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The landscape of Indian Micro-Finance

*Dr. Vinita Kalra

Introduction

Over the past 20 years, the Indian financial system has made significant progress in terms ofresource mobilization, geographical and functional reach and financial viability. Table **1 given below** provides a summary presentation of the financial system in India (with particular reference to microfinance).

At end-March 2012, the banking sector was comprised of 86 scheduled commercial banks with a consolidated asset base of Rs73 lakh crore (US$1.43 trillion). In addition, there were 82 RegionalRural Banks (RRBs) consolidated from the 196 that originally existed before the amalgamationprocess started in 2006. In 1996, the RBI mandated the establishment of Local Area Banks –essentially RRBs under private ownership – but only six were ever licensed and just four arefunctioning today. In addition, there were 12,375 Non-Bank Finance Companies in India in May2012, out of which just 271 were permitted to accept/hold public deposits.

There is also a network of cooperative banks, with 31 state cooperative banks (SCBs) and 371 districtcentral cooperative banks (DCCBs). The main aim of the rural cooperative banks is to provide cropand other working capital loans, primarily for short term purposes to farmers and rural artisans. Thecooperative banks do this either directly or by financing those of the 93,400 primary agriculturalcooperatives functioning in their operational areas. In urban areas, the financial services of thebanks and NBFCs are supplemented by the operations of over 1,645 urban cooperative banks (M-CRIL, 2012).

Table 1: The Indian financial system

Type of financial institution	Institutional ownership	Regulated by	Number of institutions
Commercial Bank	Government Private – Indian Foreign	RBI	26 20 40
Regional Rural Bank (RRB) Local Area Bank	Government Private – Indian	RBI/NABARD RBI	82 4
State Cooperative Bank District Cooperative Bank Primary Agricultural Cooperative Societies	DCCBs/State government PACS/individuals Individuals	State government/ NABARD State government	31 371 ~93,400
Non-Bank Finance Company (NBFC)	Private – Indian, some partly or wholly foreign	RBI	12,375
Business correspondents of banks	Mainly private individuals or business establishments	RBI via the banks	95,767
Microfinance institutions as...			Estimated numbers
NBFCs Section 25 companies Cooperatives, MACS and others Societies/trusts	- as above - Private – Indian Individuals No ownership structure	RBI State government Central/state government	~50 5 100 500
Self help groups	Unregistered – member equity	Self, some supported /guided by NGOs	with outstanding bank loans – 4.35 million with bank savings accounts – 7.96 million

In recent years, the Reserve Bank of India has attempted to promote financial inclusion byintroducing the device of business correspondents, individuals or business outlets in diverselocations, providing basic banking services to small account holders. By end-March 2012, the numberof business correspondents in India grew to nearly 96,000. These were in addition to the 83,000branches of scheduled commercial banks and over 14,000 branches of RRBs as well as 93,000 ruralPACs and around 2,000 branches of UCBs.

* Associate Professor, Rajarshi School of Management & Technology

With 747 deposit accounts with commercial banks per 1,000 population and another 69 withcooperatives in India, amounting to little more than 1.5 accounts per adult (a large proportion inmultiple holdings), India is well behind the 3.2 accounts per adult average of the developed world. Itis not surprising, therefore, that over the past few years the Indian microfinance industry, both thebank-financed self help group programme and the microfinance sector served by NBFCs and NGOMFIs engaged in providing micro-credit services, grew very substantially with a peak of some 75million credit accounts by March 2011. As a result, India was said, by 2010, to be the world's largestmicrofinance market having surpassed Bangladesh's total of around 30 million accounts around2006.(M-Cril, 2012)

Microfinance has emerged as an important sector in many countries for providing financial services such as savings, credit and insurance to the poor. Governments, central banks, donors, practitioners and other development agencies promoting microfinance are increasingly involved in developing suitable policy initiatives for meeting local needs

Microfinance has evolved as an economic development approach intended to benefit low-income women and men. The term refers to the provision of financial services to low-income clients, including the self-employed. Financial services generally include savings and credit; however, some microfinance oranisations also provide insurance and payment services. In addition to financial intermediation, many MFIs provide social intermediation services such as group formation, development of self confidence , and training in financial literacy and management capabilities among members of a group. Thus the definition of microfinance often includes both financial intermediation and social intermediation. Microfinance is not simply banking, it is a development tool (Ledgerwood, 2008).

Its popularity reached a peak in 2005 when the UN created the*„'International Year of Microcredit"*, and one year later, father of the *'banking for the poor'*,Bangladeshi Muhammad Yunus, was awarded the Nobel Peace Prize.

Microfinance Defined

One of the first few definitions of microfinance in India is the "provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and urban areas for enabling them to raise their income levels and improve living standards". This definition was proposed by the Task Force on Supportive Policy and Regulatory Framework for Micro- Finance set up by the National Bank for Agriculture and Rural Development (NABARD) in 1999.

According to RBI�'s Priority sector finance Guidelines, available at the RBI webpage, providing microfinance as a category of priority sector lending goes as follows:

Micro Credit: Provision of credit and other financial services and products of very small amounts not exceeding Rs. 50,000 per borrower to the poor, either directly or indirectly through a SHG/JLG mechanism or any intermediary (including NBFC/NGO/MFI), or to an NBFC/NGO engaged in provision of credit to the poor up to Rs. 50,000 per borrower will constitute micro credit. The poor for this purpose, shall include persons below the poverty line in the respective areas. (Reserve Bank of India, 2007).

Further, The Micro Finance Institutions (Development And Regulation) Bill, 2012 introduced some changes in the definition "micro finance services" and explains its meaning as any one or more of the following financialservices provided by any micro finance institution, namely:

(A) micro credit facilities involving such amount, not exceeding in aggregatefive lakh rupees for each individual and for such special purposes, as may bespecified by the Reserve Bank from time to time, such higher amount, notexceeding ten lakh rupees, as may be prescribed;

(B) collection of thrift;

(C) pension or insurance services;

(D) remittance of funds to individuals within India subject to prior approvalof the Reserve Bank and such other terms and conditions, as may be specifiedby regulations;

(E) any other such services, as may be specified, in such manner.

The Genesis

Microfinance concepts have existed since 1904, when the CooperativeSocieties Act was passed for ensuring production credit loans forfarmers through primary credit societies. The formation of long-termcooperative credit institutions to meet investment needs of farmers startedin 1928. The Syndicate Bank, started in 1921, concentrated on raisingmicro-deposits in the form of daily/weekly savings and also sanctionedmicro-loans for its constituents. With the various priority sector targetsunder social banking in 1967 and after bank nationalization in 1969,microfinance concepts in banking institutions once again

came to thefore. However, in the rural areas, the moneylenders and traders did extendloans at high rates of interest and even for consumption purposes (Karmakar, 2008).

The earliest initiative in microfinancein India can be traced to the initiative undertaken for providing bankingservices to the poor women employed in the unorganized sector ofAhmedabad city in Gujarat. Shri Mahila SEWA Sahakari Bank was set upby registering it as an urban cooperative bank in 1974. Since then the bank has beenproviding banking services to the poor as self-employed working as hawkers,vendors and domestic servants. This MFI model has not been replicatedelsewhere in the country, though the Working Women's Forum(WWF) was promoting working women's cooperative societies in TamilNadu since 1980.

The roots of microfinance can be found in many places, but the bestknownstory is that of Muhammad Yunus and the founding ofBangladesh's Grameen Bank.In the middle of the 1970s, Bangladesh was starting down the longroad to build a new nation. The challenges were great: Independencefrom Pakistan had been won in December 1971 after a fierce war, andtwo years later widespread flooding brought on a famine that killedtens of thousands. Government surveys found over 80percent of the population living in poverty in 1973–1974 (BangladeshBureau of Statistics 1992).

Muhammad Yunus, an economist trained at Vanderbilt University,was teaching at Chittagong University in southeast Bangladesh. Thefamine, though, brought him disillusionment with his career as an economicsprofessor. In 1976, Yunus started a series of experiments lendingto poor households in the nearby village of Jobra. Even the little moneyhe could lend from his own pocket was enough for villagers to runsimple business activities like rice husking and bamboo weaving.

Yunus found that borrowers were not only profiting greatly by accessto the loans but that they were also repaying reliably, even though thevillagers could offer no collateral. Realizing that he could only go sofar with his own resources, in 1976 Yunus convinced the BangladeshBank, the central bank of Bangladesh, to help him set up a specialbranch that catered to the poor of Jobra. That soon spawned anothertrial project, this time in Tangail in North-Central Bangladesh. Assuredthat the successes were not flukes or region-specific, Grameen wentnation-wide. One innovation that allowed Grameen to grow explosivelywas group lending, a mechanism that essentially allows the poorborrowers to act as guarantors for each other. With group lending in place, the bank could quickly grow village by village as funding permitted.

Microfinance Models practiced in India

While the Grameen model was being conceptualized inBangladesh, the National Bank for Agriculture and RuralDevelopment (NABARD) in India, and Aloysius Fernandez,the conceiver of Self Help Group (SHG) initiatives, werescripting another low-cost and effective technique ofproviding banking access to the poor, through a programnow widely known as the SHG-Bank Linkage Program.

SHG Model

It all started when NABARD sponsored an action research project in 1987 through an NGO called MYRADA. For this purpose a grant of Rs 1 million was provided to MYRADA for an R&D programme related to credit groups. Encouraged by the results of field level experiments in group-based approach for lending to the poor, NABARD launched a pilot project in 1991–92 in partnership with non-governmental organizations (NGOs) for promoting and groomingself help groups (SHGs) of homogeneous members and keeping savings with existing banks and within the existing legal framework. Steady progress of the pilot project led to the mainstreaming of the SHG-bank linkage programme in 1996 as a normal banking activity of banks with widespread acceptance. The RBI set right the policy environment by allowing savings bank accounts of informal groups to be opened by the formal banking system.

The model envisages forming small, cohesive and participative groups of the poor, encouraging them to pool their savings regularly and using the pooled thrift for small interest-bearing loans to their members, and in the process learning the nuances of financial discipline. The SHG concept is unique because of several factors.

_ First, it is built around both formal and informal systems.

_ Second, it seeks to promote both social capital and financial capital that are prerequisites for any meaningful development.

_ Third, it allows for flexibility (in interest rates, repayment schedules, instalment size, etc.) around certain core principles.

_ Fourth, it allows for interaction between professionalism of bankers and wisdom and local knowledge and experience of the group.

The SHG model is a model that is homegrown. Unlike other models of micro-credit, the SHG model starts off with savings as a base. The model is like the Grameen model, but not as regimented. Mainstream banking has accepted this model for a nationwide bank linkage programme and it is quite popular with bankers who see potential in microfinance. The essential design elements of the SHG model are as follows:

- Homogenous affinity group of 15-20 members
- Regular meetings
- Regular savings
- Lending decisions are of the group
- Group selects their leaders
- Group accesses external funds

Groups federate at Cluster/Block level. Most of the groups in India have been promoted by NGOs. The groups tend to be dependent on the intervening agency for a long time to help them not only maintain accounts and conduct meetings, but also to manage the external interface with the bankers and others.

MFI / JLG Model

The more recent model adopted by Indianmicrofinance is that of the Joint Liability Group (JLG),adapted from the Grameen modelpioneered by Prof Muhammed Yunus of Grameen Bank. It has been widelyembraced by Indian development professionals, and overtime has become the major alternative to the SHG model.

The JLG is not linked with a bank but is intermediated by theloan officer of a MFI who is responsible for formation andmanagement of the group. Unlike the SHG model whereinthe loan is given to the group and the bank does not trackindividuals' credit history, in the Grameen-inspired JLGmodel the loan is given to the individual (usually by the MFI),backed by the group guarantee; and an individual credithistory is created, even though it may be skewed by the
group guarantee scheme (An Intellicap white paper, 2010).

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 46-50 installments

The JLG 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 costeffectively 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 JLG 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 JLG model works only under certain assumptions. As all the loans are only for enterprise promotion, it assumes that all the poor wantto be self-employed.

Regulatory Framework

In its Monetary Policy Statement for 2011-12, the Reserve Bank of India communicated its acceptance of "the broad framework of regulations recommended by the (Malegam) Committee". In its follow up circular of 3 May 2011 the RBI provided a framework ofoperations for the microfinance sector and a basis for NBFC MFIs' relationship withmicrofinance clients, state governments, commercial/ development banks, rating agencies,capacity building/training organisations and other stakeholders.

It would be relevant here to mention that MFIN and Sa-Dhan, the two national Self-Regulatory associations of microfinance institutions in India, have collaborated to create a unified Code of Conduct for their member institutions. The Code of Conduct seeks to ensure that microfinance services are provided in a manner that is ethical and transparent and benefits clients in a holistic manner and lays special emphasis on client protection and good governance, illustratively:

- Mandatory training on Code of Conduct for MFI staff and awareness building for clients
- Integrity and Ethical Behaviour
- Transparency
- Appropriate interaction and collection practices
- Privacy of confidential client information
- Mandatory client data sharing with Credit Bureau
- Good governance structure for Member MFIs
- Grievance Redressal Mechanism
- Client Education

Recent trends in progress of MFIs

While large numbers may have been reached, the lack of commitment on either side led tosubstantial multiple lending and created an environment of concern about the rights of clients thathad been oversold microcredit.With the reports of suicides in rural Andhra Pradesh thrown into the Microfinance Information Exchange (MIX), microfinance took the blame this time around.

In the month of October 2010, the sector was confronted with its biggest crisis in the two decades since it was launched as a methodology to link poor with financial services. A series of events over the last four years, ever since the Krishna crisis, eventually culminated in the Andhra Pradesh government bringing in a tough ordinance, which effectively scuttled the ambitious aggressive plans of MFIs hitting the capital markets, post the runaway success of the SKS IPO. Operations of all MFIs in the State came to a grinding halt, recoveries dipping to an all time low of 10 per cent, in a sector which boasted of PAR > 1 per cent and soon banks refused to pump in fresh debt. The situation came to a stage where the central bank, reluctant so far, set up the Malegam Committee to look into the issues. Several rounds of discussions between the MFIs and their networks and the State, and with the Reserve Bank of India(RBI) did not see any breakthroughs. Based on the Committee recommendations, the RBI issued a set ofcomprehensive guidelines, which has significantly changed the way MFIs had operated so far.

The observed deterioration in MFI portfolio quality is related to three trends in microfinance, which weakened repayment incentives and allowed borrowers to amass a level of debt that they could not repay. First, the fast expansion of microfinance in some markets led to an increase in the share of wealthier and more risky borrowers, leaving MFIs more vulnerable to an economic downswing. Second, MFIs that now face difficulties failed to live up to the challenge of constantly adjusting their internal structure and lending policies to keep up with fast market growth. They lacked adequate risk management capacities and subordinated prudent lending to fast growth and short-term profits. Third, microfinance was introduced as a development tool in a largely non-competitive setting. But with increasing commercialisation and competition, the instruments used to overcome moral hazard and adverse selection became less effective. This weakened incentives to repay on the part of borrowers, increasing the probability of multiple borrowing and strategic default. In some cases, all three developments reinforced each other, leading to overindebtedness of MFI clients and outright crisis in the affected countries.

In order to rehabilitate microfinance as a development tool, a new balance needs to be achieved between the social development approach and the commercial approach, i.e. a new "socio-commercial approach". Central to this idea is the insight that microfinance is not a business as any other and should and cannot work like one, but that social development goals have to remain at its core.

The further development of the industry should not be left to market forces alone. Many steps have already been taken or are being implemented to ensure that the crisis and its consequences will not be repeated. These include bringing client protection principles to work, strengthening market infrastructure by establishing credit bureaus, information networks building client awareness etc., and improving microfinance regulation. Social performance indicators need to be further developed and the measurement of social performance goals implemented in practice.

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