

SYNTHESIS

Putting wealth management at the centre of micro finance

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Let's talk about 'Shanta' — a standard rural micro finance customer. She is a woman in her late-20s and manages a household of young children, elderly dependents and her spouse. She has plenty of economic entrepreneurialism that results in incomes from agriculture, dairy and labour. Her income is adequate, but there are many claims on her money. Children falling sick, school fees, a relative's marriage, neighbours taking a loan, and so on. Add to this the fact that her income is extremely volatile — rain failure in particular years results in total crop failure; labour opportunities disappear due to economic cycles; or, more commonly, a health shock results in inability to work and earn money. Cash for her household therefore is a leaking bucket. There are days (far too many) in the year when there is simply not enough.

Enter a micro finance institution (MFI). It makes an important difference to Shanta's life by letting her take a loan when there is not enough money, providing some element of a safety net. This allows her to manage cash mismatches in ways that are superior to taking usurious loans from moneylenders, selling assets like gold or buffaloes, or pulling her daughter out of school!

The growth of micro finance in India has been unambiguously important for millions of poor households in the country. However, much more can and should be done.

Need for wealth management

Shanta's financial life can be seen as a combination of certain exposure to time (income today, income tomorrow, expenses the day after, and so on) and uncertain exposure to shocks such as failure of the monsoon, or ill-health. Her financial wealth can be seen as a combination of assets that she currently owns (jewellery, cows, goats, etc) and the present value of her future

income computed by using a risk-adjusted discount rate.

How do we give Shanta the full range of financial services and wealth management by a financial services provider so that she is able to both manage her family's consumption needs on a day-to-day basis and fully utilise her skills and assets to increase her wealth?



Low-income households are vulnerable to financial shocks, which cannot be addressed by adopting a product-centric approach

The need for such wealth management support is universal; it is even more important for low-income households. Low resource levels imply that while mistakes are expensive for everyone, it is far more so for poor households that juggle many balls for survival.

Wealth management is a notion that transcends product-centric thinking and outreach. It asks the question: How can I, as a financial services provider, steadily increase the wealth of my customers over a period of time using finance and financial advice as my only tools?

There is a need for providers to think innovatively about understanding customer needs, what products/services to make available, and the

design of these products/services. Like their middle-income counterparts, low-income households need to move resources across time and space, in a manner that meets their needs for finance smoothly over a lifetime. They require the full suite of financial services — savings, credit, risk mitigation, insurance and remittances — to meet their needs.

One critical aspect is the range of services that are available; the other is the manner in which they are customised to the needs of a particular household.

Finance is very unlike a physical product in its potential for customisation and its malleability. Liquidity can be provided either through savings or loans, with or without collateral. A loan can involve weekly repayment or bullet repayment; a loan when combined with rainfall insurance can provide a 'payment skip' when the monsoon fails; a remittance inflow can be swept instantaneously as

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an account balance into a money market mutual fund.

Very little justice has been done to this aspect of finance in existing work. We like to think of finance as playing the role of a noise-cancelling headphone that responds precisely to noises in the environment and cancels them out instantaneously, giving the listener a smooth and high-quality listening experience. Similarly, we can give households a smooth and growing income stream, cancelling out revenue and expense 'noises' in their daily life using certain financial tools.

The front-line officer in an MFI is a crucial piece of the wealth management puzzle. She is the person who interfaces with the client and has visibility in both directions: products and services of the provider, and needs of the customer. To a significant extent, decisions taken by a household are informed by its knowledge of what services it has access to, and its understanding of how these options can be best used. The need, therefore, is to expand the options and to supplement this enhanced choice set with sound advice to the household.

If access to finance is to be looked at through the prism of wealth management, financial judgment and advice have to be integrated with the products. The relevant analogy is that of a doctor who diagnoses the patient's condition based on manifest symptoms and then applies his judgment to recommend a particular course of treatment (he does not merely offer a generic list of medicines).

There is an important role for expertise on the part of the financial services provider. Investment in training front-line officers acquires tremendous importance.

Continuing with the doctor analogy, if it is obvious that no single pill works well for all patients, why should it be any different with finance? Insurance, for example, is almost mandatory for an individual who is in the prime earning age bracket and the sole breadwinner of the family. But the relevance is less obvious for an individual who is elderly and depends on savings and children's income. Similarly, a household with high dependence on seasonal cash flows from agriculture, for instance, might experience severe stress in taking a loan that requires weekly repayments due to the mismatch between inflow and outflow. Financial services providers cannot wish this heterogeneity away if they want to be true to wealth management.

Need for adaptation

We believe that local financial institutions such as MFIs are well suited to play this wealth management role if they can adapt their operating models over a period of time. Although the current models of micro finance have grown at a rapid pace, they fall short in the wealth management dimension as discussed here. Some MFIs have started exploring expanding their product suite, but nowhere is the entire set of financial services being offered.

There are regulatory and other barriers that restrict MFIs from providing the entire range of financial services. For example, most MFIs cannot offer savings products, and rightly so given their typically fragile capital base and strongly local character. But they can provide savings through the business correspondent model, by associating with larger commercial banks or as agents of mutual funds. Similarly, MFIs can enter into innovative tie-ups to provide other financial services such as remittances, insurance, and pensions.

Wealth managers have to be part of the community fabric, spending most of their time understanding client needs

Some current processes would need to be changed to effect this transition. For example, most MFI loan officers travel to where their clients are located for disbursement and repayment of loans; they spend a lot of time travelling and processing. While this may have its benefits — bringing banking services to the client's doorstep — it also limits the client's exposure to the range of products and options available, and the amount of quality time spent with the service provider. The wealth management approach of providing financial services entails continuous contact with the front-line officer. There is also a strong case for branch-based models that give customers a sense of permanence as the provider is part of the community fabric rather than an 'outsider'.

Managers should spend most of their time understanding the needs of clients, in terms of the dynamics of their livelihoods. Since such advice is customised, there has to be a deep understanding of the household,

supported by appropriate analytical tools. One analytical tool, for instance, is household typologies based on risk profiles (heavy dependence on wage incomes, high volatility of cash flows due to rainfall risks) matched with financial portfolios (combination of savings, loans and insurance). It's on the basis of this knowledge that managers are in a position to offer sound advice. To save time doing routine activities, they can use technology to reduce the time spent on processing and back-end operations. Therefore, institutions offering services should make investments in technology, product development, analysis, and training client-facing managers.

From an incentives perspective, there is a conflict between incentivising front-line officers on sales/disbursement targets and providing customised advice to households, because for many households taking a loan may be a bad idea. Incentivising officers on the basis of the impact on the customer's wealth would align the organisation's goal with the officer's actions, even though measuring such an impact would be challenging.

Horizontal versus vertical growth

Most MFIs are growing horizontally across geographies, with a single product. This, again, is not ideal as the wealth management perspective calls for institutions that are embedded within the community and growing vertically rather than horizontally. It means they should be serving a limited set of clients in a more complete way, rather than be spread across a large number of clients across geographies. This, in some ways, ties the fate of the institution with that of the financial wellbeing of clients in the given geography.

This paradigm of wealth management, coupled with a sound institutional architecture that ensures sustainable delivery of services, can go a long way in unlocking the true potential of financial services providers, including MFIs. Such complete access to financial services could enhance capital accumulation at the household level. Appropriate risk management tools like insurance and savings buffers would also lead people to specialise in what they do best. All these are important pathways between access to finance and income increases, and we have an unprecedented opportunity to make this happen in India with the growth of the micro finance movement.

Read a related article in the online version of *The Wall Street Journal* here: <http://online.wsj.com/articleSB124581691732345881.html?mod=googlenews_wsj>

CENTRE FOR MICRO FINANCE

Micro credit

Landmark study on impact

Despite mounting evidence on the positive impact of micro credit on low-income households, critics have expressed fears over excess borrowing. Responding to this criticism would require credible evidence on the impact of micro credit. But such evidence has been difficult to obtain due to the self-selecting nature of micro finance clients and the selection of branch locations by micro finance institutions (MFIs): the profile and progress of a client taking a loan may be altogether different from a non-client. Thus, the difference in indicators between clients and non-clients may not give a proper sense of the net impact of micro finance.

Against this background, Abhijit Banerjee, Esther Duflo, Rachel Glennerster, and Cynthia Kinnan (all from the Massachusetts Institute of Technology, USA) of Abdul Latif Jameel Poverty Action Lab, South Asia (J-PAL South Asia), in partnership with the Centre for Micro Finance, IFMR, designed the first large-scale, randomised trial to address a key question: What happens when micro credit becomes available in a new market? The trial was launched in 2005 by Spandana, one of India's largest and fastest growing micro finance institutions, and the results are out.

Spandana identified 104 neighbourhoods in Hyderabad in which they saw potential for a branch and where there was a not very large migrant worker population. These 104 areas were paired off, with one of each pair assigned to the treatment group and the other to the control group, such that each area had an equal chance of being in the treatment or the control group. In contrast to previous trials designed to gauge the impact of micro credit, Spandana's trial was randomised such that households in the treatment group (clients) had no apparent reason to be different in terms of profile or trajectory from those in the control group (non-clients). Accordingly, differences between indicators for the two groups could be confidently attributed to the treatment, that is, the provision of micro credit.

Spandana began operating branches in the 52 treatment areas between 2006 and 2007 and subsequently conducted a survey of each neighbourhood between August 2007 and April 2008.

The household survey exhibited a variety of uses for loans: 30% were

used to start new businesses, 22% were intended to increase the asset base of existing businesses, 30% were taken to repay existing loans, 15% were employed to purchase durable goods for household use, and 15% were used to smooth household consumption. Interestingly, the treatment areas saw 32% more new businesses being opened compared to their control partners, and new business owners in the treatment sectors enjoyed higher profits.

Although the results of the trial show no discernable effect on women's empowerment, education, or health, it should be kept in mind that the data only provides short-term findings.

While more research is required to understand the longer-term effects, the study does show clearly that micro credit allows households to borrow, invest, create and expand businesses to a degree that was previously impossible.

Read a full report on the randomised trial here:

<<http://econ-www.mit.edu/files/4161>>

Read a review of the report in *The Economist*:

<http://www.economist.com/displayStory.cfm?story_id=14031284>

Access to finance survey

There has been a sea change in the nature of financial services being offered to the poor in India. Micro finance has witnessed an explosion in popularity, with the total number of people served by MFIs or members of SHGs growing at more than 50% every year. But, as the last comprehensive survey on access to finance in India is now almost five years out of date, little is known about how the rapid expansion of micro finance has translated to access to finance on the ground. Other key issues are:

- How do clients of the two main models of micro finance differ?
- What percentage of the poor is still not reached by micro finance even in high-competition areas?
- What characterises the un-reached poor?

The Centre for Micro Finance is conducting a comprehensive survey on access to finance in India, to answer these and other questions, via a project in Andhra Pradesh. Work on the survey began in June 2009 and is expected to conclude in September.

CENTRE FOR INSURANCE AND RISK MANAGEMENT

Livestock insurance

Reducing risk with technology

Livestock is one of the main sources of income, and a popular livelihood diversification strategy for rural households in India. The contribution of the livestock sector to GDP of agriculture has been growing steadily, and was about 25% in 2004-05. However, the sector is highly vulnerable.

Owners of livestock face many risks that could affect production or price. Some of these risks are insurable. But coverage of livestock insurance is very low in India. According to industry estimates, less than 10% of cattle in India are insured.

There are many challenges impeding the increase in insurance coverage. Main supply-side challenges include: difficulty in identifying insured animals, variables in assessment of cattle value, fraud in the claim settlement process, and absence of a large volume of historical data. Delivering livestock insurance in remote rural areas is difficult.

CIRM and IFMR Rural Finance have developed a livestock insurance product that is expected to address some of these challenges by improving the management of operational risks. The idea is to use radio frequency identification (RFID) technology for identification of animals, thus reducing the chances of fraud in livestock insurance. This and other product and process innovations are expected to lead to significant reductions in premiums.

The product will provide a safety net for clients in case of cattle death. As cattle constitutes an important source of income for most clients, the safety net will help clients deal with this financial shock and provide some support for buying the asset again. The money can also be seen as a protection to the provider's portfolio when the client takes a loan for dairy activities. The product is being tested at the IFMR Holdings' Pudhuaaru Kshetriya Gramin Financial Services (KGFS) company in Thanjavur, and will eventually be scaled to other locations and providers.



Livestock is an important source of rural livelihood

Excerpts from the INDIA DEVELOPMENT blog*

THE TRUTH TAKES TIME... (WITH SURVEYS)

I've been having a great time reading the recently published *Portfolios of the Poor* by Murdoch *et al.* One of the interesting points the authors make early on in the book relates to research design, trust between surveyors and surveyed, and the quality of data. I think it has implications for all of us field researchers who rely on surveys to elicit quality data.

In the book, the research team used a year's (or more) worth of financial diaries to piece together the financial lives and financial management of a number of poor households (spread across the globe). The team visited each household at least twice a month to capture its financial inflows, outflows, assets and liabilities. What I found fascinating was the opacity of information that the survey team received from the household during initial visits as compared to the information elicited after multiple visits...

Posted by Alex, July 31, 2009

Read more here: <<http://www.indiadevelopmentblog.com/2009/07/truth-takes-timewith-surveys.html>>

QUASI-EXPERIMENTAL DESIGNS AND QUASI-VALID RESULTS

Performing a randomised evaluation of a social programme can be a real pain. In fact, randomised evaluations are probably the worst method for evaluating the impact of a social programme out there — except for all the other methods available.

The problem with the other methods, in the case of micro finance and many other programmes where there are likely to be a lot of unobserved differences between participants and non-participants, is that no matter how sophisticated the econometrics used is, it is extremely difficult to account for these unobserved differences. In addition, 'publication bias' (the bias of journals to only publish papers with interesting, as-yet-unseen results) and the strong public demand for positive results can lead to systematic bias in what ends up in the public domain...

Posted by Doug Johnson, June 26, 2009

Read more here: <<http://www.indiadevelopmentblog.com/2009/06/quasi-experimental-designs-and-quasi.html>>

*Maintained by research staff at the Centre for Micro Finance, Centre for Development Finance, and Centre for Insurance and Risk Management at IFMR. Views expressed are personal.

WORKSHOP

Climbing the ladder of life

On July 13, 2009, a half-day workshop titled 'Ladder of Life Workshop' was organised at the IFMR business school. Dave Wallack, Team Leader, IFMR Trust Transformation Team, initiated the workshop with a discussion on how one can make people more resilient by providing appropriate financial products and services.



Participants listening to Soumya Kapoor

In his introductory address, Nachiket Mor, President, ICICI Foundation, dwelt on the importance of capturing household-level information and the need to gain specific insight that can be translated into targets and deliverables for wealth managers. Vijayalakshmi, Team Leader, InnerWorlds, gave a presentation on 'Think Rural India' and shared interesting findings from the team's ethnographic study in Tamil Nadu, Orissa, Uttarakhand and Rajasthan. Gurunathan, CEO, Pudhuaaru Kshetriya Gramin Financial Services (PKGFS), a next-generation financial institution built on the idea of 'wealth management' for rural households, shared the experiences of PKGFS. Lead presenter, Soumya Kapoor from the World Bank, and co-author of the report 'Moving out of poverty', deliberated on questions and findings on how and why some households move and stay out of poverty, and some remain trapped in poverty.

Kapoor explained the use of the 'Ladder of Life' technique to identify and classify clusters of rural households into chronic rich, movers, and chronic poor. The lively discussion that followed helped participants understand how to use the 'Ladder of Life' technique in their work.

AN IDEA WHOSE TIME HAS COME?

Revisiting MFI interest rates

A discussion note 'MFI pricing and valuation: an analysis of key drivers', by Nitin Chaudhary and Suyash Rai from IFMR Trust, explores the pricing model of micro finance institutions and the factors that could be determining prevailing interest rates. The analysis revolves around the stylised model of a twenty-branch-unit (TBU) that mirrors a typical Indian MFI's operations. The authors 'shocked' the cost structure with a number of variants to understand the effects of varying field officer productivity, loan sizes and rate of growth.

The study found that operating costs as a percentage of loans outstanding fall sharply as the TBU approaches full capacity utilisation. At full capacity utilisation, operating costs are insensitive to historical growth rates. However, across all scenarios, the authors found that the range of operating costs is 3.7% to 11.5%. Based on the cost calculations in the note, and the prevailing interest rates in the sector, it seems that the rates of return to investors in MFIs are much higher than what one would expect. Prevalent pricing of MFIs, even accounting for pessimistic operating cost assumptions, provides equity investors returns of 40%. There seems to be a fairly strong case for significantly reducing the interest rates charged by most micro finance institutions, and yet delivering 25% post-tax ROEs to investors.

The discussion note and toolkit are available online at:

<www.ifmrtrust.co.in/mfiresources>

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