1. CREDIT AND RURAL POOR
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1.1 INTRODUCTION

Rural financial institutions have a pivotal role in the development of the rural economy, as they provide a positive institutional alternative to the exploitative moneylender, on the one hand, and promote livelihood options through enhancing the availability of credit for productive investment, on the other (Banerjee and Newman, 1993; 1994). However, theoretical and empirical literature on rural credit markets have demonstrated that rural credit market as an institution has not been able to fulfil its objective efficiently in meeting the credit needs of the poor in the low income countries.\footnote{See literature on characteristics of the rural credit market in developing countries in Adams and Vogel, 1986; Braverman and Gaush, 1986; Conning and Udry, 2005.} The low participation of formal financial institutions has often been attributed to the high costs of transactions, lack of reliable collateral (limited liability restriction), high covariant risks, segmented markets and large seasonal fluctuations in rural areas in the demand or/and supply of short-term financial resources. Recognising the bottlenecks in institutional credit delivery to the poor, the low income countries, having large underdeveloped rural economy, have emphasised on targeted credit delivery programmes to expand the outreach of the formal lenders to the rural poor. Undoubtedly, such welfare oriented government policies have led to significant improvement in network of commercial banking in rural areas, as experienced in India during the pre-reform period (Shetty, 2004). But a large number of studies of rural financial markets in many low income countries, including India, have concluded that the directed subsidised credit allocation has failed to drive the moneylender out of the market, despite the progress of institutional alternatives. Further, the interest rates charged by the moneylenders remain unchanged, even after the increasing intervention of institutional agencies in rural credit market (Hoff and Stiglitz, 1990). Besides, such policies have suffered from improper targeting and political intervention in credit allocation that severely affected the state of health of formal financial institutions due to mounting loan loss and huge non-performing assets (Adams \textit{et al.}, 1984).
While traditional explanations of the fundamental imperfections in rural financial markets analysed them on the basis of interest rate determination, the new strand of economic literature explains the causes of imperfections by their alliance with information asymmetry and the subsequent adverse selection and moral hazard problems. This leads to allocation inefficiency and bias in favour of premium loans and wealthy borrowers; and therefore, the less-qualified loan demand remains unfulfilled by the formal sector (Hoff and Stiglitz, 1990; Besley, 1994). A famous theoretical explanation of such problems suggested the use of credit rationing (the number or size of loans) as a tool to respond to the problem of adverse selection and moral hazard (Stiglitz and Weiss, 1981). A number of theoretical and empirical studies have found the persistence of credit rationing and also the extent of quantity rationing by different lenders in rural areas of low income countries which is mainly attributed to lack of feasible collateral by a large section of population and the consequent problem of limited liability restriction of the lender.

The existence of wide disparity in wealth in the rural areas can create non-degenerate processes of growth by limiting the access of capital to certain section of population - those above a minimum level of wealth to become eligible for the loanable fund, as hypothesised by Banerjee and Newman (1993). Further, Banerjee and Newman (1994) have analysed the dynamic effects of lack of access to credit which may push the poor to a poverty trap. Similarly, Bell (1990) did point out a pessimist hypothesis

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3 See Carter, 1988; Aleem, 1990 among others.
4 Also see Aghion and Bolton (1997).
5 The hypothesis that credit market imperfections lead to poverty traps can be found in Gator and Zeira (1993). But, Banerjee and Newman (1994) explained the conditions which lead to generation of poverty trap under capital market imperfections, and according to them the critical determinant of such process is the initial wealth positions of households. In their analysis the poor are often not able to meet the incentive-compatibility condition of the formal lender which depends on a critical level of wealth and it varies according to loan size. Therefore, lower the level of wealth lower will be the probability of getting a loan, mainly because the lender will face enforcement problem as the poor are less afraid of the threat (The poor are closer to the lower bound on their utility than the rest of the population. So, threats of punishment work less well against the poor than against others. The poor behaves as if they have nothing to loose.), and consequently, they will be less willing to repay. As against this, higher the level of wealth higher will be the loan size as long as it satisfies the incentive compatibility condition. In case of large share of poor than the rich, the labour market will not be competitive for the poor, so wages will not be high enough to raise the wealth position of the poor. Having no access to capital market they will have no choice of occupation other than depending on wage work, which will never be able to accelerate their wealth accumulation rather it will create further dampening effects. Conversely, the process of wealth accumulation of the rich entrepreneurs will be high and they will be able to borrow more with higher the level of wealth accumulation. Therefore, “dispersed wealth distributions lead to dispersed income distributions, which in turn engender dispersed future wealth distributions” (Banerjee and Newman, 1994, page 214).
that in backward region the institutional lenders will not be able to meet the credit needs of the poor because of demand side problems. These explanations have pointed to the limits of rural poor, particularly in backward regions, in accessing institutional credit mainly because of lack of collateral. To overcome such restrictions in access of capital by the poor, the recent group-based credit innovation schemes have become popular in usage. These schemes remove the restriction of physical collateral and instead, suggest social collateral (a restricted form of it is joint liability) through peer selection, peer monitoring and peer pressure which works for better repayment performance and thereby, encourages the lender to participate in the market. So, this helps in solving the problem of lender as also the borrower in this new form of contractual arrangement. Grameen Bank of Bangladesh is the pioneer of this most popular group-based credit mechanism. However, there are other important variants of this method as well, which modified Grameen’s design in an attempt to localize the contract design. For example, the solidarity model followed in Latin American countries and the Self-Help Group (SHG) model promoted by NABARD in India are also group-based credit arrangements, which do not use one of the basic premises of Grameen, viz. joint liability. Literature also suggests that the group-based credit arrangements not only solve the problem of limited liability restriction for the lender and the borrower, they also reduce transaction costs for both of them (Huppi and Feder, 1990).

This study is primarily motivated by three propositions evinced from the existing literature. First, the theoretical analysis of Banerjee and Newman (1993, 1994), which provides a dynamic account of institutional change as the driving force in determining occupational structure and the process of development. It tests the hypothesis that in a backward region where the proportion of poor is much higher to the economically better-off population, with limited liability restrictions the poor would not be able to access capital and, therefore, a larger section of them remain as wage labour whereas the rich (having access to capital) becomes the entrepreneurial class and, therefore, the gap between the two widens over the period, with the later being able to appropriate the surpluses. Second, Bell’s (1990) study of Indian villages pointed out

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7 See URL:http://www.grameen-info.org/bank/index.htm
8 In Grameen’s group-based credit methods, the external lender requires borrowers to form small groups whose members are to assume responsibility for ensuring the repayment of each other’s loans.
the inability of the institutional financial sector in serving the credit needs of the poor, particularly in the backward regions, because of constraints arising from the demand side and therefore, he suggested that intervention in the credit market will do little to remedy the miserable conditions of life for the people of such areas, rather government poverty alleviation programmes should be promoted. Third, the premises of group-based credit arrangements suggests that the instrument of peer selection, peer monitoring and social collateral can deal with the problems of information asymmetry and improve repayment rates (Stiglitz, 1990; Besley and Coate, 1995; Aghion, 1999; Aghion and Gollier, 2000). Theoretical as well as empirical studies have analysed the innovativeness of the new form of credit arrangements and suggested that they may encourage the formal lender as well as the borrower, particularly the poor, to participate in the rural financial market.

Therefore, it can be argued that the premises of group-based credit arrangements help in removing the imperfections in formal credit market, arising out of adverse selection and moral hazard, and thereby, improve credit access by the poor in rural areas, even in backward regions. Thus, within the framework of Banerjee and Newman (1993; 1994) access to capital will help the poor or the small farmers in diversifying their livelihood options and thereby dismantle the poverty trap and the process of economic development will be faster. However, the proposition needs to be tested empirically, particularly focussing on backward regions, which makes certain research questions of this study pertinent: Does removal of limited liability restriction in group-based credit programmes increase the access of formal sector credit to rural poor? Does repayment condition improve in group-based credit arrangements? Does access of credit to the poor diversifies the household production and employment choices? Before looking at the abovementioned questions, it is prudent to understand the deficiencies in the rural credit market that can impede credit access to the poor borrower. The following section succinctly overviews these factors.

9 The theoretical studies have mostly concentrated upon group-based credit arrangements with joint liability. The concept is pioneered by Grameen Bank in Bangladesh and now practised by a wide number of institutions around the world. But, there are other variants of group-based credit contracts as well which do not use joint liability. India’s SHG-Bank linkage model or government promoted group-based credit programmes follow the later category of institutions.
1.2 DEFICIENCIES IN INSTITUTIONAL CREDIT ACCESS BY RURAL POOR – A THEORETICAL OVERVIEW

1.2.1 The Supply Side

1.2.1.1 The Traditional View

When rural financial markets are analysed by the classical perfectly competitive market conditions, high interest rate has been explained as the correcting factor for high default risks that the moneylender internalises (Bottomley, 1963a; 1963b; 1964; 1975; Nisbet, 1967). But, the inability of commercial banks to take advantage of such a market has been the subject matter of research even today. A common explanation is given by the lack of collaterisable asset or the limited liability restriction of the lender arising out of default risk of the loan. Default risk of the loan is calculated by the probability that a certain portion of loan may not be repaid. It implies that the portion of loan which is not covered by collateral (which is recoverable) is under default risk. In extreme case, if the loan is not given on the basis of any physical collateral at present, rather on the basis of future harvest, then the entire loan amount is under default risk. Therefore, it is necessary for the lender to incorporate this default risk into his earning function to arrive at break even. Such an explanation justifies the prevalence of high rate of interest charged by the moneylenders in local financial markets (Bottomley, 1963a; 1963b). Bottomley attributed this market clearing high rate of interest as a premium for lender's risk (Also see Nisbet, 1967). While moneylenders can perform efficiently in such markets, what restricts the intervention of commercial banks? The main problem that the commercial banks face in these markets is the absence of recognisable physical collateral. Often, the poor borrower extends future harvest as the collateral or labour service as the collateral which the organised financial market does not recognise. But, moneylenders or the employers, using their advantage of local knowledge and personalised relationship with the borrower, agree to extend loan by keeping such future returns as collateral for which they charge the high rate of interest and the borrower without having any option agrees with the terms of these lenders.

The above proposition has been contradicted and debated by another strong proposition that the prevalence of high interest rates in rural financial markets is not
due to lender's risk. Rather, it is the result of high monopoly power of moneylender over the tenant borrowers, a phenomenon mostly prevalent under semi-feudal agriculture (Bhaduri, 1973; 1977). Bhaduri’s arguments suggest that the borrower remains perpetually indebted to the agriculturist moneylender. While both the arguments have their acceptance as also critic by different schools of thought\textsuperscript{10}, there is still no conclusive evidence on the reason for prevailing high rate of interest in informal rural financial markets (Srivastava, 1987). Despite the high rate of interest charged by the informal lenders, and the remarkable recovery rates of the loans, the commercial banks have not been able to penetrate much into rural credit market. McKinnon (1973) and Shaw (1973) argued that the failure of commercial banks in rural financial markets may be seen as a result of government intervention which puts ceilings on interest rate, and thereby makes the lending operations of banks unprofitable. While interest rate fixing partly explains the credit market behaviour, there are other features of rural credit market that are completely overlooked by this view. Hoff and Stiglitz (1990) pointed out some of the other features of rural credit market that include;

- The formal and informal sectors coexist despite the fact that formal interest rates are substantially lower than those of the informal lenders.
- Interest rates may not be able to bring equilibrium in supply and demand for credit and there may be ‘credit rationing’, and in periods of bad harvest, lending may be unavailable at any price.
- Existence of segmented credit market. Often the variation in interest rates across regions or across borrowers may be out of proportion to calculated default risk.
- Existence of interlinkage of credit transactions with other markets is another notable feature of rural credit market.

In order to analyse such features of rural credit market, a number of new tools of analysis have emerged in the past few years. It is discussed in the following section.

\textsuperscript{10} Even Bhaduri’s proposition of technological innovations leading to lower loan demand of the tenants is contested by Srinivasan (1979) and Braverman and Stiglitz (1986b).
1.2.1.2 The Problem of Information Asymmetry

The lenders’ problem is explained to a large extent by the emergence of a new approach of analysis of rural credit markets which is known as imperfect information and imperfect enforcement paradigm (Hoff and Stiglitz, 1990). The main argument of this school of thought as against the traditional view is that, although interest rate serves the important role of screening mechanism, the equilibrium interest rate need not clear the market and therefore, there may be credit rationing (Jaffe and Russel, 1976; Stiglitz and Weiss, 1981). The two popular notions of information problem which lead to credit rationing are adverse selection and moral hazard.

Under the risk sharing framework, higher the risk of default higher should be the rate of interest. By dividing borrowers into risky type and safe type on the basis of their expected returns from the project, Stiglitz and Weiss (1981) argued that at higher rate of interest only the former will demand loan, as they have lower probability of return while the safe type borrowers will stay away from borrowing (they assume that the returns on safe type projects are lower than the returns on risky type projects). The lender will ultimately incur high losses. Therefore, interest rate is serving a dual role in which it has an allocative role of equating supply and demand for loanable funds and it also affects the quality of lender’s loan portfolio. Therefore, in order to minimise the risk of adverse selection Stiglitz and Weiss (1981) suggested that the lender may be better off by rationing access to credit at a lower rate of interest rather than raising the interest rate further. In their mechanism the solution lies in collateral guarantees. Supporting this argument, several scholars have demonstrated that when available collateral is not sufficient to completely guarantee loans, rationing may occur in loan size or number (Gale and Hellwig 1985, Carter 1988). Similarly, Banerjee and Newman (1993; 1994) have demonstrated the lack of access of capital due to lack of adequate feasible collateral and the subsequent perpetual deprivation of the poor.

11 Contrary to the assumption of Stiglitz and Weiss (1981), DeMeza and Webb (1987) assumed that good projects more likely to yield good returns. But they also suppose, as do Stiglitz and Weiss, that the market functions under the imperfect information paradigm. However, their conclusion supported that of Stiglitz and Weiss which says at any given interest rate, set to break even at the average quality of project funded, some projects with a negative social return will be financed. Thus the competitive equilibrium has socially excessive investment levels (as quoted in Besley, 1994).
Stiglitz and Weiss (1981) also analysed the instrument of rationing as a solution to the problem of moral hazard. Moral hazard can arise when lenders are unable to discern borrowers’ actions. In other words, the failure of a project may be due to lowering of effort of the borrower which the lender cannot monitor. Under the imperfect information conditions, the lender’s risk is higher while it enters into contractual arrangement with the borrower. Had it known about the future lowering of effort by the borrower, the contractual agreement would have been different\textsuperscript{12}. While recognising the presence of moral hazard in any type of contract, Stiglitz and Weiss (1981) argued that riskier projects are more attractive at higher interest rates because, at higher rate, the borrower will prefer a project that has a lower probability of being repaid. So, higher interest rate may have a counterproductive effect on lenders’ profit because of its adverse effects on borrowers’ incentives. Once again, Stiglitz and Weiss (1981) suggested credit rationing as a corrective measure for bringing equilibrium between borrowers’ incentives and lenders’ return\textsuperscript{13}.

1.2.1.3 The Problem of Enforcement

The issue of loan repayment constitutes the central problem of rural credit markets in developing countries. Besley (1994) defines a pure enforcement problem is a situation in which the borrower is able but unwilling to repay. This is also an important constraint for the lender because the costs of enforcement are high once the borrower defaults. Indeed, the costs of sanctions, such as seizing collateral, may not be the only cost involved. Khan (1979) demonstrated from a study on Bangladesh that rich farmers who failed to repay are not penalised because the political costs are too high. Similar evidences of political capture are noted from studies in India (Dreze, 1990; Gaiha, 2001a).

Further, Besley (1994) pointed out that another kind of enforcement problem arises in case of poor development of property rights. According to this, in developing countries the ability to foreclose on many assets is a complex procedure, mainly

\textsuperscript{12} Also see Stiglitz (1974) where moral hazard is analysed in case of sharecropping and actions of tenants.

\textsuperscript{13} The above analysis assumed that borrowers have access to one lender. Bell \textit{et al.} (1997) argued that the problem of moral hazard may persist while the borrower has access to more than one lender, often mixing both formal and informal lenders. Further, if borrower undertakes several projects funded from different sources, effort on each project may not be separable, so that the terms of each loan contract may affect the other lenders.
because of ill defined property rights. For example, although land is generally used as collateral for extending loans, the foreclosure of land by the formal lender in case of default is not very simple. In many cases the rights to land are usufuctual, which is based on user rights to land, and have a limited value of the land as collateral. The court practices in foreclosing by the lender or its reclaim by the borrower are not fare. Such difficulties of enforcement discourage the formal lenders to intervene in the rural credit markets.\textsuperscript{14}

\textbf{1.2.1.4 The Problem of Government Intervention}

The traditional explanation of limited credit supply by formal lenders in rural financial markets was attributed to the intervention of government, in the form of imposing ceilings on interest rate. They explained the prevalence of high rate of interest in the rural informal credit market as a premium for internalising the default risk and therefore, the ceilings on rate of interest makes banking unprofitable with the poor (McKinnon, 1973; Shaw, 1973). However, government intervention has been promoted in many of the developing countries as a welfare measure to provide access of poor to formal credit and also to save them from the exploitation of moneylenders. For example, government intervention in rural banking in India has witnessed significant expansion of commercial branches in rural areas along with substantial credit flow to the poor and vulnerable sections of population until the initiation of the process of financial liberalization in 1991 (Shetty, 2004; Burgess and Pande, 2004).

The regulation of credit market has also led to the launch of directed subsidized credit programmes in the developing countries, for example, Integrated Rural Development Programme in India, a similar programme in Bangladesh etc.

While some have supported the intervention of government in rural credit market as a regulator of interest rate or deciding the direction and coverage of allocation of credit, a large number of scholars have attributed such approach as “repressionary” (McKinnon, 1973; Shaw, 1973; Adams \textit{et al}., 1984). They argued that such policies have undermined rural development because cheap credit leads to credit diversion.\textsuperscript{14}

\textsuperscript{14} However, a number of empirical studies have brought out ambiguous findings on the hypothesis that property rights security will enhance credit supply and/or demand. While some studies have concluded strong and significant effect of farmers secured wealth positions on formal credit supply (Siamwalla \textit{et al}., 1990), others have found muted or insignificant effects (Carter and Olinto, 2003). See more literature in Conning and Udry, 2005.
from production purposes to consumption use, low revenues to the lender and it invites corruption and political intrusion. Further, the subsidized credit and the often bail out of loans for political populism, which has largely benefitted the medium and large farmers more than the targeted small farmers and poor, resulted in mounting loan losses and eroded the financial health of formal lenders, as experienced in India, Thailand, Bolivia, Senegal and other low income countries (Adams, 1971; Gonzalez-Vega, 1977; Ladman et al., 1981; Adams et al., 1984; Burgess and Pande, 2003). In view of above, the critics of subsidized credit programmes have convincingly argued that the failure of banks in providing credit access to poor may be attributed to the repressory policy of concessional interest rate.

1.2.2 The Demand Side

1.2.2.1 Scarce Collateral and Interlinked Transactions

If every loan is backed by sufficient collateral guarantee there would have not been any default risk, in case the borrower defaults. Unfortunately, most of the rural households are poor; they are landless labourers, tenants or small farmers, and they need credit for consumption or for investment (mostly in agriculture) purposes. But, the formal lenders need collateral guarantee which could satisfy their limited liability restriction. When the borrowers do not have such collaterisable asset they are unable to access loan from formal lenders, as mentioned in the above section. Indeed, the denial of loans to poor borrowers is mainly because the formal lender does not recognise the type of collateral security the poor has; for example future harvest of a tenant or labour service of a landless labourer. In such occasions the poor borrowers have to depend on the moneylenders and they often use their monopoly power to exploit the borrowers, as argued by Bhaduri (1973; 1977). While such understanding of credit constraint due to lender's monopoly power has not been accepted by many scholars\(^5\), Bardhan and Rudra (1978) provided interesting understanding of the complexity of operation of rural financial market in the presence of tied credit or the interlinkage of credit with other markets\(^6\). For example, the tenant borrower keeps future harvest as collateral with the landlord and obtains a loan either for investment

\(^{5}\) See Srinivasan, 1979; Braverman and Stiglitz, 1986b; and for more see Srivastava, 1987.

\(^{6}\) Later Floro and Yotopoulos (1991) analysed several types of interlinkages in their study on Philippine informal credit market. They are out of scope of the present analysis.
or for consumption purposes. The landlord provides him a loan because he does not want to lower tenant's productivity as he has a share in the total produce. Similarly, a labour employer can provide a loan to a landless labourer only if the labourer attaches his future labour service to the employer who may need him at time of emergency or scarce labour availability. Further, many of the households obtain loans from retailers or the small farmers obtain loan from traders. A trader offers a loan to a farmer on the promise that the farmer will sell his harvest to him at a pre-determined price. A retailer sells goods on credit in order to maintain his market size. Such evidences indicate that the rural credit market operates with personalised relationship, which means the lenders do not provide all borrowers who can provide such kind of collateral. This kind of segmentation in the rural credit market often takes place along occupational lines and the complementarities of some production relationships (Besley, 1994). Therefore, the rural poor not only fall outside the domain of the organised credit market but their access to informal lenders in the village is also highly restricted (Basu, 1997). The nature of collateral they offer, therefore, determines their lender's profile.

1.2.2.2 Transaction Cost

Adams and Nehman (1979), in their study on rural credit markets in many countries, concluded that borrowers' transaction cost, along with interest payment, acts as a significant determinant in affecting borrowing behaviour. And particularly, they provided evidence of increasing transaction costs from formal lenders which discourages the rural poor from borrowing from these sources. Further, Ladman (1984) argued that in the presence of concessionary rate of interest (through government intervention) lenders rely heavily on borrower transaction costs to ration credit, as observed in his Bolivian case study. In other words, the borrower's transaction cost for obtaining a loan at concessional rate of interest is significantly higher than a normal loan. This is explained by the evidence that a subsidised loan requires a complex procedure and detail documentation and all such costs are borne by the borrower, because the bank obtains low revenue from such loans and therefore, it does not want to bear any cost over it.
1.2.2.3 The Nature of Loan Demand

The rural poor have fluctuating income stream and, therefore, they are vulnerable to a variety of shocks or natural calamities. There may be a bad harvest season, drought or flood or any other external shock in which the small farmer looses the crop and there was also job loss. In such situations the poor demand credit for sustaining their consumption. Similarly, they may need credit for meeting medical expenses, ceremonial expenses etc. Therefore, a large number of loan demands of the poor are consumption loans, which the formal lenders do not consider financing (Bell and Srinivasan, 1985). But these loans add value to the borrower, as Morduch (1995) argued that a labourer may need some small amount of loan today to maintain the consumption level, so that he can provide his labour service tomorrow. Denial of loan, thus, will reduce the productivity of the labourer due to cause of starvation. So consumption smoothening role of credit cannot be ignored, particularly for the very poor. Nevertheless, these loans have never been interesting for the formal lenders because of their proportionately high transaction costs and also the risk of default.

The above discussion, therefore, points out some of the major constraints of rural financial transactions from supply as well as demand side. While such inherent imperfections in the rural credit market exist, scholars have argued for redistributionary policies rather than credit-led intervention for alleviating poverty (Bell, 1990). However, credit has been perceived as an important instrument of innovation since Schumpeter brought out his thesis of finance and economic development in 1912. Recently, scholars like Banerjee and Newman (1993; 1994) have explained the innovative role of credit in correcting the wealth distribution in society through diversifying occupational choice as also employment options, but also cautioned that lack of access to capital market will result in widening the disparities in income in the long run. Similarly, Binswanger and Rosenzweig (1993) argued that the small farmers have good investment opportunities that go unexploited because of high risk and limited access to credit. Such observations demand innovation in the rural credit market to design contractual arrangements so that the poor would get access to financial services from formal lenders. Emergence of microfinance is seen as a welcome step in this regard, which is discussed in the following section.
1.2.3 Microfinance and Credit Access by Rural Poor

We noticed in the above section the supply side as well as the demand side constraints that inhibit the rural poor to access formal credit market. The emergence of microfinance is believed to establish an innovative method of financial provisioning which will not only help access the poor to the formal sector loans, but also encourage the formal lenders supply their service to the rural poor. It has been popular against the so called suspicions among the formal lenders that the poor households are neither credit worthy nor do they have any savings potential (Rutherford, 2000). The innovative methods, particularly those based on the use of peer group-based credit (Grameen in Bangladesh, BancoSol in Bolivia and many such financial institutions offering alternative microfinance models), have demonstrated the success of group-based financial arrangement in overcoming many of the predominant imperfections in rural credit markets and making the financial sector inclusive (Aghion, 1999; Morduch, 1999). The innovative design of the group-based credit institutions can be seen from both the lender’s and the borrower’s perspective. They are discussed as follows.

1.2.3.1 The Supply Side

Can microfinance solve the supply side (lender’s) problems as mentioned in the above section? One of the early explanations in this regard was documented by Huppi and Feder (1990) in which they have argued that the group-based based credit contracts have the potential to provide affordable credit to small farmers because they can reduce transaction costs and lower the risk of default (Huppi and Feder, 1990). They argued that the successful group lending schemes work well with groups that are homogeneous and jointly liable for defaults. The group-based approach suggests that, instead of physical collateral, joint liability through peer selection, peer monitoring and peer pressure works for better repayment performance and thereby, encourages the lender to participate in the market. Grameen Bank of Bangladesh is the pioneer

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17 Some microfinance programmes are not group-based credit arrangements (such as Bank Rakyat and Bank Kredit Desa in Indonesia, FINCA village Bank in Latin America, SEWA Bank in India and similar others elsewhere), but they have also shown success by adopting innovative methods of financial provisioning. However, the present research is focussed on the group-based microfinance programme, which is most widely replicated in many countries of Asia, Africa and Latin America.

of this most popular group-based credit mechanism\(^19\). However, there are other important variants of this method as well, which modified Grameen’s design in an attempt to localise the contract design. For example, the solidarity model followed in Latin American countries and the SHG model promoted by NABARD in India\(^20\). However, one of the most widely replicated microfinance models is Grameen and we first analyse the tenets of the popular Grameen methodology from the lender’s perspective.

One of the fundamental imperfections in the rural credit market arise due to the problems of screening the safe borrowers. As pointed out by early literature, use of interest rates may not be useful in deselecting risky borrowers (Stiglitz and Weiss, 1981). Instead, they suggested rationing as an instrument in bringing credit market equilibrium, but it has been criticised by the fact that rationing limits the access of credit to small farmers and the poor borrowers who lack sufficient collateral (Carter, 1988). Besides, screening the borrowers adds to the transaction cost to the formal lender. As against this, group-lending scheme brings an innovative solution to the problem of screening safe borrowers by providing incentives for homogeneous borrowers to group together (Ghatak, 1999). By the logic of Olson (1965) the group cannot be a mix of risk as well as safe type borrowers, the occurrence of which would threat the sustainability of the group. The reason can be explained by the incentive problem which suggests that the disincentive of cosigners when one member borrower defaults influences to limit the entry of the risky type borrower to the group. Ghatak (1999) argues that this sorting process is instrumental in improving repayment rates, allowing for lower interest rates, and raising social welfare. Wenner (1995) has empirically tested this theory by studying 25 Costa Rican credit groups and concluded that repayment performance was greater among groups who are able to screen the members effectively. Under the premise of joint liability of the group members, scholars have shown that there is no beneficial way for risky and safe type borrowers to group together (Ghatak, 1999; 2000; Morduch, 1999). Further, Ghatak (1999) argues that under group-lending contract the lender can charge differential prices to risky type and safe type borrowers which was not possible under standard individual-

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\(^{19}\) See URL: www.grameen-info.org/bank/

\(^{20}\) These microfinance models are also group-based credit arrangements, but they do not use one of the basic premises of Grameen, viz. joint liability. In Grameen’s group-based credit methods, the external lender requires borrowers to form small groups whose members are to assume responsibility for ensuring the repayment of each other’s loans (other members are ‘cosigners’ to member borrower).
lending contracts. This induces the safe-type borrowers to enter into credit market and the lender, thus, enjoys higher repayment rates. Therefore, peer selection is one of the first and most important instruments in improving lender’s access to rural credit market.

Peer monitoring is largely responsible for the successful functioning of the Grameen Bank of Bangladesh and other similar group-lending programmes elsewhere. It says that the neighbouring member monitors borrower’s activity in managing loanable funds to limit the risk of default. Understandably, if peer group are cosigners to the borrower, they have to return the loan if the borrower defaults. So the peer puts pressure on the borrower to keep prudence in loan use so that he/she should not fall into bankruptcy. Then, borrowers mostly choose safe activities. Peer monitoring, thus, helps increasing repayment rates (Stiglitz, 1990; Varian, 1990; Besley and Coate, 1995). Importantly, the lenders use this instrument to transfer their cost of monitoring to the group. Therefore, it not only benefits the lender in terms of high repayment rate, but also lowers the cost of managing loanable funds, and moreover, it offers a way to lower equilibrium rate of interest rate and raise expected utility of the borrowers (Stiglitz, 1990; Morduch, 1999). In this context, Rashid and Townsend (1994) pointed out that the group-lending approach is superior to the individual-lending contracts provided borrowers are able to monitor one another.

The mechanisms of group-lending, thus, promises to solve the problem of screening that were pervasive in the rural credit market, and it also promises high repayment rates. Under strict conditions group-lending models also provide solution to the enforcement problem. For example, the instrument of joint liability applied by Grameen Bank in Bangladesh says that the cosigners are responsible if the member borrower defaults to repay a particular loan. Otherwise, the entire group will not get any further loan. By such conditions, the Bank ensures the return of the loanable fund without any additional cost. The group exerts pressure (social pressure or sanctions) on its member borrowers to pay back the loan (Besley and Coate, 1995; Aghion,

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21 It may be noted that the level of peer monitoring differs across group-lending programmes depending upon the nature of contract. Under group-lending programmes with joint liability, peer monitoring is associated with penalty imposed on the peer if the borrower defaults. Such examples are Grameen in Bangladesh or BancoSol in Bolivia. In India, the SHGs put emphasis on peer monitoring but their contract with the bank do not have a clause of joint liability. So, often peer monitoring is found to be low and consequently default rates high, as discussed in chapter 7.
To avoid this limitation, there are alternative microfinance models, which do not apply the condition of *joint liability*. Further, that may restrict the group membership to better-off borrowers as many of the poor members would fear to join the group if this condition is applied. For example, in India the popular group-lending programmes that are promoted by government and NABARD do not use *joint liability* as a criterion to ensure better repayment. Rather, they lure the borrowers by designing incentives so that repayment rates would rise. Besides, many a times historic and cultural factors do restrict the use of *joint liability* as a criterion to ensure high repayment rate (Harper, 2005). Nevertheless, group-lending contracts ensure high repayment rate of the lender either in the use of *joint liability* or by incentive provisions, thus, promising a solution to *enforcement problem* of the lender.

### 1.2.3.2 The Demand Side

As discussed in section 1.2, lack of *collaterisable* asset forces the poor and the small farmers to depend on informal credit agencies, such as moneylender, landlord, employer or trader. But, group-based credit contracts relax the requirement of *collaterisable* asset and instead, emphasises on the instrument of *joint responsibility* or *social sanctions* that would ensure repayment rate (Besley and Coate, 1995; Aghion, 1999). While the collateral requirement condition is lifted everybody in the group become eligible for getting a loan from the bank. Therefore, it would help increase the demand for loanable funds from the formal agencies. Understandably, with the functioning of group-lending arrangements the initial level of wealth of household as a determinant of credit allocation would become meaningless.

Repayment incentives tend to increase borrower's participation in formal credit market and also help increase in repayment rates (Besley and Coate, 1995). The repayment initiatives may be in the form of increasingly larger loans or successive loans on concessional rate of interest. Generally, the initial loans are given small in size and then the loan size increases depending upon the satisfactory repayment of the borrower. The repeated nature of the interactions and the credible threat to cut off any future lending motivates the borrower to repay the loan and ensure future goodwill. However, dynamic incentives work better in areas with relatively low mobility than in urban areas. BRI in Indonesia faced greater problem securing repayments in their urban programmes than in their rural ones, which maybe due to greater urban
mobility. Furthermore, if the lending relationship has a clear end, borrowers have incentives to default in the final period. In this respect, dynamic incentives too have limited scope. It is to be noted that the advantages of progressive lending is the ability to test borrowers with small loans at the start and experiment. In fact, it has been found that targeting women clients have shown better results, which is partly due to their relatively less mobility and fewer alternative sources of borrowing than men (Goetz and SenGupta, 1996).

So lifting collateral constraint and designing repayment incentives would influence the members of the group to access formal loans and oblige their repayment according to the schedule. We have noted how group-based credit arrangements attempt to overcome the barriers of credit access to formal lenders by the poor from the lender's as also borrower's perspective. However, the experience of some microfinance institutions are to be examined to know, whether the benefits of microfinance programmes are actually realised or not? This is discussed in the following section.

1.3 EXPERIENCE OF MICROFINANCE INSTITUTIONS

The microfinance movement has demonstrated possibilities of lending to the poor households and has transformed discussions on issues of poverty alleviation. Its popularity has grown across developing as well as developed countries around the World. Particularly, the policy planners in most of the developing countries of Asia, Africa and Latin America are looking at microfinance as a measure to transform the lives of the poor. The development practitioners and institutional lenders are also scrutinizing microfinance as a crucial strategy in the process of building inclusive financial sector (UN, 2006). However, few microfinance programmes have received rigorous statistical evaluations. While theoretical literature has demonstrated the effectiveness and viability of these institutions in lending to the poor, the empirical findings are more often debated by number of studies undertaken in various parts of the world, on account of the possible trade-off between outreach and impact or outreach and sustainability. Such debates have captured the imagination of researchers in view of the fact that large outlay are spent on microfinance programmes in the form of providing start-up capital to the microfinance institutions, support services to the groups, loan subsidies etc. It is, therefore, pertinent to assess the experience of microfinance programmes across countries. However, one does not
have aggregative data on these programmes on any outcome indicator, neither at the global level nor at the regional level. So, one has to mostly draw upon some of the important evaluation studies in specific countries and on specific institutions. Microfinance Information Exchange (MIX) has recently conducted a global survey of 446 major microfinance institutions covering South Asia, Africa and Latin America (MIX, 2006). The present study sums up the results, particularly focusing on South Asian microfinance institutions (MFIs). The analysis is focused on three aspects of microfinance institutions; (a) Outreach (b) Impact and (c) Repayment performance.

1.3.1 Outreach

The global outreach in terms of clients of microfinance institutions (MFIs) has gone above 42 million, as reported by MicroBanking Bulletin (MBB), 2006. MFIs have not only shown expansion in terms of scale of serving clients but also expansion in terms of product types and service delivery methodologies depending on the local requirements. Interestingly, the South Asian MFIs stands alone in scale of credit delivery, serving one in two borrowers globally. The proliferation of Grameen (Bangladesh) replicators and the SHG revolution (India) lie at the heart of the region’s tremendous expansion. One may see from Figure 1.1 that the median outreach of borrowers ranges from around 10,000 in Philippines to as high as 330,000 in Bangladesh (MIX, 2006). It may be pointed out that three of the Bangladeshi MFIs – Grameen, BRAC and ASA – count for nearly 75 percent of the borrowers in South Asia alone. They also lead both regional and global outreach in terms of credit disbursement. However, MIX (2006) reports that there is a boom in the Indian microfinance sector during the recent years. Some of the MFIs like BASIX, SHARE, Spandana and SKS have shown impressive growth of clients. Besides, MIX also reports that the Asian MFIs target the most poor and vulnerable sections of population than other regions of the world. It measures depth of outreach mainly by two indicators; such as average loan balance per borrower and percentage of women clients. Average loan balance of $115 per borrower is reported to be the lowest among all regions around the world, which amounts to only one fifth of local income (Figure 1.2). Further, the Asian MFIs have mostly focused on serving women clients, with the

22 See documentation of a large number of evaluation studies in Sebstad and Chen, 1996.
23 MicroBanking Bulletin is an international organization which collects data on major microfinance institutions (MFI) worldwide, particularly those who register with it.
median outreach of nearly 85 percent of the total clients, which is the highest level experienced among any other regions in the world. However, the MIX does not contain any direct information on borrower’s profile. The measurement of depth of outreach by using the proxy indicators such average loan amount or percentage women borrowers does not give sufficient evidence of targeting the poor, since they are not direct measures of household level of living. Further, they do not provide any information about the poor who are left out by the programme.

Figure 1.1 Number of Active Borrowers (Median) of MFIs in South Asia

![Bar Graph](image1)


Figure 1.2 Depth of Outreach (Median) of MFIs

![Graph](image2)

Other studies have tried different methodologies to estimate the depth of outreach of microfinance programmes. For instance, Grameen in Bangladesh uses a criterion of landholding to identify the poor (those less than 0.5 acres of land). Osmani (1991), Pitt and Khandker (1998), Hossain (1988), Mosley and Hulme (1998) and others have sown that about 95 percent of the loans from Grameen Bank reached the target group, setting aside the rest 5 percent which may be going to the non-target clientele. However, scholars have questioned this argument by measuring depth of outreach from the data on consumption and income of Bangladeshi households before they borrow from Grameen (Amin et al., 2003). They argued that Grameen has been successful at reaching the poor but it is unsuccessful at reaching the group most prone the destitution, the vulnerable poor24. Similar findings are also reported by Navajas et al. (2000) in their study on five major Bolivian microfinance programmes. However, they found that group-based credit institutions have better depth of outreach than those of the individual lenders25. Further, Mosley and Hulme (1998) in their study of 13 microfinance institutions found that targeting of the programme depends on the design principles. Nevertheless, while studies on identifying targeting have been questioned on methodology grounds, the issue has been debated for the possibility of an existing trade-off with sustainability of the programmes, without donor support (Conning, 1999; Bhatt and Tang, 1998).

1.3.2 Impact

Evaluation of microfinance programmes has captured the imagination of researchers, donors and policy markers all around the world. But, there is no empirical study which can give a holistic overview of impact assessment at the household level or at the community level, mainly because of the problems arising due to the diversity of the programmes across regions. However, a number of evaluation studies have been commissioned on Grameen and similar programmes in Bangladesh, as also in other countries. Many of the studies have pointed to the positive change in the income of the beneficiaries26. Some of the major studies and the debates are discussed here. In their study Pitt and Khandker (1998) have argued that programme participation makes a difference to the poor households who are members of Grameen Bank and similar

24 Also see Osmani, 1989.
25 This supports the well established theory of group-based credit (See Conning, 1999; Sadoulet, 1997).
micro-finance programmes in Bangladesh. Khandker (2003) reconfirmed this finding from a follow-up survey of those households. The difference is noticeable in raising per capita income and consumption as well as household net worth, thereby increasing the probability that the programme participants lift themselves out of poverty. Further, they went on to argue that such programmes have spill over effects on the local economy, although the impacts are very small. Nevertheless, micro-finance is significant in Bangladesh for its innovations in rural credit markets and its impact of empowering the poor, especially the women.

Contrary to this proposition, analysing sample households from Grameen and similar programmes, Morduch (1998) argued that the most important potential impacts are associated with the reduction of vulnerability, not of poverty per se. According to his findings the households that are eligible to borrow and have access to the programmes do not have noticeable higher consumption levels than control households, and, for the most part, their children are unlikely to be in school. Further, households eligible for programmes have substantially (and significantly) lower variation in consumption and labour supply across seasons. Zaman (2000) noted somewhat similar findings from a Bangladesh programme (BRAC). He argued that microcredit contributes to mitigating a number of factors that contribute to vulnerability, whereas the impact on income-poverty is a function of borrowing beyond a certain loan threshold and to a certain extent contingent on household’s initial level of living. Similar results are also reported by Diagne and Zeller (2001) in their study of Malawian microfinance programmes.

Hulme and Mosley (1996) in their study of 13 microfinance institutions from seven developing countries of Asia, Africa and Latin America concluded that although the beneficial impact of microfinance programmes are noticeable, they exclude the poorest and moreover, the impact factor depends on the programme characteristics. In their synthesis, they drew attention to an “impact frontier” which explains the trade-off between serving the poorest clients and impact realization (Figure 1.3). They suggested that the tradeoff can often be moved by appropriate innovations in institutional design, in particular modifications to savings, loan collection, and incentive arrangements for borrowers and staff.
1.3.3 Sustainability

Sustainability plays a determining role in targeting and scaling up microfinance activities. It is generally considered at two levels; operational sustainability and financial sustainability. While the former is concerned with revenue generation to cover up the operating costs, the later is defined by whether or not the institution requires subsidised funds in order to operate. While most of the MFI's around the world have crossed the barrier of operational sustainability, many of them have still not been able to attain financial sustainability, particularly those in South Asia (MIX, 2006). However, one of the most studied institutions is Grameen Bank, Bangladesh. It provides largely transparent information on a wide list of performance indicators and scholars have debated over its sustainability by using different methodology of calculation (Pitt and Khandker, 1998; Morduch, 1998). However, most of the other MFI's are reluctant to share their financial data to the researchers. Further, the calculation standard differs across institutions. Therefore, unavailability of comparable data on performance indicators limits the scope of assessing the capacity of the institutions. In view of the above constraints, many researchers have attempted assessing financial sustainability of the MFI's by examining repayment rates or loan...
delinquency rates (Zeller, 1996; Sharma and Zeller, 1997). Their results show that socially cohesive groups pool risks by diversifying the members’ asset portfolio so that their repayment performance is improved even in communities with high-risk exposure. Further, it has been more or less accepted that the success of the institutional arrangement is likely to be dependent on the strength of social cohesion or social relations that facilitate individual action within borrowing groups (Floro and Yotopolous, 1991; Wenner, 1995; Gomez and Santor, 2001).

Nevertheless, most of the microfinance programmes across countries are supported by donor agencies. A number of studies on Grameen Bank and other microfinance models have demonstrated that without donor support (government and/or non-government) there exists a trade-off between targeting and financial efficiency. For example, improving outreach to the poor tend to increase the operating costs of MFIs, as the average loan size and savings would be smaller (Conning, 1999). Indeed, MFIs have remained largely dependent on either concessional credit or donors’ grants and therefore, to function in the absence of donors’ support in a commercially viable manner is a major challenge before them. Examining the challenges faced by various group-lending programmes worldwide, Bhatt and Tang (1998) have illustrated that to be commercially viable, MFIs need to economise on transaction costs for both lenders and borrowers. Therefore, the issue of designing the contract becomes crucial in the success of the programme.

A recent survey of MIX (2006) provides statistics on a wide number of sustainability indicators of the 446 microfinance intuitions across Asia, Africa and Latin America. But, they are not published by organisation wise. Most of the available indicators are calculated in aggregation across the countries or the regions. However, some observations are noteworthy from the study, particularly focussing on South Asian MFIs.

- As MFIs have increased their outreach in the recent years, they now access a range of funding sources to finance this growth.
- South Asian MFIs rely less on voluntary savings to fund their assets. Rather, they depend mostly on debt in the form of compulsory savings and loans.
• Indian MFIs enjoy an unprecedented access to financing by banks and other financial institutions, thereby, making them among the most highly leveraged institutions in the world.

• Operating cost is the lowest among the South Asian MFIs, which has been mainly attributed to the group-based credit programmes. Despite the low cost structure, South Asian MFIs do not fare so well as compared to their global peers in generating profits.

• Portfolio risk weighs more in South Asia than in almost any other regional portfolio (See Figure 1.4). Although loan write offs are a few, the study observed that many of the MFIs do not have write-off policies and carry delinquent loans on their books well beyond maturity. Portfolio risk varies across countries and it is very high in Pakistan and Sri Lanka.

Figure 1.4 Portfolios at Risk and Write-Offs of MFIs


Note: EAP: East Asia and the Pacific; ECA: Eastern Europe and Central Asia; LAC: Latin America and the Caribbean; MENA: Middle East and North Africa; S.Asia: South Asia

Portfolios at Risk >30 days: Outstanding balance, loans overdue > 30 Days/ Adjusted Gross Loan Portfolio

Write-Offs: Value of loans written-off / Adjusted Average Gross Loan Portfolio

Importantly, the MIX survey pointed out that a wealth of information on microfinance in the region continues to escape analysis. Portfolio quality remains uncertain, and the level of dependence on soft loans and donations is largely unknown. Besides, SHG model in India suffers from lack of widely available standard performance
information (MIX, 2006). Even the outreach information provided by the NABARD is limited to data on disbursements and it does not provide any information on client profile. The calculation of repayment rate varies greatly and it serves better for cash flow management than for risk measurement. No specific guidance is given to disclosure standards for microfinance institutions, irrespective of their legal form. Audits lack sufficient disclosures related to the portfolio and its provisions. In India, two apex institutions; the NABARD and the SIDBI, finance most of the SHG programmes have started rating microfinance institutions to on-lend funds. They may be having a wide range of information on the MFI’s performance level, but the information are not available at the public domain.

In spite of lot of caveats in the microfinance sector, it has been regarded as the crucial strategy of poverty alleviation apart from being the most viable strategy for building a financial inclusive sector (UN, 2006). The NGOs/MFIs promise that the microfinance can be the most viable tool to alleviate poverty. Most of them replicate Grameen model while many other microfinance programmes used different innovative methods. However, the key concerns before them are achieving greater depth of outreach in a financially sustainable manner. Their approaches, thus, differ from one region to another and for one community to other. Some of the major concerns and the approaches are discussed as follows.

1.4 KEY CONCERNS AND APPROACHES

Microfinance rests on the premises that it provides a ‘win-win’ solution to the financial institutions and also the poor clients. This implies greater access of credit to poor with good banking principles. Indeed, microfinance not only does overcome the errors of targeting 27 but also the repayment behaviour demonstrated by many programme participants around the world are excellent (Sebstad and Chen, 1996). However, theoretical as well as empirical studies on group-lending have brought out the existence of trade-off between outreach and sustainability (Conning, 1999; Mosley and Hulme, 1998). Further, some development economists have emphasised on very restrictive role of credit, which should be taken as a tool in promoting investment rather than an instrument in poverty reduction (Adams et al., 1984). Therefore, they have suggested the strategy of market mechanism with rising interest

rates and lowering costs for achieving the desired objective of sustainability (Gonzalez-Vega et al., 1997). On the contrary, some have argued for priority of poverty alleviation over the goal of financial sustainability. In fact, they have suggested a holistic approach of group-based credit innovation which includes better targeting as well as improved performance which may be possible by way of extending support services to the group members, other than just credit (Hulme and Mosley, 1996).

In sum, the various approaches that confront with many of the financial service intermediaries promoting group-based microfinance are; (a) whether their approach should promote savings-first or credit-first? Or should credit be a proportion of savings mobilised? (b) whether MFIs should provide only credit or credit as well as support services? Or should the donor agencies be persuaded for providing grant funds that may help in extending support services? (c) Should there be individual-lending or group-lending microfinance? All these link to the contractual design of the loan. Our study would discuss these three approaches of microfinance service providers in the perspective of their outreach and sustainability, and then try to contextualise them in case of Indian microfinance programmes.

1.4.1 Savings-first vs. Credit-first Approach

The terminology itself implies that ‘savings-first’ approach gives priority on mobilising local deposits first and then gradually provides some of their members with loans. On the contrary, the ‘credit-first’ programmes emphasise on reaching a targeted group of clients by providing credit to each of their clients, for which they may often rely on donor funds. A common criticism which the ‘savings-first’ institution faces is that they have a restricted outreach, as the very poor remains out of programme owing to her/his inability to regular saving. But at the same time mobilization of savings brings collective responsibility and also a sense of mutual insurance, among the group members. Guy Bedard from the International Alliance of Co-operatives introduced the terminology of ‘warm money’ to qualify the savings generated by the communities themselves, over which they had greater responsibility than over ‘cold money’, the funds provided by outside donors (as cited in Paxton and Fruman, 1997). Savings-first and credit-first financial institutions in West Africa have been examined by many authors. Among these, Graham concludes that either
approach can lead to the eventual provision of sustainable financial services. He identified several advantages of both the approaches, as mentioned below (Graham, 1994).

Advantages of Savings-first Approach:

- Generates internal source of funds
- Facilitates the MFIs in screening and monitoring of clients
- Effectively decides the credit worthiness of the customer
- Encourages voluntary savings
- MFIs can evaluate the potentiality of the borrower since the latter have developed depositor relationship with the MFI
- They have to develop sound banking practices as they are dependent on internally generated funds

Advantages of Credit-first Approach:

- Large outreach can be possible in a relatively short period due to their reliance on external funding and technical assistance
- Credit is targeted and depth of outreach tends to be high
- Avoid transaction costs associated with mobilisation of savings
- May emphasise on organising clients into solidarity groups, which are instrumental in overcoming information asymmetries and thus, leading to effective internal screening and monitoring of clients.

However, savings-first programmes have been criticized on the ground that they only target middle-income clients and do not reach very poor people. Question also arises regarding their capability to mobilize savings as well as attaining financial self-sufficiency. On the other hand, credit-first programmes suffer from the drawback that they rely heavily on donor funds which makes them dependent and thereby, distant them from integrating into formal financial sector. Nevertheless, experts have challenged the sustainability and magnitude of delinquency in the credit-first approach as well as the conservative and limited outreach nature in the savings-first approach. Practically, advocates of microfinance have synthesized the validities of

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28 A case study of 3 MFIs of ‘savings-first’ approach and 5 MFIs of ‘credit-first’ approach were undertaken in Sub-Saharan African countries for evaluating the efficacy of both the approaches. The study found that the Credit-first approaches have shown relatively more dependence on subsidy than the Savings-first programmes (Paxton and Fruman, 1997).
both the approaches and recently, many institutions have adopted the synthesis of the
two.

1.4.2 Minimalist vs. Integrated Approach

MFIs offering only financial intermediation, savings and credit provisions, are
referred as minimalists. Savings and credit facilities help individuals or households
build up or acquire funds for all kinds of investment. But, an important question at the
practical level is whether poor households have, on their own, simultaneous access to
other inputs required to start or expand an enterprise (farm or non-farm). Credit will
generally have high returns if complementary inputs are available, such as access and
information about raw materials, irrigated farms, secure tenancy rights, educational
attainment, efficiently functioning markets, and a reasonable degree of social and
infrastructure development. Unfortunately, many of the rural economies have
imperfect factor as well as product markets. Further, marketing linkages are very
weak, rather non-existent in many parts of the rural hinterlands in the country. For
example, in the absence of seeds or irrigation water for the farmers and market access
for the rural producer or elementary bookkeeping skills for the would-be entrepreneur,
the returns to financial services may be low or even nonexistent. Various empirical
studies on investment led benefit impact essentially test whether this is the case but
the conclusions remain ambiguous (Sebstad and Chen, 1996; Pitt and Khandker,

The role of savings and credit in poverty alleviation, thereby have gained recognition
in the recent decades because of their insurance-led support provisions. For example,
when the poor face catastrophic risks – risks arising out of erratic rains, human illness,
crop pests, diseases, and other problems – and when formal insurance markets are
nonexistent, credit transactions (consumption credit) allow the poor to borrow during
bad times and repay when times are better. It may be noted that unlike in the case of
investment related benefits, ownership or access to other investment inputs are not
prerequisites for the insurance benefits to materialise. Further, it is also hypothesised
that the insurance effect does have an important bearing on household labour supply
and resource management (Morduch, 1995).

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29 See a number of studies in Sebstad and Chen, 1996.
Hulme and Mosley (1996) made a synthesis of investment-led benefits (increasing income impact) and insurance-led benefits (consumption smoothing impact) of group-based credit programmes and drew an "impact frontier" from a study of 13 MFIs in seven different countries. They found an overall positive impact on the member borrower, although impacts vary accordingly with the design of the institutions. Thus, they suggested that the tradeoff between outreach and impact can often be moved by appropriate innovations in institutional design, in particular, modifications in savings, loan collections and incentive arrangements for borrowers and staffs along with support services other than credit. That motivated the MFIs to follow an 'integrated approach' in promoting microfinance groups to alleviate poverty along with enterprise development. Therefore, credit and support services including social intermediation\textsuperscript{30}, enterprise development services\textsuperscript{31} and social services\textsuperscript{32} have essential for helping the poor borrower in its endeavour to undertake microenterprise activities. Presently, the integrated or 'credit-plus' approach is widely practised by the financial intermediaries in scaling-up microfinance activities around the world. Even the worldwide Microcredit Summit on reaching the 100 million of the world's poorest families has emphasized on credit as well support services (Microcredit Summit, 1997). A World Bank study examined the array of financial and nonfinancial services offered by two hundred MFIs around the world, which suggests that NGOs were more active in providing credit-plus services including training relating to health, nutrition, education and group formation (Paxton and Fruman, 1997).

\subsection*{1.4.3 Individual-Lending Vs. Group-Lending}

Presently there exists a variety of NGOs/MFIs that adopt group-based microcredit designs congenial to the contextual and socio-economic factors of the locality. Usually, they follow the local methodologies banking upon their knowledge of the area of operation. Hence, the methodologies vary widely across the regions as well as among the MFIs within the region. Broadly, they can be grouped under two categories; (a) individual-lending models (b) group-lending models.

\textsuperscript{30} Social intermediation involves group formation, leadership training and co-operative learning.
\textsuperscript{31} Enterprise development services educate them regarding marketing, business training, production methodologies and sub-sector analysis.
\textsuperscript{32} Social services like improvement in education, health and nutrition, and literacy training prepares them to look forward in their struggle for survival.
Individual-lending is defined as the provision of credit to individuals who are not members of a group that is jointly responsible for loan repayment. Bank Rakyat Indonesia unit desa has demonstrated this model. Understandably, the borrowers constitute the ‘better off poor’ and non-poor households from whom the bank can have security of returns. Also, unlike others, it requires collateral. This may be reason for which it has registered a record recovery rate of 97.8 Percent in 1998 (McGuire, 1998). It also charges higher interest rate but gives concession to loans that are paid with no delay, which may be attributed to the high recovery rates of the Institution. In India, SEWA microfinance follows the individual co-operative banking model.

However, the popularity of group-lending has been overwhelming over the recent decades than that of individual co-operative models. The modern group-based credit innovations have been inspired by the old credit unions of Rotating of Savings and Credit Associations (Besley and Coate, 1993). But, Grameen Bank Bangladesh, Badan Kredit Desa (BKD), village banks and Bank Dagang Bali (BDB) in Indonesia, BancoSol in Bolivia and other ACCION affiliates in Latin America, various NGOs, Credit Unions and Co-operatives in various countries are considered as the pioneers in developing the group-based financial systems approach to microfinance. These institutions have developed innovative lending methodologies and popularised the concept that microcredit provided at interest rates that enable full cost recovery could be delivered with high repayment. The popular models that are adopted in many of the developing countries include Grameen’s joint liability group-lending 33, BancoSol solidarity group-lending 34, village banking models 35 and NABARD’s SHG-Bank linkage models in India.

1.5 RELEVANCE OF THE STUDY IN THE PRESENT INDIAN MICROFINANCE SCENARIO

The microfinance movement in India started with the launch of SHG-Bank linkage programme by NABARD 36 in the year 1992. Eventually, many national and

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33 All members in the group are jointly liable to the borrowers' loans.
34 While loan is given to the group, the jointly liability group is formed by three to seven members of the group. This is popularised by ACCION international in Latin America.
35 Village banks are community managed credit and savings associations established to provide access to financial services in rural areas, build a community self-help group, and help members accumulate savings (Otero & Rhyne, 1994). The model was developed in the mid 1980s by the Foundation for International Community Assistance (FINCA), Mexico. Another variant of this model is known as self-reliant village banking.
36 NABARD is the apex bank of the country for agriculture and rural development.
international donor agencies have come together for promoting SHGs, providing wholesale loans to NGOs and non-bank institutions for on-lending to the poor, besides supporting micro-entrepreneurship through training and technical assistance. However, the most prominent model of group-based credit programme followed in India is that of NGO facilitated SHG-Bank linkage model and its growth has been substantial during the last ten years. The cumulative total numbers of SHGs linked to banks are more than 1.9 million by 2005-06.

Recognising the innovative means of identifying and targeting the beneficiaries under the group-based credit programmes, government of India lunched a country-wide promotion of microfinance programme in 1999; popular as Swarnajayanti Gram Swarozgar Yojna (SGSY). It has grown enormous since its inception. More than 2 million SHGs have been formed under the SGSY programme by 2004-05 and among them about 0.24 million SHGs have been provided loans for taking up economic activity. Importantly, unlike NABARD’s SHGs, the SGSY has a provision of subsidy which most often turns out to about half of the total credit disbursed to the group. So, large outlays were spent on SGSY in the name of group formation and poverty alleviation.

The progress of microfinance has been overwhelming in the last decade in India. Microfinance institutions in India can be classified under two broad categories: formal and semi-formal. The formal banking sector constitutes the first category. They include National Bank for Agriculture and Rural Development (NABARD), Small Industries Development Bank of India (SIDBI), Housing Development Finance Corporation (HDFC), Commercial Banks, Regional Rural Banks (RRBs), and the credit co-operative societies. The semi-formal institutions consists of a variety of NGOs/ MFIs who are not institutionalised under the umbrella of financial sector but they got the support of formal financial institutions in formation of SHGs and facilitating microfinance provisioning. These are regarded as alternative institutions, which have come up to fill the gap between the demand and supply of microfinance. Some of the prominent among them are Society for Helping Awakening Rural people through Education (SHARE), Credit and Savings for the Hardcore Poor (CASHPOR),

37 The informal lenders, including moneylenders and various social networks, can also be categorised as microfinance providers. But they are not legal entities or organisations.
38 The formal financial institutions are regulated by the Reserve Bank of India (RBI) or government.
39 The SHGs can be formal or non-formal group of individuals.
BASIX, Professional Association for Development and Action (PRADAN), Spandan and many other institutions. In fact, these semi-formal financial institutions are the dominant players in this sector today.

The overwhelming popularity of the microfinance programmes in recent years has generated curiosity among researchers and policymakers in scrutinizing the outcomes of such large outlay, most particularly measuring depth of outreach, and impact on household level outcomes of interest. That aside, there lies dearth of studies on examining the financial viability of the institutions that have mushroomed in every nook and corner of the country. It may be noted that there are number of studies commissioned by international organisations to study the impact of Grameen or similar programmes in Bangladesh, Malawi, Bolivia and other countries. Contrast to this, there is no serious attempts to evaluate India’s microfinance sector. Besides, there is no major study carried out so far on Indian microfinance programmes carried on independently which explains the impact of participation on outcomes of interest, while controlling for household characteristics. Unavailability of data at the aggregate level and the diversity of regions and programmes make it difficult for any researcher to undertake comprehensive evaluation exercise. No wonder, many studies on Indian microfinance programmes are carried out by practitioners. Most of them have found measuring impact to be challenging in terms of methodological rigour, but using simplistic analysis they argue that microcredit substantially improves credit access to poor and also affects positively to household level of living.40

In sum, microfinance still plays a modest role in India. At the All-India level, less than 5 percent of poor rural households have access to microfinance (as compared to 65 percent in Bangladesh) but significant variations exist across states. The southern states in particular, account for almost 75 percent of the funds flowing under microfinance programmes. Although Grameen model has been replicated by some microfinance programmes, the most popular approach in India is NABARD’s SHG-Bank linkage programme.41 While there are some commonalities of the SHG approach with Grameen, there are also critical differences among them. However, these programmes have commanded a large outlay in the name of poverty alleviation and many of the rural development policies have been directed to accommodate SHG

41 The SHGs can be formal or non-formal group of individuals.
promotion. Importantly, there is no systematic investigation into the outreach and impact of the programmes on rural poor, especially in the backward regions, envisaging absence of astute regulatory mechanisms.

In this context, the present study is an attempt to examine the promises and challenges of India's microfinance programmes, focussing on the impact on poor in the backward region of the country. The contribution of the study may be examined at three levels. One, it would contribute to the empirical literature on group-based credit programmes keeping in view the theoretical perspective in the background. Two, the study would measure the depth of outreach, impact and financial sustainability of the microfinance programmes, using fieldwork in a backward region; Three, it attempts to elucidate what and the best lessons and practices to be adopted for further replication and institutionalisation of the processes.