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A Special Issue Presented with The Rockefeller Foundation

THE INNOVATIVE FINANCE REVOLUTION

Private Capital for the Public Good

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Introduction

Framing

Policy

Investing in the Transformation of Financial Access in India

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India has had a long history of attempting to solve the problem of financial exclusion and to bring its citizens, their households, and their enterprises under the fold of formal financial services. Despite a combination of interventions and institutional reforms introduced to accelerate the process of financial inclusion, India has a long road to cover.

As of 2015, only 42% of adult Indians hold active bank accounts.[1] Rural branches, which constitute 37% of the banking system, contributed only 10% and 8% to banks' deposit and credit respectively.[2] As of 2014, credit depth for India, which is measured by the credit to GDP ratio, stands at almost 76%.[3] However, the regional variations in financial access and depth are vast at the district level. For instance, credit to GDP for Maharashtra

1 India Wave Report, FII Tracker Survey, Financial Inclusion Insights, March 2016

2 RBI Basic Statistical Returns, 2015

3 Domestic credit provided by financial sector (% of GDP), World Bank, 2014

(excluding Mumbai) is comparable to that of the more rural state of Bihar at 16%. The districts in the North-Eastern States have a median credit to GDP ratio of 6% (for rural) and 18% (for urban) with the lowest values of 0.40% (for rural) and 1.15% (for urban).

Individuals and enterprises are hardly protected from risks that insurance products can mitigate. As of 2015, only 13% of Indian adults had insurance, largely by life insurance (10 out of the 13%).[4] Non-life insurance penetration[5] stood at 0.8% in 2013 for India—the lowest compared to other emerging economies—meanwhile it is 2.7% for South Africa, 1.8% for Brazil and 1.4% for China.[6] Households save predominantly in physical assets. NSSO (National Sample Survey Office) data indicate that for both rural and urban India physical assets form 86.55% and 82.27% of their asset portfolios, respectively. This finding is validated by service area data from IFMR Holdings' retail financial services delivery arm which show households that rely on agriculture labor typically have 90% of its asset portfolio in three categories of physical assets, namely land, house and gold.[7] The ubiquitous absence of financial assets as an important component of household asset portfolios is further reflected in the fact that 74% of assets under management for the mutual fund industry is concentrated in the top 5 cities of the country. From the lens of public policy, one of the pivotal roles of financial services is to cover for unforeseen catastrophic events through market-driven approaches in order to reduce the fiscal burden on governments. Estimates indicate that India faced losses that accounted for up to 2% of its GDP due to natural disasters.[8] There is no catastrophe risk insurance market that exists to help households, businesses, institutions or governments protect themselves against these potential losses. The Uttarakhand floods of 2013 saw the state lose 11% of its GDP with losses to tourism pegged at USD 1 billion[9] for the same year.[10]

4 India Wave Report, FII Tracker Survey, Financial Inclusion Insights, March 2016

5 Insurance penetration is measured as the ratio of premium to GDP

6 Sigma Volumes 3/2014, SwissRe

7 How much can Asset Portfolios of Rural Households Benefit from Formal Financial Services? Vishnu Prasad, Anand Sahasranaman, Santadarshan Sadhu, Rachit Khaitan, NSE Working Paper Series No. WP-2014-2

8 Government of India Planning Commission Report of the Working Group on Disaster Management for the Twelfth Five Year Plan (2012-2017), October 2011

9 Exchange rate is assumed throughout is USD 1 = INR 65

10 Rapidly Assessing Flood Damage in Uttarakhand, India, World Bank, 2013

The above numbers reflect the innumerable challenges that a well-functioning financial system can effectively mitigate for India's individuals, households, enterprises and local governments. A design for such a well-functioning financial system can be considered to have three pillars, namely, high-quality origination, orderly risk transmission and robust risk aggregation.

A Vision for the Financial System

To elaborate further, ***High Quality Origination*** is understood to be the design and delivery of financial services that provide households and firms the ability to manage liquidity (moving resources across time) and risk (moving resources across "states of the world") in a smooth, convenient and affordable manner. Origination spans activities and functions such as the design of products to overcome moral hazard and adverse selection, establishment of the identity of the customer, underwriting of risk, and servicing on an on-going basis. Financial institutions that deliver the service of origination are called originators. India needs thousands of high quality originators across the length and breadth of the country that can fully understand each and every household they serve and offer financial services that maximise their financial well-being. ***Orderly Risk Transmission*** in the financial system involves the movement/assignment of risk from entities that originate risk to entities that are best placed to manage these risks, in return for a compensatory payment at a market-determined rate, thus improving the overall capability to manage risk. ***Robust Risk Aggregation*** involves the movement of risk to external, well-capitalized and well-diversified counterparties that are better positioned to hold those risks. Any well-functioning financial system should have robust risk aggregation capacity with a range of institutions, such as commercial banks, insurance companies and mutual funds, and the appetite and the ability to play the role of aggregators.

IFMR Holdings was set up to establish and strengthen the three pillars elucidated above. It operates, invests in and provides strategic direction to commercially operating companies and other business opportunities that further its mission *to* *ensure that every individual and every enterprise has complete access to financial services*. Today, IFMR Holdings provides the following services:

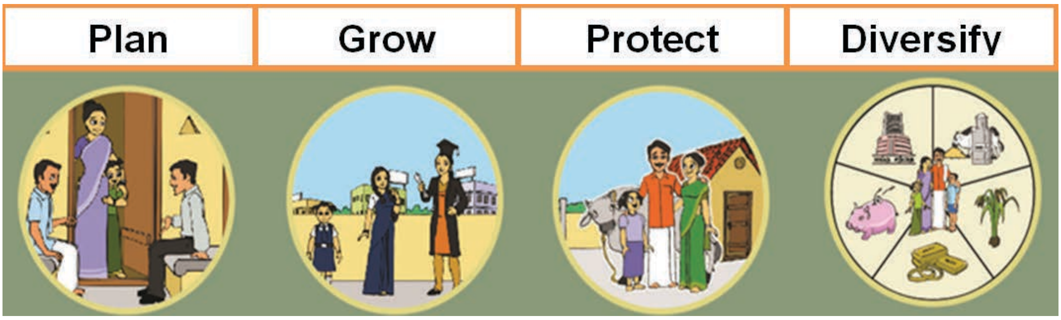
- a complete suite of financial products and services to remote rural India through a wealth management approach
- complete access to debt capital markets to high quality financial institutions that serve the financially excluded
- technology and product platforms that enable the growth of highly customer-centric financial institutions

A subsidiary company, IFMR Rural Channels (IRCS) operates a network of rural financial institutions called KGFS (Kshetriya Gramin Financial Services) that offer a full suite of financial services and cumulatively reach more than 650,000 customers across 4,200 villages through 236 branches in remote rural India. Another subsidiary is IFMR Capital, which is a debt capital markets platform serving 105 originators offering micro-loans, small business finance, agricultural finance, affordable housing and commercial vehicle finance, that reaches more than 19 million financially excluded people. Relevant to the overall mission of IFMR Holdings is its co-subsidiary,[11] IFMR Finance Foundation (IFF), a non-profit research and advocacy entity that carries out nonpartisan, evidence-based policy research and dialogue with policy makers and regulators across the important themes of financial systems, design customer protection and household finance.

IRCS delivers financial services at a retail level through its network of KGFS branches in remote rural areas that offer a complete suite of financial products and services through a ***wealth management approach***. The wealth management approach has been a core part of the financial services offering since its inception in 2008, and is designed to ensure financial planning, asset growth, asset protection, and risk diversification for rural households and enterprises only after obtaining a comprehensive understanding of the customer's needs and aspirations. The most important part of the approach is the conversation that the wealth manager (the field staff of a KGFS branch) has with the customer about her financial needs and

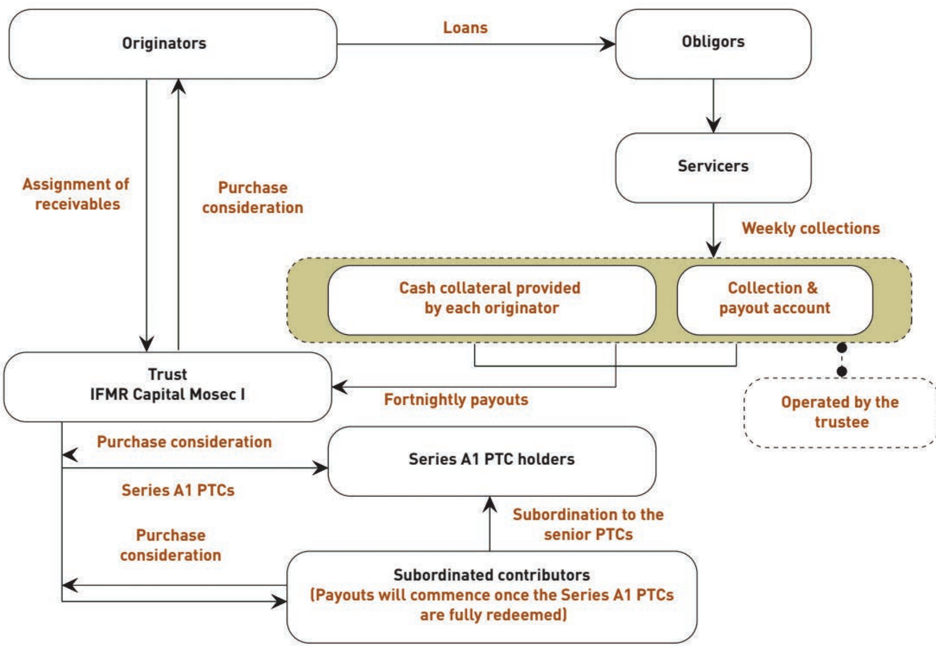
11 Both IFMR Holdings and IFF are subsidiaries of IFMR Trust, a private trust and controlling shareholder in IFMR Holdings. IFF is the ultimate beneficiary of the IFMR Trust

goals, both immediate and long-term. This is supported by a robust customer management system, which enables the capturing of all household income, expense, asset, liability, and cash flow details, to generate a ***Financial Wellbeing Report*** (FWR). This system-generated comprehensive financial plan highlights the unique aspects of the individual customer's and household's risk profile and helps in making specific financial recommendations for the household along a pre-specified pathway (Plan, Grow, Protect, and Diversify) for household financial wellbeing.



Critical to the delivery of financial services through a wealth management approach is IFMR Rural Finance (IRF), which offers technology and product platforms that enable the growth of highly customer-centric financial institutions. It also forms the technological backbone of the KGFS. IRF's technology and financial product solutions provide originators with the infrastructure to become customer-centric by facilitating deeper conversations with their customers as well as enabling them to potentially offer multiple products to serve their customers' varying needs. The technology platform also provides vital business intelligence capability that helps originators continuously learn from their customers' financial behaviour as well as mobility solutions that offer the full functionality of all its technology products on mobile devices, reducing the effective distance to the customer.

IFMR Capital sits squarely in the risk transmission pillar. IFMR Capital's aim is to provide efficient and reliable access to capital markets to high-quality originators serving financially excluded sectors. Loan pools contributed by a single originator are often too small and too geographically concentrated to take to the capital market. A secure pool must have a minimum critical size in order to make them financially viable and hence only large originators can traditionally access capital through securitization. Small originators, therefore, are most in need of access to capital markets. Spurred by the overarching need, IFMR Capital developed the ***Multi-Originator SECuritization*** or MOSEC. MOSECs allow smaller MFIs (microfinance institutions) to participate actively in securitization transactions and collectively access capital markets when they are too small to access capital markets individually, and by pooling loans across originators and geographies, a well-diversified portfolio is achieved which provides an attractive risk-return trade-off to investors.



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12 CRISIL Credit Rating Report IFMR Capital MOSEC 1, 2010

The first MOSEC closed in January 2010. Since then, MOSEC has transformed the way financial inclusion focused originators access capital markets in India. The small MFIs that participated in the first MOSEC in 2010 had on average loan assets of USD 5 million and have since grown to a balance sheet size of USD 234 million in the past six years, representing an annual growth rate of more than 80%. One of the largest MOSECs IFMR Capital executed had nine MFIs contributing a pool of almost 45,000 loans. Since the launch of the first MOSEC in January 2010, IFMR Capital has structured, arranged and invested in 88 such transactions. The structure is flexible enough to accept a wide range of underlying loans with varying sizes and tenures. The MOSEC structure gained a higher level of prominence in January 2013 when the senior securities issued under IFMR Capital MOSEC XXII were listed on the Bombay Stock Exchange. This was the first instance of listing of securitized debt in India and marked a significant step towards greater disclosure, liquidity, transparency, and sustainability in IFMR Capital's efforts towards financial inclusion and simultaneously marking a milestone for debt securitization in India. Similar to the evolution of the MOSEC, **IFMR Investments** emerged from two underlying needs. Indian MFIs primarily have access to Priority Sector Lending (PSL) bank-funding, which is primarily motivated by regulatory obligations, and is short-term and expensive in nature. Since India has the largest microfinance sector in the world, the opportunity to expand financial services and deepen bond markets is substantial. As a natural externality from this construct, there was a clear dearth of access to affordable long-term debt funding for MFIs and other originators. To meet this need, IFMR Holdings set up IFMR Investments, an asset management company that would help bridge this gap in access to long term funding. IFMR Investments has launched three funds so far with total assets under management at USD 62 million.

Each of the pillars that IFMR Holdings has focused on has had several innovations. In time, these innovations will reach their full potential when other stakeholders interested in financial inclusion replicate each one and truly scale their impact. There are some innovations that traverse all three pillars and one such innovation that is critical to hold together the fabric of the Origination-Transmission-Aggregation framework is the tenet IFMR Holdings strongly believes in: the ***Suitability of advice and sale of financial products and services***. Suitability entails placing a primary responsibility on financial services providers for recommending and selling products that are 'suitable' for their customers, given their goals, needs and financial situation, and IFF has been advocating for this protection.[13] This is important because India has so far had a customer protection regime for retail financial services that overwhelmingly emphasised a combination of disclosure requirements (of product terms and conditions) otherwise called *caveat emptor* or buyer beware, and customer education measures, both of which have been inadequate to prevent rampant mis-sale of products and services. Under the 'suitability' regime, accountability and supervision are to be driven by the extent to which providers adhere to processes laid down in their own policies instead of (traditionally) placing such responsibility on customers to decide for themselves. IFF performed the function of the Technical Secretariat to the Reserve Bank of India's (RBI's) Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households,[14] and within this, provided a detailed rationale and set of recommendations for moving towards a suitability-based customer protection regime of regulation and supervision. Thereafter, the newly published RBI's Charter of Consumer Rights,[15] for the first time enshrined such a Right to Suitability. The provision of such a Right for retail customers will pave the way for customer protection to shift from being an *ex-post* redressal process to becoming an *ex-ante* feature of product advice and sale.

Way Forward

Over the past 8 years, IFMR Holdings, through its direct operations via IFMR Rural Channels covering 650,000 rural customers, has been able to assess households' liquidity needs, taking into account their unique financial situations and goals, and deliver efficient and suitable financial solutions to help meet their individual goals. In the last fiscal year, an average of 62% of all active customers and 80% of all loan customers had an active insurance cover for their human capital or for other income earning assets—a level of protection that simply did not exist before. By essentially bringing to market viable debt capital markets products in financial inclusion, IFMR Capital has, in the last financial year itself, provided almost USD 2 billion in debt financing to 105 high quality local and/or specialised originators, indirectly impacting

13 A New Framework for Financial Customer Protection in India—IFMR Finance Foundation Position Paper. Anand Sahasranaman, Deepti George, Darshana Rajendran, Vishnu Prasad, 2013

14 Report of the RBI Committee on Comprehensive Financial Services for Small Businesses and Low-Income Households (Chair: Dr. Nachiket Mor), 2014

15 RBI Charter of Customer Rights, 2014

more than 18 million people. Prior to the existence of IFMR Capital, debt capital markets infrastructure for financial inclusion originators was not present. In the last fiscal year, structured products enabled partner originators to raise more than seven times the amount IFMR Capital invested from its own balance sheet in their transactions. Furthermore, IFMR Capital has helped partner originators grow into mature institutions. For example, MFI Satin Creditcare Network went from managing under USD 3 million of loan assets in 2009, to more than USD 54 million today. Eight out of the ten small finance banks (regulatory structure specifically created by the RBI to serve the underbanked) are partner originators of IFMR Capital.

Although we have come a long way toward fostering financial inclusion in India, more work can be done towards this goal by amplifying and scaling-up existing IFMR Holdings' businesses. Still many critical challenges remain:

1. How do we ensure that there are many more multi-product customer-centric originators delivering financial wellbeing for their customers?
2. How do we protect households and enterprises against risks beyond their control such as life, accident, health and catastrophes?
3. How do we better facilitate access to finance for SMEs (small and medium-sized enterprises) and vital sectors such as agriculture and local infrastructure?
4. How do we implement a workable suitability regime for originators that is not prohibitively expensive and yet provides value to both customer and originator?

It is clear that many more game-changing innovations are required. Some of the answers lie in innovating to leverage several enabling mega trends currently seen in the Indian regulatory, infrastructural and market landscape. More than one billion Indians now have a unique biometric identification number called the Aadhaar number, which makes it possible to enable real-time paper-less self-authentication through biometrics such as iris and fingerprint matching. This, along with other specific components of the IndiaStack[16] such as the Aadhaar e-sign, an online electronic signature service, and the Digi-Locker, a secure online e-document storage space, makes possible paperless signing of contracts and the authentication of financial transactions as a 3rd party utility. The RBI has also

16 http://www.indiastack.org/

provided 21 new bank licenses including 11 payments banks and 10 small finance banks, dramatically increasing the number of banking transaction points, and providing likely competition to incumbent banks. India has 76 million smartphone users, and this is expected to cross 700 million by 2020[17]. Since its inception in 2013-14, IMPS (Immediate Payment Service, an electronic funds transfer service) has overtaken debit card POS volumes by 2015-16, an indication of the grand shift towards electronic payments by Indians. The unprecedented generation of rich customer data through various digital and payment channels, is finding its way to applications in financial intermediation and credit and insurance underwriting. Better understanding of the customer due to the presence of specialized credit bureaus with in-depth data on customers in the informal sector as well as rich customer data owned by several financial inclusion focused originators will become much more valuable in underwriting. We are convinced that by capitalizing on these mega trends, we will make faster strides than ever before towards our mission of achieving complete access to finance for every individual and enterprise.

17 Indian Financials Sector, Credit Suisse 2016