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Technical Note

Access to Micro-Savings[1] for Remote Rural India

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The views presented in this technical note are solely those of the authors and do not in any way reflect the views of IFMR Trust[2] and/or its affiliates.

[1] Disclaimer: Savings in this note means putting money aside and does not specifically represent bank deposits. The word "savings" has been used interchangeably with "investments".

[2] IFMR Trust is a private trust whose mission is to ensure that every individual and every enterprise has complete access to financial services.

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Abstract

Rural households need relatively large sums of money for life cycle needs (such as marriages, festivals and old age), emergencies (such as illness, the death of a bread-winner and floods) and investment opportunities (as much in assets and household goods, for example, as in investments in micro-businesses)[i]. They therefore need access to a basket of financial services. When looking at rural financial markets, we discover not only the lack of access to credit, but also other financial services (Investments, Insurance, etc) not being available.[ii]

This note discusses how innovative modes of savings products like money market mutual funds can be used to cater to the need of rural households in India. Such financial instruments can be used for planning and investment which can contribute in many ways to enhance their security by building capital for consumption and investments at the same time provide liquidity to meet emergencies.

Background

Rural households face numerous constraints in their efforts to immune themselves against risks by accumulating assets. Lack of savings instruments makes it challenging for them to accumulate their risk capital. They invest in informal savings vehicles such as gold and other precious metals[iii]. These households for whom savings is a risk coping strategy have been saving even if the returns on these assets are negative[iv,v]. Because of paucity of savings instruments they borrow to save down instead of save up[vi]. They have been paying to save because their motive is not to take advantage of the financial opportunities but for their financial security. For any household real financial security is dependent on the cushion they have built which can help not only smooth consumption but also deal with emergencies. Even if the assets have negative returns, rural households may choose it as a hedge against the risks[vii]. Some, who are lucky enough to stay close to a bank branch, invest in bank savings accounts or fixed deposits. But in India, where the number of villages serviced per branch is 19, around 60% of the rural population is unbanked (See Box 1).[viii]

Box 1: Some statistics on financial inclusion

Total bank accounts	300 million
Unbanked population (rural)	60 per cent
Unbanked population all India	40 per cent
No of villages in India	6,00,000
PSU, RRB rural branches	45,000

Source: Sreelatha Menon, *Business Standard,* RBI sets financial inclusion at a distance with 15 km cut-off, May 12, 2008

Given the outreach of the Banking network, Savings intermediation is left to poorly capitalized entities like SHGs/Co-operative Banks/RRBs/NBFCs with prudential norms which could lead to the following risks:

- Systemic Risk : On account of not having geographical diversification these entities when borrow and lend in the same geography would expose the savings thus collected to systemic risks like natural calamities, catastrophes, etc.[3]
- Because of the inherent systemic risk in the above approach, these institutions may have to pay higher rates of interest to attract depositors which will increase their cost of funds and push the lending rates higher. This means they may face adverse selection and their portfolio quality may deteriorate over a period of time.[ix]

This could be one of the reasons for RBI not allowing MFIs (Section 25 companies/Societies/Public and Private Trusts) to collect savings to on-lend. To make these services available to people where banks do not have branches, RBI in 2006 introduced the business correspondents (BC)[4] model to offer savings accounts on behalf of banks to increase the outreach to remote rural locations in India (See Box 2). BC model offers

Box 2: Fact[5] File

January 2006: RBI issues notification permitting banks to appoint Business Facilitators and Correspondents to deliver financial services as their agents.

March 2006: RBI advises banks to defer selection/use of NBFCs as BCs. However, banks can use NBFCs licensed under Section 25 of the Companies Act, 1956 as Business Correspondents.

April 2008: RBI sets limit of 15 km for operation of a bank through business correspondents.

August 2008: Banks can engage companies registered under Section 25 of the Companies Act, 1956, as Business Correspondents (BCs) provided in such Section 25 Companies NBFCs, banks, telecom companies and other corporate entities or their holding companies do not have equity holdings in excess of 10 %.

[3] If a geography where such deposit taking entities (SHGs/Co-operative Banks/RRBs/NBFCs) operate is hit by a natural calamity, all the depositors may withdraw money from their deposits to cope with difficult situation, at the same time borrowers may default on their repayments. In such a scenario there is high probability of run on such entities and the entities not being able to manage the liquidity.

[4] Business Correspondents are bank agents to open accounts of the unreached masses.

[5] RBI circulars – (1) RBI/2005-06/288 DBOD.No.BL.BC. 58/22.01.001/2005-2006, (2) RBI/2005-06/331 DBOD.No.BL.BC. 72/22.01.009/2005-2006, (3) RBI/2007-2008/295 DBOD.No.BL.BC.74 /22.01.009/2007-2008 and (4) RBI/2007-2008/295 DBOD.No.BL.BC.74 /22.01.009/2007-2008

an alternative structure to branch based banking in order to ensure that Financial Inclusion and outreach of Financial Services to all citizens of the country, becomes an operational reality. In other words, the Business Correspondent /Business Facilitator model can provide the last mile reach for delivery of Financial Services in the country. But the RBI guideline notifying that all business correspondents must be located within 15 km of the base branch puts serious limitations to the purpose of BCs[6] [x].

While everyone has been looking up to banks to offer the savings vehicle to the remote population in India, Mutual funds also as one of the instruments for financial inclusion has not been given a careful thought. From the perspective of a remotely located household, a savings instrument is expected to offer,

(a) Principal protection,

(b) Liquidity and

(c) Low ticket sizes.

One of the instruments that can be offered to these households which encompasses the above features without the entity risk discussed earlier is Money Market Mutual Fund detailed below:

Money Market Mutual Funds (MMMFs)

A mutual fund is a company that pools investors' money to make multiple types of investments, known as the portfolio. Stocks, bonds, and money market funds are all examples of the types of investments that may make up a mutual fund. Mutual funds are, by definition, well diversified, that tends to lower the risk (avoiding the old "all of your eggs in one basket" problem). Money market funds[7] are generally the safest and most secure of mutual fund investments. The main goal of these funds is to preserve principal and maintain high liquidity while yielding a modest return by investing in most liquid financial instruments widely available; they are, therefore, the least volatile among debt funds. Moreover, money market funds today offer modest initial investment requirements. Just

[6] RBI circular, RBI/2007-2008/295 DBOD.No.BL.BC.74 /22.01.009/2007-2008 – "The distance between the place of business of a BC and the base branch, ordinarily, should not exceed 15 kms in rural, semi-urban and urban areas. In metropolitan centers, the distance could be up to 5 kms."

[7] A money market fund is a mutual fund that invests solely in money market instruments. Money market instruments are forms of debt that mature in less than one year and are very liquid. Treasury bills make up the bulk of the money market instruments. Securities in the money market are relatively risk-free.

as equity and fixed-income mutual funds[8] have greatly simplified the world of investing, money market mutual funds have made money market investing accessible to individual retail investors.

What do MMMFs offer?

The main purpose of money market funds is to offer **principal protection**. These are very short-term funds with investments in very **liquid**, fixed income securities of highest credit quality and manages to keep a low, but **steady rate of growth in NAV**[9]. Each of these features is explained in detail below:

Principal Protection

The primary objective of the MMMFs is to protect the portfolio from risks of changes in value, while providing a competitive rate of return. The portfolio is structured to generate optimum accrual return (interest income) with reduced mark to market volatility. The short duration of the portfolio makes it less sensitive to movements in interest rates compared to income funds. There have been very rare cases in India where MMMFs have given one day negative returns[10]. Correspondingly, it has less upside potential than income funds, if the interest rates were to fall from this level. Also since these funds provide debt to organizations/entities spread across the country, they do not face the systemic risk and are diversified across various geographies.

Returns

MMMFs earn compound interest; the interest earned is reinvested into the principal, earning even more interest. The entry and exit loads for these funds are usually nil and expense ratios are also very low due to

[8] Equity fund is a fund that invests in Equities more commonly known as stocks. Such funds are typically held either in stock or cash, as opposed to Bonds, notes, or other securities.

Fixed Income Fund is a debt fund that invests solely in fixed income securities, such as bonds. These funds are dependable and limit the amount of risk an investor takes on, although it could mean a lesser return than would be possible in a more risky fund.

[9] NAV (Net Asset Value) - Net Asset Value is the market value of the assets of the scheme minus its liabilities. Per unit NAV is the net asset value of the scheme divided by the number of units outstanding on the Valuation Date.

[10] In the month of November 2008 when all mutual funds were facing redemption pressures because of the global liquidity crunch, MMMFs also had to liquidate their investments to meet the redemption pressure. But only those MMMFs which were maintaining portfolios with relatively higher maturities were the ones affected. But the latest SEBI circular dated 19 January, 2009 stating that fund houses will have to hold papers in liquid funds (MMMFs) that mature within three months will protect investors, in such events going forward.

their large corpus. Unlike Savings/Fixed Deposits that give fixed returns to investors, MMMFs don't give fixed returns but have been giving returns that are even higher than Bank fixed deposits (Box 3 compares the annualized post tax returns from a Savings bank account, a fixed deposit account and a Money market mutual fund).

Box 3: Comparison: Annualized post tax returns

	Savings	Fixed Deposits	Liquid Funds (MMMFs) Dividend plan*
Annualized interest rate (Yield)	3.50%	7.50%	8.06%
Tax rate**	33.99%	33.99%	22.06%
Annualized post tax returns	2.31%	4.95%	6.28%

Returns over three months

* Quantum Liquid Fund

** Highest tax for individuals

*** Effective dividend tax paid from NAV

Source: Put 'idle' cash to use, Aug 31, 2008, *Business-Line*

Liquidity

Deposits marginally score over liquid funds as far as liquidity is concerned. In bank deposits the investor can walk into any branch/ATM and withdraw money if he/she is availing the Savings bank facility. However, in case of MMMFs settlement period is T+1 , which means if the investor gives a redemption request to the fund within the cut off time on T0, the cheque is issued/money is credited to the bank account of the investor on the next working day.

LFIs[11] as MMMF channels[12]

Mutual funds unlike banks do not set up their own outlets to collect the investment money. They work with channel partners/brokers/agents to source clients for them. The cost of intermediation of money for mutual funds is therefore likely to be lower than cost of intermediation for banks.

[11] Local Financial Institutions (LFIs) are private, professionally run, community based entities engaged in the delivery of financial services. These entities could be set up either as a for-profit or a not-for-profit entity. LFIs, being community based institutions, are aware of the intricate social structures in the area they operate and are also able to closely monitor the financial inflows and outflows of the enterprise. – 2005, Rupalee Ruchismita and Puneet Gupta (An Approach Paper for the Delivery of Comprehensive Financial Services to the Informal and Unorganized Sector).

[12] It is mandatory to obtain an AMFI certification in order to sell mutual fund products.

LFIs are already serving the remote populations with credit products. And the BC model when introduced generated a lot of interest amongst these entities and many of them actively sourced business for banks. If LFIs can become channel partners (see Box 4 to know how to become a Channel Distributor) of Mutual Funds they can not only have another source of revenue by way of brokerage fees they get from Mutual Funds but can also reduce their portfolio risk by allowing their clients to save for the rainy day. Though this would require investment in technology to smoothen the flow of information with the Mutual Fund, the savings from the reduced paperwork (because of such investment) would justify such investments.

Box 4: How to become a Mutual Fund Distributor

It is mandatory to obtain AMFI certification in order to become a Mutual Fund distributor. For corporate, all the employees indulged in the sale of Mutual Funds need to be registered with AMFI. NCFM conducts AMFI Advisor exam, which is required to get AMFI Certification. One can either give an AMFI certification online test or AMFI certification offline written test. Once the AMFI registration number (ARN) is issued, the company needs to sign on the empanelment form and send it to the Mutual Fund whose Distributor/ Channel Partner it wants to become.

Challenges in LFIs as MMMF channels

- Mutual Fund distribution is a highly data and computation intensive business process, which requires taking inputs from the Registrar and Transfer Agents or RTAs[13]. Majority of LFIs in India use rudimentary technology systems that lack credible transaction trails or alternatively incorporate manual operations[xi]. If these LFIs in the absence of robust technology platform are to become Mutual Fund distributors they will be spending substantially on paper and paper transport costs, which can raise questions on feasibility of this product at low ticket size of investment.

[13] The RTA is a specialized entity which possesses the expertise and skills to maintain the records of a large number of investors and also service them. The operations of RTAs are also subject to registration and inspection of the capital market regulator.

- Investors in a Mutual Fund need to have a PAN[14] [15] card. If money market mutual fund is to be taken to remote areas of the country, having PAN cards will pose a challenge. In India, where number of taxpayers is not more than 40 million, penetration of PAN cards is less than 3.5%[xii].
- Money market mutual funds can be redeemed with a settlement of T+1 days, but if they are to offer liquidity akin to that of Savings bank account, the liquidity at the time of redemption of MMMF needs to be as good as T0.

IFMR Holdings Case Study

IFMR Holdings Private Ltd[16] has tried to address the above challenges with some innovations in this space. Their subsidiary Pudhuaaru Kshetriya Gramin Financial Services (PKGFS)[17] offers money market mutual fund as an agent to IFMR Holdings which is a channel partner to ICICI Prudential

[14] Permanent Account Number (PAN) is a national identification number, issued to all taxpayers of India whose income is taxable. This number is issued by the Income Tax Office. This number is required for many activities such as opening an account, getting a phone line, receiving salary or professional fees. The PAN is unique, national, and permanent. It is unaffected by a change of address, even between states.

[15] SEBI through letter no. MRD/DoP/PAN/PM/166999/2009 dated June 19, 2009 to AMFI, conveyed their decision that the investment in Micro Schemes such as Systematic Investment Plans of Mutual Funds up to Rs.50,000/- per year per investor shall be exempted from the requirement of PAN and this has been implemented effective August 1, 2009.

[16] IFMR Holdings Private Limited is piloting a rural financing model of creating a network of companies called Kshetriya Gramin Financial Services (KGFS) to meet the huge, unmet demand for financial services in rural, under-served parts of India. Each KGFS is governed by tight geographical focus and works on hub and spoke model. It has branch based operations, with one branch for every 10,000 rural populations, where client interaction happens only at branch. (More info on - http://www.ifmrtrust.co.in/ventures/ithc.php)

[17] PKGFS is a Section 25 company which is wholly owned by IFMR Holdings Private Limited. Its mission is to maximize financial well being of every individual and every enterprise by providing financial services in the remote rural Thanjavur and Thiruvarur.

Asset Management Company (AMC) for its ICICI Prudential Liquid Plan - Growth Option via Micro SIP facility[18]. For product features of this plan see Box 5.

Box 5: Fact File

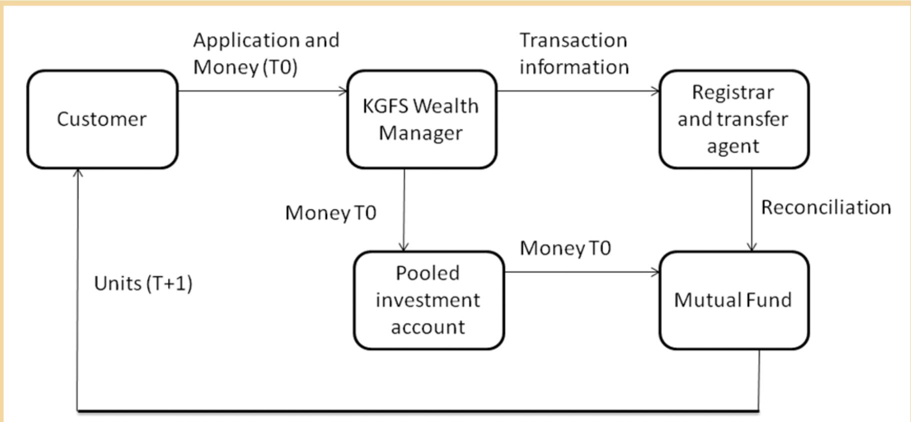
- Name of the instrument – ICICI Prudential Liquid Plan - Growth Option via Micro SIP facility
- Initial invest amount – 100 INR
- Subsequent investment amount – Minimum 100 INR in multiples of 10
- Redemption amount – Minimum 100 INR and multiples of 1
- Micro SIP dates – SIP dates are kept flexible to allow customers to invest and redeem as per their requirements
- Redemption TAT = T+1

The process and product innovations by IFMR Holdings are explained below:

- *Flow of money*. The investments made by customer are transferred to an investment parking account and the same is remitted to the Mutual Fund before the cut off time (See Box 6). To avoid netting off of the investment and redemption amounts a separate redemption parking account is maintained. When the Mutual Fund transfers the redemption amount at T+1, the same is used to set off the bridge financing made to the customer.

All the transaction related data is maintained in the Customer Management System (CMS)[19] which mirrors with the data maintained by RTA on behalf of mutual fund.

Box 6: Investment process

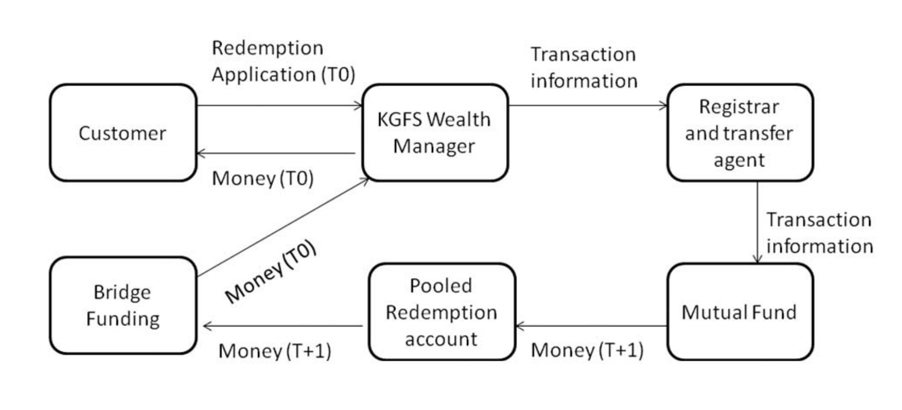


[18] ICICI Prudential Liquid Plan – Addendum 182 Dt. 11/11/2008

[19] Customer Management System (CMS) is a proprietary system developed by Sen-Sei technologies for IFMR Holdings. This system is used for capturing demographic profile of its customers. CMS is capable of generating pre-populated application forms; generating transaction feeds for different products and also acts as a RTA's mirror database for the MMMF product.

- *One day credit line to make MMMFs more liquid.* As already mentioned, the settlements for debt funds redemptions in India happen at T+1 day. In order to enhance liquidity, bridge finance is provided to the customer. The customer gets money from PKGFS upfront after submitting the redemption request as a loan for the period of redemption request placed by customer to the actual receipt of money from the Mutual Fund. This loan gets appropriated with the amount transferred by Mutual Fund after processing the redemption request (see Box 7). Effectively this reduces the settlement period of T+1 to T0 for the customer.

Box 7: Redemption Process



- *Flow of information.* PKGFS plays a facilitative role for the mutual fund in terms of handling cash, capturing data and flow of information to Registrar and Transfer Agent (RTA). Customer Management System is used to transfer transaction information in bulk to RTA and Mutual Fund using the straight through processing (STP) system. Transacting through STP reduces a lot of duplication of effort at RTA and Mutual Fund level and thus reduces cost making this product feasible for them at ticket sizes as low as INR 100. CMS takes inputs from RTA in the form of Daily NAVs; transactions which have taken place through the Distributor and the customer account statements feed that are available periodically. The data is then processed, reconciled with the native data in CMS. Given the low value high volume transactions, investment in technology becomes a key element for this product. A solution like CMS automates number of sub processes and reduces loss created by human error.

- *Assist customers in getting PAN card.* In order to facilitate acquisition of PAN cards by its customers, PKGFS sends bulk PAN applications for its customers to authorized entities who manage IT PAN centers. The turnaround time from the time a customer, applies for a PAN card to PAN card received is less than 20 days. The PAN card application fee of INR 94 is a nominal one-time investment by the customer to get access to mutual funds.

Conclusion

Today financial intermediation is focused on functions which banks perform for households in the economy. This note expresses a view that for maximizing financial inclusion these functions be performed by mutual funds at the back end by leveraging the distribution network of MFIs/ LFIs. The IFMR Holdings case study discusses various aspects from the point of view of the MFI/LFI distributor[20] and shows that by designing a technically sound product and process structure the access to micro savings for the people who do not have access to these services from existing formal channels can be addressed. Steps by regulator to enable funds to route investment and redemption transactions at a quicker pace could bring about a more significant change in the Liquid Mutual Funds industry and will address the demand for access from a wider investor base.

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[xii] Economy Bureau: *The Financial Express*, Number of taxpayers growing at 2.4% CAGR, Mar 11, 2008

[20] As a part of its mission IFMR Holdings is willing to offer free software and training to LFIs interested in offering this product.