

Financial INclusion Improves Sanitation and Health (FINISH)

The case for financing Micro Finance Institutions

1. Background:

India has 135 million financially excluded households. Rural households represent a big share of these. By 2010, 17 million households will enter the financial markets thanks to income growth and 30 million more thanks to innovative banking business models. These 30 million households represent a bottom of the pyramid business worth Rs 10,000 crore (about \$2.5 billion) for banks and Rs 20,000 crore (\$5 billion) for insurance companies, or \$83 and \$166 per household.¹

Inclusion of the 'excluded' segment represents both a social reality and an economic opportunity. The social aspects prime the interest of the Government of India. Economic opportunities require redesigning of business models. Business models need to take into account Bottom of the Pyramid market characteristics. The value chain of distribution and transaction of financial services needs to be deconstructed in order to determine which activities are to be outsourced and which one are to be kept in house, so as to become leaner, reduce costs and thereby offering quality products at affordable prices.

Financial inclusion ideally should encompass micro credit, micro insurance, micro savings and financial literacy to mirror organized financial sector. What is prevalent today is micro credit through either Civil Society Organisations (CSOs including CBOs/SHGs) refinanced by commercial banks or retail micro credit through organizations/NGOs that are generically categorized as micro finance institutions (MFIs). MFIs again depend on commercial banks/Micro-finance Investment Vehicles (MIVs) for a mix of debt and equity for long-term refinance as well as capitalization.

Essentially MFIs service the financially excluded with a single product in a process that is in synchrony with their credit needs. Few fields in development or commerce emphasize both economic and social performance as strongly as micro finance. Investing in micro-finance institutions presents the financial bottom line opportunity in credits!

There are however challenges to the growth of micro-finance in India:

- ◆ There are many small micro-finance institutions that operate as NGOs and not for profit societies and trusts. They are yet unregulated and do not have an exit route for equity investments. The size of these institutions presents difficulties in accessing debt funding.
- ◆ Very few Tier 1 MFIs registered as Non-Banking Finance Companies (NBFC) exist with a track record. Though they are regulated, they are dependent for external sources of debt and equity as they are not permitted to tap community savings.
- ◆ The combination of the above two means that there is great pressure on growth for the Tier 1 institutions. This can result in indebtedness of micro-finance clients, which is a large social and development concern.
- ◆ Tier 1 MFIs do not deal with the ultra poor by design as the potential for delinquency often overrides other developmental considerations
- ◆ There is a negative correlation between the operating cost spread and scale of the MFIs with the result that the ultra poor and below poverty line families end up paying the highest rates of micro-finance interest.
- ◆ Lack of incentive to MFIs and pressure to scale up fast means that there are no efforts to create different product categories with variations in terms.

¹ Boston Consultancy Group in 'A Roadmap for Expanding Financial Inclusion in India'

Micro-insurance (MI) provides a social security cover to the vulnerable poor. It also protects assets and incomes created through micro-credit. Mostly micro-insurance has been driven by availability of insurance for the borrowers, so as to reduce risks for the micro-finance institution and helps promote micro-credit.

In 2005 the Indian Insurance regulator created an enabling regulation that would enhance penetration of micro-insurance to the Rural low income communities. These regulations allowed non-profit NGOs and MFIs to become distributor/ agents on MI and earn a commission on the sales and service. It also deregulated training requirements to enhance reach at grassroot levels and with a cap allowed a levelised commission structure that emphasised the importance of agent service in micro-insurance.

With the above regulations the regulator expected that the insurance sector would deploy some resources on innovatively developing micro-insurance and establish it as a sustainable emerging market business across the country. TATA AIG Life management supported the development of micro-insurance in the company by dedicating a special team. It developed relevant and affordable MI products and processes. Finally it empanelled civil society organizations as distributors in line with the regulations. Many other insurance companies in India both on the life and non life side have MI programs operating at various levels of effectiveness.

However, micro insurance has its own challenges:

- Since rural markets are largely unorganized only a few homogeneous groups exist where group MI products can be promoted. To enable voluntary off take of insurance products which can justify the high cost of awareness creation in the target market a portfolio of **retail** MI products is imperative for long term sustainability.
- Retail MI is a supply side service and needs to be of a sufficiently larger tenure than micro credit. The bulk of which is a demand side short tenure (1-2 years) service. How can MFIs be made to play a significant role in distribution of retail MI products?
- Pricing of long tenure MI retail is sensitive to distribution and transaction costs. The distribution and servicing costs need to be reduced by combining insurance activity with other activities of the intermediary so that premiums can be kept affordable. How to build long tenure partnerships between insurance companies and MFIs alongside which relevant and affordable MI products can be promoted?
- Can we identify integrated development programs where MI product(s) can become an integral part?
- Can we develop a critical mass of MI customers (subscribing across insurance products like life, health, livestock etc) using existing partner infrastructure, which can then be serviced by the risk carrier on a stand-alone basis? How long and how much capital will this critical mass take to develop?
- Distribution and servicing costs need to be reduced. This forces insurance providers to look for the group insurance format through MFIs. Yet the group format is not necessarily the most sustainable long-term option for insurance companies.
- Creating awareness and developing range of products to enable heterogeneous low income market exercise their choices is a cost that can only be sustained by long tenure retail insurance programs. This may not interest MFIs.

2. Health and sanitation

Incidental data from Micro Finance Institutions hint that around 25 - 30% of their clients disposable households' income is not realised due to poor health. Major cause of frequent illnesses is poor sanitation. Thus the Government of India has recognised sanitation as a priority.

Currently India is lagging in its sanitation MDG target. If unofficial stories are extrapolated it is much further behind.

Government of India has taken right steps in promoting sanitation through Total Sanitation Campaign. Under it educational and promotional materials are developed, subsidies are given for the poor (below poverty line) and awards are given to reach 100% sanitation coverage.

Challenges:

- ◆ On average about 75% of villagers are NOT eligible for subsidies.
- ◆ In practice sanitation is most often equalised with construction of toilets. Having a household toilet offers privacy and comfort, but does very little for health of the family members unless several other measures are taken, such as safe treatment and disposal of faeces, water supply and hand washing.
- ◆ There are no incentives for villages going from current 25% sanitation coverage to 100% coverage. Yet high sanitation coverage is needed for health impact to take effect.

So to tackle these challenges different organisations, different strengths, common markets, a large synergising opportunity leading to a win-win situation for all stakeholders - would this scenario be a conducive climate for the assembly of financial and social industry majors and creation of a unique forum serving a commercial and social purpose simultaneously. The answer is a big YES.

3. FINISH

Financial Inclusion Improves Sanitation and Health (FINISH) programme has been conceived by its promoters – TATA-AIG, SNS-REAAAL, UNU-MERIT, BISWA, WASTE - with the objective of expanding sanitation coverage in rural India, at the same time providing basic health insurance cover to the 'to be included' population. Though the number of promoters and partners at present are limited, FINISH seeks to enlist the support and involvement of more similarly oriented partners as well as leveraging with various other schemes of government and non-governmental agencies operating in rural India with similar objectives. The ultimate objective is to enable emergence of a rural society whose health is improved not only through better sanitation facilities and an improved knowledge and awareness of the concept of safe sanitation, but also by being financially included.

FINISH promoters have worked out interlinked strategies to address the challenges of micro finance, insurance and sanitation and health. FINISH promoter, TATA-AIG LIFE Insurance Co Ltd, through its dedicated Rural Channel delivers affordable products at the doorsteps of the poor. It creates distribution and servicing through development organizations including MFIs. This model of financial inclusion (financial services and insurance) is scaling up fast and also creates livelihoods for the semi literate poor who are largely self-help group (SHG) women. TATA-AIG today operates in 14 states with about 200 development sector partners for the distribution of micro-insurance products. MI accounted for a quarter of the company's new policies during the financial year 2008-09. This is an ever-expanding distribution channel with a focused business strategy.

Some of TATA-AIG micro insurance distributors, i.e. MFIs with interest and experience in sanitation, partner as FINISH implementers. These Tier 1 (BISWA), Tier 2 (ESAF, IIRD) and Tier 3 MFIs (BWDC, SAMBHAV) are extending households loans for sanitation as part of their micro credit portfolio.

To achieve the health objective, the project enables strengthening of sanitation capacities of MFIs and their partners including local governments with, new methods and technologies.

Safe sanitation impacts health only if it is taken beyond mere toilet construction. It has to include hygiene promotion and safe excreta treatment and disposal. In addition, health effects of sanitation are expected to correlate positively to the density of household sanitation systems in a village (more than 95% coverage). FINISH supports increased coverage with output based incentives. It also supplements income of animators/ community organizers/ SHG women for their efforts towards awareness creation. Finally, it generates livelihoods through sanitation business support (soap, phenol, construction, ceramic pans, biogas units, compost and urine diversion etc). FINISH promoter WASTE (Dutch sanitation and waste NGO) assists MFIs in this technically and through grant support.

SNS-REAAL (Dutch listed insurance-banking group) is looking at commercially funding the project implementers to promote water and sanitation projects through its erstwhile water fund and existing micro-finance investment fund. It will also provide financial engineering advisory services as programme management board members. SNS-REAAL has reached its lending ceilings with some of the individual MFIs, such as BISWA. Yet others are not mature enough to avail of external commercial borrowing.

UNU is working with the project partners and implementers on the impact monitoring mechanism funded partially by the project and partly by the research funds of the university. In different areas it will conduct timeline studies (about 2,000 households per area with both household and village surveys as well as medical tests) and repeat interviews and tests within 1 to 2 years. Medical tests will be conducted with about 3,500 women and children and for the FINISH project as a whole, about 6,000 households will be surveyed.

FINISH uses grants for the following purposes.

- (i) To mobilise larger amounts of commercial funding for enabling household sanitation systems.
- (ii) To build dedicated sanitation capacities with the MFI partners that would enable them build a viable sanitation loan portfolio over time.
- (iii) To support sanitation awareness measures in the target market with audiovisual tools and human capital building in the form of sanitation animators.
- (iv) To measure impact of sanitation interventions on family income, health and gender over time across different geographies

Using structural relations already established between TATA-AIG and MFIs, MFIs are stimulated to increase sanitation coverage loan products using the World Bank developed Output Based Aid (OBA) model, whereby small subsidies are paid to MFIs if they reach their sanitation density targets. This money is raised from donors, i.e. the Dutch government approved Euro 4.5 million for this. To further increase sanitation density - coverage of 95% and above-, US\$ 3.5 million Bill and Melinda Gates Foundation grant funding is requested. The grants are primarily targeted on enabling MFIs to get greater access to sanitation loans through first loss guarantee mechanisms. The grant request is in its final evaluation stages

4. Opportunities

The large percentage of financially excluded households suggests that commercial banks have been unable to reach out to the low-income communities. The exponential growth of the credit

portfolio of MFIs also suggests that the MFI model works better than the banking model for micro finance services including micro savings and micro insurance. Indeed the lack of financial services infrastructure in rural areas (roads, communication, banking etc.), where micro insurance is promoted makes it imperative that existing intermediaries like MFIs and CSOs play a significant role in enabling access to micro insurance products by the target market. Distribution and servicing costs of MI products, and ultimately premiums, can be reduced if it is combined with other activities of the MFI.

There is thus a clear-cut need for a long tenure partnership between insurance companies and MFIs to include the financially excluded. This partnership also sustains MI business in the long run.

The role of the intermediary becomes even more significant in supply side services like risk transfer which require a greater degree of comprehension even to the best of us. Let alone the uneducated and illiterate target markets who have a limited disposable income and media reach.

A key question is: how to get this social commitment out of NGOs/MFIs for a seemingly financial sector activity? We believe this needs to be centered on integrated development programs whereby MI product(s) become an integral part. FINISH is set up along these lines taking sanitation as the integrated development entry point.

Using sanitation as an entry is strengthened by recent MFI's assessment that about 25% of household budget is health related. Both as non-realised income from poor hygiene as family members' illnesses prevent income earners from working and as direct cash expenses on doctors and drugs. These impoverish the family. This impacts downstream delinquencies that contribute to a lower PAR of the MFI itself.

Finally there are ongoing efforts relating to safe disposal of sanitation waste. Apart from compost and use of urine as fertilizer (stone-old technology gaining ground again), there are pilots in generating biogas and energy from sanitation waste.

For investors a key question is: How to identify these financially and socially sound MFI? Investors find this difficult to assess, as rating agencies have taken a plunge. MFI rating agencies have not gained the same level of acceptance. Also MFI investment is by nature unsecured and delinquency risk becomes the only parameter for assessment.

TATA-AIG suggests MFIs for partnering in FINISH based on the latter's participation in the micro-insurance programme. This is more a supply side intervention devoid of the social risk. Final decision on acceptance of the MFI partner is taken by the programme management board comprising banks (NHB, NABARD, SNS-REAAL) and others (e.g. TATA-AIG, UNU-MERIT, WASTE). Having two DFIs from India in the board also serves as a risk mitigation measure. There lies another clear reason for MFI investors (MIVs) to look at FINISH as an opportunity. Dealing with the FINISH MFI partners will surely mitigate reputation and social risk.

To sum up the partnering opportunities in FINISH.

For MFI investors/MIVs:

- ◆ Dealing with the MFI partners on the FINISH project will surely mitigate reputation and social risk, yet partially contribute to reduced risk on delinquency .

- ◆ It is said that there are television sets than toilets in India. Given the sanitation and public health link, there are sizable opportunities in the field of “market based solutions “ in sanitation micro-finance leveraging the triple bottom line impact through FINISH.
- ◆ Investment may be in various forms: participation in a guarantee; NBFC equity; dedicated debt funding

For micro insurance companies:

- ◆ Leveraging FINISH creates a better risk profile. While most of the intended benefits of current health insurance products flow through hospitalization and surgical cover yet there is a vast scope of exploring the space of primary health insurance covers linked with improved hygiene of the target market. This throws up a large socially relevant and equitable opportunity for health insurance.

For MFIs:

- ◆ Support in sanitation capacity development, such as exposure, training, new materials, and implementation, such as financial support for SHG women, mural paintings, film viewings etc.
- ◆ Accessing technologies and other refinancing solutions (e.g. carbon credits leveraging implementation capacities of MFIs) and exposure / access to different funding sources

For donors:

- ◆ To fill in this gap in sanitation density through community sanitation, or through innovative financing mechanisms. These will need to be worked out on a case to case basis in cooperation with the implementers and local communities.
- ◆ Participate in an ongoing public-private sector programme with established operational and monitoring mechanism that allows for upscaling and add-ons. Respective contribution to water and sanitation MDGs is measurable.
- ◆ Testing new, innovative impact analysis methods and specific areas of interest through academic partners

For sanitation businesses (construction materials, ceramic, soap, disinfectants, biogas):

- ◆ Market access and advanced market information
- ◆ Possibility of using existing rural marketing channels thus lowering transaction and distribution costs

For ICT businesses:

- ◆ Dedicated testing opportunities for ICT based models of reporting and monitoring, mapping, GIS etc. in several states of the country.

For academic institutions:

- ◆ Very detailed panel household and village surveys will be conducted, partly accompanied by medical tests. These surveys will be conducted in several states of India with same questionnaires being used (where needed adapted to local conditions). These data sets are available for institutions to work with for research purposes after sending a proposal to FINISH Society.

For further information, please contact any of the following programme management board members:

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