USAID
FROM THE AMERICAN PEOPLE

microNOTE 18

Opening Markets through Strategic Partnerships – ICICI and Cashpor[1]

A Perfect Match

Both large- and small-scale MFIs operating in India have difficulty expanding their operations due to a lack of funds, which are in part limited by MFIs' low level of capital. Commercial banks in India, on the other hand, must comply with the priority sector lending quota, which mandates the provision of credit to agricultural enterprises for exports and to small-scale industries.

March 2006

This publication was produced for review by the U.S. Agency for International Development. It was prepared by Development Alternatives, Inc.

U.S. Agency for International Development
www.usaid.gov

INTRODUCTION

Finance institutions in developing countries are implementing a wide range of linkages to reach new and more remote markets and clients. These linkages often occur between regulated financial institutions and more informal, unregulated entities serving low-income clients. The linkages represent important advancements in service provision to the low-income market, and present possibilities for providing more sophisticated or expansive financial services. Moreover, these linkages serve to overcome institutional or operational obstacles, as well as obstacles related to physical infrastructure, geography, limited population density, or regulation.

The strategic linkage between CASHPOR and ICICI Bank in India demonstrates how ICICI intends to reach millions of low-income clients in regions where it has no physical presence by outsourcing credit processes to microfinance institutions (MFIs) operating in such regions.

Both large- and small-scale MFIs operating in India have difficulty expanding their operations due to a lack of funds, which are in part limited by MFIs' low level of capital. Commercial banks in India, on the other hand, must comply with the priority sector lending quota, which mandates the provision of credit to agricultural enterprises for exports and to small-scale industries. The chronic lack of funds faced by MFIs in India coupled with the priority sector lending quota for commercial banks catalyzed the partnership between CASHPOR and ICICI.

[1] This microNOTE is based on the Accelerated Microfinance Advancement Project (AMAP) Financial Services Knowledge Generation (FSKG) report, *Opening Markets Through Strategic Partnerships The Alliance Between ICICI Bank and Cashpor*, prepared by Robin Bell. The full report is available on http://www.microlinks.org.

THE INSTITUTIONS

ICICI Bank

ICICI Bank is India's largest private bank, and is the second largest bank overall. ICICI aims to be a leader in every field of banking in India, including corporate banking, foreign transactions, housing, insurance, conventional consumer banking services for the salaried middle class, and banking and financial services for the poor (microfinance).

The bank began to engage in microfinance in 2002 after it acquired a regional bank with successful experience in the sector. ICICI's approach to microfinance has taken two forms: the bank-led model, which ultimately evolved into the partnership model.

Bank-Led Model. To achieve the desired scale of operation in the rural branches previously owned by the acquired bank, ICICI opted to test a variation of its existing and highly cost effective model of outsourcing consumer banking services through agents in the microfinance sector. Instead of contracting separate sales, credit processing, and collection agents, ICICI opted to consolidate these functions into one "manpower providing agency." The agency would employ the promoters and coordinators engaging them to work in the field under the supervision of ICICI's project managers.

Although the bank-led model worked well for ICICI in the regions where it had branches, ICICI felt it was not an appropriate model for districts or regions where the bank had no branches or physical presence. Hence, ICICI developed an alternative outsourcing model—the partnership model—that could leverage local capabilities.

Partnership Model. ICICI did not have branches in rural areas. Its internal market study revealed that there were many MFIs like CASHPOR operating in rural areas that could not expand their operations due to poor capitalization and lack of funds for on-lending. At the same time, it was in ICICI's interest to have qualifying assets on its books to calculate its priority sector lending quota. To address these, ICICI developed the following model:

- The MFI acts as a service agent of the bank handling the loan analysis, processing, and recovery;
- The bank, as per the Central Bank guidelines, approves all loans based on the recommendations of the MFI;
- The bank advances funds to the MFI in an uninterrupted manner to facilitate disbursement of loans, all of which is recorded on the bank's balance sheet and in the bank's name; and
- The bank shares in the credit risk with the MFI.

CASHPOR

The CASHPOR group of companies has as its vision to provide financial services to one million poor rural women of eastern Uttar Pradesh and western Bihar in Northern India by 2010. CASHPOR uses a group lending methodology. The groups are then organized into village-based "centers" consisting of at least six groups.

Despite CASHPOR's undercapitalization and its high level of accumulated operating losses, Indian banks have been willing to lend to them. The key factors contributing to their success in accessing bank finance have included, among others:

- CASHPOR included low-cost subordinated debt as quasi-equity in their calculation of capital adequacy, making them appear to have a stronger capital adequacy position;
- CASHPOR had a favorable record of accomplishment in its lending operations in the poorest region of India; and
- CASHPOR was willing to give commercial lenders such as ABN AMRO and SIDBI seats on the Board (ex-officio capacity).

THE PARTNERSHIP

Partnership Foundation

In 2002, ICICI approached CASHPOR to form a partnership that would allow ICICI to expand its client base in

eastern Uttar Pradesh by outsourcing its micro loan credit process to CASHPOR. ICICI and CASHPOR agreed that CASHPOR would act as a service agent on behalf of ICICI.

The first Memorandum of Understanding (MOU) between ICICI and CASHPOR stipulated that:

- CASHPOR would act as a service agent on behalf of ICICI to set up and manage self help groups (SHGs) within the areas of Chandauli District and the bordering parts of surrounding districts in eastern Uttar Pradesh.
- CASHPOR would ensure that members of the SHGs in districts covered under the MOU access finance only from ICICI.
- ICICI would sign off on all loans and advances the funds to the members of SHG based on the recommendation of CASHPOR.
- ICICI would ensure that CASHPOR would always have credit limits sufficient to achieve the projected loans outstanding according to its business plan, as approved by ICICI.
- CASHPOR would collect an up-front fee of 6 percent to cover its costs.
- CASHPOR would assume credit risk or loan losses of up to 12 percent before ICICI would share in the risk.

Partnership Mechanics

Risk Management. ICICI selects partner MFIs, such as CASHPOR, that have substantial outreach and high-quality microfinance portfolios. The appraisal and selection process is essentially based on the quality of the portfolio and of the MFI's accounting and information systems, rather than on the financial strength of the MFI itself.

Methodological Adjustments. ICICI came into the partnership with a proven record of working with SHGs in southern India using its bank-led model. However, ICICI realized that it was important to give a great deal of flexibility to its partners and not standardize its approach with respect to methodology.

Flow of Funds. CASHPOR submits a consolidated requisition of funds to ICICI on an as needed basis. ICICI disburses the amount requisitioned to CASHPOR. CASHPOR, in turn, disburses the loans to the clients via other banks that actually have a presence in the districts where CASHPOR operates.

Documentation. ICICI prepared an MOU and other documentation pertaining to the transaction between ICICI and CASHPOR.

Partnership Outcome

During the first two years of the partnership, CASHPOR and ICICI expanded their microfinance operations into four new districts in eastern Uttar Pradesh and western Bihar. The amount of money onlent under the partnership grew so rapidly that the allocated on-lending funds for the first year of operations were exhausted in less than 10 months. Pursuant to its agreement to provide an uninterrupted flow of funds, ICICI then provided additional open-ended credit facilities.

In addition to the open-ended credit facility for on-lending, ICICI approved a loan to CASHPOR to fund a portion of CASHPOR's operating deficits in districts financed by the partnership.

As of March 31, 2005, the four partnership districts had 23,739 active clients with a total portfolio of Rs. 87.8 million ($2 million). The growth in clients during the past two years represented 52 percent of CASHPOR's total growth in clients and 46 percent of its growth in total portfolio.

MEASURES OF SUCCESS

ICICI came into the partnership with a range of objectives, including the need for additional qualifying assets to meet the priority sector lending quota, the desire to improve its overall image, and the desire to be the market leader in all market segments, including microfinance. ICICI had not developed a business plan nor quantified any measures of success. Regardless, ICICI is very pleased with the performance of the partnership

model in general and the partnership with CASHPOR specifically.

ICICI's microfinance portfolio, US$90 million as of March 2005, is of high quality and is yielding good returns. Through CASHPOR's activities in eastern Uttar Pradesh and western Bihar—regions and districts where ICICI's presence is very limited—ICICI's image has been established, and they are considered one of the market leaders in the sector.

The microfinance portfolio contributes to ICICI's priority sector lending quota, but it represents a small percentage of ICICI's total portfolio and does not come close to meeting the requirement that 40 percent of its net credits be made to the microfinance sector;

CASHPOR came into the partnership with the main objective of securing an uninterrupted flow of funds. CASHPOR recognized that mutual trust would clearly be a condition precedent for this to occur. CASHPOR believes it has been able to develop a business relationship based on trust and ICICI has fully delivered on all of its commitments to the partnership.

In the first year, CASHPOR on-lent its funds more quickly than expected and although this caught ICICI unaware, ICICI quickly approved additional credit in honor of its commitment. ICICI's ongoing commitment in this regard has enabled CASHPOR to effectively manage its cash flow and focus on expanding its outreach as fast as institutionally possible without worry of funding.

ICICI has also proven to be quite flexible and open to ongoing negotiation and resolution of problems—hallmarks of a good partner. For example, with time ICICI began to launch similar partnerships with other comparatively large MFIs that were not only more financially sound than CASHPOR, but also were more aggressive in the negotiation of terms. Despite CASHPOR's comparatively weaker position, given the size of its operations, ICICI extended the more favorable terms that the other partners have demanded to CASHPOR. Moreover, when CASHPOR needed funding to cover its deficits in new districts, ICICI agreed to lend it the funds.

LESSONS LEARNED AND RECOMMENDATIONS

The partnership between ICICI and CASHPOR has been successful in part because the institutions have been able to navigate successfully the common pitfalls for partnerships. Although ICICI developed the concept and launched the model without a business plan, the expectations for the specific partnership between ICICI and CASHPOR were established in CASHPOR's business plan.

Aside from the roles and responsibilities of each partner that were defined in the MOU, the more critical elements to the partnership's success were the:

- Commitment of senior management of both institutions;
- Communication between the two institutions that allowed mutual trust to develop; and
- Flexibility within both institutions that allowed the partnership to adapt to changing circumstances.

Despite its success, the following key issues should be resolved to make the partnership not only more successful for both institutions, but also more replicable in India and on an international level.

Exit Strategy. The current MOU does not specify a specific term of the agreement, but the tenor of the advances does not exceed 24 months. The agreement is renewable, but its "short-term" structure creates some uncertainty on the part of CASHPOR.

The partnership has become increasingly important for CASHPOR's operations, and in a very real sense, they are becoming dependent on ICICI. An ICICI change in management or strategic direction that would cause the bank to retract from the microfinance market could seriously jeopardize CASHPOR's operations as it is highly unlikely that CASHPOR would be able to replace the

ICICI funds with conventional debt quickly. As a result, CASHPOR is actively trying to identify other potential financial partners to reduce this dependence.

Capital Adequacy. The growth of CASHPOR's portfolio is off balance sheet; thus, CASHPOR, in theory, does not have to be overly concerned about its leverage ratio. Regardless, its capital adequacy remains a serious issue. In growing the balance sheet of another institution, CASHPOR generates operating deficits for a period of three to four years, which erodes its capital base. Once CASHPOR breaks even, it still takes an additional two to three years to restore its capital base to its original level. While ICICI receives good returns at the outset, CASHPOR will not begin to earn real returns for approximately six to seven years.

Equitable Alignment of Costs and Benefits. CASHPOR has been willing to accept its weak equity position even though it jeopardizes the financial capacity of its organization not only because it perceived itself to be in a comparatively weaker bargaining position, but also because its paramount concern is to serve one million poor women.

ICICI, on the other hand, has been able to obtain qualifying assets toward meeting its priority sector lending quota that are of high quality and are yielding returns of at least 8.75 percent (less ICICI's operational costs). ICICI also has been able to gain new bank customers who will remain loyal to the bank that first served them, and it has established ICICI's name and image in eastern Uttar Pradesh and western Bihar, regions and districts where ICICI's presence is very limited.

New Product Development. Another challenge for the future of the partnership relates to product development. ICICI is licensed to offer savings account services, but its small branch network does not provide nationwide access to savings for microfinance customers. CASHPOR instituted a "no cash" policy last year that stipulates that credit officers cannot handle cash.

Institutional Capacity Development. Other key challenges faced by the partnership relate more to CASHPOR's operational issues involved in realizing its mission and not to the partnership. Institutional capacity and staff development are always a challenge for a rapidly growing institution.

Regardless of its longevity, the partnership between CAHSPOR and ICICI presents an innovative financing model for others to consider. Not only are the two partners happy with the arrangement, but also the partnership model is now being replicated throughout India with ICICI and other commercial banks. As global microfinance markets deepen and grow more competitive throughout the world, the incentive to form these types of partnerships will undoubtedly increase.