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Banks size up micro-loans: Millions of rural Indians have **no access to financial services**, writes Khozem Merchant

By KHOZEM MERCHANT

Indian banks face a dilemma. They know that the next big opportunity is lending to rural customers, who make up the majority of the country's population. But they also realise that the cost of opening branches to serve the 300m rural Indians who lack access to formal credit is prohibitive.

That is why banks are increasingly turning to micro-finance lenders (MFLs) - which lend tiny sums to poor people - as a bridgehead into rural India.

Two other factors underpin this emerging partnership. First, there is increasing political support for improving access to credit for the rural poor. Second, banks are beginning to acknowledge that they lack not only the branch networks but also the expertise to judge the credit risk of people earning USDollars 30 a month and requesting loans of USDollars 60.

The large domestic commercial banks, such as ICICI, HDFC and UTI, that have taken a lead have learned that while the rural poor may earn low incomes, their credit quality is unusually high, with a record of repayment that shames most larger borrowers.

"The poor constitute a rich credit risk," says Kishore Kumar, head of micro-finance at HDFC Bank, which has partnerships with four MFLs and hopes to expand its micro-finance book fivefold this year to USDollars 25m, covering 250,000 poor, first-time borrowers.

Foreign banks such as ABN Amro and ING Vysna, for whom rural lending is new, are also interested.

"There's a big market out there but the problem is how to address it," says Bart Hellemans of ING Vysna in Bangalore, which is testing the water with a micro-lending scheme launched in conjunction with a community services unit of Microsoft.

Yet the biggest boon to micro-borrowers could be if state-owned banks such as State Bank of India reverse a tradition of under-utilising their vast rural expertise.

"The big banks coming is a lifeline for micro-lenders," says Vithal Rajan, who advises Ankuram Sangamam Poram, an MFL in Hyderabad.

The issue for the banks is choosing the right way in. ICICI, India's second largest bank, has formed partnerships with 30 MFLs and has grown its micro-finance portfolio from USDollars 45m two years ago to USDollars 100m.

ICICI has also gained access to 2m rural customers - a market one-fifth the size of its urban customer base but gained in half the time. ICICI advises the MFLs on operational efficiency and technology, leaving credit-risk and loan-monitoring to partners with on-the-ground experience.

"We believe this model will make entry harder for the competition," says Nachiket Mor of ICICI.

"The issue is not cost of funds - we have the balance-sheet strength to support this foray. It's about who's best equipped to address a market that is expected to reach real scale."

ICICI wants to use its partnership with Share Microfin in Hyderabad as a platform to cross-sell, provide term loans, co-brand and leverage the quality of its partners' loan books.

This year, ICICI securitised two blocks of micro-loans - for Share Microfin, worth Rs162m, and for Basix, valued at Rs42.1m. The MFLs sold the loans to ICICI, which repackaged them into bonds and sold the paper on to a private-sector investor.

For the micro-lenders, such deals allow them to raise funds while offloading some of their credit risk. ICICI, meanwhile, is expanding its micro-finance portfolio, helping to meet mandatory quotas on loans to the poor and gaining access to elusive rural customers.

Udaia Kumar, Share Microfin's founder, says MFLs need banks as much as the banks need rural customers.

"Rising demand for loans is forcing me to look beyond donors and traditional lenders for capital," he says.

Share needs to raise USDollars 147m to service its internal forecast of doubling its number of customers to 1.1m by 2008.

Observers say the partnership model has its limitations. Only a quarter of India's 200-plus MFLs have good management and credit ratings. Most lack experience handling big sums and have a non-profit culture.

"We have to look at these MFLs even though it can mean taking on larger risks. But we judge them on parameters of prudence and good management," says Mr Kumar at HDFC.