MICROFINANCE

"A POVERTY LENS ON FINANCIAL INCLUSION"

Based on A Representative State-wide Study of Microfinance in Karnataka

This report demonstrates that it is possible (and necessary) for the microfinance sector to measure and understand itself through a strongly pro-poor lens and make decisions based on this. But why make this a central point of a report when there seem to be even more urgent issues at stake today in the sector?

PUTTING THE REPORT IN ITS CONTEXT

It is because microfinance was started with a mission and an ideal of serving the poor. No doubt, any ideal has to be constantly balanced against the possible and the practical over time. But in microfinance this balancing act has led the sector to the question **"What do the poor really mean in the context of microfinance and financial inclusion?"** In essence this question is a mirror to the sector.

No stakeholder within the sector doubts the importance of serving the poor. But when we ask ourselves **if decisions in microfinance are consistently approached in terms of serving the poor** the answer, at best, is uncertain. This report outlines an empirical and data-driven method to do so.

And in the process of answering this question **the report** *touches* **upon a few of the important debates of the day**. The practitioner and the regulator at whom the report is primarily directed will find it of interest that the data from the study can also inform discussions on margin caps, RBI income ceiling as well as the need for stronger poverty targeting by the practitioners.

But the report is not about "pushing" or "advocating" specific recommendations. It is part of a series of efforts to open a dialogue with the regulator and the practitioner and other stakeholders about a way to understand microfinance portfolios and the end clients in a different light. More importantly, how this understanding can **qualitatively as well as quantitatively help to define the contribution of microfinance to financial inclusion.**

CHOICE OF KARNATAKA

The report is based on the results of poverty measurement of **5,800 microfinance clients across 9 MFIs[1] in the state of Karnataka conducted from October to November 2012, using the Progress out of Poverty Index[2] (PPI)**. It is, in effect, a first-of-its kind attempt at poverty profiling of portfolios of MFIs at a state level in India.

Karnataka was chosen because it has a large and diverse microfinance presence as well as a strong and active association, AKMI, that was keen to undertake this exercise on behalf of its members. In particular, AKMI's position as the nodal body of microfinance institutions in Karnataka guaranteed access to a **statistically representative sample of microfinance clients at a state level**. The 9 MFIs that participated in the study have a combined share of 64% of the microfinance market

1. The participating MFIs follow either the JLG or the SHG group model.
2. Please refer to Annexure 7 for further information on PPI.

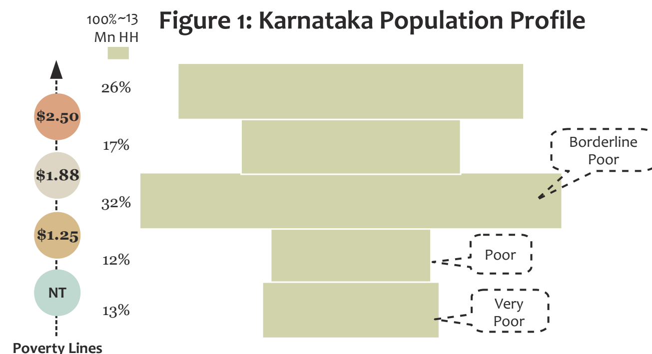
in Karnataka and include institutions following the SHG Model. Because of the statistical significance of this sample, the report can interest and engage stakeholders outside Karnataka.

The findings from the study are proportionately extended to the total client base of the participating MFIs (*and not to all the MFIs in Karnataka*). The findings presented here are indicative of the performance of all the nine participating MFIs *as a group* and not of any one of the participating MFI. However, separate reports highlighting organisational data and comparisons have been prepared and shared with each of the participating MFIs.

WHAT DO WE MEAN BY A POVERTY LENS ON FINANCIAL INCLUSION?

At the very outset, before the report can link microfinance with financial inclusion, it has to confront the question: Is microfinance for the poor or financially excluded? This is a point of constant debate within the sector. The report asserts that poverty is closely linked to financial exclusion and that the **current distinction between financially excluded and the poor is a largely artificial one**. Several studies show that the poorer you are the more likely are you to be financially excluded. Thus if microfinance can improve its outreach to the poor then it is directly contributing to financial inclusion. How does the report define the term poor in the context of microfinance?

Figure 1: Karnataka Population Profile



In a way, there are as many definitions of poor as there are stakeholders in microfinance. As the report emphasizes this often confuses and discourages the use of poverty measurement as a practice. **This report adopts a "kaleidoscopic" segmentation of the microfinance portfolios. It uses the Progress out of Poverty Index (PPI) to measure microfinance outreach to different economic levels of households**. The population and the portfolio are divided into five economic segments by means of the international 'poverty' lines ($1.25, $2.5, and $1.88 in between) as well as the National Tendulkar line to bring in the national perspective as figure 1 shows.

For the purpose of this report, we define those households below $1.25 as poor and those below the National Tendulkar line as very poor. But there is also a large fraction of the households that fall between $1.25 and $1.88. This segment can be deemed as borderline poor. Thus, while the report focuses on the households below

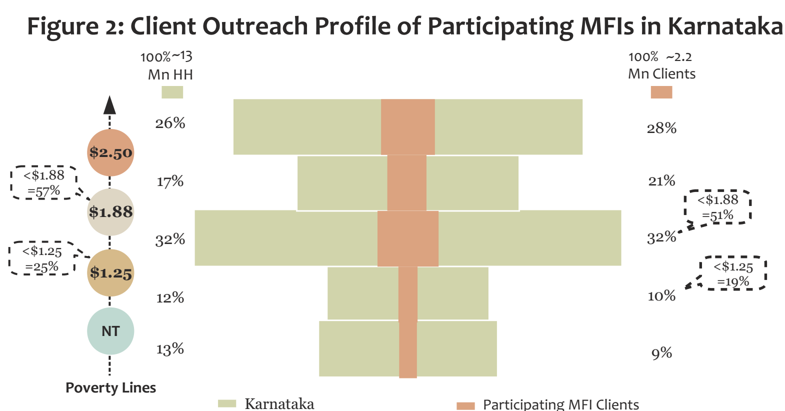
$1.25 it would be important to keep the entire picture in mind at all times. Accordingly, in all our illustrations we display data across all economic segments.

This should also benefit all readers to some extent. **Different stakeholders will also want to interpret the data within their own definitions and analytical frameworks**. This type of kaleidoscopic segmentation is also in line with our objective that the aim of this report is to create a dialogue, to deepen understanding of the microfinance target market, and not impose a specific line of defining the poor.

THE POOR AND MICROFINANCE IN KARNATAKA

As far as Karnataka is concerned, as figure 2 (below) shows, the portfolio of the participating MFIs in our study is reflective of the make-up of the underlying population. That is, 25% of the households in Karnataka were poor and very poor and they formed 19% of the portfolio of the MFIs. Significantly, the poor and the borderline poor combined, constituted 57% of the Karnataka population and over half of the portfolio of the MFIs participating in the study.

Figure 2: Client Outreach Profile of Participating MFIs in Karnataka



In our opinion these results are a reasonable accomplishment which compares well to available information for microfinance outreach in other states. More importantly the results do signify that MFIs are already playing a measurable role in reaching the poor to enable their financial inclusion. The question is one of how to make this linkage between microfinance and the poor *as strong as is feasible*.

We add a cautionary *"as strong as is feasible"* because information on microfinance portfolios like above can easily lead to over-interpretations and far-reaching conclusions. To avoid this we strongly encourage stakeholders to bear in mind that **what is observed with regard to poverty segmentation of microfinance portfolios can be attributed to several factors** including conscious choices made by MFIs, specific geography of operation, regulatory environment, characteristics of the client base and the MFI model itself among others.

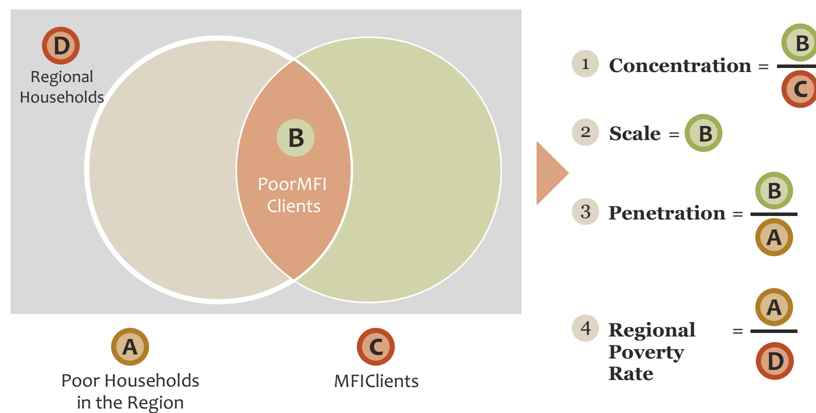
This study is not in a position to assess all of these factors and how they affect MFI portfolios. However, it is in a position to see **how microfinance portfolios may vary as the context of operation changes**.

PUTTING THE MFIS IN THEIR OPERATING CONTEXT

The sample design in the study enabled a mapping of microfinance portfolios in Karnataka in several geographic contexts: at the level of Karnataka itself; North Karnataka; South Karnataka; rural and urban parts within North and South Karnataka; and finally, the four districts of Karnataka—Bangalore and Mysore in the South; and Gulbarga (Hyderabad Karnataka) and Belgaum (Mumbai Karnataka) in the North.

And in each of these operating contexts we looked at microfinance portfolios from **four poverty related aspects** of scale, concentration, penetration and poverty incidence. These measures, defined in Figure 3, were first developed by Grameen Foundation as part of a study carried out in Philippines in 2010-11. This **gives us a simple language** to compare microfinance portfolios against their operating context and with each other. We strongly believe that a language like this is a useful permanent addition to industry vocabulary, and can help to define performance in a parallel manner to financial ratios (such as OER and PAR).

Figure 3: Four Aspects of Poverty Outreach



The report further compares the participating organizations' concentration with the poverty rates in different regions of the state for different poverty lines. Such analysis offers insight into the effectiveness of organizations in reaching out to the poor. Poverty rates at the state level therefore become an important parameter for analysis and comparison in this report.

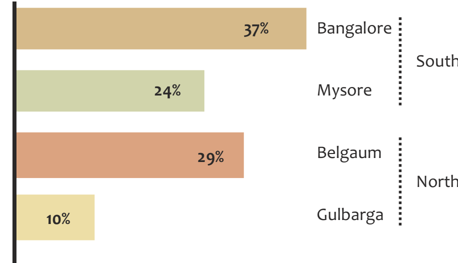
The conclusions around the 4 aspects of poverty measured in this report have been drawn from the NSSO data for 2009-10. The following table shows the total MFI data for the state of Karnataka and the Sample drawn from each area—rural and urban—for the purposes of the study.

Table 1: Sampling of the Client-Base of Participating MFIs

	TotalMFI Clients	MFI Sample Clients
All Karnataka	***22,89,100***	**5,843**
Rural	17,13,750	3,413
Urban	5,75,350	2,430

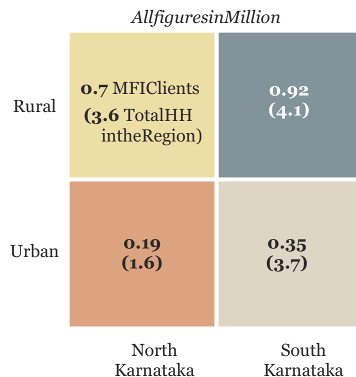
Note: Concentration here refers to poverty outreach of a total portfolio. In a dynamic framework, in which there may be changes in poverty level over time, it is relevant to measure separately the poverty level of clients at entry to a programme. The poverty level—along with other indicators—can then be tracked after a period of time to measure progress. For the current report, the sample selection did not take into account the loan cycle as a criterion for selection. Hence, a dynamic analysis is not included here.

Figure 4: Region-wise Distribution of MFIs in Karnataka



As shown in figure 4, in the Karnataka sample, as far as overall Scale and Penetration are concerned, the MFI presence was much larger in the South of Karnataka than the North; which is (maybe not unexpectedly) in line with the greater average economic development and prosperity of South. Similarly, when we compared the four different regions of Bangalore, Mysore, Belgaum and Gulbarga, it was the economically least developed Gulbarga that lagged significantly behind the other three with only 10% of the total MFI presence in Karnataka while Gulbarga has 18% of the total population of Karnataka.

Figure 5: Scale & Penetration of Outreach of Participating MFIs



Going into the study we knew that overall MFI outreach was higher in rural than in urban Karnataka. Though, in South Karnataka, we had expected overall MFI penetration in urban areas (with cities like Bangalore) to exceed that of rural South in our sample. Instead rural South had more than twice the client base and overall penetration of urban South.

A QUESTION FOR THE REGULATOR

The case of Gulbarga begs attention. Among the four regions of Karnataka it very clearly stands out in terms of its low economic development and overall levels of

outreach, mandate the microfinance model to innovate on several fronts to address issues of less favourable income generation opportunities on one hand and higher service delivery costs on the other.

But, encouragingly, our data also shows that the Gulbarga portfolio of our participating MFIs has the highest share of poor households. It could be that it is a sheer co-incidence, or MFIs indeed have stronger targeting in Gulbarga compared to other areas, or simply that it is an effect of Gulbarga having a large fraction of the poor in its population. **Nonetheless, it needs to be recognized that there are MFIs active in Gulbarga and reaching the poor in an important manner**. In our opinion, the regulator and the sector needs to take particular note of this.

Places like Gulbarga have been the focus of financial inclusion efforts for some time now. Indeed, the district (not region) of Gulbarga was singled out for RBI promoted financial inclusion drive[3] as early as 2006. But, as a working paper by Institute for Financial Management and Research (IFMR) titled *"Financial Inclusion in Gulbarga: Finding Usage in Access"* (January 2009) noted that, at best, the results were mixed. The paper focused on BPL households in particular, and in its recommendations it referred to various challenges. Financial inclusion is a continuing challenge in these areas. Against this background, **the MFIs in places like Gulbarga present an important option for the regulator to expand financial inclusion efforts**.

But this possibility raises an important question for the RBI. **Is there a need to provide greater regulatory room, in areas like Gulbarga, to those MFIs there that are already serving the poor?** For that, the regulator would need to study the challenges unique to MFIs in these areas, both on demand and delivery front, and subsequently be ready to re-visit regulatory provisions including ones such as margin caps if found necessary. In our opinion, this report strongly nudges the regulator and the sector to commence a discussion that recognises different market contexts and the challenges of reaching less developed regions and poor households.

CLOSING THE POVERTY GAP

When we come to the third of our three measurement parameters, i.e. concentration of microfinance portfolios (% of clients below different poverty lines for the portfolios of participating organizations) and when this is compared with the regional poverty rates (% total households in the region below different poverty lines), the results are intriguing and difficult to explain. As the MFI portfolio distribution in figure 6 (next page) shows, **urban South and Gulbarga have a noticeable variation in the share of the poor and the very poor in MFI portfolio**. Both Gulbarga (North region, urban and rural) and urban South (Bangalore and Mysore) represent extremes in our sample—one region lags economically far behind while the other region is much developed and sees strong MFI competition.

3. RBI announced a drive in 2006 for financial inclusion to be initiated in every state whereby the State Level Banking Committees and the Lead Banks would be responsible for promoting 100 per cent financial inclusion in at least one district in their home state . 100 per cent financial inclusion implied that all households in the district which desired a savings bank account would be provided with one. The first pilot project was conducted in Pondicherry, led by Indian Bank and completed in December 2006. Since then, several drives, typically lasting from six months to a year each time, have been completed in different parts of India, the most notable examples being Palakkad in Kerala and Gulburga in Karnataka.

Figure 6: Comparison of MFI Portfolio Concentration

	Rural South	Urban South	Rural North	Urban North	Bangalore	Mysore	Belgaum	Gulbarga
$1.25-$2.5	55%	52%	55%	54%	53%	54%	54%	55%
Poor <$1.25	20%	12%	22%	21%	18%	18%	20%	25%

As the report highlights, it requires a significant change (or discontinuity) in the operating context of MFIs to result in a change in their poverty concentration or poverty penetration in terms of outreach to the poor and very poor. Even these changes in MFI portfolios, while definitely noticeable, are not fully commensurate with the changes in the external environment. For example, a shift from Belgaum to Gulbarga produces only a 5% increase in the poverty concentration.

Further, the above contrasts with the remarkable similarity of the microfinance portfolios in the remaining contexts. It is difficult to explain why the MFI portfolio poverty concentrations should be almost identical between North Rural and South Rural where the context in terms of poverty rates are very different. It is obvious that **these poverty concentration characteristics need further research and thus, are an important point of departure emerging from this report**.

But even as unexplained observations they have immediate implications. The similarity of MFI poverty concentration across different geographic contexts shows the MFIs that they certainly have room to align their portfolios better to the underlying population characteristics. We do recognize that today in India from a practitioner's perspective it is the changes in the external regulatory environment that are a real need of the hour. But we feel it is also necessary to drive efforts in this direction *at the same time* to strengthen the poverty outreach of microfinance as part of financial inclusion.

As the report illustrates with an example, experience in the Philippines (supported by the Grameen Foundation) and elsewhere does show that **improved targeting of the poor** accompanied by investments from the MFIs into capacity building and product development can yield to higher concentration (of entry level clients) in a short period of time. For this a targeting strategy that is consciously pro-poor has to become a critical agenda of investors, funders and the practitioners.

On the other hand, the cases of urban South Karnataka and Gulbarga reveal a hint for the sector as a whole—the interaction between microfinance and the poor is not as straightforward. At the very least, the sector needs to adopt a far more **empirical mind-set when it comes to making decisions that could introduce discontinuities** in MFI's operating environment. Decisions such as margin caps, income ceiling restrictions, balancing commercial and social considerations and so on qualify in this bracket. They need to be scrutinized for their effect on the orientation of the MFIs to the **poor and very poor** and that this necessarily needs to be done on a frequent and periodic basis.

RBI INCOME CEILING AND MFI PORTFOLIOS

The report examined MFI portfolios through a more granular economic segmentation outlined earlier and did not explicitly factor in the RBI Income ceiling limits. If we were to map the RBI income ceilings to our segmentation scheme, the rural income line would lie between $1.25 and $1.88 while the urban income line would lie just above $2.5. But the income ceilings are important standard of measurement and assessment at a sectoral level today. So it was necessary to also see how the MFI portfolios in our sample fared against these income ceilings criteria.

In Karnataka overall, the RBI ceilings cover 67% of rural households, 75% of urban households. Our data showed that **the compliance to RBI income ceiling was better in urban areas than in rural areas**. In rural areas 51% of the MFI portfolio was below the RBI rural income ceiling while in urban Karnataka it was 78%. This finding reinforced that of an earlier study conducted by Grameen Foundation on the client base of Grameen Koota in 2011, and is reflected in data reported in M-CRIL's Social Ratings. Now, as was the case in 2011, a strong suggestion is that the **rural income ceiling provisions need to be revised upwards to set the level for financial inclusion**.

But, alongside, there is also a need to **enable MFIs to comply with RBI specified income ceiling** provisions, and the approach has to be more practical than the one in use today. That is, it is imperative to move from an individual client level income ceiling specification to broader compliance criteria that specify poverty concentration that a MFI portfolio as a whole should meet. And at the same time, the compliance mechanism has to ensure that MFIs uses simple but standard and objective measure of poverty to test for client eligibility.

DO DIFFERENCE IN SIZE AND MODEL PLAY A ROLE?

Do larger MFIs have better poverty outreach than smaller MFIs or it is the other way around? Does the SHG model outperform the JLG on poverty outreach? Several factors dictate preference of various stakeholders towards SHG or JLG models. This preference, in turn, is manifested in many ways including the extent of finance (governmental, institutional, philanthropic, impact investing, etc.) that is channelled to either of these models. Note, that the sample covers MFIs with Self Help Groups, it does not cover the SHG Bank linkage model.

Table 2: MFI Outreach by Size & Delivery Model

PovertyLine	Large	Small	SHG	JLG
<$2.5	72%	75%	73%	73%
<$1.25	18%	20%	19%	18%

As Table 2 shows, when we looked at our own sample we actually found no difference between large MFIs (defined as those with client base greater than 75,000 clients and 5 in number) and small MFIs (4 in number) with regard to the

share of the poor and very poor in the MFI portfolios. The same "statistical indifference" was observed between poverty outreach of MFIs following the SHG model (3 in number) and those following the JLG model (6 in number). We also found no difference when disaggregating by rural and urban areas.

This report in no way claims to resolve the open questions on these issues. But the idea in presenting the above figures is to leave behind a thought that t**here is room for a nuanced position especially with regard to the JLG and SHG models of delivery, linked to MFIs**.

WHAT NEXT ?

There is a definite point of departure that future research would need to follow-up on—orientation of MFIs to the poor and very poor with a change in their operating context. More immediately, the report touches upon a few topical issues raising questions and suggestions for the regulator and practitioner alike. In the process, it also introduces a new pro-poor sensibility of re-looking at these issues.

And in our opinion, it is most important for the sector to internalize this sensibility. To reiterate the point made at the beginning, the way to do this is to understand microfinance portfolios *consistently* through a pro-poor lens. It is possible to make it an industry practice and habit; but there has to be an industry consensus on this to move it forward. This dialogue, among all stakeholders (and especially the practitioners and investors), needs to begin.

There are initiatives already under-way, world-wide, such as the Pro-Poor Seal of Excellence (newly branded Truelift) that are bringing a pro-poor focus back into microfinance, through development of a community of practice around issues of outreach, services and tracking progress at the client level of the MFIs. The approach that the report proposes is complementary to these. All these only go towards strengthening the linkage between microfinance and financial services for the poor, within the broader mandate of financial inclusion.

Finally, the study, in itself, is hardly an isolated and one-time effort. It is a progression of similar work done by Grameen Foundation and its partners in Philippines, as well as the experience of EDA in poverty measurement and use of the PPI, and initiatives increasingly taken up by MFIs to measure the poverty level of their clients at entry and over time. It would make sense to continue to extend this study to other geographies in India or to target specific issues. At the end of the day, what underlies these efforts is the goal to steer the spotlight in microfinance where it rightfully should rest—to those who are financially excluded from formal banking services, and within the financially excluded to include poor segments. We strongly hope the report, and similar future efforts, take the "possible" towards the "ideal" in microfinance.