Despite risks, informal sector financing sees growing interest

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This panel discussed the challenges surrounding informal sector financing. It consisted of Vishwavir Ahuja, managing director (MD) and chief executive (CEO) of RBL Bank Ltd; Jaspal Bindra, executive chairman of Centrum Group ; Vasudevan P.N., MD and CEO of Equitas Small Finance Bank Ltd; Rajeev Yadav, MD and CEO of Fincare Small Finance Bank Ltd; R. Baskar Babu, MD and CEO of Suryoday Small Finance Bank Ltd; and Samit Ghosh, founder, CEO and MD of Ujjivan Financial Services Ltd. It was moderated by Tamal Bandyopadhyay of *Mint*. The discussion has been edited for brevity and clarity. Excerpts:

What are the challenges you see in financing the informal sector?

Vasudevan: One way that we define the informal sector is (in terms of people) not really having proper financial documents to show their income levels. When we go for credit assessment, and we are not able to see any documented proof of the income and we have to do lot of surrogate methods to determine the income, from an internal perspective we treat that as an informal sector. And if you look at it from that perspective, (there is) something like about Rs12 trillion as the potential demand for credit from such kind of segments. We have been doing the micro-loan against property, micro-SME (small and medium enterprises) loans for the last about six years and maybe in about 150,000 clients that we have funded so far, what we find is that 95% of such borrowers are first time borrowers from a formal institution, which means that penetration of formal credit is still really, really low. So there is a lot of demand (for) anyone who has the appetite and the organizational capability to manage the risk. But it is not easy. There are a lot of challenges in that, both from a process and from a business credit perspective as well as from regulatory perspective.

From a business perspective, how do you assess the cash flow in absence of a documented income proof? So we actually sit in the shop for two hours each day for three continuous days and then we determine how many people walk in and how much of sales get done, and we extrapolate for a month and once you extrapolate, you arrive at the turnover and the possible sales, then we go around with all the vendors and we have to do a validation with vendors to see whether our assumption tallies with the vendors' and so on. It is a very tedious process. If you can do that well, of course the risk is always there so you got to have a very strong collection mechanism also in place.

Ghosh: I think the biggest challenge is that you need an enabling regulatory environment because we are actually now tackling a sector which has been dependent on informal sources of financing and I think we got to have a process of dialogue with the regulators so that we can modify all the regulations which are there—which are targeted more for commercial banks—to meet the requirements of a small finance bank. It is true not only for the MSMEs (micro, small and medium enterprises) but also for the agriculture sector and the rural sector.

I think there is a process of evolution. If we are put into the straitjacket of regular commercial banks, despite having all the restrictions which we have as a small finance bank of very high capital adequacy of 15% capital adequacy requirement of 75% PSL (priority sector lending), 50% of our loans have to be less than Rs25 lakh, we have a number of restrictions you know, even our branching is highly restricted. Commercial banks have it free, they can open branches virtually wherever they want, whereas we have to get prior approval for opening branches, not only from RBI (the Reserve Bank of India) in some cases also from the state. So it is a very complex kind of an environment that we have been put into and slowly we have to work towards easing those restrictions so that we can be successful. Otherwise we will also end up like the RRBs (regional rural banks), all the previous experiments which have been done to bring about financial inclusion. So that's what I think is the biggest challenge.

So let us hear a banker, Mr Ahuja. By choice you have gone into financing of the informal sector...

Ahuja: There is a huge opportunity for (informal sector) kind of lending and I think the risks that prevailed in the previous regulatory environment when some of these so-called prudential norms were not in place were much higher. In some senses, while I empathize with my friends here, I think it is also a regulatory evolution that is taking place and it is moving in the right direction and in one sense it has protected the system. We have just come out of the phase of demonetization which definitely has impacted this space more but the very fact that everybody is standing tall and actually looking at growth suggests that there is something right about the regulatory framework also.

First, the national payment architecture, the entire framework around Aadhaar and how technology has been used to be able to create a delivery model at the last mile that is now much more efficient, it has brought down the cost of acquisition and also made credit very affordable. Second, India needs credit in this informal sector more than it needs savings account or stuff like that. So we actually drove our business model first around credit, extending credit rather than focusing on some other aspects. Now, we have created a scalable architecture which allows us to now deliver services not just in space of credit but also now going into remittances, insurance services, savings accounts and so on and so forth.

So a non-banker Jaspal, what brings you to this space?

Bindra: There are two critical reasons that we chose to be on this path. One, the size of the opportunity is very, very significant. It is also less crowded on the supply side. The second is that there is now a very determined policy thrust from the government in this direction. And I think that combination is quite compelling because when we analysed that sector, the single largest challenge for us to address was how do the informal players of the economy earn the trust of financial institutions? They have to rely on a credit score. Most of these players do not have a proper credit history to speak of. I think BCs (business correspondents) are doing a good job and I think now technology has started playing its part because the mobile data is creating a financial identity, so it is substituting for credit score and I think there will be further developments and as there are more people that enter this sector, there will be an ecosystem that will help this grow at a geometric rate.

How do you meet external challenges like, say, demonetization or a farm loan waiver?

Yadav: Last year has been tough at least for some of us on two counts. One is the generic impact of demonetization on the overall economy and the borrowers at large and the microfinance sector, and the second point that we are dealing with is the full transformation into a bank. Having said that, fundamentally I think we have come out well out of the transformation, that is not a big challenge any longer and the demonetization impact is a lot more subdued and solved out.

I feel some of us brush off these issues as black swan and move forward with our business as if it never happened but fundamentally the frequency of some of these things is no longer black swan and therefore it is, at least from thinking as an institution and as a bank risk management, I think we have to think a bit differently and say that some of these risks will materialize at some point of time and given the root causes of what triggered some of the issues, they are related to loan waivers, they are related to some degree of political activities and we do ask ourselves this question that with elections in various states coming up, in the central government elections coming up, would some of those issues come up again in some form and if they were to come up, how do you mitigate your risk at the bank level and strengthen the portfolio to diversify across various asset classes, various segments and strengthen the balance sheet. But I guess it is part of business now and we have to continuously sort of have ways of looking at risk management to manage this. We have to learn to either hold greater reserves on our portfolio, keep reserving at a point where in the good times you are able to create a surplus of reserving which we can handle in some of the bad times.

Babu: As far as demonetization or GST (goods and services tax) goes, while one had a clear immediate negative impact, GST on the other hand, to the segment we are addressing, we haven't seen any impact either positive or negative. They will get into the formal sector over a period of time. From the challenges point of view, the entire sector managed it through by just probably leaving six quarters of profit on the table but didn't take a dent on the net worth, didn't default to the banking system, did not cause any systemic risks. I think that is what the sector post-the Andhra crisis is—be far more capitalized. For Samit and Vasu, the challenges are higher and capital adequacy and so on, ours as the smaller ones have the luxury, that on our own, probably we would have had these restrictions because we are far more paranoid than the larger ones would be. There were not black swans but probably brown rhinos, they are always there on the horizon, and each one decides the risk that they want to do it but as an NBFC (non-banking financial company) our relationship with our lenders were purely transactional and lending. What we have as an opportunity as a SME platform is can we convert that into a relationship by banking. So what we need to do is that when you assess the income, create track records. For creating track records, collection mechanism cannot be the same as a regular banks'. Your cheque gets bounced, you will have to take it, you can't make the customer feel delinquent, you will have to take him back on track. The costs involved for that are high but the opportunity space is so large. I think that the challenges are not as large as the opportunities available.

(From left) Rajeev Yadav, MD and CEO of Fincare Small Finance Bank; Vasudevan P.N., MD and CEO of Equitas Small Finance Bank; Vishwavir Ahuja, MD and CEO of RBL Bank; Tamal Bandyopadhyay, consulting editor, Mint; Jaspal Bindra, executive chairman of Centrum Group; Samit Ghosh, founder, CEO and MD of Ujjivan Financial Services; and R. Baskar Babu, MD and CEO of Suryoday Small Finance Bank, at the 11th Mint Annual Banking Conclave in Mumbai.

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