MAKING MARKETS WORK FOR THE POOR: THE SMALL INVESTORS' FUND

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Introduction

Cities are growing at a rapid pace – by 2020 half of India's population will be urban residents – but at the same time, the percentage of the poor within these cities is also increasing. While, on one hand, the city's growth is fuelled by the cheap labour of poor migrants, slum and pavement dwellers, on the other hand, there are no provisions to plan for their housing. However, when the poor build houses in the empty spaces they can find, the city deems these illegal encroachments and demolishes the structures. Thus a constant war of attrition continues - with the city demanding the poor's economic participation but refusing to recognise them as legitimate urban citizens who are included in development plans. The result is the mushrooming of slums. In Mumbai alone, about 60% of the city lives in slums, the majority of these residents having lived in the same slum for decades.

Life in slums is characterised by its complete informality. Since most slums are outside the purview of municipal allocations and management, people depend on informal methods for acquiring land, water, drainage, sanitation, safety and money, and they are extremely vulnerable to exploitation by middlemen, money lenders, corrupt officials, politicians and policemen, all of whom charge high prices for these services. For instance, it is not uncommon for slum dwellers to pay higher rates for electricity and water than most middle class residents in their city. However, the poor are viewed - by the rest of the city - as free riders and encroachers who do not pay taxes and a huge burden on collective resources.

This complete disconnect from the rest of the formal city -- in which urban planners, middle class residents and financial institutions primarily control how the city is run, managed and organised -- produces disturbing social and political exclusions. In Mumbai, while any middle class Indian can arrive and live in the city whenever she or he chooses, among the poor, who is and who isn't a citizen of the city is determined by whether they can prove they have been living in a slum before a certain – politically decided – cut off date. One of the most alarming instances of the city's drive against the poor is the recent and large scale demolitions that were conducted in Mumbai. All those slum dwellers who had come to the city after 1.1.95 – almost a decade ago – were considered illegal and became liable to having their homes demolished. Some 60,000 families were rendered homeless. Another instance of the severe hostility against the poor is a recent Public Interest Litigation that was filed by several middle class citizens in Mumbai. This group argued that since slum dwellers lived on lands illegally, they should be treated as illegal residents and denied the fundamental democratic entitlement of all Indian citizens - the right to vote.

Social and political exclusions also go hand in hand with the inability to practice financial citizenship. Since the urban poor lack land tenure or most formal proofs of residence, their engagement with both the private and nationalised banking sector is limited, and their ability to keep their money safe, invest wisely and upgrade their homes is curtailed. As a result, financial scams and exploitation abound as the poor pay exorbitant rates for interest for loans they take from local moneylenders and are easily duped by opportunistic middle men who promise rich returns.

In light of the social, political and financial isolation of the poor discussed above, few examples (outside the literature on microfinance, which primarily involves the rural poor) exist of successful partnerships between the poor and their organisations, on one hand, and financial institutions. There is a critical need for initiatives that demonstrate the mechanisms to bridge this financial divide, that view the poor as reliable financial citizens with assets to contribute, and that point towards the strategies to tap into all the opportunities of an important untouched (and enormous) market. Moreover, it is important to have some concrete examples that illustrate how this can actually be done.

This case study is particularly significant because it documents an unusual and successful collaboration between the most unlikely of partners - poor slum dwellers, middle class activists and a financial institution. The paper presents the Small Investors' Fund (SIF) – the first ever mutual fund specifically created for the urban poor. Conceived by the Unit Trust of India, an NGO called the Society for the Promotion of Area Resource Centres (SPARC) and a network of slum and pavement dwellers, it was a very successful scheme that ran for five years.

This case study is particularly useful for NGOs interested in exploring similar engagements as well as for financial institutions that are serious about expanding and deepening their customer base. It points towards some of the social, organisational and regulatory issues that prevent the access of the very poor to capital markets and discusses the need to re-examine and redesign regulations empathetically. It recommends two things - first that a similar scheme be set up, and second, that financial institutions invest in creating solutions that set the precedent for large scale participation of the poor in the formal financial sector. This requires a shift in mindset towards recognising the poor as credible financial citizens who form a profitable market that has the means to contribute to as well as benefit from the overall progress of the Indian economy.

Introduction to the actors

The alliance of the Society for the Promotion of Area Resource Centers (SPARC), the National Slum Dwellers Federation(NSDF) and Mahila Milan

The alliance of SPARC, NSDF and Mahila Milan has been working on issues related to urban poverty for the last two decades. SPARC, an NGO, provides administrative and financial support for two people's movements of slum and pavement dwellers – the National Slum Dwellers Federation and Mahila Milan - to mobilise around issues of housing and infrastructure. NDSF organises and links poor communities, builds local leadership, and undertakes affordable housing and infrastructure projects. MM is a network of poor women's collectives that manages savings and credit activities within slums and pavements and supports women assume positions of local leadership. Currently the alliance works in more than 70 cities in India. It also works with similar NGOs and community organisations in 15 Asian and African countries. This network is known as the Slum/ Shack Dwellers International.

UTI

The Unit Trust of India was set up in 1964 as a trust under an Act of Parliament and was the largest mutual fund in the country until 2003, when it was split into two institutions. One of the institutions, UTI Mutual Fund, inherited all the mutual fund schemes of UTI.

<u>Looking for collaborators</u>

In 1986, when SPARC and Mahila Milan began encouraging the poor to save,[1] they realised that most of their members didn't have a safe place to put their money. The very process of opening a bank account was intimidating to illiterate poor women – involving filling in various kinds of forms and maintaining their records. When SPARC approached the Bank of Baroda to open accounts for its members, they found the bank very reluctant because depositing and withdrawing small amounts of money meant very high transaction costs. It took a lot of negotiation on SPARC's part before the bank agreed to open a Mahila Milan account which would be operated on a weekly basis – depositing the collected savings and withdrawing the required amount. Within a few years, opening Mahila Milan accounts has become routine for the federation. And over time, on Mahila Milan's recommendation, Bank of Baroda has opened several thousand accounts for the poor in their individual names.

By the mid 1990s, a considerable amount of community money was sitting in Mahila Milan bank savings accounts earning an interest rate of barely 3% - 4% a year. The alliance began considering how to assist communities of the poor to invest, as was routine for the middle class, in better instruments that were available in the market. At the same time, the alliance wanted to explore a possibility that, although initiated by SPARC and its federated communities, would be easy enough for other NGOs and communities all over the country to also adopt and replicate.

When the Alliance began to talk to various Mutual Funds, many of whom were interested in helping invest this money, they found that these institutions wanted to deal only with SPARC and not the constituency of the urban poor. There were two main reasons for this. First, like the Bank of Baroda staff, they did not want to deal with large numbers of poor

[1] One of the most important community mobilisation tools of the alliance has been daily savings and credit facilities. Here, Mahila Milan groups visit members' homes on a daily basis to collect savings, distribute cheap credit and ensure repayments. Another important activity is to encourage people to immediately begin saving for housing – which is a long drawn-out process that often takes decades. The idea is that once the house becomes a definite possibility, the savings can be used as a down payment for a loan, or as a contribution towards the construction costs.

people frequently depositing and withdrawing small amounts of money. The transaction cost of dealing with so many small investors on an individual basis – especially those who didn't even have a bank account – was just too high. The second reason was that the existing mutual fund schemes at the time did not meet the special needs of the poor for small investments: quick liquidity and low risk. Instead, these investment schemes required high initial investments or locked-in money for certain periods of time or had high reinvestment or carried a moderate amount of risk**.** Unwilling to make any concessions for these potential low-income customers, the mutual funds advised SPARC to invest the money as a lump sum in SPARC's name. Nonetheless, the alliance was clear that it did not want to compromise on its goal to create the conditions where banks would learn to deal with the urban poor, and see them as a valuable customer and market base. As a result, none of these discussions worked out because SPARC wanted each pavement/slum dweller to have an investment in his or her own name.

When SPARC began meeting with UTI in late 1997, it was apparent that the only solution was for UTI to start an entirely new scheme specifically tailored to the needs of slum dwellers. At the same time, the issue of high transaction costs was a very real concern for the bank. A solution needed to be devised which would address this issue as well as fulfil the Securities and Exchange Board of India (SEBI)[2] highly regulated formal requirements.

<u>The Small Investors' Fund</u>

Dr. P.J Nayak, UTI's Executive Trustee at the time, worked with a small team of very committed bankers and asset managers to devise an appropriate strategy that would keep transaction costs to a minimum as well as maximise secure returns. The team knew that if UTI was to maintain thousands of individual accounts and deal with them directly, its Board would simply not approve this scheme because it would be too expensive. The solution the team devised was simple yet clever. A well established practice amongst mutual funds to keep transaction costs low is to use agents who collect investments from individuals and act as intermediaries between individuals and the mutual funds. In fact, mutual funds even incentivised agents by giving them commissions to do this because it reduced their operational costs substantially. The question was - why not make SPARC, an NGO, the agent in this case?

The next point of debate was about whether to create an open ended or a close ended scheme. In the former, the money would be locked in for a fixed amount of time, but it would also receive higher returns. The team decided to create an open ended scheme because it was more important to the very poor to be able to take their money out at any time.

What emerged was the Small Investors' Fund. As outlined in the Offer Document, the objective of this plan was "for people – especially those with small investible surpluses – looking for building up capital without taking much risks of investment. Accordingly the plan aims at generating maximum returns as is possible through investments in a debt

[2] SEBI is the regulator for capital markets, including the mutual funds.

portfolio with high degree of safety."[3] Therefore, the mutual fund would invest only in very reliable AAA securities.

This document also stated that the "scheme is meant for poorer sections of the society – normally bypassed by most financial intermediaries – who are looking for building up capital out of small savings."[4] As a result, the initial investment was kept low at Rs. 1000 and above and the additional investments were as low as Rs. 500 and above. Units were Rs. 10 each. Even those who did not have bank accounts could participate and have the investments in their name, as long as SPARC was a 2nd and joint holder. For those who did have a bank account, redemptions were made directly in their names and in their account. Moreover, although people could withdraw their money at any point, because the scheme aimed at building up capital, it did would not distribute any dividends, but reinvest profits back into the corpus.

In order to deal with the problem of large transaction costs, SPARC was given the status of an agent and a resolution was passed that members purchasing the UTI units would deposit their investment – either in cash or from their individual accounts -- into a Bank of Baroda Account in the name of SPARC, from where a cheque would be issued to UTI, along with a document outlining the details of each individual member's account.

In this manner, the scheme fulfilled all the needs of the poor for minimum risk, maximum returns and a high level of flexibility, and also allowed those people who did not have bank accounts to participate in their own right.

It is to the great credit of both Dr. Nayak and the UTI team that they created such a fund because, in terms of UTI's portfolio, the SIF was small change for the institution. One branch at Ghatkopar was put in charge of all the required administration and documentation before sending the money to the UTI central office to manage the fund.

The scheme was introduced and inaugurated in April 1998 and the initial offer was open for 45 days. At that time, 315 poor families who had organised themselves into 15 housing societies joined and invested Rs.14.21 lakhs. By the time it had closed, these numbers had grown to 1420 people from 57 different societies with investments at Rs. 60.8 lakhs.

Growth of the fund

Compared to a savings account, where an investment would have grown at barely 3% - 4% a year, the SIF had an annualised compounded interest rate of 11.65% a year. For most of the poor who participated, this was the first time that they were connected to the formal financial world which saw them as important customers. It was a matter of great pride first, that they had UTI accounts, and second, that they had made such sound investments.

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[3] UTI Small Investors' Fund Offer Document April 1998. pg.1
[4] UTI Small Investors' Fund Offer Document April 1998. pg. 2

When the fund was started, both UTI and SPARC had envisioned that after a first couple of years of SIF where systems would be built up and refined, this scheme would be extended to other NGOs and community groups across the country. Unfortunately, this did not happen.

SPARC had promised that they would be able to channel about 1.5 crores within a few years into the SIF. Since the administrative costs of running the scheme were paid for by the returns the scheme generated, it was important that the principal kept growing so that these operation costs did not eat into the returns. Unfortunately, SPARC was unable to move beyond Rs. 60 lakhs. There were two reasons for this. One, that many of the communities who had formed housing societies and had invested their money in SIF used to live along the railways tracks. In 2000, several thousand of their homes were suddenly demolished and they were forced to live in the open for several months. Moreover, when these slum dwellers did manage to move into safe accommodation, their new homes were at a distance from their previous shacks, and many of their expenses, such as travel and schooling, went up. Thus, although most of the families did not necessarily withdraw their money, they were unable to keep up their regular investments. Also, the federation was so involved in resettling families affected by the Mumbai Urban Transport Project families – who numbered a little over 60,000 people – that they were unable to focus on mobilising other poor communities to invest. Another reason why some people began to withdraw their money was because of the US 64[5] scandal. But these redemptions were kept to the minimum, as the federation and SPARC spent much effort explaining that US 64 had little to do with SIF.

It is to UTI's credit that they were concerned that the scheme was not growing as expected and that the operational costs were becoming too high. In 2001, UTI representatives met with SPARC and the federation coordinator to encourage investments. Although the federation did increase its mobilisation efforts and started to increase its contributions by Rs. 2-3 lakhs a month, this amount was below the 8-10 lakhs a month that was required.

But the final blow to the scheme came when, in February 2003, the Securities and Exchange Board of India (SEBI) changed its rules, forcing mutual funds to re-examine their portfolios and close those schemes which were not its most profitable. Moreover, SEBI disallowed third party intermediaries from holding investments. What this meant, in terms of SIF, was that SPARC could no longer be a joint account holder for those slum and pavement dwelling families who did not have bank accounts. This affected a fifth of all the SIF members.

In August 2003, UTI issued a newspaper notice listing all the schemes that they were closing. The SIF was one of them. Although at the time of closing, the SIF unit which

[5] The UTI's flag-shop scheme was US64, a scheme that millions of middle class investors put their lives' savings into. Unfortunately, when this scheme's value started to weaken, it was coupled by a lack of transparency about this fund, and when it eventually crashed, millions lost their money.

had cost Rs. 10 when the scheme was launched had grown to an impressive Net Asset Value (NAV) of Rs.17.44[6], in the end, it was just too small to maintain.

Lessons

The SIF had been a very special fund, conceived in a unique manner, and for a most unusual clientele – people living in slums and on pavements. A great deal of effort was spent on designing the scheme in a way that took into account the specific need for flexibility that the poor have, and which is usually the very reason that formal financial institutions do not consider them a profitable investment. At the same time, it met the stringent policy regulations that all mutual funds must follow. And this collaboration produced an innovative product which was challenging and exciting for everyone, and which eventually turned out to be one of the most successful mutual funds run by UTI, in terms of rate of return. For the slum dwellers that took part, the SIF was a terrific investment because it protected their assets and grew them in a previously unprecedented manner.

Several lessons emerge from this experience.

First, that there is a way of getting around the problem of transaction costs, as demonstrated by this case study, by giving NGOs the status of agents. This mechanism can be used both by banks as well as mutual funds.

Second, since SEBI requires that all investors have a bank account, it is important for banks to reach out to NGOs to act as intermediaries so that they can help the poor open bank accounts. The bureaucratic requirements of both banks and mutual funds are complicated and intimidating – filling in boxes and forms, being regular in instalments, producing various forms of identification. This documentary emphasis, which works for formal customers, works against informal customers living in slums and pavements. It is essential to have an intermediary that is able to walk a poor illiterate woman from a slum through this process so that she can build her capital and asset base while working towards housing and other priorities. In fact, there are regulations that allow for such interventions. RBI regulations state that "No bank shall pay brokerage in any form to any person except commission to pay an agent employed to collect door to door deposits under a special scheme."

Third, and what this case study makes apparent, is that the poor do have the means to contribute towards the overall progress of the country and are an important market in themselves, which can and should be tapped. What is significant about this particular intervention – no matter how small it is or whether it was ultimately successful – is that it points towards concrete solutions for how such enormously different worlds can be bridged, and what institutional and financial arrangements and mechanisms – at all three

[6] This Net Asset Value indicates the value of each individual unit. For a person who has bought the unit at Rs. 10 - when it was initially offered - this NAV means that each unit now costs Rs. 17.44. As mentioned before, this works out to an annualized compounded rate of 11.65% a year, compared to bank interest on savings at 4% a year.

levels, UTI, SPARC and the slum dwellers themselves – need to be in place to ensure the smooth functioning of the scheme.

Fourth, it is clear that SIF-type schemes need to achieve a significant amount of scale to be self-sustaining. As mentioned before, there are millions of urban slum dwellers whose financial resources, while individually not very significant, can collectively add up to an impressive figure. The SIF's risk, return and liquidity features also incorporated the institutional arrangements that allow for large numbers of the urban poor to take part in the market. However, in order to avoid the problems of growth that the SIF faced, it is important to actively pursue more low-income customers. One way is by including more NGOs who will provide information to and increase access to community groups. The onus of bringing in more small investors must be shared by the mutual fund as well as the organisations involved.

Finally, it is important to create a committed group of people – within the financial institution as well as within the NGOs – who will not only help in the creation of such schemes but also in the sustaining of them.

Conclusion

The paper recommends that it is very important to have another SIF-type scheme, based on the lessons that emerge from the previous experience, and which create the opportunities for even the poorest citizens to participate in and benefit from India's markets. It also recommends that financial institutions invest in approaching established and reputable NGOs to act as intermediaries.

Such initiatives are representative of the true spirit of democratic participation because they pave the way for the inclusion and access of the urban poor to the financial market – an institution from which they have been traditionally excluded. The creation of such a scheme acknowledges not only that the poor could also be beneficiaries from a healthy and growing economy, but that they are an important market in themselves, with resources to contribute to the general development of the economy – both privileges typically limited to the middle classes.

In conclusion, the authors believe this case study points towards win-win partnerships that can be developed and that are beneficial to everyone concerned – financial institutions, the poor, and the overall economy.