

The Future Leaders:

Risk Sharing Microfinance Solutions:

# Overcoming The Financing Cost Constraints

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While most approaches to poverty alleviation and addressing unemployment are linked to the discourse on economic 'growth', it is observed that populations within rapidly growing economies, such as those of China and India, are not receiving any direct benefits from the same and may not for some decades to come. Since manufacturing-led economic growth takes place in urban areas; rural areas, in particular, are typically left behind.

Microfinance is one approach to this problem of unevenly distributed wealth creation: Help the rural poor directly instead of waiting for the benefits of economic growth to reach them decades later. However, the problem with the currently used structures for microfinance is that they are either based on models of charity, no-profit no-loss, or the ever so famous one of debt.

These models have the following drawbacks:

- Charity based-There is little or no real commitment towards the returns as the borrowers consider this a gift and not a borrowing.
- No-profit No-loss-These are generally funded through charity money and most of the times are not self sustaining.
- Debt based-Irrespective of whether conventional-interest based or Islamic-profit based, most microfinance ventures such as these are no better than loan sharks. Although the loan repayments structure seem to be small and at high frequencies; to appear small-the additive effect leads to a significantly high cost of financing (similar to the reason why Islam has forbidden interest).

It is fair to assume that insofar as individual borrowers are freely choosing to take loans from microfinance organizations rather than borrowing money at exorbitant rates from local loan sharks, it is likely that microfinance does, in fact, benefit the poor population, even if much of the money is used for consumption rather than investment. But merely "better than loan sharks" is not quite the beautiful dream that has inspired so many people to support microfinance.

One possibility to address this issue could be the adoption of risk sharing models for microfinance. But this approach has remained a contentious issue since the small denominations of such financings makes it almost impossible for the cost of due diligence, monitoring and repayments to be built in.

Our proposition is to develop a model that overcomes or navigates around these impediments to produce an effective microfinance structure.

By applying risk-sharing as a core driver of our structure, we are interested in moving beyond microfinance to create more sustainable enterprises that are scalable and could deliver bottom-of-pyramid impact.

Our country of focus is the India, one that is primarily agrarian and faced with several endemic challenges within its economy.

## Rural Context

In an agrarian economy, a large number of the households depend on the returns from crop harvest and livestock rearing as their primary means of livelihood. While it is plausible that loaning one or two milk cows to a given household can provide a sustainable source of income, to do so for each house individually will make it a cumbersome affair and make due diligence a challenge.

*“Our proposition is to develop a model that overcomes or navigates around these impediments to produce an effective microfinance structure”*





### Cooperative land farming

- Consolidating small holdings
- Use of newer technology
- Enhanced scalability
- Increased cost efficiency
- Reduced dependency on intermediaries

A major issue faced by farmers in India is the problem of small land holdings. With inheritance and affordability leading to disintegration of land holdings into smaller shares, economies to scale are amiss from their operational structure.

Our model proposes the consolidation of land holding with the same idea of social capital in mind, which can be achieved through awareness initiatives and sensitization programs to convince farming communities to participate. The structure will involve the establishment of a self help groups / co-operatives to ensure financing on risk sharing basis whereby it is easier to do a due diligence and monitor such financings.

The immediate goals will involve the formation of sufficiently large holdings that will justify the use of newer technologies and benefit from the economies of scale.

#### Social Capital & Collective Financing

To overcome the aforementioned challenges, we suggest the use of a social capital mechanism wherein groups of 20 or more households can be brought together as a self help group or preferably a co-operative and financed as a whole. Unlike the self help groups of conventional microfinance models the members of such a group do not stand guarantee for each other for paying back the necessary amount, but will vouch for each others' honesty.

The social capital arising from communal solidarity will become an asset to motivate repayments and transparency.

Our model proposes a transition map for commercial dairy farming, starting with the formation of a SHG of local farmers to pool resources and finance milk production through Shariah compliant modes, progressing into a cooperative model for sustainability. Eventually, depending

upon the market features, the model could be scaled further.

The larger financing ticket will ensure that the due diligence and monitoring cost is well spread over, while enable the group to take advantage of economies of scale related to stock feed, animal care, veterinary expenses, collection of the milk produce and more. There will also be an added advantage of the dilution of risk in case of any disease outbreak among animals.

The pro rata revenues after the direct costs and the cost of financing can be further distributed to the members of the SHG or co-operative, whichever seems feasible.

*“The social capital arising from communal solidarity”*



### Cooperative Dairy Farming

- Ancillary income of rural households from selling milk to be transformed into industry
- Use of newer technologies
- Enhanced scalability from individuals selling milk to dairy farming
- Increased efficiency due to scale
- Better animal feed, health & hygiene

*“To ensure honesty there safeguards will be put in place”*

#### Urban Context

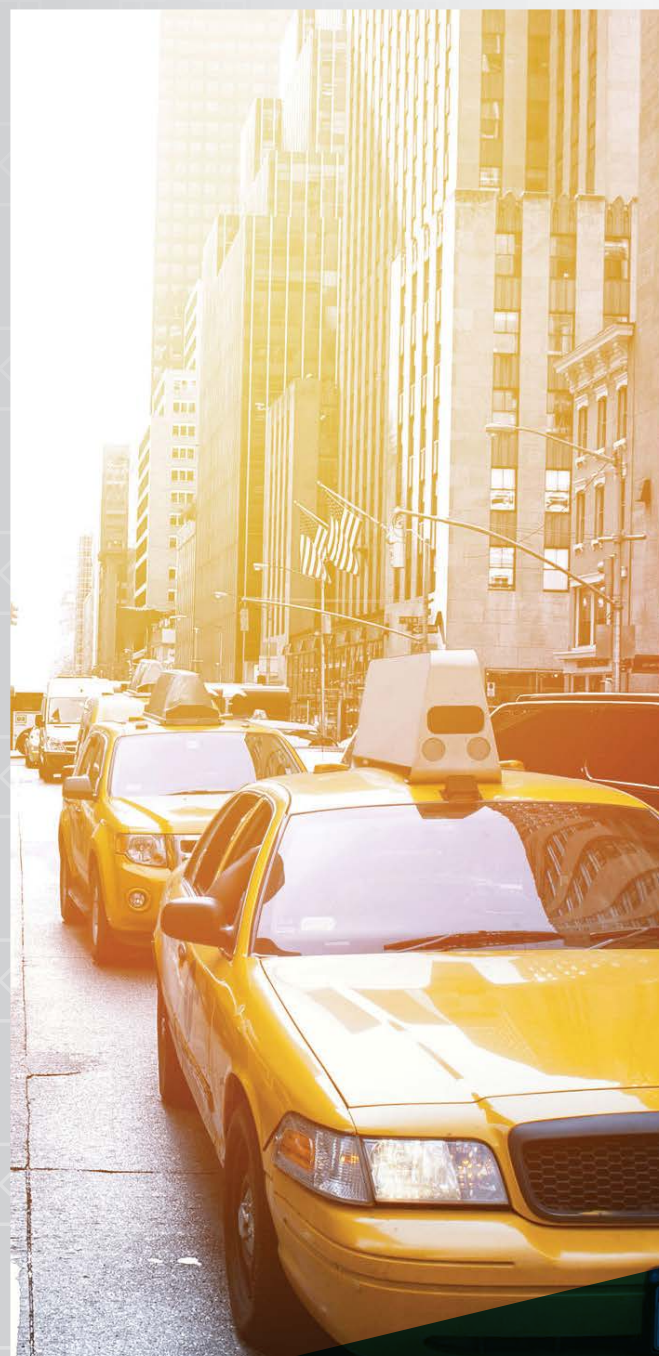
The key challenges in providing a sustainable microfinance model in an urban context would require deliberation on risks & costs involved in securing assets, regulatory structuring, due diligence etc., while ensuring adequate wages for the workers. To illustrate, we consider the taxi service proposition, where individuals take loans to buy cars, which are then used as taxi services.

While the application of a risk-sharing contract for such financing may expose the financier to the issue of moral hazard, we offer a way to overcome this problem through the creation of a co-operative or self-help group of 20+ such individuals such as in the case of our rural proposition.

To ensure honesty there safeguards will be put in place, ensuring that no single individual is the cause for the black listing of other members. To ensure this there will be a charter, or Standards of Practice, which the car owners will have to agree to—Below are few major points of consideration:

- Safeguards will include tie-ups with authorized auto garages to ensure the repairs and spares are done in a cost effective and transparent manner. The cars will also need to undergo regular maintenance and checks to ensure no genuine parts are exchanged or sold.
- Besides the maintenance, the car owners will also be made to buy fuel via fuel cards, to have a tab on the mileage and expenditures.
- By the use of technology it has become easy to





- Collective management of taxi feed for urban area
- Transparent & reliable service & repairs
- Safeguards shall include tie-ups with auto garage
- Fintech can be utilised for operational efficiency
- Ancillary tie-ups hospitals schools etc for social security members

keep a tab on the daily collections of a car owner, besides severe deviations from the average pool collections will be handled by car-owner counselling before repossession (if at all).

Car owners each month will purchase certain portion of the capital in the car and will pay profits accruing on portion owned by the financier.

#### Next steps

- Feasibility & Landscape Analysis
- Strategic partnerships with Auto garages, service and filling stations to enable supervision and diligence.

#### Roadmap:

We have proposed a roadmap to link the bottom-up approach that works at the grassroots level to the top-down approach that enables capital investments from corporate stakeholders through a transition map illustrated below:



Our proposition offers a simple and scalable solution to reconstructing traditional modes of microfinance to ensure cost benefits, economies to scale and sustainable impact.

We emphasize on the leveraging of social capital and strength in numbers as a plausible means to avoid a system of debt. The solution uses these to ensure a large enough pool size-in order to capitalize on the economies of scale to reduce costs, increase margins and distribute the per unit costs of due diligence and monitoring to a minimum.



*“Our proposition offers a simple and scalable solution to reconstructing traditional modes of microfinance to ensure cost benefits”*

Through this process the financier stands to significantly reduce risks while attaining benefit from a higher return than traditional microfinance, including debt-based structures.

As part of long-term vision, we hope that this idea of risk-sharing participatory finance can be further scaled to ensure large self-sustaining companies, which can

at some point be taken to the capital markets. This can potentially provide wealth generation sources for each of participant of the economy and thus contribute towards greater financial inclusion.