

MICROFINANCE IN INDIA: A DETAILED STUDY

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1. Introduction

Microfinance is defined as any activity that includes the provision of financial services such as credit, savings, and insurance to low income individuals which fall just above the nationally defined poverty line, and poor individuals which fall below that poverty line, with the goal of creating social value. The creation of social value includes poverty alleviation and the broader impact of improving livelihood opportunities through the provision of capital for micro enterprise, and insurance and savings for risk mitigation and consumption smoothing. A large variety of actors provide microfinance in India, using a range of microfinance delivery methods. Since the founding of the Grameen Bank in Bangladesh, various actors have endeavored to provide access to financial services to the poor in creative ways. Governments have piloted national programs, NGOs have undertaken the activity of raising donor funds for on-lending, and some banks have partnered with public organizations or made small inroads themselves in providing such services. This has resulted in a rather broad definition of microfinance as any activity that targets poor and low-income

individuals for the provision of financial services. The range of activities undertaken in microfinance include group lending, individual lending, the provision of savings and insurance, capacity building, and agricultural business development services. Whatever the form of activity however, the overarching goal that unifies all actors in the provision of microfinance is the creation of social value.

2. Activities in Microfinance

Micro credit: It is a small amount of money loaned to a client by a bank or other institution. Micro credit can be offered, often without collateral, to an individual or through group lending.

Micro savings: These are deposit services that allow one to save small amounts of money for future use. Often without minimum balance requirements, these savings accounts allow households to save in order to meet unexpected expenses and plan for future expenses.

Micro insurance: It is a system by which people, businesses and other organizations make a payment to share risk. Access to insurance enables entrepreneurs to concentrate more on developing their businesses while mitigating other risks affecting property, health or the ability to work.

Remittances: These are transfer of funds from people in one place to people in another, usually across borders to family and

Friends. Compared with other sources of capital that can fluctuate depending on the political or economic climate, remittances are a relatively steady source of funds.

3. Legal Regulations

Banks in India are regulated and supervised by the Reserve Bank of India (RBI) under the RBI Act of 1934, Banking Regulation Act, Regional Rural Banks Act, and the Cooperative Societies Acts of the respective state governments for cooperative banks.

NBFCs are registered under the Companies Act, 1956 and are governed under the RBI Act. There is no specific law catering to NGOs although they can be registered under the Societies Registration Act, 1860, the Indian Trust Act, 1882, or the relevant state acts. There has been a strong reliance on self-regulation for NGO MFIs and as this applies to NGO MFIs mobilizing deposits from clients who also borrow. This tendency is a concern due to enforcement problems that tend to arise with self-regulatory organizations. In January 2000, the RBI essentially created a new legal form for providing microfinance services for NBFCs registered under the Companies Act so that they are not subject to any capital or liquidity requirements if they do not go into the deposit taking business. Absence of liquidity requirements is concern to the safety of the sector.

4. Microfinance in India

At present lending to the economically active poor both rural and urban is pegged at around Rs 7000 crores in the Indian banks' credit outstanding. As against this, according to even the most conservative estimates, the total demand for credit requirements for this part of Indian society is somewhere around Rs 2,00,000 crores.

Deprived of the basic banking facilities, the rural and semi urban Indian masses are still relying on informal financing intermediaries like money lenders, family members, friends etc.

4.1 Distribution of Indebted Rural Households: Agency wise

Credit Agency	Percentage of Rural Households
Government	6.1
Cooperative Societies	21.6
Commercial banks and RRBs	33.7
Insurance	0.3
Provident Fund	0.7
Other Institutional Sources	1.6
All Institutional Agencies	64.0
Landlord	4.0
Agricultural Moneylenders	7.0
Professional Moneylenders	10.5
Relatives and Friends	5.5
Others	9.0
All Non Institutional Agencies	36.0
All Agencies	100.0

Source: Debt and Investment Survey, GoI 1992

Seeing the figures from the above table, it is evident that the share of institutional credit is much more now.

The above survey result shows that till 1991, institutional credit accounted for around two-thirds of the credit requirement of rural households. This shows a comparatively better penetration of the banking and financial institutions in rural India.

Percentage distribution of debt among indebted Rural Labor Households by source of debt

Sr. No.	Source of debt	Households		
		With cultivated land	Without cultivated land	All
1	Government	4.99	5.76	5.37
2	Co-operative Societies	16.78	9.46	13.09
3	Banks	19.91	14.55	17.19
4	Employers	5.35	8.33	6.86
5	Money lenders	28.12	35.23	31.70
6	Shop-keepers	6.76	7.47	7.13
7	Relatives/Friends	14.58	15.68	15.14
8	Other Sources	3.51	3.52	3.52
	Total	100.00	100.00	100.00

Source: Rural labor enquiry report on indebtedness among rural labor households (55th Round of N.S.S.) 1999-2000

The table above reveals that most of the rural labour households prefer to raise loan from the non-institutional sources. About 64% of the total debt requirement of these households was met by the non-institutional sources during 1999-2000. Money lenders alone provided debt (Rs.1918) to the tune of 32% of the total debt of these households as against 28% during 1993-94. Relatives and friends and shopkeepers have been two other sources which together accounted for about 22% of the total debt at all-India level.

The institutional sources could meet only 36% of the total credit requirement of the rural labour households during 1999-2000 with only one percent increase over the previous survey in 1993-94. Among the institutional sources of debt, the banks continued to be the single largest source of debt meeting about 17 percent of the total debt requirement of these households. In comparison to the previous enquiry, the dependence on co-operative societies has increased considerably in 1999-2000. During 1999-2000 as much as 13% of the debt was raised from this source as against 8% in 1993-94. However, in the case of the banks and the government agencies it decreased marginally from 18.88% and 8.27% to 17.19% and 5.37% respectively during 1999-2000 survey.

4.2 Relative share of Borrowing of Cultivator Households (in per cent)

Sources of Credit	1951	1961	1971	1981	1991	2002*
Non Institutional	92.7	81.3	68.3	36.8	30.6	38.9
<i>Of which:</i>						

Moneylenders	69.7	49.2	36.1	16.1	17.5	26.8
Institutional	7.3	18.7	31.7	63.2	66.3	61.1
<i>Of which:</i>						
Cooperative Societies,etc	3.3	2.6	22.0	29.8	30.0	30.2
Commercial banks	0.9	0.6	2.4	28.8	35.2	26.3
Unspecified	-	-	-	-	3.1	-
Total	100.0	100.0	100.0	100.0	100.0	100.0

* All India Debt and Investment Survey, NSSO, 59th round, 2003

Source: All India Debt and Investment Surveys

Table shows the increasing influence of moneylenders in the last decade. The share of moneylenders in the total non institutional credit was declining till 1981, started picking up from the 1990s and reached 27 per cent in 2001.

At the same time the share of commercial banks in institutional credit has come down by almost the same percentage points during this period. Though, the share of cooperative societies is increasing continuously, the growth has flattened during the last three decades.

4.3 Distribution based on Asset size of Rural Households (in per cent)

Household Assets (Rs '000)	Institutional Agency	Non-Institutional Agency	All
Less than 5	42	58	100

5-10	47	53	100
10-20	44	56	100
20-30	68	32	100
30-50	55	45	100
50-70	53	47	100
70-100	61	39	100
100-150	61	39	100
150-250	68	32	100
250 and above	81	19	100
All classes	66	34	100

Source: Debt and Investment Survey, GoI, 1992

The households with a lower asset size were unable to find financing options from formal credit disbursement sources. This was due to the requirement of physical collateral by banking and financial institutions for disbursing credit. For households with less than Rs 20,000 worth of physical assets, the most convenient source of credit was non institutional agencies like landlords, moneylenders, relatives, friends, etc.

Looking at the findings of the study commissioned by Asia technical Department of the World Bank (1995), the purpose or the reason behind taking credit by the rural poor was consumption credit, savings, production credit and insurance.

Consumption credit constituted two-thirds of the credit usage within which almost three-fourths of the demand was for short periods to meeting emergent needs such as illness and household expenses during the lean season. Almost entire demand for the consumption credit was met by informal sources at high to exploitive interest rates that varied from 30 to 90 per cent per annum.

Almost 75 per cent of the production credit (which accounted for about one-third of the total credit availed of by the rural masses) was met by the formal sector, mainly banks and cooperatives.

5. Microfinance Social Aspects

Micro financing institutions significantly contributed to gender equality and women's empowerment as well as pro poor development and civil society strengthening. Contribution to women's ability to earn an income led to their economic empowerment, increased well being of women and their families and wider social and political empowerment.

Microfinance programs targeting women became a major plank of poverty alleviation and gender strategies in the 1990s. Increasing evidence of the centrality of gender equality to poverty reduction and women's higher credit repayment rates led to a general consensus on the desirability of targeting women.

6. Micro Finance Models

6.1 Micro Finance Institutions (MFIs):

MFIs are an extremely heterogeneous group comprising NBFCs, societies, trusts and cooperatives. They are provided financial support from external donors and apex institutions including the Rashtriya Mahila Kosh (RMK), SIDBI Foundation for micro-credit and NABARD and employ a variety of ways for credit delivery.

Since 2000, commercial banks including Regional Rural Banks have been providing funds to MFIs for on lending to poor clients. Though initially, only a handful of NGOs were "into" financial intermediation using a variety of delivery methods, their numbers have increased considerably today. While there is no published data on private MFIs operating in the country, the number of MFIs is estimated to be around 800.

Legal Forms of MFIs in India

Types of MFIs	Estimated Number*	Legal Acts under which Registered
1. Not for Profit MFIs	400 to 500	Societies Registration Act, 1860 or similar
a.) NGO - MFIs		Provincial Acts
		Indian Trust Act, 1882
b.) Non-profit Companies	10	Section 25 of the Companies Act, 1956
2. Mutual Benefit MFIs	200 to 250	Mutually Aided
a.) Mutually Aided Cooperative Societies (MACS) and similarly set up institutions		Cooperative Societies Act enacted by State Government
3. For Profit MFIs	6	Indian Companies Act, 1956
a.) Non-Banking		Reserve Bank

Financial	of India Act,
Companies	1934
(NBFCs)	
Total	700 - 800

Source: NABARD website

6.2 Bank Partnership Model

This model is an innovative way of financing MFIs. The bank is the lender and the MFI acts as an agent for handling items of work relating to credit monitoring, supervision and recovery. In other words, the MFI acts as an agent and takes care of all relationships with the client, from first contact to final repayment. The model has the potential to significantly increase the amount of funding that MFIs can leverage on a relatively small equity base.

A sub - variation of this model is where the MFI, as an NBFC, holds the individual loans on its books for a while before securitizing them and selling them to the bank. Such refinancing through securitization enables the MFI enlarged funding access. If the MFI fulfils the “true sale” criteria, the exposure of the bank is treated as being to the individual borrower and the prudential exposure norms do not then inhibit such funding of MFIs by commercial banks through the securitization structure.

6.3 Banking Correspondents

The proposal of “banking correspondents” could take this model a step further extending it to savings. It would allow MFIs to collect savings deposits from the poor on behalf of the bank. It would use the ability of the MFI to get close to poor clients while relying on the financial strength of the bank to safeguard the deposits. This regulation evolved at a time when there were genuine fears that fly-by-night agents purporting to act on behalf of banks in which the people have confidence could

mobilize savings of gullible public and then vanish with them. It remains to be seen whether the mechanics of such relationships can be worked out in a way that minimizes the risk of misuse.

6.4 Service Company Model

Under this model, the bank forms its own MFI, perhaps as an NBFC, and then works hand in hand with that MFI to extend loans and other services. On paper, the model is similar to the partnership model: the MFI originates the loans and the bank books them. But in fact, this model has two very different and interesting operational features:

(a) The MFI uses the branch network of the bank as its outlets to reach clients. This allows the client to be reached at lower cost than in the case of a stand-alone MFI. In case of banks which have large branch networks, it also allows rapid scale up. In the partnership model, MFIs may contract with many banks in an arms length relationship. In the service company model, the MFI works specifically for the bank and develops an intensive operational cooperation between them to their mutual advantage.

(b) The Partnership model uses both the financial *and infrastructure* strength of the bank to create lower cost and faster growth. The Service Company Model has the potential to take the burden of overseeing microfinance operations off the management of the bank and put it in the hands of MFI managers who are focused on microfinance to introduce additional products, such as individual loans for SHG graduates, remittances and so on without disrupting bank operations and provide a more advantageous cost structure for microfinance.

7. The BANDHAN MODEL

Bandhan is working towards the twin objective of poverty alleviation and women empowerment. It started as a Capacity Building Institution (CBI) in November 2000

under the leadership of Mr. Chandra Shekhar Ghosh. During such time, it was giving capacity building support to local microfinance institutions working in West Bengal.

Bandhan opened its first microfinance branch at Bagnan in Howrah district of West Bengal in July 2002. Bandhan started with 2 branches in the year 2002-03 only in the state of West Bengal and today it has grown as strong as 412 branches across 6 states of the country! The organization had recorded a growth rate of 500% in the year 2003-04 and 611% in the year 2004-05. Till date, it has disbursed a total of Rs. 587 crores among almost 7 lakh poor women. Loan outstanding stands at Rs. 221 crores. The repayment rate is recorded at 99.99%. Bandhan has staff strength of more than 2130 employees.

As on July 2008

No. of states	: 8
No. of branches	: 528
No. of members	: 1,182,741
No. of staff	: 3,191
Cumulative loan disbursed	: Rs.1,249 crores
Loan outstanding	: Rs. 417 crores

Operational Methodology

Bandhan follows a group formation, individual lending approach. A group of 10-25 members are formed. The clients have to attend the group meetings for 2 successive weeks. 2 weeks hence, they are entitled to receive loans. The loans are disbursed

individually and directly to the members.

Economic and Social Background of Clients

- Landless and asset less women
- Family of 5 members with monthly income less than Rs. 2,500 in rural and Rs. 3,500 in urban
- Those who do not own more than 50 decimal (1/2acre) of land or capital of its equivalent value

Loan Size

The first loan is between Rs. 1,000 – Rs. 7,000 for the rural areas and between Rs. 1,000 – Rs. 10,000 for the urban areas. After the repayment, they are entitled to receive a subsequent loan which is Rs 1,000 - 5,000 more than the previous loan.

Service Charge

Bandhan charges a service charge of 12.50% flat on loan amount. Bandhan initially charged 17.50%. However from 1st July 2005, it has slashed down its lending rate to 15.00%. Then it was further reduced to 12.50% in May 2006. The reason is obvious. As overall productivity increased, operational costs decreased. Bandhan, being a non profit organization wanted the benefit of low costs to ultimately trickle down to the poor.

Monitoring System

The various features of the monitoring system are:

- A 3 tier monitoring system – Region, Division and Head Office
- Easy reporting system with a prescribed checklist format
- Accountability at all levels post monitoring phase
- Cross- checking at all the levels
- The management team of Bandhan spends 90.00% of time at the field

Liability structure for Loans

When a member wants to join Bandhan, she at first has to get inducted into a group. After she gets inducted into the group, the entire group proposes her name for a loan in the Resolution Book. Two members of the group along with the member's husband have to sign as guarantors in her loan application form. If she fails to pay her weekly installment, the group inserts peer pressure on her. The sole purpose of the above structure is simply to create peer pressure.

8. Grameen Bank Model

The Grameen Model which was pioneered by Prof Muhammed Yunus of Grameen Bank is perhaps the most well known, admired and practised model in the world. The model involves the following elements.

! Homogeneous affinity group of five

! Eight groups form a Centre

! Centre meets every week

! Regular savings by all members

! Loan proposals approved at Centre meeting

! Loan disbursed directly to individuals

! All loans repaid in 50 installments

The Grameen model follows a fairly regimented routine. It is very cost intensive as it involves building capacity of the groups and the customers passing a test before the lending could start. The group members tend to be selected or at least strongly vetted by the bank. One of the reasons for the high cost is that staff members can conduct only two meetings a day and thus are occupied for only a few hours, usually early morning or late in the evening. They were used additionally for accounting work, but that can now be done more cost effectively using computers. The model is also rather meeting intensive which is fine as long as the members have no alternative use for their time but can be a problem as members go up the income ladder.

The greatness of the Grameen model is in the simplicity of design of products and delivery. The process of delivery is scalable and the model could be replicated widely. The focus on the poorest, which is a value attribute of Grameen, has also made the model a favourite among the donor community.

However, the Grameen model works only under certain assumptions. As all the loans are only for enterprise promotion, it assumes that all the poor want to be self-employed. The repayment of loans starts the week after the loan is disbursed – the inherent assumption being that the borrowers can service their loan from the ex-ante income.

9. Success Factors of Micro-Finance in India

Over the last ten years, successful experiences in providing finance to small entrepreneur and producers demonstrate that poor people, when given access to responsive and timely financial services at market rates, repay their loans and use the proceeds to increase their income and assets. This is not surprising since the only

realistic alternative for them is to borrow from informal market at an interest much higher than market rates. Community banks, NGOs and grass root savings and credit groups around the world have shown that these microenterprise loans can be profitable for borrowers and for the lenders, making microfinance one of the most effective poverty reducing strategies.

A. For NGOs

1. The field of development itself expands and shifts emphasis with the pull of ideas, and NGOs perhaps more readily adopt new ideas, especially if the resources required are small, entry and exit are easy, tasks are (perceived to be) simple and people's acceptance is high – all characteristics (real or presumed) of microfinance.
2. Canvassing by various actors, including the National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Friends of Women's World Banking (FWWB), Rashtriya Mahila Kosh (RMK), Council for Advancement of People's Action and Rural Technologies (CAPART), Rashtriya Gramin Vikas Nidhi (RGVN), various donor funded programmes especially by the International Fund for Agricultural Development (IFAD), United Nations Development Programme (UNDP), World Bank and Department for International Development, UK (DFID)], and lately commercial banks, has greatly added to the idea pull. Induced by the worldwide focus on microfinance, donor NGOs too have been funding microfinance projects. One might call it the supply push.
3. All kinds of things from khadi spinning to Nadep compost to balwadis do not produce such concrete results and sustained interest among beneficiaries as

microfinance. Most NGO-led microfinance is with poor women, for whom access to small loans to meet dire emergencies is a valued outcome. Thus, quick and high ‘customer satisfaction’ is the USP that has attracted NGOs to this trade.

4. The idea appears simple to implement. The most common route followed by NGOs is promotion of SHGs. It is implicitly assumed that no ‘technical skill’ is involved. Besides, external resources are not needed as SHGs begin with their own savings. Those NGOs that have access to revolving funds from donors do not have to worry about financial performance any way. The chickens will eventually come home to roost but in the first flush, it seems all so easy.
5. For many NGOs the idea of ‘organising’ – forming a samuha – has inherent appeal. Groups connote empowerment and organising women is a double bonus.
6. Finally, to many NGOs, microfinance is a way to financial sustainability. Especially for the medium-to-large NGOs that are able to access bulk funds for on-lending, for example from SIDBI, the interest rate spread could be an attractive source of revenue than an uncertain, highly competitive and increasingly difficult-to-raise donor funding.

B. For Financial Institutions and banks

Microfinance has been attractive to the lending agencies because of demonstrated sustainability and of low costs of operation. Institutions like SIDBI and NABARD are hard nosed bankers and would not work with the idea if they did not see a long term engagement – which only comes out of sustainability (that is economic attractiveness).

On the supply side, it is also true that it has all the trappings of a business enterprise, its output is tangible and it is easily understood by the mainstream. This also seems to sound nice to the government, which in the post liberalisation era is trying to explain the logic of every rupee spent. That is the reason why microfinance has attracted mainstream institutions like no other developmental project.

Perhaps the most important factor that got banks involved is what one might call the policy push.

Given that most of our banks are in the public sector, public policy does have some influence on what they will or will not do. In this case, policy was followed by diligent, if meandering, promotional work by NABARD. The policy change about a decade ago by RBI to allow banks to lend to SHGs was initially followed by a seven-page memo by NABARD to all bank chairmen, and later by sensitisation and training programmes for bank staff across the country. Several hundred such programmes were conducted by NGOs alone, each involving 15 to 20 bank staff, all paid for by NABARD. The policy push was sweetened by the NABARD refinance scheme that offers much more favourable terms (100% refinance, wider spread) than for other rural lending by banks. NABARD also did some system setting work and banks lately have been given targets. The canvassing, training, refinance and close follow up by NABARD has resulted in widespread bank involvement.

Moreover, for banks the operating cost of microfinance is perhaps much less than for pure MFIs. The banks already have a vast network of branches. To the extent that an

NGO has already promoted SHGs and the SHG portfolio is performing better than the rest of the rural (if not the entire) portfolio, microfinance via SHGs in the worst case would represent marginal addition to cost and would often reduce marginal cost through better capacity utilisation. In the process the bank also earns brownie points with policy makers and meets its priority sector targets.

It does not take much analysis to figure out that the market for financial services for the 50-60 million poor households of India, coupled with about the same number who are technically above the poverty line but are severely under-served by the financial sector, is a very large one. Moreover, as in any emerging market, though the perceived risks are higher, the spreads are much greater. The traditional commercial markets of corporates, business, trade, and now even housing and consumer finance are being sought by all the banks, leading to price competition and wafer thin spreads.

Further, bank-groups are motivated by a number of cross-selling opportunities in the market, for deposits, insurance, remittances and eventually mutual funds. Since the larger banks are offering all these services now through their group companies, it becomes imperative for them to expand their distribution channels as far and deep as possible, in the hope of capturing the entire financial services business of a household.

Finally, both agri-input and processing companies such as EID Parry, fast-moving consumer goods (FMCG) companies such as Hindustan Levers, and consumer durable companies such as Philips have realised the potential of this big market and are actively using SHGs as entry points. Some amount of free-riding is taking place here by companies, for they are using channels which were built at a significant cost to NGOs, funding agencies and/or the government.

On the whole, the economic attractiveness of microfinance as a business is getting established and this is a sure step towards mainstreaming. We know that

mainstreaming is a mixed blessing, and one tends to exchange scale at the cost of objectives. So it needs to be watched carefully.

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