

**Microfinance in India –
Banyan Tree and Bonsai**

A Review Paper for the World Bank

By

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Microfinance in India –The Great Indian Hope Trick?

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Status and Performance of India's Microfinance Sector

Introduction

This paper is about microfinance, not only about microfinance institutions (MFIs). It deals with the whole range of microfinance providers – from the village mahajan to self-help groups (SHGs) to cooperatives, banks and insurance companies. The paper is also not just about micro-credit but microfinance – covering savings, insurance, credit, and money transfers. Finally, the paper is about the future but it also dwells on the past and the present, since there are lessons to be learnt from experience. The central thesis of this paper is that since the onset of reforms, the mainstream financial sector has turned its back to the needs of India's small farmers and informal sector producers. In the meanwhile, the growth of micro-credit, mainly through Self-Help Groups, is distracting attention from the big picture of the systematic financial exclusion of the majority.

Village moneylenders in India are as old as villages, agricultural credit cooperatives are about a hundred years old, commercial banks' involvement in agricultural and small loans nearly 50 years old, the regional rural bank network over 25 years old, and the first "new generation" microfinance efforts about 10 years old. Thus microfinance in India is still in its infancy, though its growth rate is impressive, and particularly the SHG-bank linkage program appears to have the potential of becoming a big banyan² tree. However, if we view the microfinance sector in context of the unmet demand, the image that comes to mind is that of a bonsai.

Outreach to small borrowers has declined since financial sector reforms were triggered. The proportion of bank credit to small borrowers (below Rs 25,000) has come down steadily from 18.3 percent of total commercial scheduled bank credit in 1994 to 5.3 percent by March 2002. Even the number of borrower accounts has reduced from 55.8 million to 37.3 million.

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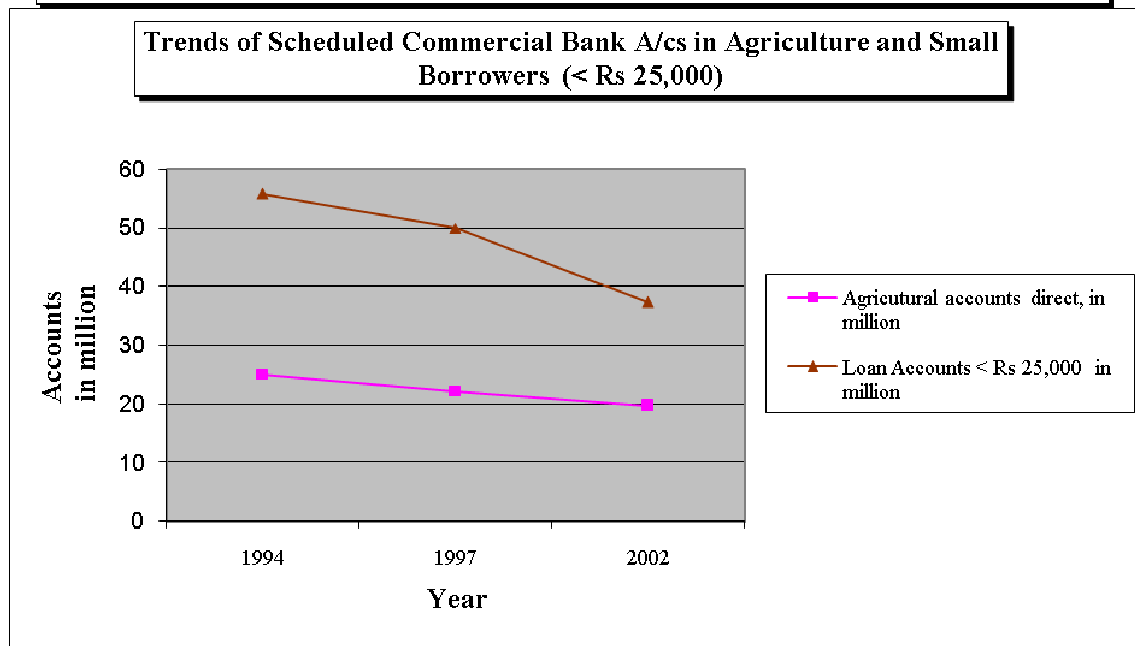
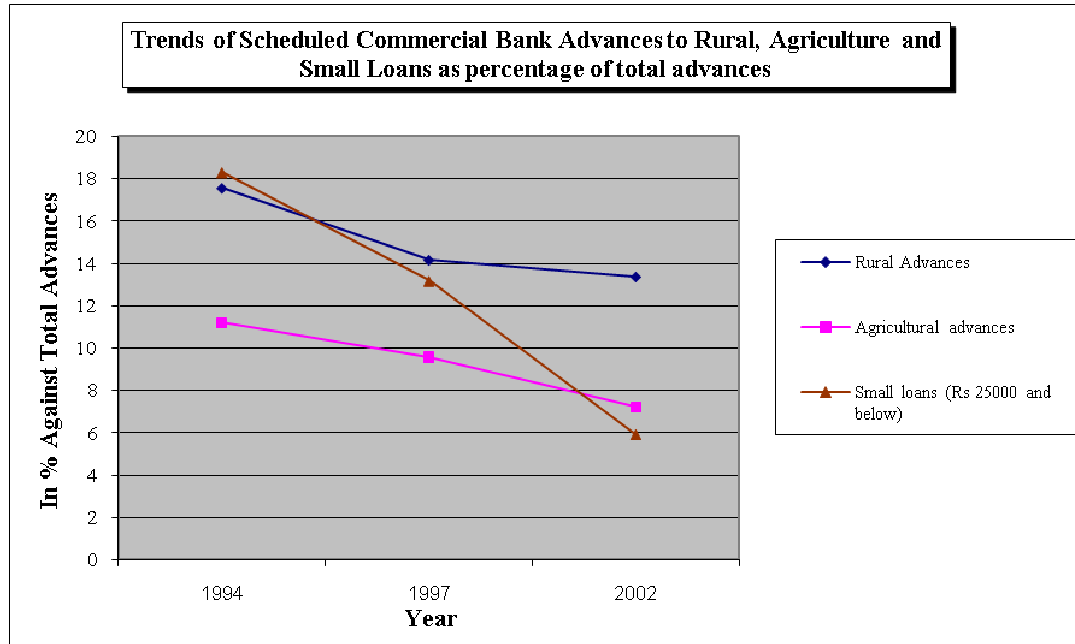
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The authors have written two previous papers reviewing rural and microfinance in India.. See "Financial Services for the Rural Poor and Women in India - Access and Sustainability" in the *Journal of International Development*, Vol 8, No. 2, 1996 and "Dhukka Starting Microfinance in India" jointly with Mathew Titus of Sa-Dhan, in Basu, Kishanjit and Krishan Jindal (Eds.) "*Microfinance: The Emerging Challenges*" Tata-McGraw Hill, New Delhi, 2000.

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² The Banyan tree acquired its English name because "banias" or traders sat under it to do their business. The tree is of religious and cultural significance. However, a popular proverb maintains that nothing else grows under the Banyan tree because of its dense shade. In Japanese, a bonsai is a dwarf tree growing in a pot, produced by special methods of cultivation and is usually used for ornamental purposes. (Oxford English Dictionary).

Compare this to the fact that India has nearly 110 million farms (operational agricultural holdings) and nearly 35 million non-agricultural enterprises³. Thus, even if there were to be just one account per economic entity, the banking system should have been striving to increase its base to 145 million borrower accounts rather than reduce the number of accounts from 55.8 to 37.3 million.



³ The numbers have been rounded off. The latest available official estimates for agricultural holdings are from 1990-91, of 105 million holdings of which 62 million were below 1 hectare in size (Planning Commission) and for non-agricultural enterprises (rural and urban), the Economic Census, 1998, which counted nearly 33 million such enterprises.

Microfinance Demand and Supply

Estimates of demand are projected on the basis of average credit usage per household multiplied by the estimated number of poor households. A NABARD staff study (Puhazhendi and Satyasai, 2000), found that the average credit outstanding of SHG households was Rs 4,282 before an SHG loan and rose to Rs 8,341 afterwards. Various other micro-studies, cited below in section 1.3.1, show that the average annualised credit usage of poor households varies from Rs 3,000 to Rs 9,000. Applying this to the rounded off estimate of poor households in India to 50 million, we arrive at the demand for micro-credit at between Rs 15,000 to 45,000 crore (\$ 3.25 billion to \$9.75 billion).

Since 1992, the Self- help Group (SHG)-bank linkage program has reached over 800,000 SHGs and through them, some 12 million women and their households, cumulatively providing over Rs 2049 Crore (US\$ 445 million) as credit from 1992 to March 2003. Yet, when we look at either the detail or the bigger picture, we find that microfinance supply is far, far behind the demand. In 2003, the SHG member households got an average of Rs 1766 as credit, after being in a group and meeting monthly for anywhere between 9 to 24 months. Thus impressive as the SHG bank linkage growth may be, the fact is that the poor of India are not getting much credit, either compared to what they need, or compared to what the banking sector is delivering to the rest of the economy, or even what it was delivering to them earlier before reforms set in. The outstandings of the SHG program in March 2003 were around Rs 1000 crore (\$ 217 million), thus catering to 2.2 to 6.6 percent of the estimated demand. Even the microfinance institutions (MFIs) had outstandings of Rs 240 crore (\$52 million) with less than one million borrowers as on March 2003.

In terms of scope, microfinance is still largely micro-credit. Savings services are not easily available to the poor. Banks raise a lot of deposits, but not much from the lower income groups. This is in spite of a large number of branches. Banks do not have the products and procedures tailored to meet the savings needs of the poor. Many of the poorer people use the Post Office Savings Bank when they can. In 2001, there were 59 million savings accounts in the post office with an average saving of Rs 1350 and another 44 million recurring deposits with an average balance of Rs 3261. SHG members also have very limited, usually once a month, fixed amount (Rs 10-50) opportunity to save. While MFIs would like to offer savings services, because of regulatory reasons, they are not able to do so. The informal sector also offers savings services, through money guards, chit funds, bishis and so on, as also doorstep deposit collectors, but the cost of these is high and reliability is low. Thus, there is little availability of safe savings services – the most important first step for a poor household to enter the world of financial transactions.

Insurance, of lives and livelihoods, is important to the risk-prone economic life of the poor. As per a study by David Gibbons (2001) of the clients of SHARE, “Almost half (49%) of the mature client households had experienced a family crisis or natural disaster over [a period of] four years, with one-third having experienced two or more”. This is reflective of the experience of all the people working in poverty alleviation. Yet micro-insurance services are not widely available. The Life Insurance Corporation (LIC) insures a large number of poor people, but mainly through government sponsored group insurance schemes. Only 5 percent of the population is insured and the proportion among the poor is likely to be much less. Life insurance is also being offered by MFIs as retailers of private insurance companies, but perhaps no more than 200,000 lives have been covered. Asset or loss insurance coverage is similarly negligible.

What is the Microfinance Sector in India?

Definitional Issues

An “authoritative” definition of microfinance in India was attempted by the Task Force on Microfinance, 1999 as follows:

“Provision of thrift, credit and other financial services and products of very small amounts to the poor in rural, semi-urban and or urban areas for enabling them to raise their income levels and improve living standards”. (Report of the Task Force on Microfinance, 1999)

A number of features of this definition are not satisfactory. To begin with, “very small amount” has not been defined. In case of credit, the Reserve Bank of India, which, till 1999 used to define small loans (not “very small”) as those below Rs 25000, changed the definition to loans below Rs 200,000. In January 2000, the Reserve Bank of India (RBI) issued a circular⁴ where it indirectly defined the ambit of microfinance as “Rs 50,000 for loans to a business enterprise and Rs 125,000 for a “dwelling unit”. How such a large limit was accepted by the RBI for housing is still a mystery, since the Housing Development Finance Corporation (HDFC), which administers concessional funds on behalf of the Government of India from the KfW, Germany, puts an upper limit of Rs 33,000 per dwelling unit on housing loans for the “economically weaker sections”.

One can ask: what is in a definition? Unfortunately, a lot depends on such definitions. Because the banking system is large and has to necessarily work on written guidelines, a badly drafted definition can lead to operating problems. For example, since the January 2000 circular only mentions loans to business enterprises and dwelling units, it has left out loans to agriculture, live stock rearing, forest-based activities, fishing and other allied activities out of the purview of microfinance. Ironically, these activities account for the livelihoods of over two thirds of India’s poor.

Another problem is that the definition of thrift is not given but the use of that word instead of savings seems to imply some features such as regular and frequent savings of “very small amounts” perhaps mainly by women. A monthly saving of Rs10 to 30 in an SHG does not really count towards thrift, and a number of micro-studies show that the poor can and want to save more, provided they can do it at their doorstep and frequently, even daily. The requirement is for what banks call “pygmy” deposits but most banks are averse to offering that service for cost as well operational reasons. On the other hand, the RBI does not allow MFIs to offer savings services, since deposit taking is reserved for regulated banks.

Nor has “very small amount” been defined in case of insurance, and this led some private insurance companies to initially offer rather low coverage amounts in order to fulfil their numerical obligations for social sector policy under the Insurance Regulatory and Development Authority (IRDA) guidelines.

However, one good thing about the definition cited above is that, in line with second generation developments all over the world, it recognises that microfinance is more than just micro-credit: it also spans savings, insurance and also other financial services such as money transfer and pensions.

⁴ Circular no. DNBS/138/CGM(VSNM)-2000

India's microfinance sector can be divided into three segments, the predominant informal, the emerging semi-formal MFIs and the formal financial sector's various schemes and wings engaged in microfinance directly or indirectly.

The Informal Sector

The informal sector continues to dominate the financial life of the poor, though the proportion appears to be decreasing. The authoritative data on this comes from a large decadal survey, first conducted in 1951 and repeated every ten years. This is the All India Debt and Investment Survey (AIDIS).

The magnitude of the dependence of the rural poor on informal source of credit can be observed from the findings of the AIDIS, 1992, which shows that the share of the non-institutional agencies (informal sector) in the outstanding cash dues of the rural households continued to be quite high at 36 percent even though the dependence of the rural households on such informal sources had reduced from 83.7 percent to 36 percent over three decades (1961-1991).

Outstandings from Informal Sources as a percentage of Total Dues of Rural Households

Year	Cultivators	Non-Cultivators	All
1961	81.6	89.5	83.7
1971	60.3	89.2	70.8
1981	36.8	63.3	38.8
1991	33.7	44.7	36.0

If we look at the AIDIS data rearranged by household asset size, then we find that for households in the lowest asset ownership category (less than Rs 5000) the share of the informal sector was 58 percent.

A number of other studies shed light on the financial behaviour of the poor. Most of these are micro-studies, and though they have smaller sample sizes, they are carefully carried out. These include a study carried out by the authors on behalf of the World Bank (summarised in Mahajan and Ramola, 1995), covering 600 rural poor households in two states, which found that as much as 84 percent of the credit usage of these households was from the informal sector. This contrasts with the figure of 58 percent for the lowest asset class households in the AIDIS survey of 1991.

In a micro study (Nag and Bala, 2002) conducted in June 2002 in the Ganjam district of Orissa with 263 respondents, it was found that only 72 percent households borrowed at all and of the borrowers only 12 percent received loans from banks, although the amount accounted for 29 percent of the total borrowings. The informal sector accounted for 70 percent of the credit usage of this sample (one percent was from a local finance company). In a companion study, (Seth and Jamuar, 2002) in the Adilabad district of Andhra Pradesh, it was also found that 70 percent of the credit used by households came from traditional informal sources.

Another study (Sinha, and Patole, 2002), showed that the informal sector accounts for a vast majority of the financials transactions in poor households, both in rural Allahabad district of UP and of the poor living in Delhi's urban slums. A study by the Paradigm group cited in

Supriti et al (2002), indicated that the informal sector provided fully 93.5 percent of the total credit usage by the urban poor in Bangalore in 2002.

Thus the discrepancy between the data from the AIDIS and a number of carefully conducted micro studies in different parts of the country by different individuals/NGOs shows that the official data does not seem to capture the full extent of the dependence of the poor on money lenders, pawn brokers, landlords and traders. Yet, there is no authoritative source of data on microfinance services in India. Instead the numbers that keep getting reported are the cumulative disbursements to SHGs. The fact is that we have a long way to go before either the SHG-bank linkage program or MFIs make a significant dent on the credit dependence of the poor on the moneylenders.

The other form of this self-deception that goes on is in the matter of comparison of interest rates of banks, MFIs and the informal sector. It is important to measure the transaction cost adjusted interest rates that borrowers effectively pay. This is shown in the table below:

Comparison of Interest Rates of Various Sources after Adjusting for Transaction Costs

Source/type of loan	Quoted interest rate	Effective interest rate incl. transaction costs	Details
Bank loans to IRDP borrowers	12-16.5%	22-33% (Source: Mahajan and Ramola, 1996)	Number of visits to banks, DRDA, documentation, and in some cases, bribes. All paid up front.
Bank loans to SHGs	12-13.5% pa	21%-24% pa (Source: survey by APMAS, 2003)	Number of visits to banks, DRDA, compulsory savings and costs incurred for payments to animators/ DRDA staff /local leaders.
MFI loans to micro borrowers	15%-24% pa	15%-24% pa	No transaction costs except time spent in meetings.
Moneylenders, Landlords, Traders	36%-120% pa	48%-150% pa	

Note: all interest rates have been converted into per annum rates, on a declining balance basis

Mainstream Institutions

Commercial banks in India can claim that they “have always been doing microfinance”, at least since 1980, the year that the “Integrated Rural Development Program” (IRDP) was launched. The IRDP was a nationwide program of poverty alleviation through self-employment of the poor, and it involved banks in giving loans for purchase of productive assets, while the government gave a subsidy. By the time the IRDP ended (or rather was transformed into its successor program SGSY in 1999), it had reached 56 million households. This is not the place to analyse the IRDP and its performance (instead, see Pulley, 1989) but suffice it to say that while it provided millions of small loans to poor people, in spirit and methodology it was quite the opposite of what microfinance stands for.

An attempt to define what microfinance stands for was made by the authors as follows:

The seven I's of successful micro-finance programmes for the poor

Attribute	New Generation behaviour
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Image of the poor	Not see them as the beneficiaries, but as entry level customers
Independence	No political interference, such as loan waivers, no bureacuratic control
Interest rates	For deposits: high enough to attract savings. For loans; high enough to cover costs of funds, cost of operations, cost of loan losses, and cost of equity capital.
Incentives	For staff: to ensure good customer service but prudent lending. For customers: to ensure deposits come in and loans are repaid on time
Intermediation	Between local savers and borrowers; and between local surpluses and non-local financial markets.
Increased capacity	Larger scale; broader scope of services to include savings, consumption and production credit, and insurance; better systems for MIS and internal supervision; and greater ability to deal with regulatory authorities.
Integration	With social intermediation (e.g. by Self-Help Groups) and technical assistance (e.g. by NGOs and government bodies in micro-enterprise promotion.)

Source: Mahajan, Vijay and Ramola, Bharti Gupta 1996.

The SHG-Bank Linkage Program

NGOs working in rural development were the first to realise that the IRDP style of small loan would do more harm than good, both to the poor as well as to the banking system. Thus, some of them, such as MYRADA in Karnataka and PRADAN in Rajasthan and later in Tamil Nadu and what is now Jharkhand, began to experiment with alternative methods of extending credit to the poor. Out of this emerged what is now the SHG methodology. Between 1987 to 1992, NGOs experimented with SHGs and tried to persuade some local banks to try to lend to such groups. However, in the command and control structure of the Indian financial sector at the time, it could not be done in the absence of guidelines from the RBI, which were issued in 1992, to experiment with a pilot of 500 SHGs to link with banks. NABARD supervised and refinanced these loans. By 1995, about 2500 groups had been linked with banks.

This pilot program as well the work of a number of NGOs was reviewed by a Working Group on Bank Lending to the Poor through NGOs and SHGs (1995) and detailed guidelines were drawn to encourage banks to use this method. NABARD was given the task of leading this effort and it took to task with exemplary diligence. It involved NGOs, commercial banks, regional rural banks and even cooperative banks in forming SHGs and then linking those up with nearby bank branches.

Growth in volumes of SHG-Bank Linkage

By Mar 31	Number of SHGs linked to banks, cumulative nos.	Cumulative bank loans (Rs. million)
1999	32,995	571
2000	114,775	1,930
2001	263,825	4,809
2002	461,478	10,263
2003	717,306	20,487

As can be seen from the table above, banks have greatly increased their exposure to SHGs over the last three years. The SHG-bank linkage program is now the predominant model for

delivering micro-credit. The program is both promising and problematic. There are a number of problems with the SHG bank linkage program.

Cost of new SHGs: While the first few lakh SHGs were made available to banks by NGOs and government agencies, thereafter virtually all the good SHGs have got bank loans. The newer SHGs are either formed by government agencies or sometimes by banks themselves and rarely display the quality and the principles of good SHGs. If new SHGs have to be formed, someone has to incur the cost of organising meetings, training the members and eventually linking with the banks. The estimate of this cost is controversial, with NABARD claiming it to be as low as Rs 1000 per group and NGOs saying it takes as much Rs 12000. The Ministry of Rural Development has established a norm of Rs 10000 per group which is quite realistic. This is paid over four phases. Thus to form an additional one million group, the amount required is Rs 1000 crore. Where will this come from and what mechanisms can be put in place to ensure that if this money does become available that it is not frittered away in the form of local favors.

Quality of SHGs: As the movement has caught the attention of government officials and politicians, targets are beginning to be imposed and as a result the quality of groups is suffering. A survey by APMAS in 2002 indicated that only 17 percent of all groups were of adequate quality for bank linkage and this was in a state which is considered the leader in the movement. Quantitative targets and government directed SHG formation are the main cause of this deterioration. For example, under the SGSY, nearly 12 lakh SHGs have been formed over the last three years but less than 10 percent of these are linked with banks. The main reason is that the others are still new and relatively unformed groups. Many have come together only because they want a loan.

Is SHG-Bank Linkage Headed Towards another IRDP?

There is also the problem of banks chasing targets without concern for quality and politicians using the program for popularity. A survey of 400 randomly (multi-stage stratified sample) selected SHGs linked with banks, was carried out by the Andhra Pradesh Mahila Abhivruddhi Society (APMAS) in eight districts of AP.

The survey found that only 67 percent of the SHGs were appraised by banks before giving loans. Further, in APMAS' assessment using NABARD criteria for bank linkage, only 60 percent of the bank-linked groups were of adequate quality to get loans from banks. Further, the survey revealed that nearly 33 percent of the funds had gone to the group leaders. Only 17 percent of the groups had ever changed their leaders.

In terms of services/favours and payments, some groups reported that animators were paid Rs 200 to 500 per group, the EO (DWCRA) Rs 400 to 500 and/or local leaders Rs 1000 to 2000. However, the average of all transaction costs, including fares and documentation was Rs 276 per group, or about 0.8 percent to an average loan of Rs 34037. In addition, funds were borrowed from local moneylenders to show adequate savings in the bank account. For this, money lenders charged 5 percent pm. The savings of the group were in the bank for an average of around four months before loans were sanctioned and disbursed.

Moreover, as many as 10 percent of the groups reported that they were asked to take bank loans against their wishes, because of pressure by bankers and animators who had to fulfil targets. Not surprisingly therefore, 12 percent of the bank-linked groups in AP have repayments overdue to banks. If this trend is not controlled, the SHG-bank linkage program could get a bad name and suffer the same fate as IRDP lending to the poor. (APMAS, 2003)

business without losses even when interest rates are capped at 12.5 percent. Indeed recently, the State Bank of India and the Andhra Bank have announced their intention to lend at 9 percent per annum. About transaction costs, banks have the view that they any way have a rural branch network with fixed costs and there are little incremental costs for SHG lending.

However, there is contrary data emerging from careful studies, notably by Sinha (2003), whose study of five RRB branches seems to show that if all the costs of SHG formation and lending are allocated and accounted for, it costs banks anywhere between 22 and 28 percent to do SHG lending, and in one case, where the RRB was located in a low density, forested district the cost was as high as 48 percent. It is very important for banks to pay attention to this study and carefully work out their actual costs for SHG lending. While the SHG portfolio is a small part of the total bank lending, and portfolio quality is good, it may be possible to cross subsidise this but eventually full costs must be charged, even as all efforts are made to reduce the costs. Thus the assertion that SHG lending is profitable at 12 percent is questionable.

Politicisation: Since more than 12 million women are now part of the SHG bank linkage program and perhaps an equal number of them are members of hurriedly formed groups in the hope of getting bank loans, or gas connections or whatever other largesse that politicians may want to distribute, this is a potentially huge vote bank. This point is not lost on politicians. While, a number of Chief Ministers, notably those of AP and MP have supported the SHG movement for good reason, as they saw it as a way of extending bank credit to the poor and women in particular, this image is now changing in the election year. The reports on the ground from AP show that SHGs are increasingly being used for political mobilisation and distribution of pre-poll goodies. There is also a pressure on banks to increase their lending to SHGs, while using the not yet matured SHGs for disbursing all kinds of government subsidies. While this is disturbing enough, the biggest blow has come from Tamil Nadu, where the state government promulgated an ordinance prohibiting loans at exorbitant interest rates, this being defined as 12 percent. Legitimate MFIs trying to run sustainable operations find that their staff are being harassed by local politicians and petty officials. Karnataka has followed suit with a similar ordinance in September 2003.

The fact is that imposing an upper limit on interest rates is actually an anti poor step because it is the surest way to ensure that legitimate lenders will be driven out and closed down. In theory, the poor could then borrow from reluctant public sector banks but we all know in practice that this will mean that they have no recourse except for the money lenders. Thus, in the name of populism politicians are once again ensuring that the poor get no access to credit. It is important that all truly pro-poor politicians and well meaning bureaucrats should come out in favour of the deregulation of interest rates. Those who are not yet convinced, should look at the experience of Indonesia where interest rate deregulation has ensured the sustainable operation and nation wide outreach of a number of micro-finance institutions.

Geographical Concentration: Despite its numerical success, we must note that the outreach of the SHG-bank linkage program has remained a largely south Indian phenomenon, with nearly 75% of funds flowing to SHGs in the four southern states.

Other Models for Microcredit by Banks and FIs

Other models of banks giving microcredit are extant, the main one being on-lending through MFIs. Though this approach was initiated by the Friends of Women's World Banking and the government sponsored Rashtriya Mahila Kosh, it was later developed and enhanced by the Small Industries Development Bank of India (SIDBI).

Starting in 1994 with a micro-credit scheme, SIDBI upgraded its work into an internal department called the SIDBI Foundation for Micro Credit (SFMC). The total amount disbursed by SIDBI since the beginning of the scheme till March 31, 2003 was Rs 161.3 crore to 183 NGO/MFIs, eventually reaching an estimated 860,000 individual borrowers.

As can be seen, this "second channel" of disbursing micro-credit is dwarfed in contrast to the numbers achieved by NABARD through the SHG-bank linkage program. Nevertheless, SFMC has played an important role in providing micro-credit in those locations where banks were reluctant or tardy in providing credit through SHGs.

Microfinance Institutions (MFIs)

The MFIs are a middle ground in the sense that they offer some of the features of the informal sector such as flexible products, customer friendly practices but at a higher interest rate than formal sector, while bringing in some features of the formal institutions – such as documented loan contracts, detailed books of accounts, MIS, staff, and some degree of supervision by a regulatory authority.

For all the excitement about MFIs in India, it should be noted that they are very small, individually – the biggest being SHARE Microfin Ltd with loans outstanding of about Rs 50 crore and BASIX of Rs 35 crore in March, 2003. Even collectively, the MFI sector is small, as can be seen from two recent estimates. The first is an estimate by Micro-Credit Ratings and Guarantees India Ltd (M-CRIL) based on 69 MFIs rated by it (and thus most likely, among the top 100). These MFIs had Rs 163.8 crore of outstandings and 14.2 lakh "members", only 4.5 lakh of whom were borrowers by June 2002. (Sinha, 2003), which averages to 6500 borrowers and Rs 2.3 crore loan outstanding per MFI.

M-CRIL's analysis of the performance of 69 rated MFIs in India, June 2002					
Indicators	NGOs lending to SHGs	Individual lending	Grameen	Mixed	All Sample MFIs
Sample size	43	10	7	9	69
Total Membership (000s)	1.032	112	174	105	1423
Average Membership (000s)	24	14	24.8	11.7	20.6
Active borrowers/MFI (000s)	4.6	5.5	21.9	5.0	6.5
Loans outstanding (in Crore)	54.6	35.6	45.6	28.0	163.8
Average portfolio (in Crore)	1.3	3.6	6.5	3.1	2.4
Average loan outstanding (Rs)	2800	6500	3000	6200	3600
Savings (in Crore)	45.1	28.5	12.4	6.2	92.2
Savings per member (Rs)	440	2550	710	590	650

Source: Sinha (2003)

Another compilation, with assistance from V. Nagarajan & Co., who audit most of the larger MFIs in India, shows that the top 10 MFIs had loans outstanding of Rs 159 crore in March 2003. Thus, at average of Rs 16 crore, even the big MFIs are still small, though growing fast.

Name of the MFI	Outstandings (Rs crore)	Savings (Rs crore)	No of Borrowers	No covered under insurance
SEWA Bank	13.4	62.4	50,849	5584
SHARE Micro Fin Ltd.	49.4	9.5#	132,084	
SHARE – Asmita	8.3	NA	22,168	
Cashpor	8.8	0.5#	22,164	7028
BASIX – Samruddhi	38.8	No savings	51,379	25,600
BASIX- KBSLAB	5.0	2.5	3,898	163
BASIX –Sarovodaya	9.7	9.5#	45,082	
Spandana	15.2	2.1	34,131	34,131
SKS	4.9	0.4	13,519	
LEAD	5.1	1.5	26,661	
Total	158.6	88.4	401,939	72,506

Savings are kept with member SHGs/mutual trusts/MACS in cases marked by # above.

Source: V. Nagarajan & Co and compilation by BASIX team. Data is for March 31, 2003, or in some cases for August 31, 2000.

Savings: In addition to small scale, MFIs also tend to have a limited scope. Due to regulatory reasons, very few of them offer savings as a service. Some offer a vast range of products – see for example the box below on savings products of VSSU, West Bengal. Apart from promoting mutual savings among groups (SHG or Grameen type), a few NGO MFIs offer savings services by taking deposits from their members. Others have had to use mutual benefit trusts or mutually aided cooperative societies (MACS). Only the SEWA Bank, Ahmedabad and the BASIX local area bank KBSLAB (in three districts of AP and Karnataka) offer savings as RBI regulated entities.

Savings Products offered by Vivekananda Sevakendra-O-Sishu Uddayan (VSSU) Source: MCRIL, 2002

Product	Features	Clients	Organisation's Perspective
Daily Deposit	Fixed amount to be deposited each day Lock in period of 18 months 7-in-1 facilities after lock in period 4 percent interest after lock in period	Daily wage earners (rickhsaw pullers)	Easier for clients to save daily Early viability established thorough transaction cost analysis
Savings Deposit	Additional withdrawable product for clients of other schemes. Min balance Rs 500, Max 4 transactions allowed pm. Door step collection for > Rs 1000 5 percent interest for period > 90 days	Bank savings account holders	Withdrawable savings option for existing clients; Lower collection costs due to add on transaction; Meets organisations's fund requirement
Fixed Deposit (FD)	Deposit up to Rs 45,000 for a maximum of 78 months 7-in-1 facility for depositors 8-11 percent qtlly compound interest	Investors of post office deposits/banks	Clients need investment options for long term and bulk funds Source of long term funds for the organisation
Recurring Deposit	Minimum monthly deposit Can be used as collateral for loans 7-in-1 facility 10-11 percent compound interest	Clients who do not have a daily income	A flexible option for savers augments deposits Increased member credit worthiness, use as loan collateral
Monthly Income Scheme	Pension plan One time deposit for 60 months Personal accident insurance 9 percent simple interest paid out monthly	Retired persons and pensioners	Reduced cost of funds for the organization. Costing done on the basis of cost of external and idle funds More stable cash flow

What Impact have Microfinance Programs had?

Impact on the Livelihoods of the Poor

Since microfinance involves working in the public space, and almost always with some implicit or explicit subsidies in the form of public funds at costs lower than market, it is important to continue to measure the impact of microfinance programs. In practice, this is quite difficult due to a number of operational and methodological reasons. MFIs, which are responsible for providing microfinance services, are not always objective in assessing the impact of their own work, even as this is based on day to day familiarity with the borrowers.

In India, there are no sophisticated studies on the impact of microfinance. However, a number of simple studies have been conducted on the impact of microfinance programs. These mostly focus on the impact of microcredit, and not of savings and insurance, since those services are provided relatively less often. Two of these are summarized below:

A study by NABARD staff (Puhazhendi and Satyasai, 2000), which covered 560 SHG member households from 223 SHGs spread over 11 States showed perceptible changes in the living standards of the SHG members in terms of ownership of assets, increase in savings and borrowing capacity, income generating activities and in income levels. Some highlights from the study are presented below:

- Poverty outreach: “Member households were mainly from among the poor: landless agricultural labourers 31 percent; marginal farmers 23 percent; small farmers 29 percent; and others 17 percent.”
- Increase in credit usage: “The average borrowing/year/household increased from Rs 4282 to Rs 8341. The share of consumption loans declined from 50 to 25 percent. About 70 percent loans taken in post SHG situation were for income generating purposes.”
- Increase in employment and income: “Employment increased by 18 percent from 318 man days to 375 man days per household... The average income per household increased from Rs 20,177 to Rs 26,889 or by about 33 percent.”
- Reduction in proportion below poverty: “About 74 percent of the sample members had income below Rs 22,500 in pre-SHG situation. During the post-SHG period, the proportion came down to 57 percent reflecting improvement in the incomes of about 17 percent of the households.”
- Increase in asset ownership and housing: “Average value of assets per household which included livestock and consumer durables etc., increased by 72 percent from Rs 6843 to Rs 11793. About 58 percent of the households reported increase in assets. Housing conditions generally improved with a shift in the ownership form kuchha (mud walls, thatched roofs) to pucca (brick walls, tiled roofs) houses.”
- Increase in savings: “Almost all members developed saving habit in the post-SHG situation as against only 23 percent of households who had this habit. Average annual savings per household registered over threefold increase from Rs 460 to Rs 1444.”
- Social Empowerment: “The involvement in the group significantly contributed in improving the self confidence of the members. The feeling of self worth and communication with others improved after association with the SHGs. The members were relatively more assertive in confronting social evils and problem situations. As a result there was a fall of incidence of family violence.”

According to this study, the impact is considerable and all-round. The poverty outreach is quite satisfactory, even though it could have had a higher proportion of landless households, since they comprise the vast majority of the poor. The study does not mention the social categories, such as scheduled castes, scheduled tribes and minorities. There is no mention also of the proportion of women, but presumably it is very high since almost all SHGs are women's groups.

Very positive results have also emerged from an impact assessment of the clients of SHARE Microfin Ltd (SHARE). This was carried out by Prof David Gibbons and his team in 2001. The approach used was to track poverty reduction over time based on a composite index of poverty based on the sources of income; the number of household members divided by number of earning members; productive assets; and housing quality. The study report states

“Three out of four (76.8%) of SHARE's mature clients have experienced significant reduction in their poverty over the past four years, and half of these are no longer poor... Of the remaining 23.2% of the sampled mature clients, who had been in the microfinance program for at least three years, 21.6% had experienced no significant change in their poverty, and 1.6% had actually become more poor than they had been at the time of entry into the program.

Poverty Movement	Mature Clients	%	Cum. %
Very Poor to Moderately Poor	48	38.4	38.4
Very Poor to Non Poor	22	17.6	56
Moderately Poor to Non Poor	26	20.8	76.8
No Change	27	21.6	NA
Non Poor to Moderately Poor	1	0.8	NA
Moderately Poor to Very Poor	1	0.8	NA
Totals	125	100	NA

The poverty status of households at the time of joining SHARE's program (three to four years before 2001) and at the time of the study in 2001 is summarised below:

Poverty Status	Upon availing of SHARE's loan	Three/four years later
Very Poor	64%	7.2%
Moderately Poor	36%	56.8%
No longer Poor	0%	36.0%
Totals	100% (n=125)	100% (n=125)

The study showed that

“An important path out of poverty ... has been the purchase and care of a milch buffalo(es), with loans provided by SHARE. Of the mature clients who did not purchase any buffalo with their loans, only 68% have experienced a significant reduction in their poverty, as compared to 85% of those who have one milch buffalo and 84% of clients who have two or more milch buffaloes...In general, clients had reduced their poverty by using their loans to increase the number of income (cash) earners in the household, often through the wife becoming an earner by investing all or part of her SHARE loans in creating self employment for her.

“With subsequent loans from SHARE these processes of increasing the number of income earners in the household and diversifying its sources of income continued, where possible. Those mature clients who had three or more earners in their household, 84% of them had experienced significant poverty reduction, as compared to only 33% of households with only one income earner. Diversification of

the source of household income also is strongly related to poverty reduction: 82% of client households with three or more sources of income had experienced significant reduction in their poverty compared to only 47% of households with one source of income. Adding income earners and diversifying source of household income are about equally related with poverty reduction.”

The results of the above two studies are quite at variance with international literature on impact assessment. For example, Hulme (2000) argues that the poor benefit much less from microcredit than the less poor and that many do not benefit at all and indeed, some are left worse off due to the additional indebtedness which they are not able to pay off due to failure in the activity or other contingencies. Indeed, if we look above at the first table, we find slight evidence of this, with 0.8 percent of the moderately poor becoming very poor as a result of the program. However, this is a very small percentage.

Impact assessment needs to be done but serious attention should be paid by donors to its cost-benefit ratio. Outside evaluators necessarily have to draw samples and conduct surveys, which are both tedious and expensive. Statistical rigour requires substantial samples and establishing control groups, so that biases can be eliminated and secular changes can be accounted for. But even the most sophisticated studies, such as Pitt and Khandker (1998), in Bangladesh are open to different interpretations. For example, Morduch (1998), using the Pitt and Khandker data, states that he found no increase in [household] consumption [children’s] education, even though the original authors estimated that household consumption increases by 18 taka for every 100 taka lent to a women and schooling of children increased⁵.

Impact on Sector Practices

Informal sector interest rate and approach

One of the beneficial impacts of microfinance is reduction in informal sector interest rates and a change in their approach from exploitative to business-like behaviour. It has been argued by Al Fernandes of MYRADA in the recent Microfinance Roundtable (Srinivasan R. and Sriram M.S., 2003) that one of the benefits of establishing SHGs or an MFI in an area is the reduction in interest rates from informal sources.

“I question the assumption that the microfinance sector has to meet the total demand. The goal is to promote an environment (policies, systems, culture and practices) in which the poor can access credit and other financial services quickly easily at minimum cost. In some of our projects where the SAGs have met around 20-25 percent of the demand, the entire interest structure in the private or the informal sector has come down. The informal sector was always easy to access, it was the interest rate that was exploitative...”.

Similar results are reported in a number of micro impact studies. The dynamics of this are two fold. First, the availability of credit from an SHG or an MFI simply opens up one more channel for the poor to draw upon, thus creates a downward competitive pressure on moneylenders. However, as the indebtedness and acute consumption needs come down due to even a marginal increase in incomes resulting from economic activities pursued using micro credit, the desperation for credit goes down and along with that the demand for overnight hand loans at 10 percent per month, tied transactions and debt bondage, all of which are abominable forms of usury.

⁵ Interestingly, as a side point, the increase in household consumption is lower at 11 Taka for every 100 Taka lent to a man.

Indeed the positive results have encouraged some to go one step further – to involve moneylenders and other informal financial service providers in the spread of financial services, particularly to the poor. But the issue of involving informal lenders in microfinance is still debatable, though attempts should be made through some pilots. This has been suggested a number of times, most recently by Sharma and Chamala (2003) but is always argued against in the same breath. See the excerpt below for example:

“...The second possibility is that of linking moneylenders with the banking institutions as a conduit. This has an inherent problem, in addition to the problem of acceptability by the other socio-political stakeholders, in the assumption of non-exploitative interest rate recovery from the clients by the middlemen/moneylenders. It cannot be ensured by financing banks as it will require substantial supervision and in turn tempering of the moneylending process according to formal set of rules.”

Developing New Approaches by Banks and Insurance Companies

Banks have had a positive experience of lending to MFIs, where transaction costs for banks are lower as compared to lending to SHGs, and the repayment rates are 98 percent and above. Based on this, the new private sector banks, mostly notably the ICICI Bank, but also the UTI Bank and the HDFC Bank are actively seeking exposure in the microfinance segment. While this is small in terms of amount to make a difference to their over all portfolio for even to their priority sector lending obligation, these new banks are pursuing microfinance with a refreshing approach – as a potential business and not merely as a social or priority sector lending obligation.

Further, though MFIs have not made a dent yet in terms of directly meeting the credit needs of the poor, their customer-friendly practices and mutual competition have pushed banks to adopt a number of products and procedures. In case of agriculture, the biggest innovation is the Kisan Credit Card (KCC), of which 31.6million had been issued by March 31, 2003. Though these are not truly credit cards in the sense normal card users understand, the KCCs have significantly reduced the paperwork and delay that farmers faced earlier to renew their crop loans every year. On the lines of KCC, banks have launched the Laghu Udhmi Credit Cards for small entrepreneurs. In addition, banks are promising a number of features, as can be seen from a recent advertisement reproduced below:

United Bank of India : Charter for Small Scale Industries	
▪	▪ Simplified loan application
▪	▪ Receipt of loan applications complete in all respect is acknowledged
▪	▪ Time norm for disposal of loan applications from the date of receipt:
	• • Up to Rs 25,000 - 2 Weeks, Rs 25,000 to Rs 5 lakhs – 4 weeks
	• • Over Rs 5 lakhs – 8-9 weeks
▪	▪ No collateral security for loans up to Rs 5 lakh and, for existing borrowers with good track record, no collateral for loans up to Rs 15 lakh.
▪	▪ Composite loan available up to Rs 25 lakh
▪	▪ Working capital finance of 20 percent of projected annual turnover available up to Rs 5 crore of fund based limit
▪	▪ Hassle free Laghu Udhmi Credit Cards available for loan limits up to Rs 2 lakh.
▪	▪ United Udyogshree Yojana provides hassle free credit facilities under SSI for borrowers and depositors with good track record for last three years at reduced rate of interest by 0.5 percent. Lower margin and service charges are considered under the scheme.
▪	▪ Present rate and interest on SSI advances of loan limits:
	• • Up to Rs 25,000 8.25%, Rs 25,000 to Rs 5 lakh 8.75%
	• • Rs 1 lakh to Rs 2 lakh 9.50 %, Over Rs 2 lakh as per credit Risk Rating

or

result they have not only established friendly partnerships with a number of NGOs and MFIs, but also have innovated a number of products and approaches. For example all the banks offer lines of credit in addition to term loans. This enables MFIs to draw down the loan at the pace they build their portfolio, thereby reducing the effective interest payment.

The ICICI Bank is actively exploring portfolio securitisation of the micro loan portfolios of some of the high performing MFIs, thereby reducing the need of MFIs to have increasing levels of equity or risk capital as their portfolios grow.

The ICICI bank is also experimenting with using MFIs as management and collection agents, where the loans are always on the books of the ICICI Bank, even though all the operations with the customers are handled by the MFI staff. The ICICI Bank has launched a pilot effort for this jointly with Cashpor Micro Credit, a section 25 company specially set up for this purpose by Cashpor financial and Technical Services Ltd, in the Chandauli district of Uttar Pradesh.

In the field of savings, however, the progress has been halting, mainly because of the understandably conservative nature of the deposit regulator, the Reserve Bank of India, particularly in view of a number of small bank failures that keep happening on a regular basis. The long standing recommendation of the 1999 Task Force to establish graded regulation on deposit taking has so far not found favour with the Reserve Bank of India. To recall, the recommendation was to exempt MFIs raising savings up to Rs 2 lakhs: establish a reserve requirement of 10 percent of savings raised up to Rs 25 lakhs and thereafter insist on an RBI registration and a 15 percent reserve requirement. Further, the Task Force recommended that deposit taking be not opened to the general public but only from members i.e. clients or beneficiaries of MFIs.

In contrast to slow progress in savings, in the field of insurance, in a short period of three years since the sector has been privatised, there have been a number of interesting innovations and approaches and new product /channel developments. SEWA Ahmedabad is by far the leader in developing and offering insurance products to its customers. SEWA provides insurance services managed through its Vimo SEWA affiliate, which works as a nodal agency for the LIC and a number of general insurance companies. Vimo SEWA is perhaps the nation's largest MFI insurer, covering over 100,000 women, for life as well risks related to houses and assets used in earning their livelihoods. It also offers health insurance covering maternity as well.

Expanding Sustainable Outreach – Challenges and the Way Forward

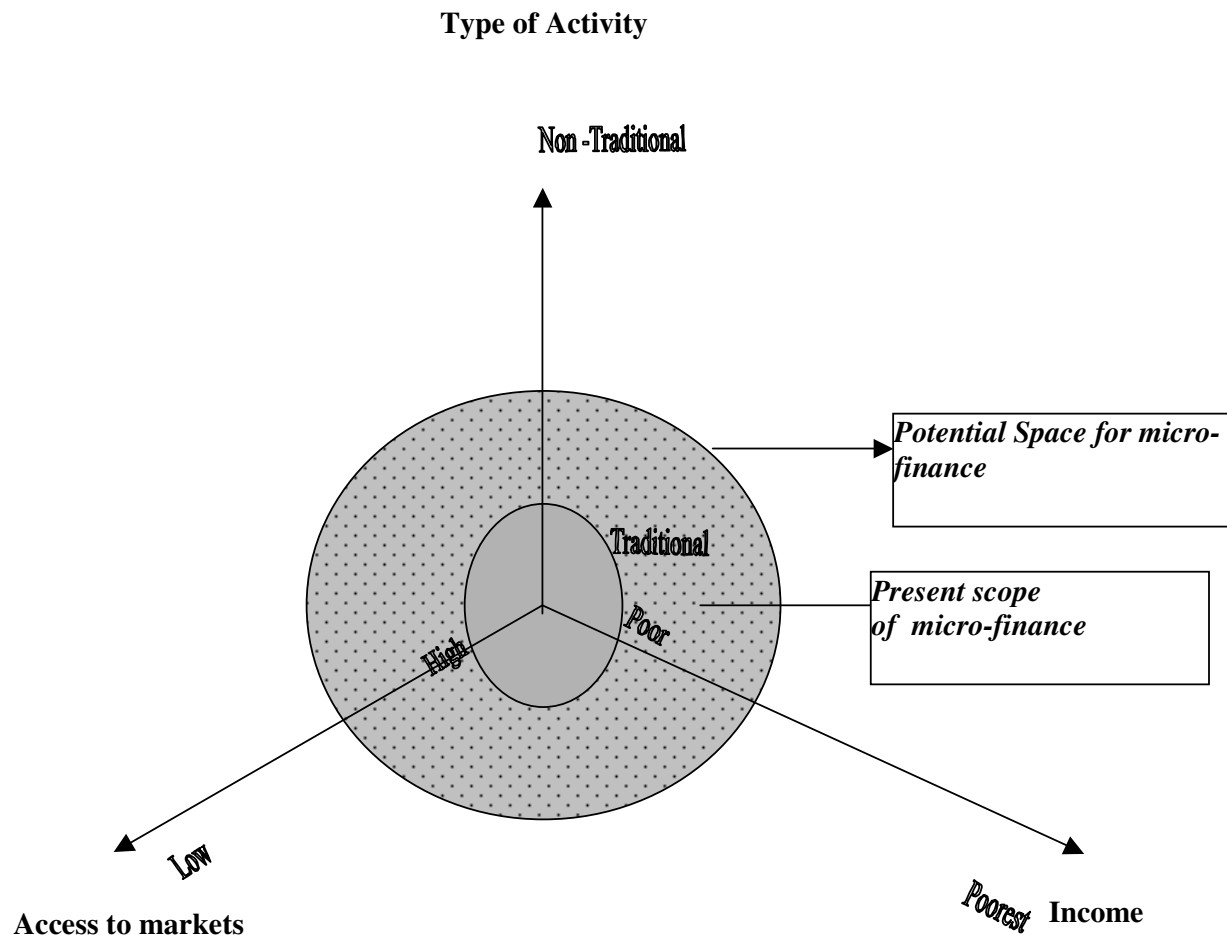
The Space for Microfinance

The demand for credit by poor households has been variously estimated at Rs. 15,000-45,000 Crore. Can we take this as the demand for micro-credit services? Or should we more narrowly define demand for micro-credit in terms of affordability and credit worthiness? Further, when we look at demand for finance for productive purposes, can we really say that the demand is for credit or should we examine the requirement as demand for investible funds with equity like features?

We propose a three dimensional approach to characterising demand for microfinance:

- Asset ownership of the poor households

- Economic Activity of the poor households (traditional occupations, extensions from those, and new, non traditional)
- Access to input and output markets.



We further suggest that microfinance from both the formal sector and the MFIs is currently largely available only to a small subset of the poor in India, perhaps primarily to the set formed at the interaction of

- the top 3 quartiles (among the poor) in terms of income/asset ownership,
- the poor engaged in traditional or extension from traditional activities, and
- the poor with reasonable access to input and output markets.

This is the subset in which all three types of microfinance players are interested and MFIs face “crowding out” by both the extensive formal financial sector network and the ubiquitous informal sector. The concentration of service providers is even more in Southern India where credit discipline is better than in the rest of the country due to a variety of reasons. Even within this subset, there are the unreached (the socially disadvantaged e.g. the dalits) and even for the members of this subset who are relatively better served in terms of credit by the informal and formal sector, savings and insurance services are conspicuous by their absence. So why have MFIs not grown by tapping into this huge unmet demand? Can microfinance reach be extended sustainably to the poor not in this subset?

Savings and Insurance are conspicuous by their absence as services available to the poor. Demand for these services from the poor has not been rigorously estimated so far. The study cited above (Ruthven, 2001) found that rural households had up to Rs 1000 of accumulated savings among the very poor and up to Rs 3500 among the poor, while the numbers were Rs 2,000 and Rs 4,000 for the very poor and the poor in Delhi slums. The study by Puhazhendi and Satyasai (2000) showed that the average saving per household in bank-linked SHGs was Rs 1,444 per annum or 5.3 percent of the average income of Rs 26,889 per annum. Extrapolating from this and various other micro-studies cited earlier, we can say that the poor do have an appetite to save anywhere between 5-10 percent of their incomes if doorstep savings services were made available. This can aggregate to between Rs 5,000-10,000 crore per annum. If one looks at the collections by Sahara India and its customer profile in Eastern UP, this figure does not seem too far from reality.

In case of insurance, again it is estimated that the poor are willing to pay between 3-5 percent of their incomes per annum for “comprehensive” insurance, that is one that covers their lives and livelihoods – or in the parlance of the industry, life, health, livestock and other productive assets as also crops. This could add up to a premium potential of Rs 3,000 to 5,000 crore a year if access could be organised.

How big an issue is affordability in realising this demand for savings and insurance services? No practical answers exist to these questions because as mentioned earlier in this paper, MFIs in India have so far been almost exclusively focussed on credit.

We discuss below some of the challenges for expanding outreach and scope, while maintaining sustainability of microfinance providers – mainstream or MFIs.

Overcoming Geographic Concentration of the South

One of the main issues of concern is that microfinance continues skewed in its geographical distribution. Within the predominant SHG Bank linkage mode, the Southern region accounted for 65 percent of the SHGs linked and 79 percent of the amount disbursed. In contrast, the North-eastern region accounted for 0.6 percent of the SHGs and 0.3 percent of the amount. Even the densely populated and highly poor Eastern region accounted for 12.6 percent of the SHGs linked and 5.9 percent of the amount. The situation is similar in case of the work of MFIs. Some notable exceptions are NGOs which have promoted a large number of SHGs for linkage with banks such as the IDSS Indore, NBJK, Hazaribagh, PRADAN all over Jharkhand, RGVN in Assam and Orissa, PREM in Orissa and VWS in West Bengal. Among the top 10 MFIs in the country, all but CASHPOR in eastern UP are located in the southern states. We believe that the underlying causes are three fold:

- the general malaise in the economy of the central, eastern and north eastern states, with very little resultant demand for credit among the subsistence poor .
- the small number of good quality NGOs, which can initiate microfinance programs in these states. There are a large number of small NGOs but all of them with limited experience and outreach.
- the systematic destruction of credit discipline over the last three decades, starting with government poverty alleviation programs such as the IRDP. Thus, only very committed microfinance institutions would be willing to take the risk of working in these states.

Based on the above analysis, one can think of a number of ways to mitigate this situation, but all of them will require a substantial number of years. To begin with, overall economic growth has to be increased in these states and that requires enhanced investments in the

natural resource base (land, water and forests) for the predominant livelihoods of the area – agriculture, livestock rearing and forest based occupations.

Investments are needed in things like watershed development, small-scale irrigation, livestock upgradation and forest regeneration. Unfortunately, none of these are amenable to the “small, short and unsecured” nature of microcredit loans. These require long term, lumpy public investments. However, once made, they unlock the potential for enhancing the livelihoods of millions of poor people, moving them up from subsistence production to surplus production and thereby increasing the demand for credit. One simple example of this is the dramatic increase that happens in the demand for credit when irrigation becomes available to erstwhile rainfed farmers.

A concrete proposal for increasing the number of good NGOs in these states was made in the Xth Plan Working Group on Poverty Alleviation Programs (Planning Commission, 2002), which recommended that well established NGOs be asked to establish branches in selected poor districts and that they be funded for this on an assured though declining basis for the first three to five years. The experience of the Rashtriya Gramin Vikas Nidhi and the Rashtriya Mahila Kosh in supporting hundreds of small NGOs all over the eastern region is useful in this regard and lessons from such experience need to be taken into account. Another proposal has been to incubate MFIs in poorer districts under the guidance of established MFIs. This particular proposal by BASIX, known as the “3+3+3 program” envisages supporting a local social entrepreneur with operating funds and on lending funds till the operations reach break even in an estimated three years.

The third cause – credit indiscipline - can only be overcome through a combination of sensible government actions. State governments need to be prohibited from waiving loans and interest whenever they think it is expedient. The laws related to foreclosure and debt recovery need to be strengthened and their enforcement made speedier and surer. This would not normally be needed for the microcredit customers, but it would create the right atmosphere to reduce perceived risk. Finally, risk funds to be established specially for MFIs working in central, eastern and north-eastern states. One way to finance such risk funds is to impose a cess on those banks, which have CD ratios below 50 percent in these states, as indeed most of them do.

Innovation and Value Creation

The lack of sustainable innovation in microfinance is another key concern. Competitive financial markets naturally innovate in managing risk, lengthening term structures, reducing transaction costs and refining valuation. Competition motivates experimentation to devise self-sustaining instruments that survive because they create value for both their buyers and their sellers (J D Von Pischke, 1991). There has been little sustainable innovation by the formal financial sector in India in meeting the needs of the poor. This may be explained by the lack of competition in the sector until recently wherein the Government owned, controlled and /or funded institutions providing a majority of the services. The informal sector is equally monopolistic (in that close multifunctional relationships lead to strong bilateral bonds with the providers). In any case, the informal sector is amorphous and dispersed.

But have MFIs focussed on innovation? Are Indian MFIs capable of sustainable innovation that will extend outreach sustainably? There are several examples of partially successful innovations and a few of truly successful ones (e.g. methodologies developed for lending for milch animals which are now prevalent in both the formal and the MFI sector, the SHG

methodology). But this pace of innovation is not enough. MFIs, save a few have tended to exclusively follow practices that are typically used by the mainstream institutions or successful models elsewhere such as the Grameen Bank.

Accelerating strategic use of Information and Communication Technology (ICT) is critical to addressing the transaction cost problem. Some experiments in this direction have been made, notably by BASIX to use to give out very small loans (below Rs 1000) and collect repayments, using smart cards readable at devices placed in STD PCOs. Though the initial experiment has not been successful, due to a combination of technical and financial reasons, it certainly established that there is a market for “nano-credit” (loans below Rs 5000 or \$100) which can be profitably and efficiently served using sophisticated ICT.

Offering Composite Microfinance Services

A recent set of studies sponsored by the Institute for Development Policy and Management, UK, (Ruthven, 2001; Patole and Ruthven, 2001), found that the extent of financial transactions (both borrowing and lending, often simultaneously, and at all levels of income) characterised the financial life of the poor. The aggregate financial transactions were between 113% to 167% of the income levels of the very poor and the poor respectively, in rural Allahabad and 149% to 135% in urban Delhi slums. The poor are thus constantly borrowing, lending, saving, withdrawing, using and losing money, through contingencies, and calamities. They need someone to help them with all these transactions, not in a specialised but a composite way. To use the paradigm suggested by Morduch and Rutherford (2003) in this volume, the poor need “convenience, reliability, continuity, and a flexible range of services financial services”.

Thus as seen by the poor, the specialisation developed by the financial sector is perhaps dysfunctional. What they need is a composite service which provides them at least the three main components, savings, credit and insurance, and perhaps add on a few services such as money transfer, which is increasingly needed by the poor as part of the family migrates in search of a livelihood. There are only a few examples of composite financial services, mostly to be found among MFIs. The three top MFIs of India, are all trying to offer a composite set of services to their customers, in spite of a fragmented and unsupportive regulatory framework. For example,

- SEWA Ahmedabad provides a combination of savings and credit through its Sri Mahila SEWA Urban Cooperative Bank and insurance services managed through its Vimo SEWA affiliate, which front ends for the LIC and a number of general insurance companies.
- SHARE in Andhra Pradesh provides savings services to its members through the Sneha Mutually Aided Cooperative Society (MACS), in the same weekly meeting where they gather to repay loan instalments and seek fresh loans from Share Microfin Ltd, the NBFC. The members also insured against death.
- The BASIX group’s Krishna Bhima Samruddhi Local Area Bank, is able to provide all the services – savings, including daily deposits collected from the doorstep of its borrowers, credit for a range of purposes from crop loans to non-farm activities and to SHGs; and crop insurance to farmers under the Kisan Credit Card / Rashtriya Krishi Bima Yojana. BASIX retails life insurance on behalf of AVIVA Life Insurance Company and provides livestock insurance to its borrowers through Royal Sundaram General Insurance Company.

What is the logic for such composite services? As far as the poor are concerned, it reduces their problem of having to deal with a number of agencies and thus reduces the transactions costs. Moreover, if they are good savers in an agency's record, but want to borrow from another, this does not count in the absence of credit history registries. But if the agency is a composite and has a good internal MIS, it can use the savings history as a "collateral" for loans. Similarly, if the same agency provides insurance for lives or livelihoods, it will be more willing to give a loan. From the MFIs' point of view, transaction costs come down as the same delivery system can be used, with the addition of training, software and some staff. There is need for regulators to also look at this issue. It may even be time to think about a Microfinance Services Act, which would recognise the composite and special needs of the poor and of institutions serving them.

Need for Changes in Regulatory Framework

Need for Strategic Attention by the GoI and RBI

Microfinance in India suffers from the fact that it is not the official responsibility of any particular department in the Government of India or in the Reserve Bank of India. For example, the Banking and Insurance Division of the Ministry of Finance has a Joint Secretary in charge of priority sector lending, but that is a much bigger category than micro finance and includes things like credit to small scale industry, agriculture, exports, small road transport operators, professionals and self employed. On the other hand, the Joint Secretary, SGSY, in the Ministry of rural Development is much more concerned about micro-credit, since the SGSY program cannot move forward unless banks give out the loan component. Neither, in any case looks after issues other than microcredit.

In the Reserve bank of India, similarly, the Rural Planning and Credit Department looks after all rural lending (including things like Rs 3 lakh tractor loans) and micro finance is a small subset of its charge. On the other hand, a number of issues effecting MFIs are handled by other departments, such as the Department of Non-Banking Supervision, which looks after NBFCs, and the Exchange Control Department. There is no department to look at the needs of urban micro-credit.

This lack of a single point of oversight for the sector is a major lacuna. It has been recommended by a number of task forces that micro finance should be brought within the purview of the Banking and Insurance Division of the Ministry of Finance by redesignating one of the Joint Secretaries as JS (Micro Finance). Similarly, in the RBI, a special cell for microfinance, which was constituted to process the 1999 Task Force report and was dissolved thereafter, needs to be re-established so as to coordinate across various RBI departments and with the GoI, NABARD, SFMC, Sa-Dhan and the major MFIs. There is also a continuing need for the sort of group established by the Prime Minister's Office in 2001 on financial flows to the informal sector.

Banks and Insurance Companies to Have Universal Service Obligation

The next most important change that needs to be made in the policy thinking is the need to establish the equivalent of the universal services obligation for banks and insurance companies. This concept is widely accepted in case of other infrastructure utilities such as telecom and electric power. Yet for something as fundamental as savings and credit services, the Reserve Bank of India does not assure that these are available to all and thus over two-

thirds of the productive enterprises and farmers in the country do not even have bank accounts, leave alone credit.

The regulator should be held accountable for market development and ensuring that a reasonable level of service by mutually competing service providers is available to all citizens of India and in all parts of the country, without discrimination. We cannot have a situation where the regulator accepts for decades a credit deposit ratio of 20-30 percent for all the states in the eastern and north-eastern regions. It is not enough to hold banks accountable for this, the RBI has the responsibility as well. The present definition of the priority sector is so broad that loans of a few crore to diamond polishing small scale units in Surat also counts as priority. This needs to be tightened to its original intent. At the same time, interest rates on priority lending should be deregulated so as to encourage banks to look at this as a profitable business. The same thinking should be applied to premiums on small insurance policies.

Need for a Graduated Legal and Regulatory Structure for Microfinance

The MFIs will benefit substantially by the streamlining of an appropriate legal and regulatory structure for them. Given the fact that most MFIs are NGOs to start with, we suggest the following step-wise legal and regulatory structure (see table below).

The main changes from the existing regulation is to establish a specialised NBFC for microfinance with Rs 25 lakh as a start up equity instead of Rs 200 lakh at present. The second change suggested is to reduce the entry level equity requirement for three district local area banks from Rs 500 lakh to Rs 100 lakh. In both cases, we are recommending that capital adequacy of 20 percent be maintained as the loan assets of these entities grow. The reduction in capital requirement is only at the start.

Finally, in line with nearly 40 other countries it is time that India thought of allowing the establishment of RBI licensed microfinance banks. These should be allowed, like the RRBs to undertake lending only to micro finance customers as defined by RBI and should be allowed to take deposits from anyone. Since they would have an all India licence, they should be bringing in at least Rs 25 crore of equity at start up and thereafter maintain a capital adequacy of 12.5 percent. All the other prudential norms should be applicable, save and except the requirement that no more than 15 percent of the portfolio be unsecured, since a large part of micro finance loans are unsecured.

Similarly, the IRDA needs to examine ways to reduce the capital requirements for insurance companies or cooperatives which would be engaged in micro-insurance exclusively. There should be a provision for insurance mutuals at lower entry level capital, but perhaps with mandatory re-insurance.

Proposed legal forms, capital requirement and regulatory framework for MFIs

Legal Form	Minimum Capital Requirement and capital adequacy	To be regulated by	Functions Allowed
NGO-Society or Trust	Nil but limit micro-credit outstandings to Rs 50 lakh	Self –Regulating Organisation (SRO)	Only micro-credit up to Rs 20 lakhs
Section 25 company	Rs 5 lakh, but limit micro-credit outstandings to Rs 50 lakh	SRO and Registrar of Companies	Micro –credit and insurance retailing
Microfinance	Rs 25 lakh and 20 percent	RBI	Micro-credit, savings

Non-Banking Finance Company	of risk assets after Rs 125 lakh of risk assets.		from borrowers and insurance retailing
Microfinance Local Area Bank	Rs 100 lakh and 20 percent of risk assets after Rs 500 lakh of risk assets.	RBI – DBS	Micro-credit, savings and insurance retailing, limited to 3-5 districts
Micro Finance Bank	Rs 25 crore and 12.5 percent of risk assets after Rs 200 crore of risk assets.	RBI – DBS	Same as above but with no area restriction. Some changes in prudential norms needed.
Mutual Insurance cooperatives	At present Rs 110 crore, to be reduced appropriately	IRDA	Allow to offer life and livelihoods insurance by this to members, with reinsurance

Encouraging Multiple Sources of Equity and ECBs to MFIs

In order to ensure that MFIs have a possibility of being incubated, a number of sources for equity need to be encouraged. Since NGOs are often the progenitors of MFIs, they should be allowed to invest in MFI equity. This is currently not allowed due to the charitable status of NGOs under the Section 11 and 12 of the Income Tax Act. However, the government can use the provision of Section 11(4)(xii) of the IT Act which gives the power to allow charitable entities to invest in specified securities. This could be used to permit investments in selected MFIs meeting pre-specified criteria so that the danger of misuse is limited. Another route would be to encourage equity investments in MFIs by the new generation private banks, which today do not have an extensive branch network, particularly in rural areas and small towns. They could thus be investing in MFIs as compared to say, ATM networks. Conceptually both are ways of extending outreach to customers.

Third, equity investment by foreign donors, development finance institutions and persons of Indian origin should be encouraged. While this is allowed at present, the minimum amount allowed is \$ 500,000 which far too high for most such investors and indeed for most recipients. This is particularly so because the foreign equity cannot be more than 51 percent and bringing in \$ 500,000 requires raising an equal amount (almost Rs 2.3 crore) from India. This is much too high for requirement of most specialised MFI NBFCs. Finally, the only source of equity in India, the SIDBI Foundation for Micro Credit (SFMC) should be encouraged to disburse from its DFID supported MFI equity fund of Rs 45 crore.

In addition to equity funds, MFIs need lending funds, which at present they can only raise as loans. While Indian banks have been lending more easily to MFIs than earlier, the supply is still limited. Till 2002, a number of foreign donors and development finance institutions were lending money to MFIs under the external Commercial borrowing scheme, which had been considerably simplified by the RBI over the years. However, in 2002, the RBI has stopped allowing ECBs to NGO-MFIs and from donor agencies, on the grounds that neither are regulated financial institutions. Given the fact that the country has over \$ 80 billion of foreign exchange reserves, there is no reason why the RBI should stop small ECBs of 1 or 2 million dollars when the lender and the borrower are legitimate and agree on the terms.

Permitting MFIs to Take Savings with Safeguards

However, borrowings cannot be the sole or the long term source of funds for lending. Thus, MFIs have to be allowed to take deposits. While, the RBI is rightly concerned about allowing deposit taking to loosely regulated entities the safeguard we suggest is to confine the deposit taking by MFIs to only its borrowers and to impose an appropriate level of Statutory

Liquidity Reserve. This can be monitored on a quarterly basis and any misuse should be dealt with by closure of the concerned MFI. Given the fact that the poor need to save much more than they need to borrow, the offering of saving services by MFIs is useful for this purpose also.

Another problem is that regulations, such as high entry-level capital requirements, restrictions on deposit taking and on use of agents, upper limits on unsecured part of the loan portfolios, are all designed for the mainstream financial sector. The regulators, jointly with the MFIs, must also evolve prudential norms which are more appropriate to institutions serving the poor and set up supervision mechanisms around those.

How the conventional wisdom of financial sector regulation is not always right for the good of the majority can be seen from an article on the Bank for Agriculture and Agricultural Credit, (BAAC), Thailand, by Townsend and Yaron (2002). They have taken a contrarian view of the real worth of development banks, even if those are subsidised, as the BAAC is. They describe the de facto operations of BAAC, which includes roll-overs of loans to farmers in bad years, thereby offering a kind of insurance-cum-loan package. These roll-overs, earlier criticised as attempts to disguise defaults, are now seen as a form of welfare enhancing device for farmers, who can continue to access cheap credit the following year and then repay both the current and the earlier loans. They conclude:

“the bottom line, and the main policy implication of the article, is a new system for the evaluation of financial institutions, including state development banks, which should not be assessed merely on their financial profitability grounds... Overly stringent and ill-conceived regulation of financial institutions...can have welfare-reducing effects...financial institutions with dear accounts and reasonable profit margins may fail nevertheless to provide desirable financial services...likewise financial institutions in developing countries that allow exceptions and delayed repayments should not be judged a priori to be inefficient as was the BAAC...”

Enhancing Institutional Capacity

The banyan tree and bonsai metaphor really comes to mind when one focuses attention on issues of institutional capacity building for microfinance in India. We deal with this in three streams:

Cooperatives, including SHG Federations, Banks and MFIs. Each of these have shown the promise to grow into Banyan trees but the promise has been belied and their effectiveness limited by a variety of factors.

Cooperatives were the original modality conceived to deliver “microfinance” – at that time mainly agricultural credit. Starting as early as 1904, the sector received increasing levels of state patronage which eventually became state control. The growth of institutions in the cooperative sector has been inhibited because of state cooperative laws permitting, indeed encouraging, interference by the government in the day-to-day affairs of the cooperatives. While these laws are extant in states like Tamilnadu, the government can appoint an administrator, supercede the elected board, defer or cancel elections, appoint auditors and so on. This has made cooperatives effectively into government departments. Yet, credit for agriculture, the most important livelihood, is largely supposed to be extended through this channel. It is only when it became apparent that this channel is not working that alternatives were established for agricultural credit through commercial banks (which were nationalised partly for this objective) and then the network of Regional Rural Banks (RRBs). The laws related to cooperatives have been reformed in some states, with Andhra Pradesh leading in

1995, and similar laws spreading to the Madhya Pradesh, Chhattisgarh, Bihar, Jharkhand, Uttaranchal, Rajasthan, Punjab, Jammu and Kashmir, Orissa and Karnataka.

In AP, over 2600 mutually aided thrift and credit cooperatives (MACS) have sprung up since the 1995 Act was promulgated. This modality is found to be quite useful for establishing community based microfinance institutions, as has been done in a concentrated way in Karimnagar and Warangal districts by the Cooperative development Foundation (CDF, renamed in 2003 as Saha Vikasa). Unlike CDF, which promotes MACS of 300-500 members living a village or two-three nearby villages, the other design that has emerged in AP is to establish MACS of self-help groups. Such SHG federations are gain at two levels – at the village, comprising 10-15 SHGs in a village, and at the higher level, comprising 100-300 SHGs in a cluster/mandal of 20-20 villages.

However, a number of “top-down” MACS have also been established, either by enthusiastic government officials or by promoters where the erstwhile government control has been replaced by “promoter control” and member involvement is limited to carrying out transactions. These MACS are already showing signs of a number of shortcomings of earlier generation cooperatives, such as cornering of funds by a few member-“leaders”, lack of accounts and accountability, and dependence on outside funds and human resources. Thus the lesson is that capacity building of microfinance institutions has to be done step by step and from the bottom up, by patient support agencies like the CDF. In their absence, the chances of truly member-managed cooperatives emerging are little.

In the formal banking sector, an attempt was made to establish a second tier of banks, the RRBs, aimed at the rural, micro market, as far back as 1976. But, with few exceptions, RRBs have been stunted by a three way split in their ownership (50 percent, Government of India, 35 percent Sponsor bank and 15 percent, State Government), with the main shareholder too distant and distracted to play an effective governance role. Thus, the RRBs suffered and never achieved more than 8 percent of the total formal institutional credit in rural areas. Since 1996, their mandate to serve exclusively the small and marginal farmers, landless labourers and rural artisans was diluted and RRBs were allowed to lend up to 60 percent of their advances to the “non-target group”. The Credit-Deposit ratio of RRBs as a whole is at around 40 percent and a majority of RRBs continue to have low capital adequacy if not negative net worth, in spite of recapitalisation. Thus the RRB story is a case of neither access nor sustainability. The issue of delivering microfinance through banks remains unresolved, though the SHG-Bank linkage program is promising in this respect. The Ministry of Finance appointed Chalapati Rao Committee to Review RRBs (2002) has made a number of recommendations to improve the governance, management, operations and products of RRBs and make them more oriented to their original target group. These must be implemented forthwith.

For MFIs, institutional capacity building has been inhibited because MFIs are often NGOs and microfinance is just one of a suite of development interventions used by them. This has had implications for the type of skill sets drawn to the sector as well as scope and ambition of such initiatives. The MFI sector, with few exceptions, has not been able to attract talent from the mainstream financial sector. Nor has it been able to attract mainstream capital. For this to happen, at least the larger NGOs’ microfinance programs have to be moved over to newly incorporated non-bank finance companies (NBFCs) or even Local Area Banks

Conclusion

The microfinance sector in India cannot be seen in isolation of the overall economy – the economy comprising nearly 110 million agricultural holdings, over 60 percent of those with an area below 1 hectare, and nearly 35 million non-agricultural enterprises. The financial system of India must respond to this large base, only one-third of which is perhaps reached by the formal sector in any significant way. The thrust of the policy since the onset of financial sector reform in 1993 has been on restoring the profitability of banks and reducing their non-performing portfolios without adequate attention to outreach. The stark reduction of bank credit proportion to small borrowers from 18 percent in 1994 to 5.3 percent in 2002 shows that the challenge of extending financial services, at least to all the productive citizens of the country, must be tackled afresh. The microfinance sector, particularly the Self-Help Group – bank linkage program appears to have the potential of becoming a big banyan tree (including the adage that nothing may grow under its shade). However, if we review the details of the microfinance efforts in the last two decades, the image that comes to mind is that of a bonsai. There is a need for a policy and regulatory thrust to facilitate not banyan trees but a bio-diverse forest, with plurality of institutions and methods in symbiosis with each other. And the mainstream must play its role in this bio-diverse forest.

The citizens of this country have a right to demand that basic financial services be universally be available at reasonable rates and from a number of mutually competing sources. Regulatory authorities, particularly the RBI, need to accept their responsibility for the state of affairs where banks shirk from serving over two-thirds of India's households. Thus "universal service obligations" must be imposed on banks and insurance companies. At the same time, regulations on interest rates and insurance premiums and use of any type of distribution methodology or intermediary must be removed so that the service providers can address this market profitably and out of self-interest rather than as a social obligation.

The regulators must also evolve a framework, if necessary jointly between the RBI and the IRDA, to ensure that the poor get access to composite financial services and do not have to deal with four different entities for savings, credit, life insurance and livelihood insurance needs. The use of advanced information and communication technologies and multiple methodologies must be encouraged, to lower costs and promote competitive services. For this, the regulations related to the legal framework, entry-level capital, raising equity and borrowings, and deposit-taking, need to be reworked to encourage a larger number of players to enter this field and provide reliable microfinance services on a sustainable basis.

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