The Local Touch

ACROSS THE COUNTER In two years, the 57 Pudhuaaru branches in Thanjavur district have signed up 70,000 customers

Banks have the products, but are absent in villages. MFIs are present, but lack the products. An IFMR pilot is looking to reconfigure how financial services are delivered to rural India, reports **M Rajshekhar.**

THAMIZARASI DOES NOT KNOW JOB safety or regular income. Work comes and goes for this 40-something agri-labourer in Alakudi, a village in Thanjavur district in Tamil Nadu. This month, for instance, farm owners did not need labourers like her because the local dam was yet to release water to irrigate their fields. During such dry spells, to keep the home fires burning, Arasu pawns her jewellery.

She used to do that with a moneylender, paying 36-60% as interest. The only bank in Vallam, a village 7 km away, offered the same loan for much less. But she, like millions across rural India, wasn't entitled to a loan from a bank because she didn't have any land to pledge. For the past year, though, she has been borrowing at 16%, in Alakudi itself, from a local 'bank' called Pudhuaaru.

Pudhuaaru is not a bank, but it works like one. So, villagers can deposit and withdraw money at a Pudhuaaru branch—almost the way they would in a bank. They can take loans, that too not at punitive microfinance rates or moneylender rates, but at reasonable bank rates. They can buy life insurance or cattle insurance. There are 57 Pudhuaaru branches in the district, which is projected to increase to 100 by March 2011 and to 200 by March 2012, covering 1,000 villages in the district.

Banks have failed to provide that kind of access. According to the RBI, 292 of 626 districts were underbanked. Microfinance institutions (MFIs), the other deliverer of financial services to rural areas, have penetrated some parts, but they mostly do only loans. Savings, investments, insurance and remittance—the other basic financial services—still elude large swathes of rural India or reach them haphazardly.

That lack of access bothered ex-ICICI banker Nachiket Mor and his team at the IFMR Trust—a private trust, set up with a long-term loan from ICICI Bank, that supports research in financial inclusion. In 2006 and 2007, they experimented with alternate delivery models like ICT kiosks and lower-cost MFI models, but they couldn't crack the conundrum of delivering financial services through a model that went far and deep, and was self-sustaining.

With their latest model, Kshetriya Gramin Financial Services (KGFS), of which Pudhuaaru is one of the three pilots, they feel they are on to something. "I have absolutely no doubt," says S.G. Anilkumar, senior vice-president, IFMR Trust, and the man in charge of the project. "KGFS and KGFS-like entities focusing on a local geography can deliver complete financial services in a viable way."

IN JUNE 2008, THE KGFS PILOT WAS rolled out in Thanjavur in Tamil Nadu. Since then, Ganjam in Orissa and Tehri in Uttarakhand have been added. Each KGFS unit was named after a local river there: Pudhuaaru in Tamil Nadu, Sahastradhaara in Uttaranchal and Dhanei in Orissa.

Thanjavur is the longest running of the three. In about two years, 57 Pudhuaaru branches have come up in the district. Each branch is about 500 sq ft (25 x 20) in size. Three officials—all locals and youngsters—sit behind desks. Each has spent 24 days learning the processes and basics of financial services. In front of the desks are several bright green and orange benches, where customers sit.

Between them, these 57 branches have a catchment of about 100,000 households. They already have enrolled 70,000 customers, most of whom are accessing institutional finance for the first time. Further, the branches are breaking even faster than their creators had hoped: at the operational level in the eighth month; full break-even, where they even recover capital costs, by the fourteenth.

KGFS works on a low-cost model. Its lending rate is 16%, compared to 24-36% charged by MFIs. It is able to charge less because its costs are lower and spread wider due to, what Anilkumar calls, economies of scope. While MFIs offer only loans, KGFS offers a bouquet of financial services.

PROFITABLE **PROPOSITION**

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A KGFS currently offers four categories of products: loans, savings, insurance and remittances. The savings product, which makes it analogous to a bank, is ingenious. Since KGFS is not a licensed bank, it cannot accept deposits, which dilutes its case for a one-stop financial shop for basic financial needs.

KGFS has circumvented this by offering a money market mutual fund—a category of debt funds that offers a high degree of safety of principal and liquidity (though lower than a bank savings account). Says Vijay Mahajan, founder, Basix: "Nachiket has found a creative solution to the regulatory constraint that only banks can accept deposits."

The wide portfolio ensures that people who step into a branch look at other products too. Although IFMR Trust has an ICICI connection, KGFS won't sell just ICICI products. So, there's personal accident and livestock insurance from HDFC Ergo, gold coins from Tata Gold Plus and World Gold Council, and international remittances (Western Union).

GIVEN THE PROFILE OF PEOPLE IT IS selling to, how it sells is as important as what it sells. KGFS is looking to take the wealth-management approach—recommend products tailored to a customer's needs—to selling. Bindu Ananth, president, IFMR Trust, uses a client transaction to illustrate.

A woman who had taken a jewellery loan died in a road accident. KGFS learnt that she was an agricultural labourer, that her husband had left her, and that she was single-handedly looking after two children, her parents and a sibling. "It was obvious that the financial intervention she needed most, much before the jewellery loan, was life insurance. And that, by acting without 'knowing the customer', we might do harm," says Ananth.

IFMR is looking to automate this process of product selection, or at least a part of it. "It is not enough to just create a menu of products," says Ananth. "We need a system where we can look at the client's situation and then decide what is the right product for her." IFMR is currently working on such a software.

At the time of enrolling a new client, the KGFS will generate a financial well-being report, focusing on four aspects. Plan: what are the client's income and expense projections? Growth: how can she meet these obligations? Protect: how does she protect her assets? Diversify: how does she spread risk?

This software will throw up suggestions, which the KGFS staff will convey to the client, who takes the final call. Even then, the KGFS staff will be held accountable. With good access, products and advice, IFMR hopes to draw rural Indians in. That's the demand side.

That still leaves the supply side. Someone needs to come forward and set up these branches in every district, every village. IFMR cannot do. Its strength is ideas and research, not running a business. For KGFS, IFMR is talking about a franchise model that is on the lines of India's failed experiments with local area banks (LABs).

Says Ananth: "Each KGFS will not cover more than two or three contiguous districts—or five million households. This will ensure local relevance." For instance, in Uttarakhand, jewellery is seen as a symbol of pride, not to be pawned. So, jewellery loans are not popular, unlike Tamil Nadu. Adds Anilkumar: "A single institution cannot deal with this complexity. For a large bank, localisation is difficult."

Also, since the franchise holder's catchment is limited, this will ensure it doesn't merely skim the top of the local market and then expand elsewhere. "It would have to reach deep into the local community, ensuring financial inclusion," says Ananth.

For KGFS, localisation is its strength. According to N Gurunath, the head of Pudhuaaru, the process of identifying franchisees is likely to start in a year or two. IFMR will provide the modules, linkages with other financial institutions, knowhow, etc. Entrepreneurs will have to train for one year at an existing KGFS. Besides that, IFMR itself will set up 12 more KGFS in the next 10 years. The first of these will start in another 12-18 months. Further, any MFI or financial services distributor can buy select modules from IFMR.

But if the past experience with regional rural banks (RRBs) and LABs is anything to go by, it's not going to be easy to convince entrepreneurs to set up a full-fledged KGFS. RRBs and LABs had a similar geographical construct, but they were done in by government interference and vulnerability to local factors.

KGFS hopes it won't meet the same fate. Partly because of the multiple products it is offering and the multiplier effect of such a model. Pudhuaaru has already begun 'coordinated' loans, where women borrowing to buy milch animals are linked to a local dairy. Such assets would work as a multiplier insofar as the village GDP is concerned. Pudhuaaru also plans to offer loans for light commercial vehicles, water-purification plants (developed by IFMR Ventures), loans for warehouse construction, among others.

In Thanjavur and Thiruvarur (the second district Pudhuaaru will cover), the 'bank' will add all the branches it can (about 200) in its first five years. Once that expansion-led growth tapers off, Pudhuaaru will grow at the rate of the district. After 6-7 years of operations, each branch is projected to touch a turnover of Rs 5 crore in turnover. At 200 branches, it means Pudhuaaru becomes a Rs 1,000 crore company. Orissa and Uttarakhand are projected to ramp up to 50 branches by March 2011.

HOWEVER, BEING LOCAL HAS ITS OWN risks. If the local economy tanks, it will hurt the local KGFS, especially if non-collateralised loans account for a big chunk of its portfolio. IFMR is looking at loan insurance. As the entity grows, it might face resistance from local moneylenders and providers of informal finance like chit-fund operators. "All this leads to the question: what is the optimal size for a rural finance provider," says Ramesh Arunachalam, an independent rural-finance consultant. "Even if national is too large, is two districts too small?"

There are also questions on scalability. The model is working well in Thanjavur. In Uttarakhand and Orissa, just one or two have completed a year. While the first branch, says Anil, has attained operational break-even on target, "it is still too early to say". Says Prakash Bakshi, Executive Director, Nabard: "What is good in a focussed experiment does not always translate to exact replication on a very large scale, that too through much less efficient replicators as we go on."

Whether KGFS finds commercial expression or not, it adds to the discourse of how to speed up financial inclusion. It also forces competitors like banks and MFIs to introspect about their approach. Says K.C. Chakrabarty, deputy governor, RBI: "Many of the ills (that plague MFIs) exist because people lack alternatives. The only long-term solution is competition." The KGFS is another step, perhaps a defining one, in the long road to financial inclusion.

EASE OF ACCESS

Women at a Pudhuaaru branch are at ease doing basic financial services transactions. Part of the reason for that is the look and feel of the branches, which have been crafted by Deidra Wager, member of the IFMR governing council and former executive vice-president of Starbucks. The head office at Thanjavur (middle) currently directs operations for 57 branches.

KGFS versus MFI

Since it distributes many financial products, KGFS' cost of operations–and, so, its lending costs–are lower than an MFI. However, once it starts to scale up, it might be a challenge to keep this reined in.

	COST OF FUNDS	BAD DEBT PROVISIONING	OPERATING COSTS & MARGIN	COST OF EQUITY	COST OF JLG LOAN
MFI	12	2	10	2-5	26-28
KGFS	12	0.5	3.5	NA*	16

All figures in % *Not applicable

Source: IFMR Trust

Profits In Four Years

THE cost of setting up a Pudhuaaru branch—interiors, counters, biometric devices, safe, connectivity, burglar alarm, 2 PCs and inverter, among other things—is about Rs 3.50 lakh. The running cost of the branch—rent, salaries and utilities—is about Rs 35,000 a month. A head office for a 250-branch setup costs about Rs 50-75 lakh, which adds another Rs 10,000 to the operating cost of every branch. In other words, the operating cost of a branch is about Rs 45,000 a month, or 5.4 lakh a year.

In order to break even, assuming a spread of 4% over the cost of funds, a branch will need to disburse loans of 1.4 crore in a year. IFMR thinks it's possible. In a village of 2,000 households (or, say, 5,000 adults), the model assumes that 40-50% of them will be eligible for joint-liability group (JLG) loans, or loans taken as part of a group. Even if 1,000 of them take a JLG loan of Rs 15,000, it works out to Rs 1.5 crore. The model also assumes that 200-250 locals will take larger loans. At Rs 50,000 each, that's another Rs 1-1.25 crore. Or, a total of Rs 2.4-2.65 crore.

On an average, a Pudhuaaru branch does Rs 1 crore in its first year. At present, Pudhuaaru's portfolio is almost entirely loans. Just 3-4% of its business comes from fee-based products like insurance and remittances, on which it earns a fee. Over time, IFMR expects the fund-to-fee income ratio to stabilise at 85:15.

In its first year, 2008-09, Pudhuaaru set up 15 branches. It ramped up to 50 in the second year -- its current status. The number of branches is projected to increase to 100 in the third year and 200 in the fourth year. The faster pace is due to increasing internal accruals, which gives Pudhuaaru more funds to expand. For the first four years, surplus cash will be ploughed into adding branches. Subsequently, it is projected to break even.