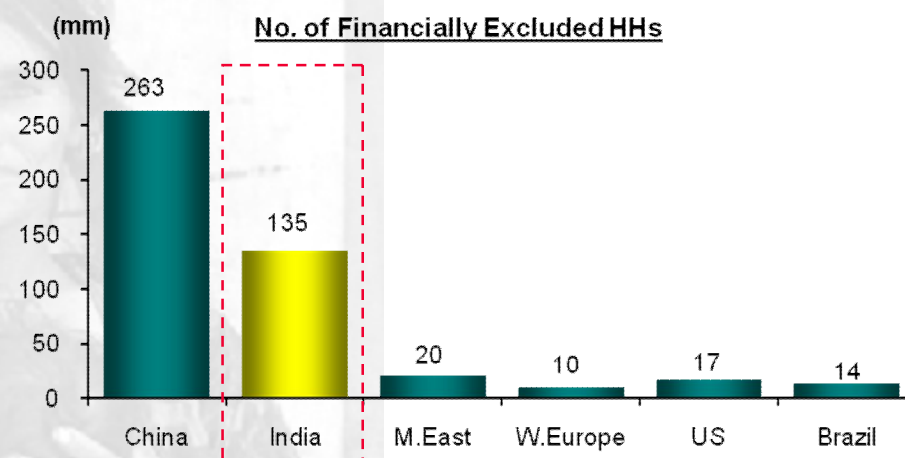


# Financial Exclusion Scenario

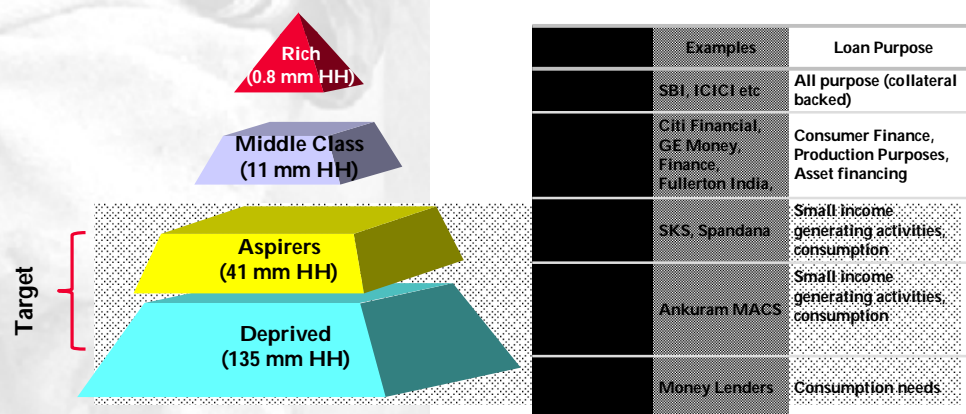
## Lack of Access to Financial Services

- To serve the financial service requirements of the Indian population (over 1.1 billion), there are:
  - 50,000 commercial bank branches
  - 12,000 co-operative bank offices
  - 15,000 regional rural bank (RRB) branches
  - 100,000 primary agriculture credit societies (PACS)
- Despite this high density, branch 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, India has ~135 mm households which lack access to formal financial services <sup>(1)</sup>
- Traditionally, this excluded segment has been serviced by money lenders who are located close to the borrowers generally and have a fast loan disbursement process. These moneylenders charge a high rate of interest ranging from 60% - 100% effective annual yields
- India stands 50th on the 'financial inclusion index' as proposed by Indian Council for Research on International Economic Relations

## Financially Excluded Households - Potential Market<sup>(1)</sup>



## Income Segments and Their Sources of Funding<sup>(2)</sup>



(1) Source: Boston Consulting Group – Presentation on Financial Inclusion

(2) Source: NCAER – The Great Indian Market 2005 (Exchange rate assumed below Rs. 50/US\$)

**Rich:** Annual household income > Rs. 1,000,000 (USD\$ 20,000)

**Middle Class:** Annual household Income between Rs. 200,000 and Rs. 1,000,000 (US\$ 4,000-20,000)

**Aspirers:** Annual household income between Rs. 90,000 and Rs. 200,000 (US\$ 1,800-4,000)

**Deprived:** Annual household income < Rs. 90,000 (US\$ 1,800)

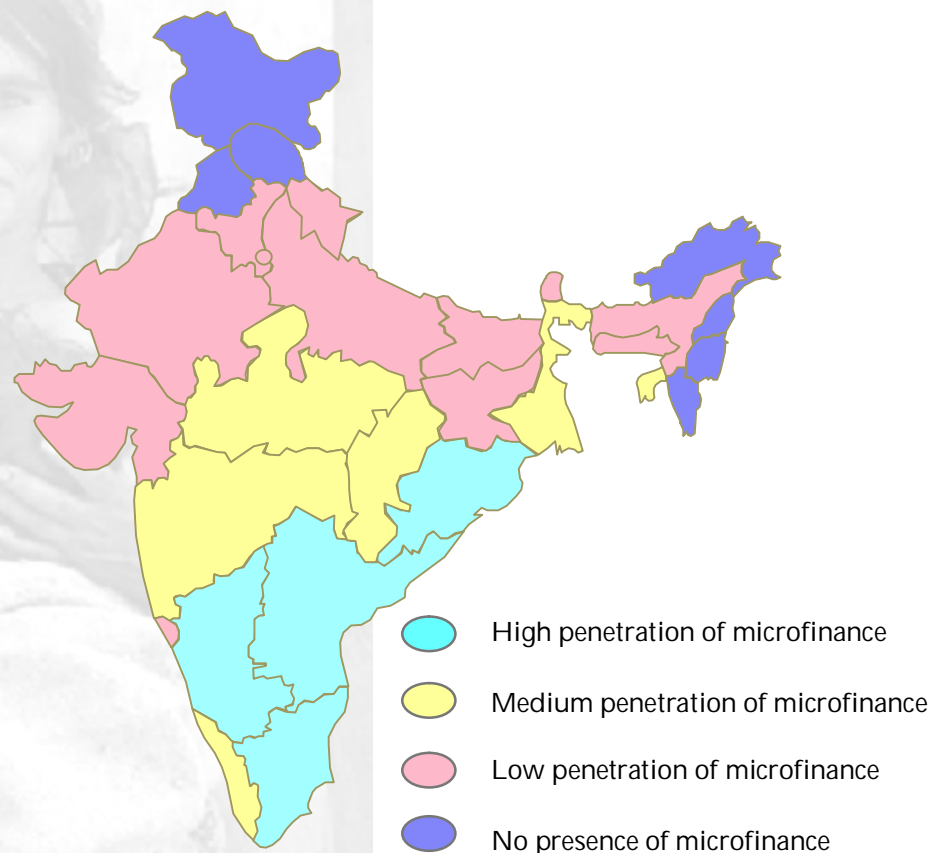
# Microfinance Penetration & Potential in India



## Microfinance Loans in India

- Microfinance loans in India range in size from \$150 to \$300 per loan – the loan sizes vary by region, client types and loan cycle
- Interest rates range from approximately 25% to 35% annually, which proves very attractive when compared to the only other alternative of going to local ‘money lenders’ who are known to charge in excess of 100% interest annually
- MFIs charge higher interest rates than traditional commercial banks as the operational costs of servicing small loans are much higher in percentage terms than the cost of servicing large loans. Additionally, MFIs provide their services at customers’ doorsteps. This too has a high cost associated with it, especially in rural areas where population densities tend to be low. In order to operate in a sustainable fashion, a MFI must price its loans so as to cover these costs

## Geographic Spread of Microfinance in India



## Market Size Estimation (Based on NCAER Classification)<sup>(1)</sup>

Segment	Daily Income	# of HH	MFI Market (HH)	MFI Market (People)
Rich	>\$55	0.8	0.0	0.0
Middle Class	\$11-\$55	11.0	0.0	0.0
Aspirer	\$5-\$11	41.0	20.5	112.8
Deprived	<\$5	135.0	67.5	371.3
<b>Total</b>		<b>187.8</b>	<b>88.0</b>	<b>484.0</b>

**Lok estimates the penetration potential of the existing microfinance model in India is ~88 million households / clients, out of which 20-25 million are existing microfinance customers, implying a current un-served demand of 63 to 68 million customers**

(1) Using NCAER income classification (pls see previous page), assuming exchange rate of Rs. 50/\$, average family size of 5.5 / household. 50% of Aspirers (median income \$8/day) and 50% of Deprived (above \$2.5/day) are included as potential microfinance clients, ignoring Aspirers earning > \$8/day and Deprived below the poverty line of \$2.5/day. Lok has also prepared more detailed estimates of potential demand and un-served demand taking into account state-level data on population and poverty levels, national-level data on income and Lok's estimate of the potential level of microfinance penetration in each state as well as the level of multiple borrowing.

# Formal Sector Credit to Rural Economy is Still Low

## Credit from Formal Sector Rising but Low<sup>(1)</sup>

Breakup of Sources of Funds for Cultivator Households (%)

	1951	1961	1971	1981	1991	2002
<b>Non-Institutional</b>	<b>92.7</b>	<b>81.3</b>	<b>68.3</b>	<b>36.8</b>	<b>30.6</b>	<b>38.9</b>
Money Lenders	69.7	49.2	36.1	16.1	17.5	26.8
<b>Institutional</b>	<b>7.3</b>	<b>18.7</b>	<b>31.7</b>	<b>63.2</b>	<b>66.3</b>	<b>61.1</b>
Co-op. Societies	3.3	2.6	22	29.8	23.6	30.2
Banks	0.9	0.6	2.4	28.8	35.2	26.3
<b>Unspecified</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>-</b>	<b>3.1</b>	<b>-</b>
<b>Total</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>	<b>100</b>

## Few Banks Have Been Meeting their PSL Targets<sup>(2)</sup>

Number of Banks Achieving 18% Agricultural Lending Target

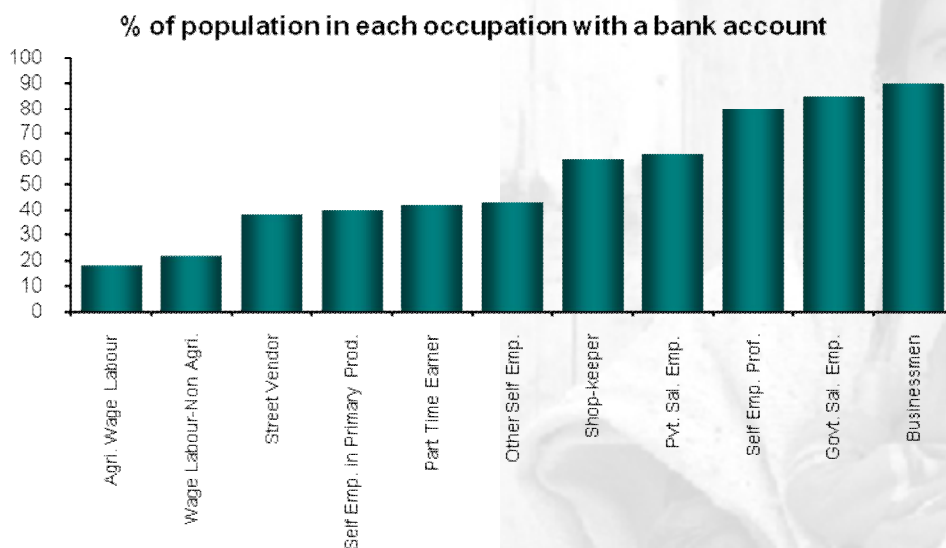
	PSU Banks		Private Sector Banks	
	Achieving Target	Not Achieving Target	Achieving Target	Not Achieving Target
2001	4	23	1	30
2002	6	21	2	29
2003	5	22	2	27
2004	8	19	NA	NA
2006	10	18	1	27
2007	8	20	3	23

- While 70% of India's population is rural and depends on agriculture, rural credit as % of overall credit remains low at 27%, similar to rural deposits to overall deposits and lower than rural GDP (50%)
- Reasons for this include low income levels of rural population and lack of access to banks but this could be changing with structural changes taking place in the economy and the rural and financial inclusion thrust of government
- Banking sector has been reporting strong growth in rural credit but the share of informal credit to total credit is still very high at ~40%, a ratio which has stagnated since the early 1980s

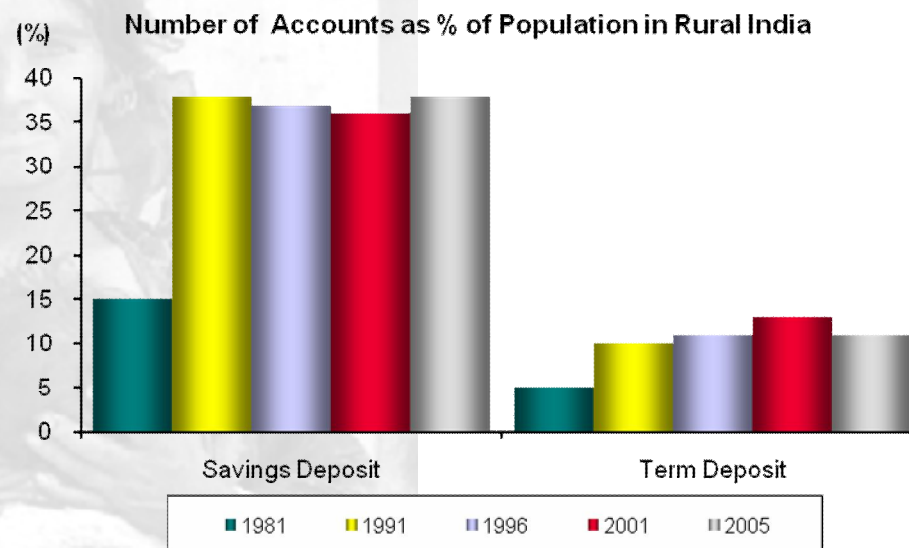
- Since FY95, banks have been required to provide the RBI with their disbursement target for agricultural loans, ranging from 20-30% as well as targets for lending to weaker sections of society (together these make up priority sector lending targets)
- However, given the difficulty of last mile challenges, banking sector has not been meeting its priority sector lending targets
  - Exposure of adjusted net bank credit to the agricultural sector is ~15.5% against regulatory requirement of 18%
- RBI plans to get stricter and impose penalties – if a bank does not meet its PSL targets, it will be penalized by subscribing to low yielding NABARD bonds

# Financial Savings in Rural Sector Also Very Low

## Low Income Groups Have Relatively Poor Access to Bank Accounts<sup>(1)</sup>



## Penetration of Liability Products in Rural Areas Continues to Remain Stagnant Since 1990<sup>(2)</sup>



- Similarly in the case of liability products, a large part of the rural economy operates in cash transactions and has fewer deposit accounts
- Around 60% of public bank branches are located in rural areas but account for just 25% of overall deposits of these companies (March 2008)
- Government of India is trying various ways to increase financial savings in the rural sector:
  - Currently there is no regulatory compulsion, only moral persuasion on the part of public sector banks to achieve coverage across villages to mobilize deposits and offer additional products and services in adopted districts
  - Government has tried to increase financial access for the lower quartile population through introduction of 'no-frill' accounts
  - Nearly 65% of all rural & semi-urban branches are those of public sector banks and only 7% those of private banks – this is expected to change going forward with the RBI requiring banks to open branches in under-banked regions
  - The Committee on Financial Inclusion has recommended that banks target 250 accounts per village per year over the next few years

# Lok Capital II - Looking at Financial Services Beyond Micro-credit

## Microfinance Business Model

- Drive customer growth through enhanced ability to scale
- Diversify revenue streams through new products and services
- Increase operational efficiency through technology , HR and process improvements
- Reduce operational risk through rigorous risk management practices

## Maximizing the Social Mission

- Maintain original mission of the sector to address poverty (soul factor)
- Deepen client relationship and make microfinance business model sustainable (commercial rationale)
- Seek favourable regulation from a conservative regulator (strategic rationale)

MFIs

## Deepening Financial Inclusion

- Micro-credit
- Micro-insurance
- Niche credit products (i.e. housing loans)
- Savings (e.g. through BC/BF model)(1)
- Remittance
- Pension

Enablers

- Front-end technology (i.e. rural ATMs)
- Back-end technology (i.e. core banking)
- Process outsourcing
- HR & training
- Risk management

**Investments in newer MFI services are critical to driving financial inclusion as they are (i) key to making the existing microfinance model in India more robust and (ii) maximizing the social mission including its commercial and strategic rationale**

(1) Business Correspondent / Business Facilitator model

# Current Limitations & Potential of Technology in Microfinance

## Monitoring

### Current Limitations

- Inability to have timely and accurate reports
- Challenges in audit processing arising from incomplete data capture

### Potential Solutions

- Improved front and back end systems enable enhanced ability to provide timely, quality reports w good systems
- Allows more transparency, better audit and access to financing

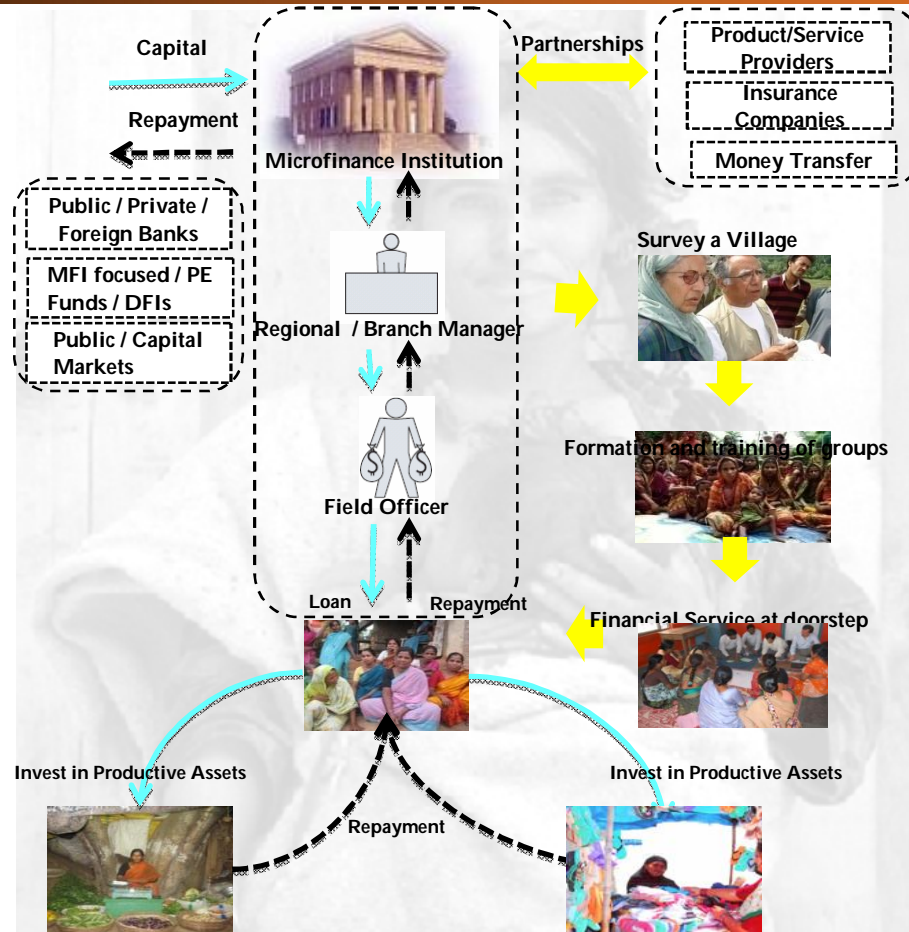
## Repayment

### Current Limitations

- Possibility of frauds
- Slow action on delinquency
- Poor or inconsistent maintenance of attendance data
- Low centre meeting efficiency
- Errors in transactions and paperwork

### Potential Solutions

- Strong back-end systems
- Front-end platform for communicating defaults/over dues, i.e. using mobile technology



**Critical elements of an enabling technology architecture include (i) a modular ERP<sup>(4)</sup> platform with integrated approach (loan tracking, accounting, HR and purchasing), (ii) credit bureau and (iii) mobile/handheld solution capable of collecting demand and recording repayment and attendance. Other elements which that are good to have are (i) point of sale network and (ii) rural ATM network.**

## Appraisal

### Current Limitations

- Non-standardized KYC<sup>(1)</sup> information
- Possibility of duplicate loans, loans to relatives in same group etc.
- Long turnaround times to appraise loans

### Potential Solutions

- Credit bureau
- Stronger, in-line, back-end system
- Better KYC norms

## Distribution

### Current Limitations

- Risk of handling cash for field staff
- Customer can only pay cash, hence loans must be made in cash
- Errors in transactions and paperwork

### Potential Solutions

- Good front-end systems, i.e.
  - Rural low-cost ATM<sup>(2)</sup> machines
  - Establishment of compatible POS<sup>(3)</sup> networks in rural markets

(1) Know Your Customer  
(2) Automatic Teller Machine

(3) Point of Sale  
(4) Enterprise Resource Planning



## *Broader Inclusion-Healthcare & Education Strategy*

- STRICTLY CONFIDENTIAL -

# Lok Capital's Philosophy on Inclusion



- Lok is focused on driving inclusive growth and is continually formulating strategies to help its investees implement inclusive growth models
- The microfinance sector enjoys an advantage in fostering inclusion because of its existing client base, market knowledge, proven outreach strategy and geographical reach – Lok's MFI partners collectively reach over 5 million microcredit and micro-insurance clients over 19 states in India

## Different Ways of Looking at Inclusion

- Serve a greater number of the disenfranchised
  - Microfinance is currently limited to the middle of the low-income bracket
  - Include the wealthier and the ultra-poor bands of the low-income group
- Deepen relationship with existing clients
  - Improve quality of service of microfinance offerings
  - Tackle last mile challenges in a socially relevant manner
- Provide more basic services and products
  - Diversify basket of financial products (i.e. insurance)
  - Provide goods and services that contribute to quality of life improvements (i.e. healthcare, education) and are better credit utilization opportunities

## The Importance of Inclusion for MFIs

- Social
  - Reaffirm MFIs' commitment to original mission and prevent disengagement from social agenda as MFIs gain scale
- Commercial
  - Need to diversify from single product focus to retain customer base with varied needs
  - Deepening relationships with clients helps MFIs formulate more appropriate growth strategies
- Strategic
  - Recognizing the pivotal role that inclusion will play in India's progress, the microfinance sector can drive favorable policies and regulation

## Existing Models being Used by Lok's MFI Partners to Implement Inclusive Growth Strategies

- There are a number of models that can be employed to implement inclusion through the MFI channel. Some of these models are:

### Provide alternative services and products directly

#### e.g. Spandana – Maternity Hospital

- Building a hospital to provide pre- and post-natal care for low-income women
- Utilizing its existing reach and knowledge of the customer base

### Provide services through different entities under one umbrella

#### e.g. BASIX – Livelihood Programs

- Houses various groups that provide various financial and livelihood products and services
- Achieves synergies and customer retention through the interaction of different units

### Act as conduit for external agencies

#### e.g. Ujjivan – Ultra Poor Program

- Partnered with Parinaam, a livelihood promotion institution for pilot program to serve specific needs of ultra-poor
- Ujjivan may gain potential future microfinance clients



# Investments in Healthcare and Education Companies



## Reasons for Lok Expanding Focus

- **We have chosen to look at certain models relating to delivery of critical basic services in low cost healthcare, education and training to the base/bottom of the pyramid**
  - We have collaborated with Monitor Inclusive Markets and other specialists to understand inclusion-focused businesses in India
  - We have found several innovative business models across education & health which are delivering high social impact and have the potential to be commercially viable
- **We have selected these areas compared to other potential areas such as agriculture (i.e. training, technology) or 'public goods' (i.e. food, water, energy) for the following reasons:**
  - Strongly supports our inclusion philosophy – critical, basic services with large unmet need and serious gaps in access, affordability and quality
  - Important avenues for productive utilization of credit by microfinance clients
  - Strong potential to generate more permanent long-term client relationships for Lok's MFI partners
  - There is proven demand and BOP clients willingness to pay for these low-cost, no-frills services
  - Delivery model is similar to microfinance – based on efficient distribution, high-throughput and para-skilling to solve last mile inclusion challenge
  - Appropriateness of Lok's VC model to catalyse new business models with high potential returns

*These requirements for are very similar to what the requirements of the microfinance sector were 3-4 years ago*

# Social VC – what the hell!

- Even for mainstream commercial businesses, VC hardly exists in India
- Social VC by definition demands a strong incubation/hand-holding feature. A) those skills are not easy to find and B) a small fund cannot afford it (pipeline is limited)
- The Social VC forgot to define “social” when they launched their funds. The measurements of “Social” are coming now
- Their return criteria were also not clear – MSDF, Lok Capital, Matrix partners
- 2-3 themes seem to be getting all the attention.. maybe at expense of others... pool is still limited
- Social Investment needs to be “institutionalized”. Lok’s LP list is limited to DFI. More sources need to be added with a permanent “impact investment” objective
- Regulations in most countries (except a few European) is not conducive to mixing ‘non-profit’ and “for profit” structure. In India it is impossible

*SO GIVE US SOME MORE TIME, WE WILL GET THERE!*

# What do they look for? – Lok perspective

## Promoter, Team

- Can we have a good working relationship for 5 years – will I have fun.
- Their motivation

### Business Plan

- Focus on 2-3 years max.
- Focus on assumptions not numbers
- Complete execution focus

Scale is very attractive!

Piloting and some proof of concept can be useful