential Index (N-SIPI 2017), NCAER (2017), last accessed on 29 December 2017

Emerging Bharat

Rural India has witnessed a significant transformation in recent years. With increased access to finance and rising digital penetration, annual per capita disposable income in rural India which was INR33,540 in FY15 is set to increase by 4.4 per cent to more than INR41,000 by 2020.¹⁵

Annual per capita income in the eastern region has been on a steady rise, having registered 8 per cent growth between FY12-15. However, with the exception of West Bengal, all the top eastern states accrue a majority portion of their GVA from rural regions, indicating towards the presence of an active rural market, which can be tapped by microfinance institutions.

Figure 4: Average annual per capita income in eastern and north eastern states¹⁶

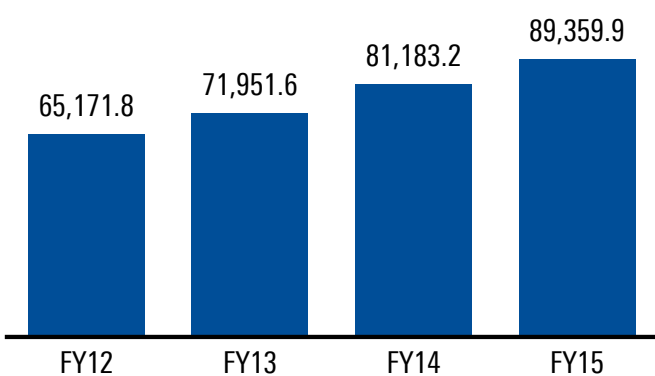
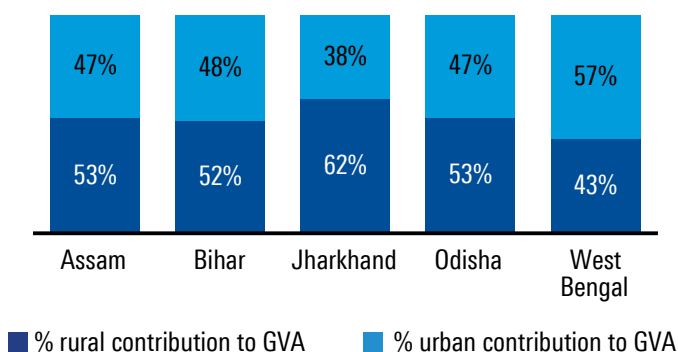


Figure 5: Rural and urban contribution to GVA in the eastern region¹⁷



Increased income levels have translated into increased rural spending on consumer products, standing at approximately INR24 lakh crore in FY16, 30 per cent higher than urban areas.¹⁸

The uptake of mobile phones and internet since 2005 have led to strong growth in digital commerce. There are around 50 crore mobile subscribers in rural India (as of June 2017) of which roughly 11 crore users own smartphones.¹⁹ Digitisation holds key benefits for MFIs including improved payment security, reduced collection costs, easy access to e-commerce and reduced paperwork. Increased internet penetration could also lead to a significant reduction in customer acquisition and marketing costs for MFIs.

Internet penetration in rural India is 16 per cent vis-à-vis 33 per cent at an all India level. The number of connected customers in rural areas is expected to jump 30 per cent from 12 crore in FY15 to around 32 crore in FY20.²⁰ Internet connectivity remains a key concern in the north-eastern states. The entire northeast region has only 4.3 lakh internet connections (as compared to 2.2 crore connections in Delhi alone). In recent years, service providers such as BSNL, Aircel, Airtel and Vodafone have been competing to make forays into the north eastern states.²²

Dependency on informal sector

The eastern region is heavily dependent on the informal sector, with the informal manufacturing sector (essentially MSMEs), being the highest contributing segment (e.g. 62 per cent in the north-eastern region)²³ in the industrial output. However, access to finance remains largely impeded on account of fewer banking facilities.

Under-penetration of banking facilities in the east has pushed customers to avail of options that are of higher risk such as chit funds²⁴ which has led to several scams that have duped the retail investor. In addition to the reputational impacts of being linked to such schemes, MFIs are also subjected to regional political, cultural and topographic differences within the eastern region.

15. Indian FMCG Industry Analysis, IBEF, December 2017, last accessed on 29 December 2017

16. Nominal GSDP series, MOSPI (Ministry of Statistics and Programme Implementation) data, last accessed on 29 December 2017

17. Key Indicators of Unincorporated Non-agricultural enterprises (excluding Construction) in India, NSS 73rd Round, June 2016, last accessed on 4 January 2018

18. How India Spends, Livemint, December 2016, Last accessed on 8 January 2018

19. Mobile Handset penetration: Why rural consumer is not rural anymore, Financial Express August 2017, last accessed on 3 January 2018

20. Rural problems that start-ups can solve, VCC circle, January 2017, last accessed on 3 January 2018

21. How many Indians have internet? The Hindu, March 2017, last accessed on 4 January 2018

22. Poor connectivity in the North East, The Arunachal Times, December 2017, last accessed on 6 January 2018

23. MSMEs Sector in North East India, XVI Annual Conference Proceedings January, Manipur University, 2015, last accessed on 3 January 2018

24. India's Chit Fund Crisis, Indicative of a Global Market failure?, Economywatch May 2013, last accessed on 7 January 2018

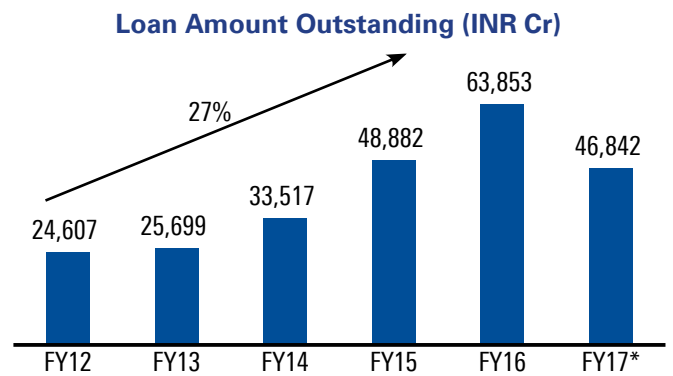
Role played by MFIs in catering to financial services needs in Eastern India

Over the years, microfinance institutions (MFIs) have been providing small-scale loans and financial services to individuals primarily in rural and semi-urban areas that have traditionally been excluded from the formal financial system due to multiple constraints, including geographical presence, unavailability of financial history, etc.

The microfinance sector has been witnessing high growth with the loan amount outstanding increasing at a CAGR of almost 27 per cent from FY12 to FY16.¹ In FY17, the total loan portfolio outstanding, excluding the Small Finance Banks (SFB), reached INR46,842 crore¹. Factoring the transition of a few MFIs to SFBs, the year-on-year growth from FY16 to FY17 was around 18 per cent¹. The relative slowdown in the growth, however, was primarily due to the impact of demonetisation. Due to the non-availability of cash, the business activity in rural areas decreased. Additionally, due to factors such as local activism, misinterpretation of regulations and misplaced expectations of loan waivers, the collections dwindled, forcing MFIs to show caution from further lending. However, rural India has now started to show signs of recovery. With real rural incomes increasing, unemployment falling and loan collections getting back on track, MFIs could disburse more loans in the coming quarters, enabling growth to get back to the pre-demonetisation levels.

MFIs currently operate in 29 states, four union territories and 588 districts in India. A total number of 223 microfinance entities [including MFI-NBFCs (Micro-finance Institute – Non-Banking Financial Company), NGOs, and societies] have reached out to 4.5 crore clients – an all-time high, with a loan outstanding of over INR1 lakh crore across the private Joint Liability Group (JLG) and the public Self Help Group (SHG) programme, 94 per cent of which were used for income generation purposes. Women

Figure 6: Loan Amount Outstanding, INR (FY12-17)²
*Excluding Small Finance Banks



borrowers represent about 90 per cent of the total clientele of MFIs, Scheduled Caste/Scheduled Tribe borrowers represent 30 per cent and minorities 27 per cent. MFIs with a portfolio size of more than INR500 crore contribute significantly to the total outreach (85 per cent) and loan outstanding (88 per cent) of the sector. The sector employs more than one lakh personnel, out of which 15 per cent are women.³

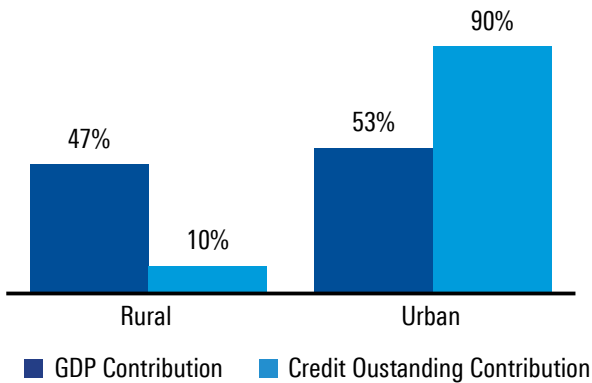
Credit gaps in Eastern India

Despite contributing 47 per cent to India's GDP, rural India's share in total credit outstanding is just 10 per cent as of FY16, indicating very low penetration of banking credit in rural areas. The government of India and the RBI have taken several proactive measures including the introduction of no-frill accounts, liberalisation of RBI's branch expansion/ATM policy, hosting of financial literacy programmes, introduction of payment banks and small finance banks and Micro Units Development and Refinance Agency Ltd (MUDRA) to buttress financial inclusion.

1. The Bharat Microfinance Report 2016-2017, Sa-Dhan, September 2017, Last accessed on 3 January 2018
2. Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

3. Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

Figure 7: Rural and urban contribution to GDP and outstanding credit (FY16)⁴



Banking credits and deposits are largely concentrated in the southern and western regions of India. Credit penetration has been significantly lower in the eastern regions as compared to southern and the western regions, which boast of 38 per cent and 25 per cent banking credit share respectively. Banking retail credit per capita income is also the lowest in the eastern states (~5x lower than that in southern states).

Low banking credit penetration points towards a large area without access to banking services, often dependent on informal sources of credit. Government initiatives for financial inclusion and the steady rise of digitisation are expected to create analytics, operational and business synergies for MFIs that can then capture these markets through operationally efficient and cost-effective models.

Figure 8: Region-wise share of banking credit⁵

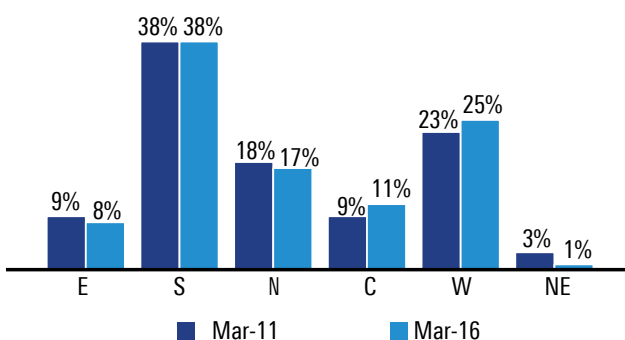
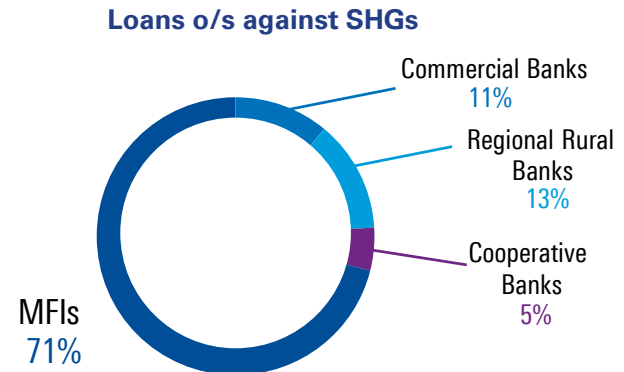


Figure 9: Loans outstanding against self-help groups in Eastern and North-eastern India⁶



Role of MFIs in fulfilling the credit gaps

While MFIs have been focusing on the bottom of the pyramid, banks have also been playing a significant role across India. In eastern and north-eastern India, however, MFIs dominate the market with 71 per cent of the share.

The low dependence on a strong branch network is highlighted by the fact that there are only 2,187 MFI branches in eastern and north-eastern India, which translates to roughly 94,000 people per branch. While banks have an under 20,000 figure for people per branch, MFIs have still been able to capture a larger market.⁷ In terms of client outreach, MFIs have 82.6 lakh customers in east and northeast India.

4. Red Herring Prospectus, Bandhan Bank, December 2017, last accessed on 2 January 2018

5. Red Herring Prospectus, Bandhan Bank, December 2017, last accessed on 2 January 2018

6. Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

7. Report on Trend and Progress of Banking in India, 2016-17, Reserve Bank of India, last accessed on 4 January 2018, Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

MFI in Eastern India - Growth drivers and key challenges

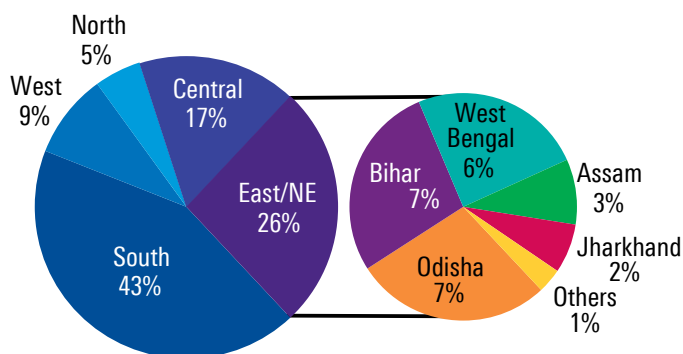
MFI in the southern region has the highest share both in terms of outreach and loans outstanding, followed by the east. Karnataka and Tamil Nadu have the biggest markets with a total of ~37 per cent share of the overall national-level disbursement. In east India, Odisha, Bihar and West Bengal dominate the market with 6-8 per cent share each. However, growth rates are higher in the north-eastern and central regions. Top 10 states, i.e., West Bengal, Tamil Nadu, Karnataka, Maharashtra, Bihar, Uttar Pradesh, Madhya Pradesh, Assam, Odisha, and Kerala account for almost 86 per cent of the total industry portfolio. Four of these states are from eastern India, which underlies the importance of the region to the industry.

In terms of average loan per borrower, south India leads with Rs 14,549 per borrower, while eastern India has the most granulated lending at Rs 10,724 per borrower. For East India, while the granularity increases challenges regarding operating costs, it has also helped reduce credit risks.

While eastern and north-eastern India combined are home to more than 35% of MFIs in India, the overall loan outstanding in the region is low due to the small average loan per borrower.

In eastern India, the top players include Annapurna Microfinance (Bhubaneswar) and Arohan Financial Services (Kolkata), both having loan outstanding above INR1,000 crore.

Figure 10: Regional distribution of loan outstanding (FY17)¹



Growth drivers



1. Physical infrastructure and population density

Improvement in physical infrastructure such as roads and electricity and increase in population density makes more areas viable for MFI operations, especially in north east India.

2. Macroeconomic/industry growth

As more and more businesses are set up or grow in rural areas, there would be an additional requirement of credit that the MFIs can support. Factors such as improvement in rural spending could further drive the industry growth.

3. Information/growth of credit bureaus/Financial infrastructure

Information through means such as mobile phone usage and social network data could enable alternative credit scoring, which can be used for assessment of target customers by the MFIs.

4. Financial inclusion/literacy

Improvement in financial literacy rates will allow MFIs to communicate their product proposition. With more basic bank accounts, the local population could have improved understanding of formal lending.

5. Human capital

Improvement in higher education enrolment, especially in areas with human capital crunch, such as the north-east region, could enable enhancing the on-ground sales force for MFIs. Since many regions require an understanding of local/regional languages, there is a specific need of sourcing local talent.

6. Political stability

Political stability guards against risks such as insurgencies, changing rules and regulations.

1. Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

Key challenges



There are several challenges in eastern India that are limiting the growth of MFIs in terms of reach and disbursement:

Human resource

MFIs compete with banks and NBFCs for the talent pool. Prospective employees prefer working with banks and NBFCs due to higher compensation and benefits offered, and better work opportunities, and a general perception of being better workplaces. Consequently, MFIs recruit inexperienced professionals which also increases training and development costs. While the target customers of MFIs are predominantly women, hiring women has been a challenge due to the travelling requirements of the job.

High operational costs

MFIs incur high operational costs, especially for searching and collecting information during loan origination, and during monitoring and collections, which limits their ability to maximize their outreach. The small loan sizes and short tenures further intensify the challenge.

Figure 11: Equity funding in the last 3 fiscal years has seen a rise across MFIs of varying sizes; however there needs to be more investment to address the funding needs (INR Cr)²

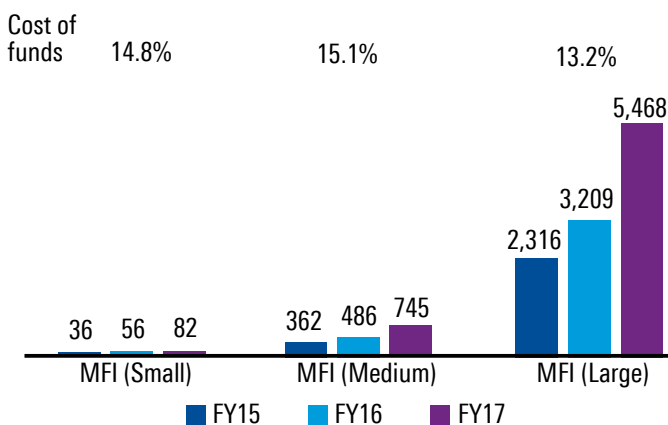
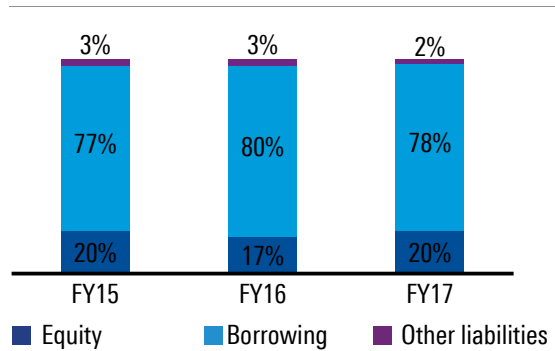


Figure 12: Equity investments form a minority part of the overall investment pool³



Difficulty in generating funds

In FY17, debt funding for MFIs was reported at INR24,896 crore.³ An important aspect to be noted is that 91 per cent¹ of the total debt funds received was by the large MFIs, that highlights the challenge that the medium and small sized MFIs face. The high cost of funds further leads to higher lending rates that affect the attractiveness/viability of the MFI's offering. However, now that some large MFIs have converted into SCBs/ SFBs, which would help them lower their cost of funds, banks are expected to be more liberal in funding small and medium sized MFIs. Additionally, to raise cheaper capital and manage credit risks, MFIs need to securitise their loan portfolios on an exchange platform.

Increased competition from banks and NBFCs

Banks are building their platforms or looking at strategic investments to connect directly with the poor. While MFIs cannot accept deposits, which leads to higher cost of funds, additional policy barriers such as the capping of margin at 10 per cent affect their profitability.

High delinquencies

The PAR (Portfolio at Risk) greater than 30 days reached double digits for many states in Q4FY17 due to cash-shortage (e.g. in Bihar, the PAR>30 days jumped from 0.74% in Q3FY17 to 14% in Q4FY17).⁴



2. Status of Microfinance in India, 2016-17, NABARD, 2017, last accessed on 3 January 2018

3. Microfinance Institutions Network (MFIN) Micrometer, Issue 21, MFIN, May 2017, last accessed on 6 January 2018

4. Demonetisation's blow to microfinance sector, Livemint, October 2017, last accessed on 3 January 2018

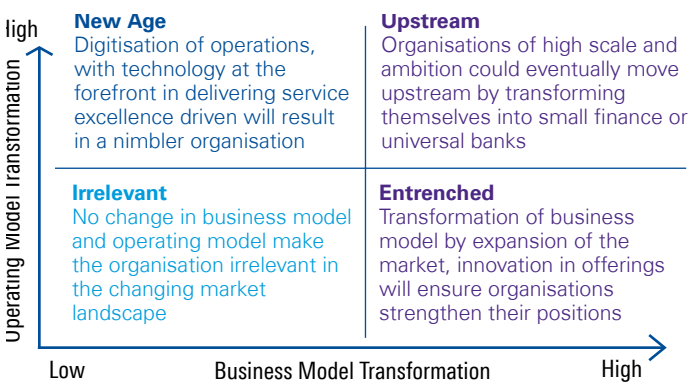
Emerging themes for MFIs in the current environment

In a fast-growing country like India, the role of microfinance institutions is critical. These institutions help in enabling the poorer sections of the society so that they are not left behind in the economic progress. Given the crucial role played by MFIs in financial inclusiveness, following are key themes to understand which would enable them to perform better and succeed:

1. **Future of MFIs**
2. **Digital: Enabling change**
3. **Collaborations and partnerships**
4. **Risk management**

Future of MFIs

The microfinance industry has played a vital role in promoting financial inclusion across the country. It has grown rapidly in the past few years at a CAGR of 27 per cent and is expected to grow at a CAGR of 25-30 per cent over the next five years.¹ While there is a positive outlook towards the microfinance industry, pure-play MFIs are facing stiff competition from SFBs and universal banks. In light of the dynamic landscape that they operate in and emerging trends in the sector, MFIs need to transform their business and operating models to survive and succeed. Following are four possible future scenarios that could play out for an MFI organisation:



Source: KPMG analysis

Critical factors that MFIs will need to effectively act upon and which will determine which of the quadrants they will move to in the future are detailed below and in subsequent sections.

Evolving Competition - SFBs

MFIs came into existence because of banks' reluctance to lend to borrowers with limited or no credit history, especially in rural areas. Over the years, MFIs have successfully transformed themselves, with the majority of the lending now happening in urban areas. Due to a variety of reasons such as the success of MFIs, regulatory push by RBI and government's focus on financial inclusion, banks have also started focusing on this sector. In addition, eight of the large MFIs have transformed into Small Finance Banks. These MFI-turned-SFBs are direct competitors and have significant advantages such as access to lower cost of capital, ability to provide a wider variety of products and services, which make it imperative for pure-play MFIs to differentiate themselves in the market in order to stay relevant. There are three key levers which MFIs could have to play on:

a. Penetrate untapped geographies

With SFBs offering a wider variety of products and services at better prices to existing customers, pure-play MFIs need to expand the size of the pie by reaching into hitherto untapped markets. With RBI's push to further financial inclusion, there has been considerable progress made in the past few years but there are still pockets in the country, which are reliant on money lenders for financing needs. East and north-east regions of the country are relatively underserved as compared to rest of the country. While penetration has been improving in these regions, there are still major gaps as compared to other regions in the country as can be seen below:^{2,3}

1. KPMG in India Analysis

2. Report on Trend and Progress of Banking in India, 2016-17, Reserve Bank of India, last accessed on 4 January 2018

Banking outlets in villages have increased from 67,694 in March 2010 to 560,910 in September 2017. The importance of Business Correspondents (BCs) is underscored by the fact that in March 2017, 91 per cent of banking outlets in villages were BCs as against 50.5 per cent in March 2010. These are important trends that can be leveraged by MFIs in entering/serving relatively underpenetrated geographies, especially with improving infrastructure, network connectivity, Aadhaar penetration and rising customer awareness.

b. Target the right customer

A typical microfinance customer has informal and irregular income patterns. While SFBs are likely to take the cream of these customers, MFIs would be forced to take on riskier profiles and segments in the future. This necessitates the need to have more robust credit assessment tools and stronger risk management practices. With increasing digitisation, algorithms which can analyse and predict consumer behaviour will be key in improving accuracy and bringing down cost of credit assessment. Janalakshmi (Jana Small Finance Bank), an MFI turned SFB, was one of the pioneers in assessing borrowers with psychometric evaluation in addition to the traditional assessment by credit bureau scores and field investigation. They found that customers who scored in the bottom quartile of the test are 2.5 times more likely⁴ to default than customer in the top quartile. Thus, data-driven decision making is critical in maintaining a healthy portfolio.

c. Innovate in product offerings

Microfinance customers need customised products that are synchronous with their earning and consumption patterns. Given their vulnerability to external shocks (medical emergencies, policy changes, etc.) there is a need to structure products, which could help them sustain these challenges. But additional flexibility increases complexity in operations and are more risky (liquidity risk, fraud risk, etc.). History indicates that ensuring strict financial discipline is critical to operate successfully in this segment. Hence, flexibility needs to go hand-in-hand with appropriate controls such as joint liability, weekly repayment, etc. Following are some innovative products and practices from across the world, which have been successful over the years:⁵

- **SafeSave, Bangladesh:** Basic savings product offered to customers, which offers flexibility in deposit and withdrawal. Loan linked to this savings balance, with adequate controls such as maximum amount limited to one-third of savings balance as collateral, increasing ceiling with good credit

history, regular visits by agents to collect deposits and repayments has helped build a strong portfolio over time.

- **Seasonal loans by Confianza (Peru) and Banco Los Andes ProCredit (Bolivia):** Given the seasonal nature of agriculture, rigid and inflexible loan disbursement and repayment schedules are not best suited for agriculture financing. Hence, both these institutions offered short-term customised loans based on client requirements. The key to their success was their strict adherence to credit discipline such as choosing customers with diversified income streams, constant monitoring, penalties on defaults, etc.

Investments in MFIs

According to reports⁶, MFIs (excluding SFBs) had total Net Owned Funds of approximately INR8,845 crore. Of this, equity constitutes INR3,615 crore and they collectively raised fresh equity of around INR1,995 crore during the year in spite of major disruptions such as demonetisation. In addition to PEs and VCs investing in the sector, a key trend in recent years is the interest shown by banks / other financial institutions in acquiring a stake in MFIs. IDFC Bank, DCB Bank, Kotak Mahindra Bank, Muthoot Finance, Manappuram Finance are some of the entities, which have invested in microfinance companies. One of the larger deals which are currently in the works is IndusInd Bank's takeover of Bharat Financial Inclusion Ltd (erstwhile SKS Microfinance). This indicates the growing importance of the under banked segments to traditional financial services players and a testament to their potential.

Funding growth

Debt financing for MFIs was INR24,896 crore in FY17⁷. Banks have traditionally been the main source of funding for the MFIs. But the contribution of non-bank entities has grown from around 20 per cent in FY13 to roughly 43 per cent in FY17.⁸

In addition to these traditional source of funding, crowd funding is another potential source for MFIs in the future. It currently forms a small part of the overall non-bank portfolio, due to various challenges around uncertainty in funding amount and timelines, additional intermediation, coordination required, stability of partnership with the platform, etc. In spite of these challenges, there are instances of beneficial collaboration⁹ such as the one between Annapurna (People's forum) and Kiva.org, and between Milaap and Arc Finance to fund multiple partners MFIs in the mission of clean energy.

3. Report on Trend and Progress of Banking in India, 2016-17, Reserve Bank of India, last accessed on 4 January 2018

4. Psychometric testing on the rise in emerging markets, Financial Times, February 2015, Last accessed on 3 January 2018

5. Innovative Flexible products in microfinance, Savings and Development, Vol. 35 (2011), accessed on 4 January 2018

6. The Bharat Microfinance Report 2016-2017, Sa-Dhan, September 2017, Last accessed on 3 January 2018

7. Microfinance Institutions Network (MFIN) Micrometer, Issue 21, MFIN, May 2017, last accessed on 6 January 2018

8. The Bharat Microfinance Report 2016-2017, Sa-Dhan, September 2017, Last accessed on 3 January 2018

9. Crowd-Funding in Microfinance in India: Issues, Challenges and Opportunities – Policy paper by Poorest States Inclusive Growth (PSIG) Programme, September 2015, last accessed on 3 January 2018

Collaborations and partnerships

MFIs play an important role in providing financial access to underserved segments in the country. Hence, they are best suited to facilitate access to a variety of products – financial and non-financial – to these segments. In addition, this also provides them an additional source of revenue. Given the potential revenue opportunities in providing products and services to consumers at the bottom of the pyramid, there is a need for MFIs to enter into alliances and partnerships. Following are a few which can benefit all stakeholders involved – consumers, MFIs and alliance partners.

MFIs as Business Correspondents (BC)

As on March 2017, BC portfolio of MFIs stood at INR10,131 crore,¹⁰ growing at a rate of 27 per cent y-o-y. This contributes to 22 per cent of the total portfolio and 73 per cent of managed portfolio of the MFIs.

In 2017, RBI's branch authorisation policy modified the definition of branches as Banking Outlets (BO) which can include centres manned by business correspondents. As per RBI reports,¹¹ by changing the definition of branches to BOs and including BCs, the number of Unbanked Rural Centres (URC) has come down to 4.25 lakh as compared to 5.55 lakh (**~25 per cent drop**). This is still a large number and presents a significant opportunity for MFIs to partner with banks, especially in URCs where banks need to open 25 per cent of new branches every year. Following are some of the benefits for MFIs to act as BCs for banks:

- Additional avenues of income generation by providing additional products and services to customers
- Increased penetration and performance of core portfolio due to improved brand loyalty on the back of enhanced customer engagement
- Reduced risk as portfolio is on the books of the banks
- Access to better technology and processes from banks, which are typically stronger in these aspects
- Faster route to furthering the purpose of financial inclusion

Portfolio securitisation

By virtue of the nature of the business and accessibility to the bottom of the pyramid customers in semi-urban/rural locations, MFIs are well-placed to generate PSL (Priority Sector Lending) eligible assets. Further with a product portfolio enabling income generating activities for agri and allied activities and micro enterprises, MFIs are able to generate assets eligible to be considered for PSL sub targets on agri (18 per cent) and micro enterprises (7.5 per cent).

Traditionally, Direct Assignment (DA) and Pass Through Certificates (PTC) are the key instruments used for securitisation of PSL eligible assets with PTC being the preferred instrument

due to availability of First Loss Default Guarantees.

The transaction volumes in these instruments had grown in excess of 40 per cent CAGR over the period of 2012-2016. The market is expected to grow with a CAGR of 21 per cent till 2020.

Small Finance Banks, who were the major securitisation originators (45 per cent market share) as MFIs are expected to be aggressive in the securitisation market in short term. Therefore it is important for standalone MFIs to work closely with target banks and other financial institutions and develop long term strategic partnerships for securitisation rather than a transaction based relationship. Further, the MFIs will also have to tackle the challenge of emergence of Priority Sector Lending Certificates (PSLC) as an alternative method of achieving PSL targets which are expected to reduce the demand of securitised portfolios from banks.

Clean energy and water

Basic necessities such as electricity, potable water are still out of reach for vast sections of our rural India. A study by WaterAid¹² says that India has 6.3 crore people living in rural areas without access to safe water – the highest in the world. The government's Rural Electrification Program has made considerable progress but many villages still do not have uninterrupted power supply. Finance, access to products of good quality and supporting ecosystem for after-sales service are key barriers in providing basic requirements to the masses.

MFIs are well poised to tackle all these challenges and improve the standard of living of rural population. Many of them already offer finance for purchasing these products such as solar lanterns, solar homes, water purifier etc. and have tie-ups with manufacturers. Following are some key imperatives for continued success of MFIs in this segment:

- Identifying the ideal ticket size of loans based on customer requirements, transaction costs for originating and maintaining the loan, and market conditions
- Collaboration with manufacturer with track record of producing good quality products
- Assess customer life cycle needs and position relevant rather than standard products.



Case study: Kenya - d.light partnership with MFIs for solar energy access¹³

A partnership between off-grid solar provider d.light and micro lender Musoni has made solar energy affordable and accessible for low-income customers in Kenya. As more than 4.7 crore households in Africa and Asia are not able to afford electricity, d.light is entering into tie-ups with MFIs to fund the cost of ownership of their solar products. The MFIs in turn are repaid by customers over a certain period. The disbursement and repayment is through M-PESA. This partnership has been fruitful due to the overlap in the target segment of the two entities, transparency in sharing data, and technology driven operations.

10. The Bharat Microfinance Report 2016-2017, Sa-Dhan, September 2017, Last accessed on 3 January 2018

11. Report of the Internal Working Group on Rationalization of Branch Authorization Policy, RBI, September 2016, last accessed on 3 January 2018

12. Wild Water – State of world's water 2017, WaterAid, last accessed on 4 January 2018

13. Low-income earners in Kenya can now access Solar energy through d.light Partnership with Microfinance Institutions, d.light, May 2017, last accessed on 6 January 2018

Fintech partnerships

Fintech and microfinance fundamentally seem to be at two opposite ends in terms of the operating models. While the key to success in microfinance is a high touch model maintaining a close connect with the customer on a weekly/monthly basis, fintechs primarily work on a low touch model leveraging technology to connect with the customers. However, a collaborative approach between fintechs and MFI institutions can go a long way in improving operational efficiencies as well as understanding and serving the customers better through technology-enabled products and services. The collaboration is also important from the perspective of educating the bottom of pyramid customers and getting them ready for the digital transformation that the entire financial system in India is going through.

Some potential areas for collaboration between fintech companies and MFIs are as below:

- Credit assessment models using big data and alternate data source
- Easy disbursement and repayment through cloud-enabled tools
- Analytics to predict portfolio quality
- Personalised service offered to the customer, based on individual needs and preferences
- Mobile/tablet based loan origination, disbursement and collection model



Case Study: Sonata Finance, Oxigen Services and Grameen Foundation India

With the objective of bringing the financial services to the fingertips of MFI customers, Sonata Finance and Oxigen services collaborated to develop an application integrating all the digital solutions launched by the government of India including AEPS, UPI, debit cards, e-wallets enabled by biometric authentication. While Sonata and Oxigen brought their respective strengths on understanding MFI needs and technology expertise to the table, GFI played a crucial role in ensuring smooth change management through digitally enabled learning programme. GFI launched Grameen Learning Program (G-LEAP) to train the front end MFI employees using an e-learning Android app that enables staff to get training anytime, anywhere using their smartphone. These employees in turn used the app to train more than 27,000 customers on various features and services leading to a strong adoption.

Telecom companies

With increasing digitisation, the boundaries between financial institutions and telecom companies are blurring rapidly. Tie-ups with telecom companies to digitise transactions and lessen reliance on cash can help MFIs reduce cost of operations and contain risks. Following are some of the possible opportunities arising from such a tie-up:

- Digital loan disbursements and repayment
- Digital deposits and savings
- Acting as agency for services
- Money transfer

Insurance

In addition to the need for finance for income generation activities, insurance is a key need for bottom of the pyramid customers being catered by MFIs. This is because a majority of these people live in a risky environment, vulnerable to risks and economic shocks such as loss of jobs, loss of property due to theft or fire, crop failure, the death of a breadwinner, etc. While micro-insurance targeted at this segment is a well-developed market in India, the key challenge is availability of channel partners to deliver this to remote locations. This is where MFIs have a strong role to play by way of collaborating with insurance companies to not only distribute the products but also as a risk management measure to ensure that the affected household is able to cope up with the unforeseen calamities and continues to have the capability to repay the MFI loan. Further there is an opportunity to bundle MFI loan products with insurance products and align them to specific needs of the customers to create a strong value proposition.



Case Study – Madison Insurance with PULSE, FINCA Zambia

Madison Insurance partnered with PULSE and FINCA Zambia to study and understand the key risks that confronted the MFI customers and accordingly Credit Life Insurance (CLAS) and Funeral Insurance Policy were specially designed to cater to the specific needs. While Madison had the responsibility for the product design and management, MFIs were responsible for premium collection and claim settlement at the last mile. The partnership was a win-win situation for both the parties as Madison got business volumes while the MFIs benefited in the form of lower credit risk, enhanced profitability through commissions and a better value proposition for the customers.

Digital – Enabling change

The year 2017 marked the year of further maturity and growth of the microfinance sector in India. As expected, with the scaling up of operations and introduction of new products/services, the role of digitisation and digital has become pivotal in the growth story of the industry. Service delivery is a key cost component in context of the business model and without investment in digital and adoption to new digital operating models, scaling up and staying profitable could continue to remain a challenge.

We will set the context by evaluating three key pillars that continue to influence the microfinance growth story at a macro level – digital infrastructure, government initiatives and mobility.

Digital infrastructure

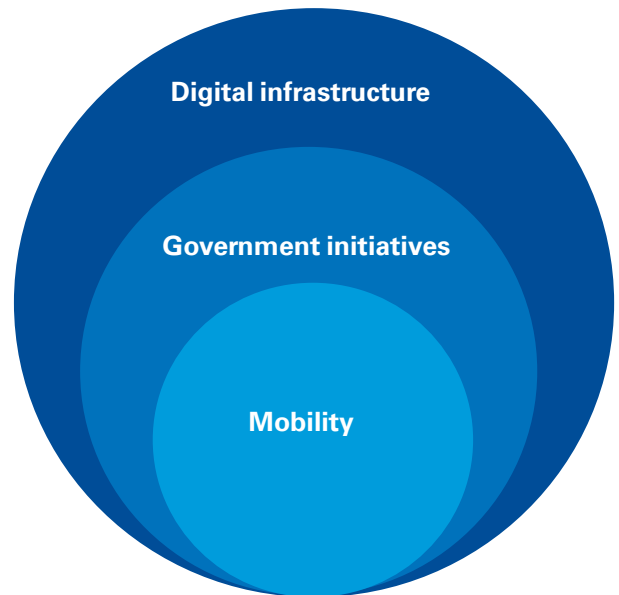
Expansion of digital infrastructure and increase in the rate of digital adoption are laying the foundation for a digital eco-system that could fuel the change required to increase the financial inclusion in the country.

Broadband development and adoption of high speed 4G networks laying the foundation for digital growth¹⁴

The average broadband speed in India is 6.5 Mbps (Q1 2017), which has marked an 87 per cent increase year on year. The broadband (4 Mbps) adoption in India is at 42 per cent representing an 81 per cent year on year change.¹⁵

The number of wireless users in India are likely to cross 98.4 crore in 2021 with mobile internet has already crossed 30 crore in 2017.¹⁶

The 4G connection base is expected to grow to 28 crore by 2020 and mobile broadband (3G and 4G) will account for just less than 50 per cent of the total connections.¹⁷



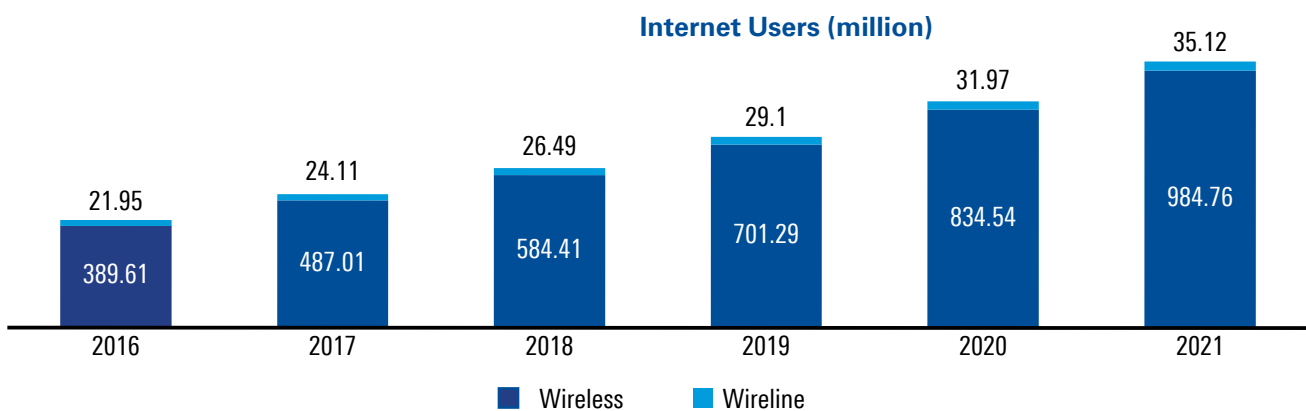
Mobility³

India - a mobile first market

With 94.6 crore mobile subscribers in India at the end of September 2017, India is the second largest mobile market.¹⁹ The number of smartphones have crossed 30 crore in 2017 and is expected to touch around 70 crore in 2020 with a 49 per cent adoption rate. The average selling price of smartphones is at INR8,500, which is half of that of China.²⁰

Mobile broadband connections are going to increase to 48 per cent in 2020 from 15 per cent in 2015 fuelled by data traffic growth of over 60 per cent. The data rates have dropped drastically across the board with the launch of Reliance Jio last year.²¹

Figure 13: – Internet users in India¹⁸



14. Akamai (State of the Internet) Q1 2017 report, last accessed on 4 January 2018
 15. Akamai (State of the Internet) Q1 2017 report, last accessed on 4 January 2018
 16. KPMG in India Analysis 2017
 17. KPMG FICCI Frames Report 2017, last accessed on 3 January 2018
 18. KPMG FICCI Frames Report 2017, last accessed on 3 January 2018

19. India's mobile subscriber base stands at 946.66 mn in September; Airtel leads with 29.80% market share, Telecom: Economic Times, October 2017, last accessed on 4 January 2018
 20. India pips China in smartphone sales pace but lags in volume, Economic Times, June 2016, last accessed on 4 January 2018
 21. Reliance Jio effect: Airtel, Idea launch data, free-calls tariff plan, Livemint, Dec, 2016, last accessed on 4 January 2018

Government policy

Government of India through its Digital India programme continues to invest and drive various digital initiatives to improve the digital infrastructure and digital ecosystem of the country.

Connecting the unconnected

Nearly 1,12,900 km of optical fibre cable has already been laid under BharatNet for high connectivity.²² Mumbai gets 1,200 Wi-Fi hotspots for free usage and Google is working with Railtel to provide free Wi-Fi at over 100 railway stations by the end of this year and 400 railway stations in the next few years.²³ Government's initiative to connect the remote parts of the country has on-boarded 8,621 villages already and plans to on-board over 55,000 villages by 2019.²⁴

Payments

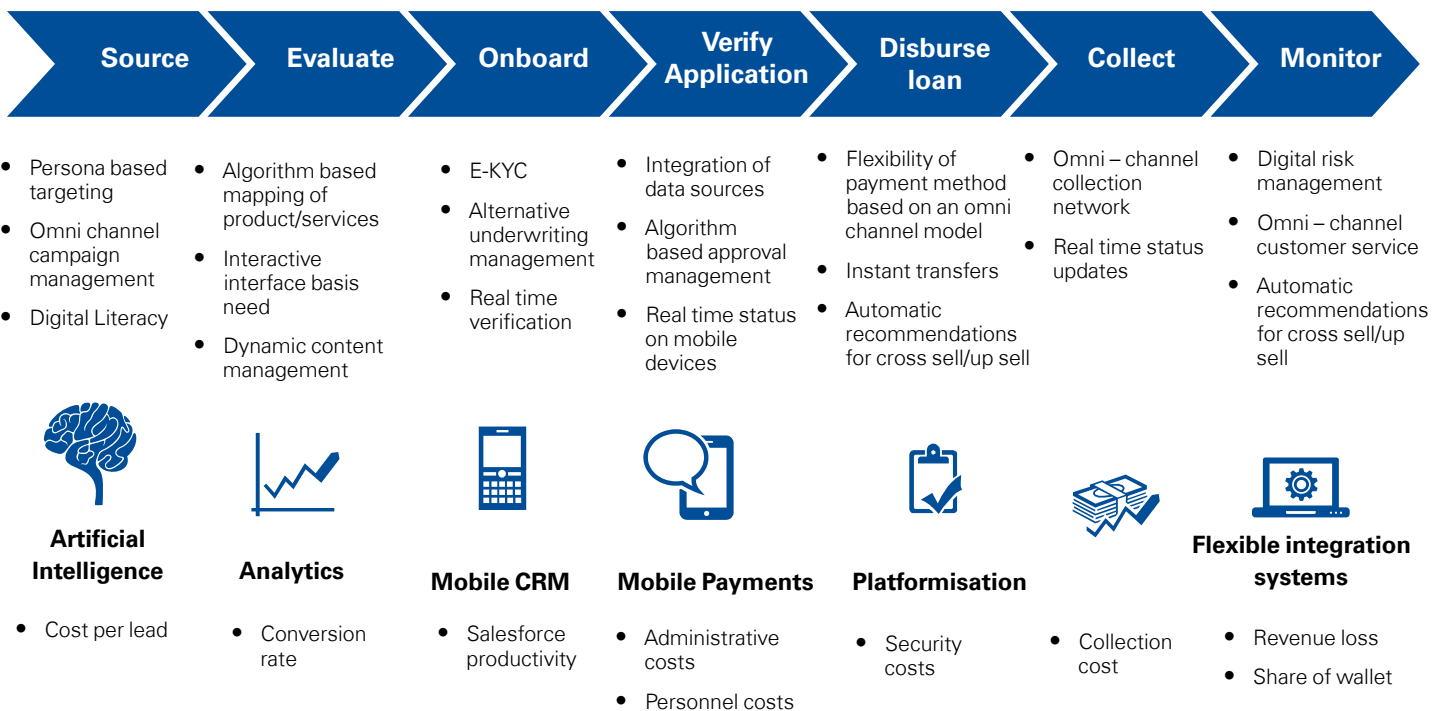
Recent development includes NPCI's pilot of Aadhaar Payment Bridge System (ABPS) with Unified Payments Interface (UPI) to digitise the last mile of payments, which has a potential to impact 8 crore annual disbursement transactions and over 90 crore repayment transactions.²⁵

Digital: Impact across the value chain

Administrative and personnel costs still remain the major cost components and contribute to over 50 per cent of the overall costs, which increase the stress on the overall margins.²⁶ Innovation in digital tools and technologies have made steady inroads across the complete value chain of the microfinance business.

Digital is enabling a service delivery that is intelligent, customer-focused and cost-efficient reducing manual processes and physical infrastructure. As an example, MIMOS in Malaysia is leveraging digital by developing an integrity assessment tool that incorporates behavioural characteristics that proxy individual's integrity as well as any adverse traits that highlight a user's inability to pay contextual to the local culture, values and norms.²⁷ This process enables continuous monitoring of the risk profile of the customer, which increases the visibility of payment ability and reduces recovery costs. Figure 23 diagram shows the various digital innovations across the value chain and the impact it has on the key service delivery and growth KPIs.

Figure 14: Customer Value Chain²⁸



22. Digital India, Newsletter, July 2016, last accessed on 6 January 2018

23. Digital India, Newsletter, September 2016, last accessed on 6 January 2018

24. Digital India, Newsletter, May 2016, last accessed on 6 January 2018

25. <https://www.npci.org.in>

26. The Bharat Microfinance Report 2016-2017, Sa-Dhan, September 2017, Last accessed on 3 January 2018

27. MIMOS to partner more companies for psychometrics assessment tool, MIMOS National R&D Centre in ICT, December 2017, last accessed on 2018

28. KPMG in India Analysis

Challenges

Development in infrastructure and devices would have to go hand-in-hand for a true transformation to take place. India has embarked on this journey and made some significant strides but there is still progress to be made. Below are some of the key factors hindering digital penetration in this industry:

Infrastructure

The issue here is supply side as supposed to demand side. Last mile access is still limited whereby there are still issues pertaining to electricity, internet and payment infrastructure in rural India. Over 55000 villages still don't have last mile connectivity.²⁹ Substantial investments would be required to invest in infrastructure to keep up with the development goals but there are roadblocks due to delays in regulatory and policy approvals and also the commercial viability of such projects is questionable.

Affordability

Although digital technologies have increased the art of possible in the financial sector, it comes with a price tag. Most of the small- mid size microfinance organizations find it financially unviable to invest in high end technologies given their existing business models and transaction size and volume. In most cases, there is an ongoing operational cost element attached to the technology investment which is unviable to sustain in the long run absence of minimum required transaction size/volume.

Adoption

Adoption of digital driven business models is a challenge on the customer end as well as on the field force end. Digital literacy as well as digital awareness is low in rural India.

Given this, there is an inertia to change their ongoing habits of loan requisition.

On the field force end, there is reluctance to adopt to new digital tools and processes due to inadequate training, fear of change or value add for them is either absent or limited.

Absence of security frameworks and protocols in a digital enabled business model sometimes causes more damage than advantage in the form of frauds, which reduces the adoption levels.

Future State: Service delivery models

Service delivery models could go through continuous disruption, but the key is to keep the customer at the centre of this change and align the business models around customer's needs.

Increase in customer focus

The target customers in this industry have fragmented geographical catchment areas, varied cultural backgrounds, inconsistent cash flows, low education and digital literacy levels. The element of human touch also is very high in this business. Understanding the customer and remaining close to their needs becomes critical. Analytics-based digital solutions should be leveraged to capture and mine customer needs and behaviour.

As an example, companies like First Access and Demyst Data create alternative credit history out of parameters such as phone payment and social media history data. This solution tackles a very realistic problem statement in the industry where potential customers don't have any credit history.³⁰

Transition of focus from product to service

The MFI competition landscape is already intensifying with over 160 MFIs operating in over 560 districts across India.³¹ Given this, the customer experience provided across each of the touch points could become very important, not only from a servicing perspective but also as a differentiator. Microfinance companies will have to focus on service delivery to deliver superior customer experience to attract and retain customers keeping the cost quotient in check. Adoption of cost efficient digital solutions to educate, on-board and service to simplify the customer's journey through its product portfolio could be key.

As an example, Ujjivan Financial Services is investing and upgrading its customer facing digital solutions to provide a seamless omni channel experience to its customers.³²

29. Last mile issues in digitization drive, Business Line, April 2017, last accessed on 5 January 2018

30. How financial technology is changing financial inclusion, Accion, last accessed on 23 December 2017

31. Sa Dhan (2017). The Bharat Microfinance Report 2017

32. Annual Report 2016-17, Ujjivan Financial Services, last accessed on 3 January 2018

Flexibility of business models

Innovation in digital technologies and services is enabling the microfinance sector to scale at a very fast pace, which was not possible through its traditional distribution model. However, these innovations call for transformation of existing business models. Given the recent rate of disruption, change is becoming the new constant and businesses have to constantly re-align to the changing customer behaviour and customer needs. This would mean that the business models should be flexible enough to adopt to new solutions and go to the market swiftly to capture the market.

Musoni Kenya is leveraging digital to reduce the human touch component from operational tasks to focus on problem solving and deepening customer relationships. This has helped the organisation to increase its outreach by disbursing over 11,000 loans with a value of USD25 million³³. It invested upfront in training customers about its app and then slowly removed the human component from operational tasks as adoption increased.

Some change can be incorporated into the business models but some changes would mean partnering with start-ups and other specialised institutes to provide end-to-end solutions to the customers. Microfinance institutes must be ready to partner with providers of new technological and business solutions to remain relevant to their customers. As an example, Ujjivan Financial Services has roped in Pradeep Sarkar, a renowned director to create a film on financial literacy called 'Paisa ki ABCD' in collaboration with the Parinam Foundation.³⁴

Risk management

The microfinance industry has grown at good pace in the last few years and government initiatives like financial inclusion and Digital India are pushing further the growth story of the industry. With the growth in credit offtake and operations, the exposure to various risks have also increased manifold.

Credit risk, which is inherent in any financing business, is generally lower in the MFI space. The structure of Joint Lending Groups (JLG) and access of personal information of each group member and social pressure are key reasons for the same. The same is evidenced through Portfolio at Risk (PAR) measures as provided in the table³⁵ below:

S.no	Year	PAR >30	PAR >90
1	FY 13-14	0.58%	0.48%
2	FY 14-15	0.46%	0.35%
3	FY 15-16	0.36%	0.26%

The table above indicates the portfolio levels above key risk criterion of 30 Days Past Due (DPD) and 90 DPD. Shorter repayment structures and high interaction with the counterparty are the key drivers for the same. On the systemic risk side, political risk is a key factor that affect the entire sector. The



33. 110,000+ loans disbursed with value of 2.6+ billion, Musoni: Next Generation finance, last accessed on 7 January 2018

34. Annual Report 2016-17, Ujjivan Financial Services, last accessed on 3 January 2018

35. The MicroScape FY 15-16, Microfinance Institutions Network, last accessed on 4 January 2018

political situation in few states had increased the GNPA in multiples of normal scenario. The legal and administrative framework over and above the regulatory framework also provide a key source of systemic risk. Additionally, any parameters affecting the low income households like rainfall, natural disasters, etc. also fall in the systemic risk category.

On the event risk (low probability and high severity) side, the demonetisation has had a major impact on the collection efficiencies of the entire sector. There was an immediate decline in the quality of the portfolio post November 2016. The measure of portfolio quality like PAR>30 increased to 14 per cent from under 1 per cent. This anomalous deterioration in portfolio quality was directly attributed to lower recoveries post the demonetisation event. Shortage of cash and related impact on income of low income households adversely impacted the repayment capacity of the borrowers.

The operational and fraud risk for MFI industry is high, given the cash intensive nature of the business. Additionally, vulnerability to security risks in relation to theft etc. is also critical. MFIs generally set up cash limits and purchase insurance to manage such risks.

Finally, the table³⁶ below shows the write off rate for the sector:

S.no	Year	PAR >30	PAR >90
1	FY 13-14	0.38%	0.48%
2	FY 14-15	0.27%	0.35%
3	FY 15-16	0.25%	0.26%

Comparison between the PAR 90 rates (asset quality) and write-off rates for the MFI signify that most of the portfolio that goes past 90 DPD has no/little recoverability. The unsecured nature of lending also contributes to the same. This places high importance on the collection mechanism and efficacy of collection process to manage recoveries.

Developments

A few of the MFI/NBFC institutions were required to assess the credit risk of the financing book based on new accounting standard of Ind AS 109. The standard requires the institution to assess the provisioning requirements based on forward-looking expectations vis-a-vis the backward looking Days Past Due (DPD) earlier used in line with regulatory requirements. These requirements require the entity to assess four key parameters:

- 1. Probability of Default (PD)** - PD is the measure of the probability of default of a financial instrument over a period of specific length. Ind AS 109 requires the use of multi-year (or lifetime) PDs in order to indicate a collection of PD values referring to different time periods
- 2. Loss Given Default (LGD)** - LGD is the estimate of the loss from a transaction given that a default occurs. Lifetime LGDs would be defined as a collection of LGD estimates applicable to different future periods
- 3. Exposure at Default (EAD)** - EEAD represents the estimate of the value at the time of default, taking into consideration financial instruments' existing cash flow profiles, as well as expected additional drawings from credit lines up to the date of default.
- 4. Forward Looking Overlay** – A key requirement of Ind AS standard is to build future expectations based on the macroeconomic outlooks.

The Expected Credit Loss (ECL) were generally higher than values that were already provided for. This has directly affected the profitability and net worth of these MFI/NBFCs.

Additionally, there are multiple issues with institutions in the assessment of ECL and effectively the credit risk of the financing books of the MFI/NBFC. There are challenges around adequate data history, quality of data and adequacy of modelling capabilities within the institutions.

Effective risk management requirements

- Building of strong internal control framework to manage operational framework - An effective system of strong internal controls is the primary mechanism to identify, measure and mitigate operational risks.
- Robust systems to manage risk data and framework
- Building capabilities to model risk scenarios
- Policies and procedures at the branch level to minimize the frequency and scale of the risk.

36. The MicroScape FY 15-16, Microfinance Institutions Network, last accessed on 4 January 2018

Conclusion

India, which has been on a strong growth path in the last few decades is expected to transform into an economic powerhouse in the coming years. Eastern region is expected to be a key contributor to this growth along with the rural economy which has seen positive changes in recent years. But this growth will be truly impactful only when it is inclusive and benefits all sections of the society.

The role of MFIs in this context is crucial as they are best positioned to serve the bottom of the pyramid and uplift them. But given the ever changing market landscape, it is imperative for MFIs to transform themselves to stay competitive and succeed. They need to tackle competition not just from other MFIs but also banks, charter into untapped markets, be innovative in their offerings, and tap into the right customers. Given the nature of the business, prudence through strong controls and risk management practices is critical. But they cannot do all this by themselves and need to have strong tie-ups with like-minded organisations, both financial and non-financial, which will help them and their clients. They need to do undertake this transformational journey by embracing technology and digital and be drivers for long term sustainable impact to bottom of the pyramid customers as well as the Eastern India economy as a whole.

About KPMG in India

KPMG in India, a professional services firm, is the Indian member firm affiliated with KPMG International and was established in September 1993. Our professionals leverage the global network of firms, providing detailed knowledge of local laws, regulations, markets and competition. KPMG has offices across India in Ahmedabad, Bengaluru, Chandigarh, Chennai, Gurugram, Hyderabad, Jaipur, Kochi, Kolkata, Mumbai, Noida, Pune and Vadodara. KPMG in India offers services to national and international clients in India across sectors. We strive to provide rapid, performance-based, industry-focussed and technology-enabled services, which reflect a shared knowledge of global and local industries and our experience of the Indian business environment.

About AMFI-WB



AMFI-WB is an institution which endeavours to promote and develop microfinance in the state of West Bengal. Founded as a self-regulatory organisation, and registered as a Public Charitable Trust in 2010, AMFI-WB encompasses a community of microfinance organisations that operate in West Bengal.

It was formed to deliver better services to the poor, thereby helping these populations improve their standards of living. AMFI-WB envisions a community of microfinance institutions who are committed to initiating a significant change in the lives of the poor, especially women. AMFI – WB currently caters to around 60.75 lakh poor women by providing them with financial services, especially micro credit. With a membership of 27 Micro Finance Institutions especially micro credit through approximately 14,600 employees who hail from a lower economic background.

Their primary goals include: encouraging MFIs to maintain healthy relationships with banks, ensuring that MFIs stay on track and focused with the guideline prescribed to them, and mediating between various government officials and other important sector stakeholders. AMFI – WB regularly conducts stakeholder meets at the district level, management development programs for its members, microfinance industry-related seminars & workshops, and member meetings on matters of mutual interest. Some of the major initiatives/events recently conducted include the 2nd Eastern India Micro Finance Summit 2016 and HR Workshop on Legal Issues with the MD/CEO/HR personnel of all MFIs.

Acknowledgements

We would also like to acknowledge the core team from KPMG in India who worked extensively in preparation of this compendium:

Adil Iqbal

Aditya Rath

Anumita Chakrabarti

Anupriya Rajput

Dev Khandwala

Gurpreet Singh

Kaushik Narasimhan

Muralidharan Iyer

Rahil Uppal

Rajosik Banerjee

Robin Bishwajeet

Sameer Hattangadi

Shashwat Sharma



KPMG in India contact

Mritunjay Kapur

National Head,
Markets and Strategy
Head - Technology, Media and Telecom

T: +91 124 307 4797

E: mritunjay@kpmg.com

Narayanan Ramaswamy

Office Managing Partner,
Kolkata

T: +91 44 3914 5000

E: narayananr@kpmg.com

Follow us on:

kpmg.com/in/socialmedia



The information contained herein is of a general nature and is not intended to address the circumstances of any particular individual or entity. Although we endeavour to provide accurate and timely information, there can be no guarantee that such information is accurate as of the date it is received or that it will continue to be accurate in the future. No one should act on such information without appropriate professional advice after a thorough examination of the particular situation.

© 2018 KPMG, an Indian Registered Partnership and a member firm of the KPMG network of independent member firms affiliated with KPMG International Cooperative ("KPMG International"), a Swiss entity. All rights reserved.

The KPMG name and logo are registered trademarks or trademarks of KPMG International.

Printed in India. 046_THL0118