ICICI BANK AND ITS PARTNERSHIP LINKAGES IN INDIA[1]
A Case Study

Introduction

This case study describes the MFI linkage model of ICICI Bank, India's second largest commercial bank. This Bank has developed a unique partnership model to deliver small loans to the rural poor. The case focuses on two examples of ICICI Bank's microfinance facilitation links with microfinance intermediaries serving individuals and self-help groups (SHGs), one with BISWA, a Microfinance Institution (MFI) in Orissa and one with PSS, a smaller MFI working with self-help groups in the poorest parts of Warangal in Andhra Pradesh. The two cases were selected to demonstrate how a large commercial bank can use the strengths of local MFIs to link directly with large numbers of poor clients.

Microfinance in India

India's well-developed financial sector consists of 27 government owned banks, more than 20 major private banks, of which ICICI Bank by far the largest, and over 100 000 cooperative banks; the financial sector is strictly regulated and supervised. Government legislation requires all banks in India to lend at least 40 percent of their credit (at an interest rate not more than 4 percentage points above their prime lending rate) to the so-called "priority sector" which includes rural areas, small industries, exporting firms, housing and agriculture.

This policy and the general welfare objectives of India's public sector banks, the so-called "new paradigm" microfinance, came very late to India. The government spent many years trying to alleviate poverty with massive programmes of directed and subsidised credit. These programmes had limited success, were often hijacked by the less poor and used as a patronage mechanism by politicians and bureaucrats. They did however occupy the 'institutional space', which might otherwise have been filled by micro-finance.

While these programmes helped some people, they also left long-term scars on the country's financial system. The cheap soft loans, often combined with subsidies, were distributed through the enormous network of over 150 000 bank branches, including rural co-operative banks. Recoveries were poor, often below 30 percent, and default was further encouraged by local and even national loan waivers.

In the late 1980's the Mysore rehabilitation and development association (MYRADA) started to experiment with the formation of self-help groups (SHGs), based on traditional Southern Indian savings and credit groups. SHGs are effectively micro-banks, with between ten and 20 women forming a group, on their own initiative, or with the help of an NGO or other self-help group promoter. Each member saves a small regular amount and the group either use their accumulated savings as a pool to be lent out to those members who need it or they may open a savings account with a nearby commercial or co-operative bank. The Reserve Bank of India (RBI) has, since 1994, allowed unregistered groups to open savings accounts and to borrow from banks. So if an SHG needs to supplement their savings fund to make loans to their members, it can borrow from a bank. The members are free to set whatever interest rate they like on their loans and they often add on a substantial margin over what they pay to the bank, in order to build their own group equity.

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[1] This case study was written by Malcolm Harper and Mariè Kirsten as part of the Ford Foundation-sponsored study of links between banks and MFIs, carried out by the Food and Agriculture Organization of the United Nations. It was edited by Jennifer Heney for the RFLC.

In the early 1990s the National Bank for Agriculture and Rural Development (NABARD), the government's instrument for financial deepening in rural India, started to encourage the banks to accept SHGs as customers. NABARD refinances banks' loans to SHGs at 5.5 percent. The banks have generally lent to SHGs at 12 percent, and the resulting spread of 6.5 percent was considered adequate to cover their transaction costs. SHGs become the dominant delivery channel for micro-finance in India and by the end of 2004, almost 1.5 million SHGs, with perhaps 20 million members, were said to have borrowed from banks. While this might include double counting, at least 20 percent of India's one hundred million poor households probably have some access to formal financial services.

Motivation for ICICI's linkage plan

A number of factors worked together to convince ICICI Bank, India's second largest commercial bank, to enter the microfinance market in 2002. These included priority sector targets, as well as the internal drive "to be a leader in every field of banking", and the belief that some of the new micro finance clients will eventually graduate into mainstream banking.

ICICI could meet its priority sector targets by lending directly to the "weaker sections" or by lending equivalent amounts to public sector institutions such as NABARD or SIDBI, at 6 percent or less, which these institutions then use for priority sector purposes. There are however very strong incentives, especially for private banks such as ICICI, to do a substantial amount of direct priority sector business and not to buy themselves out of their obligations with indirect investments. Microfinance, for example, can clearly be seen as a form of customer development. This played an important role in ICICI's decision to lend directly to self-help groups and individuals.

Design of the linkage system

But how does a large commercial bank reach thousands of poor people with tiny loans? ICICI Bank have developed a unique linkage methodology, through which they are now reaching close to 300 000 clients in mainly rural areas, with direct loans. Furthermore, many of these clients are in the poorest regions of India, such as in Bihar and Uttar Pradesh, home to 37 percent of India's poorest people.

The bank selects MFIs as partners who then act as managing agents for ICICI Bank. Most of these MFIs, such as PSS and BISWA which are described later in this case study, work through self-help groups (SHGs) which manage members' savings and take loans to on-lend to their individual members. A smaller number of the Bank's partners, however, are 'Grameen replicators', which follow the Bangladesh Grameen Bank's method of lending to individual clients, using groups merely to facilitate and guarantee the loans for their members.

The system or linkage works as follows: ICICI Bank carefully selects partner MFIs with substantial outreach and high quality microfinance portfolios. After a brief inspection of the MFI's loan accounting and monitoring systems, ICICI Bank staff visit a random sample of customers, to check the validity of the head office records and the quality of the SHGs' records if they are involved.

The Bank is quite clear that their intention is not to rate the strength of the MFI's own balance sheet, but its capacity to facilitate the relationships between the Bank and SHGs or other actual borrowers to whom the Bank will lend. The Bank rates the MFI's management capacity, the quality of its MIS and data reporting systems, the competence of its field staff and the quality of the training it provides to its SHGs and its own staff.

Once an MFI's portfolio has been successfully "screened" by ICICI Bank and the MFI has been recognised as an approved partner, it can start to distribute loans to SHGs or individuals on behalf of ICICI Bank, drawing the necessary funds from the nearest ICICI Bank branch. Three officers of each SHG and every individual borrower from MFIs following the Grameen system sign loan agreements with ICICI Bank, not with the MFI. The agreements include photographs of the signatories and proof of residence, such as a voter's or a ration card, although this may sometimes replaced by signed confirmation from the whole group or a local village leader. This process is intended to ensure that the borrowers understand that they are customers of the Bank and not of the MFI.

After the loans have been disbursed by the MFI, the accounts are monitored on a sample basis for the Bank by their own locally recruited contract staff and auditors. They follow a preset procedure to verify the monthly returns submitted by the MFIs. One full-time monitor is appointed for every partner whose portfolio exceeds one million dollars. These monitors are paid only about $100 a month, but reliable and well educated people can be hired in India for this amount. They are trained to follow the required procedures and to observe obvious danger signals.

The MFI will be remunerated for originating and maintaining the accounts, and for recovering the loans. The MFI usually receives a percentage of the loan interest. The final borrowers will pay, in addition to ICICI Bank's interest charges, an additional service charge to the partner MFI. This means that the SHGs or individual clients end up paying similar rates to those they would actually pay if they were borrowing from the MFI rather than ICICI (see the BISWA example later). However, their loan agreements state ICICI Bank's interest rates and do not include the MFIs' fees.

The first MFIs with which ICICI Bank formed partnerships of this kind, such as BISWA, were already directly involved in financial intermediation. They are using the Bank partnership to complement this activity and reach more clients without having themselves to access more funds for on-lending. Such MFIs may choose to continue to combine their own direct business with ICICI Bank partnerships, or, as they become financially stronger, and more bulk loans become available to them, or they become eligible to mobilise client deposits, they may replace the ICICI Bank funds with their own.

Alternatively, some smaller and financially weaker MFIs may choose to hand over the complete task of financial intermediation to the Bank and to focus on their 'core business' of community mobilisation, loan origination and collection. Given the stringent requirements demanded by banks for bulk loans, and the very great difficulties in acquiring banking status, it is more likely that many if not most partners will choose this latter route.

MFIs which are in partnership with ICICI often benefit from training, from being acknowledged as effective MFIs, from being able to serve more clients and from not being tied to one source of finance any longer. The ICICI relationship is quite flexible and can be adjusted when required.

Risk reduction

ICICI Bank reduces its risk and ensures the commitment of the partner MFIs by taking first loss guarantees from the MFIs, which vary in amount according to the perceived quality of the loan portfolio, how long they have worked with the MFI and on the MFI's own preferences. One option is for the MFI to open a fixed deposit account for between 8 to 15 percent of the total loaned, which cannot be withdrawn by the MFI until the loans have been repaid, but can be drawn down by ICICI Bank to cover any losses. Alternatively, the MFI may be given an overdraft limit with ICICI Bank up to the required amount, and the Bank can then require the MFI to use this to cover any losses.

A third party can also deposit the necessary guarantee on behalf of the MFI. The Grameen Foundation of the USA has done this for ICICI Bank loans channelled through Cashpor and SHARE, India's largest Grameen replicators. Such guarantees can be used to enhance the quality of securitised loans[2] which the Bank may choose to sell on to other institutions, and thus to improve the price obtained by the Bank. Alternatively, the loans and the associated MFIs' obligations may be retained by ICICI Bank should they decide not to package or sell on the assets arising from loans to a particular group of clients.

The Bank is aware that if an MFI collapsed they would have some difficulties in recovering all their dues, in spite of these precautions. However, they believe that their procedures would give them early warning of any serious problems, and the first loss guarantees provide some initial protection. As a last resort, they could perhaps sell the balance of any remaining portfolio to another MFI, or could sub-contract the collection to a debt collection agency.

Governance and cost considerations

ICICI Bank started its micro-finance activities under its Social Initiatives Group (SIG), a unit positioned somewhere between corporate responsibility and for-profit business. The bulk of the micro-finance activity has now been transferred to mainstream business. The five-member micro-finance team is located in the rural, micro-banking and agri-business group, within the wholesale banking division.

In early 2005 ICICI Bank's micro-finance portfolio amounted to no more than a third of one percent of the Bank's total assets, but it is growing much faster than most other areas, and is rather more profitable than the average for the Bank's business sectors. There is no need to justify the micro-finance portfolio by reference to its social or public relations benefits or to view it as an investment in future client development. The spread on micro-finance advances is as high, and the transaction costs are as low, as in other sections of the Bank's work, because the costs have been effectively out-sourced to specialist institutions. This is fundamentally consistent with the Bank's approach to any other business sector, such as housing or vehicle finance, and management are now confident that micro-finance has been securely mainstreamed within the Bank.

LINKAGES IN ACTION

i. *ICICI Bank and Services for Progress Organization (PSS)*

PSS is one of the smaller MFIs whose customers have received loans from ICICI Bank. PSS works in the poorest parts of Warangal District of Andhra Pradesh, where three quarters of the population earn their livelihoods from farming and related activities. Although it used to be relatively well off, the area has recently suffered heavily from drought. Cotton is the most popular crop, and this has led to problems not just because of the drought but also because of the high cost of seeds, fertiliser and pesticides.

PSS has an annual budget of around $240 000 and is funded from Indian government and foreign sources. PSS has promoted over 1250 SHGs, which have been grouped into 22 Mutually Aided Cooperative Societies (MACS), with about 20 000 members altogether.

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[2] Securitisation involves selling a package of loans to a third party. The seller, the originator of the loans, usually provides some sort of full or partial guarantee that they will be repaid and may be responsible for the collection. Securitisation is used by banks such as ICICI Bank which tend not to mobilise enough savings deposits to finance their loan portfolios, and therefore need to acquire funds for on-lending before the loans they have made fall due.

At the end of 2004, the members owed about $750 000 to their SHGs and the SHGs themselves owed about $200 000 to various banks. The balance of the SHGs' funds was derived from their own savings, accumulated earnings and loans from PSS.

SHGs which have been promoted by PSS have now borrowed $100 000, either directly or through their MACS, from ICICI under the new partnership arrangement. ICICI Bank has required PSS to deposit with the Bank a sum equivalent to 15 percent of the loan amount, as a first loss guarantee to lower the risk. This deposit earns the Bank's normal rate of 5.5 percent interest, but the account cannot be closed until all the SHG loans have been repaid. Any defaults can be recovered from the deposit, before it is returned. While there has, to date, been no need to exercise this right, PSS is well aware of the possibility.

As a result of ICICI Bank's satisfactory experience with PSS, the State Bank of India and Corporation Bank, another large public sector bank, are becoming interested in lending to PSS' affiliated MACS and possibly to PSS itself.

The **Jeevanajyothi MACS** is one of the 19 MACS whose member SHGs have received loans from ICICI Bank, as a result of the linkage with PSS. Jeevanajyothi has 76 member SHGs, which in turn have 722 members. All the SHG members are women and most are from the so-called 'scheduled' castes and tribes who have always been both socially and economically marginalized in India. The financial situation of the Jeevanajyothi MACS at the end of 2004 was as follows:

Assets / Use of Money		**Liabilities / Sources of Money**	
Loans outstanding with member SHGs	$17 500	Members' savings	$7 590
Fixed deposits	$760	Loans from PSS	$10 500
Cash at bank	$1 460	Accumulated surplus	$1 630
Total	$19 720	Total	$19 720

The SHG members realise that ICICI Bank loans are more expensive than loans from the nearest branch of the Kakatiya Rural Bank. They nevertheless prefer to borrow from their MACS, or from ICICI Bank, because:

- When the SHGs borrowed from the Kakatiya Bank, all the members of the group had to go to the branch, which cost them $6 in bus fares, in addition to sixty cents each in lost wages. Two of their officers had to make two further visits to the branch, which cost the group $2 for each trip.
- Loans from the Kakatiya bank were insufficient to enable the women to buy buffalos, which cost around $100 each, or to make any other significant investment.
- The loans from ICICI Bank, in the same way as direct loans from their MACS, were more expensive than from the Kakatiya Bank, but part at least of the extra cost went to support the MACS, which was their own institution.

The women believe that it would be even better to borrow direct from their MACS, rather than from ICICI Bank, since MACS loans cost 18 percent, as opposed to the effective rate of 24 percent they pay for ICICI Bank loans, and they wish to develop their own institution. They appreciate, however, that it is difficult for the MACS to access more funds, and they are satisfied with the more expensive loans for the time being.

They have used their loans for a variety of purposes, including the purchase of goats and sheep, for sums as small as twenty to thirty dollars.

ii. ***ICICI Bank and the Bharat Integrated Social Welfare Agency (BISWA)***

BISWA, an NGO in Orissa, the poorest state in India, has promoted over 4 000 SHGs with about 64 000 mainly women members, in almost 2000 villages.

ICICI Bank has lent a total of $250 000 to SHGs promoted by BISWA and through them to 4 351 final borrowers. Prior to 2004 BISWA was funded by a number of organisations, enabling them to lend directly to 1168 SHGs; the $250 000 ICICI Bank loan went to a further 297 groups. BISWA also mobilizes savings from the SHGs and in early 2005 the balance of these savings amounted to $10 500, earning 5 percent interest. It is not strictly legal for an NGO such as BISWA to take savings, but as with many similar NGO/MFIs in India, the authorities turn a blind eye to the practice.

The ICICI Bank loan was disbursed into a special account opened at the ICICI Bank branch in the town of Sambalpur. The $250 000 loan from ICICI Bank did not appear on BISWA's books, since the loan was distributed to the SHGs directly. The loans are repayable over eighteen months and the 297 SHGs that received ICICI Bank loans achieved 100 percent on-time repayment. This is better than the average SHG on-time repayment rate of 98.6 percent, partly because BISWA ensured that the selected SHGs were well established, with previous high repayment rates.

The SHGs pay a total of 18 percent interest, plus a two dollar service charge to BISWA, and the members pay 24 percent to their SHGs. The 6 percent spread is retained by the SHGs to build their own funds or distributed to the members as a dividend, depending on the preference of each group. When borrowing from ICICI, the rate of 14.25 percent that the SHGs pay includes the interest to ICICI Bank and the cost of BISWA's intermediation, and this is a considerable reduction in their costs. This reflects the general market situation of falling rates, where some banks are lending direct to SHGs at as low as 9 percent. The SHGs are free to set their own on-lending rates, but most lend to their members at 2 percent a month, or 24 percent a year.

BISWA must carry the first risk of defaults on loans to the SHGs which it has introduced to ICICI Bank, by opening a guarantee deposit with ICICI Bank's branch in Sambalpur. The deposit required is for only 12 percent of the loan amount since the ICICI Bank assessment concluded that the quality of BISWA's records and repayment performance was good. Nevertheless, this first loss guarantee deposit imposes a heavy burden on BISWA's limited cash resources and they hope that ICICI Bank will relax this requirement or replace it with an overdraft account, to be drawn down only if there are any defaults. This would not tie up any of the NGO's scarce cash resources.

The transaction with ICICI Bank was fairly simple and in many ways less difficult than the earlier bulk loans from other banks. The CARE representative who had worked with BISWA for some time made the initial introduction and only two further meetings were required, over a period of six weeks. BISWA estimate that the whole transaction, including setting up the necessary recording and reporting formats, and informing the SHGs of their obligations, took four days and cost approximately $400 in staff time and expenses.

As a result of the ICICI Bank loans, BISWA has been able to retire some of its more expensive loans from banks and other sources. By January 2005, the ICICI Bank loan represented over half of the funds that were available to their SHGs. This has significantly reduced the cost of funds to the SHGs, since their BISWA loans cost 18 percent whereas the ICICI Bank loan costs 3.75 percent less. Competition is increasing however and BISWA are being approached by other large foreign and Indian banks with highly competitive offers for bulk financing.

The SHG members themselves are also becoming more financially sophisticated and local bank branches are becoming more receptive to direct business with SHGs. BISWA can choose between bulk borrowing and the ICICI Bank partnership approach, and BISWA's client SHGs can also chose to place their business elsewhere. This diversity of sources of finance can only serve to benefit the SHG members.

The intermediation process between ICICI and BISWA is very streamlined and the transaction costs to BISWA are reasonable. Two hours after the 12 percent deposit is received by ICICI, the funds are transferred to BISWA's special account in Sambalpur. BISWA then disburse the loans, in cash or by cheque, within a day or so. BISWA has every incentive to transfer the funds to the SHGs quickly, since interest is charged by ICICI to BISWA from the moment the funds are transferred.

In addition to more readily available funds, the main benefit to BISWA of the linkage arrangement with ICICI has been its enhanced credibility among Indian and foreign banks such as ABN-AMRO and State Bank of India. Many of these banks are keen to provide bulk loans to well-established institutions such as BISWA, at competitive interest rates.

ICICI Bank is willing to lend to any SHG that BISWA recommends. However, BISWA does not want their SHGs to become entirely dependent on ICICI Bank. The Bank might choose to exercise its right to securitize the loans and sell them to a less amenable partner. In fact BISWA prefers taking direct bulk loans from banks, since they can then exercise total control over the funds and the on-lending rate which they charge the SHGs. The 5 percent management fee ICICI allow BISWA to add to the interest paid by the SHGs barely covers their costs, particularly if the opportunity cost of the first loss guarantee fund deposited with the Bank is accounted for. Ideally, BISWA would prefer to control the on-lending rate themselves.

CONCLUSIONS

ICICI Bank has designed and implemented a very innovative and apparently effective strategy to enter the micro-finance market, despite the fact that the Bank has only 88 branches outside the major cities. The partnership model enables the Bank to use the expertise and networks of specialist institutions with long experience of social and financial intermediation, without taking on the risk of actually lending money to them. Many of these institutions are financially weak, poorly capitalized, and dependent on grant funds for their survival. ICICI is lending direct to SHGs or to individual micro-borrowers, whose aggregated credit risks have been shown to be very low. The intermediary institutions provide their services for a fee, which is bundled with the interest paid by the final borrowers.

From the MFI perspective, the linkage model has some disadvantages. The MFIs are simply loan agents, and, as illustrated in the BISWA case, they do not want their SHGs to become entirely dependant on ICICI Bank. Some MFIs are becoming financially stronger and some are already able to borrow bulk funds direct from ICICI Bank's competitors, such as ABN-AMRO Bank and others. It is likely that in the future many of ICICI Bank's best collaborators, and particularly those taking the larger sums, will prefer to take bulk loans themselves and to on-lend to their SHGs, thus enhancing their own status in the eyes of their clients. The ICICI Bank linkage will help them to do this, since ICICI approved MFIs gain status by being associated with the Bank, and the MFIs can use this to court other banks for bulk loans, in essence diversifying their partner base. Other MFIs, as has already been pointed out, may prefer to focus on their agency role, and to withdraw from direct financial intermediation.

ICICI's strategy is working well for the Bank also. The portfolio is growing, and the loans are profitable. By March 2005 ICICI Bank's exposure to the microfinance sector, through 27 partner MFIs, had reached $66 million. Motivated by this initial success, ICICI Bank is now extending its linkage model, to smaller MFIs, through a strategic partnership with CARE. By dealing direct with micro-finance clients, the Bank can satisfy the Reserve Bank requirements to lend to the so-called 'weaker sections' and it has created assets, which can be securitized and sold on to other financial institutions.

ICICI Bank acknowledges that a number of challenges remain. The Bank cannot yet offer savings products to its SHG clients. It is unlikely that they will succeed in persuading the regulators to allow deposit taking, in view of the long history of dishonest savings collectors. The threat is that ICICI clients might now go to their neighbouring bank branches for savings and may then take loans from them, which are available at 10% or even less for strong SHGs.

Furthermore, the ICICI Bank loans are made to groups or to individuals and not to the MFIs. If the MFI's are unable to recover the loans, it is unclear if ICICI will be able to. The Bank has no presence in the areas where the clients live and has no staff of its own to collect. Another possible threat for ICICI Banks' long-term success is that the SHG members will become more sophisticated. As their needs increase, they will start 'shopping around' for less expensive loans, at better rates.

Despite these concerns, ICICI Bank is demonstrating that an urban-based private bank can effectively and profitably reach the rural poor. This business is now a component of the Bank's mainstream operations and other Indian and foreign banks are appreciating that the rural poor can be valuable customers. A wider range of financial services is becoming available to hundreds of millions of people who have hitherto lacked access to any formal financial services at all. This experience shows that urban based banks, with few rural branches, can make use of the community contacts and experience of rural NGOs, so that both parties can cover their costs and do what they do best, for the benefit of their clients.

Why don't you?

Reflect on the following questions:

1. Is the ICICI Bank's partnership model a replicable and sustainable means whereby commercial banks without extensive branch networks can enter the microfinance market?

2. What are its strengths and weaknesses and how might the Bank reinforce the former and reduce the latter?