CHAPTER 2

MICROFINANCE: A HISTORICAL PERSPECTIVE

2.1 Introduction

Microfinance evolved from an informal beginning in the eighteenth and nineteenth century as a type of banking for the poor juxtaposed to the commercial and private banking sector. In South Africa it has a much longer history and existed in the form of savings and credit groups operating in the form of “susus” of Ghana, “chit funds” in India, “tandas” in Mexico, “arisan” in Indonesia, “cheetu” in Sri Lanka, “tontines” in West Africa, “hui” in China, “paluwagan” in the Philippines and “pasanaku” in Bolivia, as well as numerous savings clubs and burial societies found all over the world. It is not possible to explain the origin of microfinance all over the world; yet, an attempt is made to present the microfinance movement in different parts of the world briefly in the following sections.

2.2 Microfinance in Europe

Microfinance in Europe originated out of compelling reasons of poverty and dates back to sixteenth and seventeenth century. It evolved in the form of informal banking for the poor and meant as financial intermediation between micro savings and micro credit. In the twentieth century mainstreaming of microfinance lead to its legal recognition, prudential regulation and mandatory supervision. However, in Ireland, the growth of microfinance was curtailed with regulation on the insistence of commercial banks as they felt threatened due to the rapid growth of microfinance.
2.2.1 Microfinance in Ireland

History of microfinance in Ireland is a unique case of self-help led financial innovation, rapid growth backed by conducive legal backing and decline due to adverse regulation instigated by competing commercial banks, over a period of two centuries from 1720 to 1950. In 1720 the Irish loan funds emerged as charities funded by donated funds but were later replaced by financial intermediation between borrowers and savers. They provided short-term loans to be paid in weekly instalments and peer pressure was used for enforcing repayment. After slow growth of these loan funds for over a century, two new regulations led to a boom in the microfinance sector. A special law was enacted in 1823 to legalise financial intermediation, which allowed financial intermediaries to collect interest bearing deposits and charge interest on loans and in 1836 a Loan Fund Board was established to supervise and regulate loan funds. By 1840 around 300 funds emerged as self-reliant sustainable institutions generating their resources through deposits and creating loans for the poor. They covered around 20% households in Ireland in a very short period with their financial intermediation, offering three times higher interest rates on deposits as well as charging high rates on loans. Commercial banks felt threatened by their rapid growth and loss of business. In 1843 the commercial banks used their clout to induce government to put a cap on interest rates. Loan funds lost their competitive edge due to government’s action and their decline started gradually in the second half of the nineteenth century and their ultimate demise in 1950. The history of Irish loan funds is a typical example of financial repression (Seibel, 2005).
2.2.2 Microfinance in Germany

Microfinance evolved in Germany in the later part of the eighteenth century. Two types of financial intermediaries, the community saving funds, now referred to as saving banks, and members’ owned cooperative associations referred to as cooperative banks, form the largest microfinance sector in the country. The community owned financial institutions learned two lessons from Irish charities – a) charity is not sustainable; and b) there is strong demand for safe deposit schemes from the poorer sections of society (Seibel, 2005).

Initially, thrift societies were established in 1778 in Hamburg followed by the establishment of community savings fund in 1801 (Seibel, 2005). As the savings swelled with the community savings fund it was used for lending including agricultural credit. In 1884 these saving banks formed the German savings banks association.

The second microfinance movement started after the hunger year of 1846-47 in Germany. There was widespread starvation and farmers lost their land to moneylenders from whom they had borrowed to survive. Two men, who contributed in such situation with their altruistic action need mention; Friedrich Wilhelm Raiffeisen in rural areas and Schulze Delitzsch in urban areas. Raiffeisen created credit associations of farmers, now known as Raiffeinsenbanken. Schulze Delitzsch established savings and credit cooperatives among craftsmen and other small entrepreneurs now called as Volksbanken. Raiffeisen established a rural charity association with the help of contributions from some wealthy people in 1847 and brought grains from non-affected areas to help the famine affected people. Schulze Delitzsch created a similar urban credit association but without charity and insisted on self-help in 1850. Credit associations in rural and urban
areas spread slowly but the turnaround came in 1889 with the passing of legislation, the Cooperative Act of the German Reich, the first cooperative law in the world. In 1934 all financial institutions were brought under the banking law. Thus the history of microfinance in Germany can be summed up in three stages: informal beginning with slow growth; enactment of legislation leading to rapid growth and consolidation under the banking law giving way to the establishment of universal banks.

There are a few lessons to be learnt from German experience in microfinance, which can help the financial system developers especially in developing countries. These are:

a. There is huge potential in self-help driven informal local initiative.
b. Savings are essential for self-help and self-reliance.
c. The viability of small enterprises and local financial organisations is intertwined.
d. Continuous access to financial services particularly savings and credit is crucial for poverty alleviation and economic development (Seibel, 2005).

2.2.3 Microfinance in United Kingdom

Credit transactions played an important role in development of modern Britain. There is a gradual shift from relational to codified approach from the fifteenth century onwards (Kermode, 1991; Muldrew, 1993) and by the seventeenth century letters of credit and rudimentary bank notes were in circulation. In 1740s Dean Jonathan Swift started a small loan fund for traders of Dublin (Hollis; Sweetman, 1997). Over a next couple of centuries numerous enterprise funding schemes came into existence but became more extensive after the war.
The Community Development Finance Institution (CDFI) in U.K. was strongly influenced by the U.S.A. as it was described as social finance sector and not microfinance sector. But the peer lending schemes followed the examples of the Grameen Bank and the schemes prevalent in Poland (Copisarow; Fairbrain, 2005). Majority of CDFIs were engaged in direct lending to the micro and small and medium enterprises (SMEs). Their loans were known as ‘soft loan schemes’ as their lending and collection criteria was not as stringent as banks. The survival of these funds averaged to less than three years (Klett, 1994). After incorporation of these ‘soft loan funds’ into CDFIs their sustainability has improved. Thus micro credit in U.K. has evolved a system where it can serve those who are most needy, yet making the system more sustainable.

Main actors within the system are public agencies. Main source of funding to CDFIs is done by Regional Development Agencies (RDFIs) and the devolved administrations of Scotland, Wales and Northern Ireland. The nine English regions and the devolved administrations are now individually responsible for adopting and implementing plans and budgets to support CDFIs.

Banks also play a key role in providing finance to CDFIs. Social investors, charitable trusts and foundations provide significant proportions of the support to CDFIs. Loans of less than €25000 are defined as microfinance loans by CDFIs. CDFIs are increasingly diversifying and are looking at other micro financial products. Interest rates charged by the CDFIs are structured as to target the financially excluded and the average interest rate is in the range of 0 to 26%. The loan size ranged between € 286 and € 9447 (Goggin et al, 2010). The repayment period of loans is kept at 18 to 60 months with an average of 38 months. Other financial products for inclusion are loans for consumption, training and education, debt consolidation, house purchase and home improvement.
Microfinance sector has flourished under the CDFI network. CDFIs have flourished since the inception of the Phoenix Fund and due to continual improvement in business strategies and sustainable models. Although the funding of CDFIs has been tightened with regulation but it will be supported as long as it serves the people and businesses excluded by the mainstream sector (Goggin et al, 2010).

2.2.4 Microfinance in France

In France, different types of organisations provide credit directly or indirectly. Three types of organisations – non-bank microcredit organisations, organisations that facilitate access to micro loans from banks and para-bank actors provide microcredit in France.

Non-bank micro credit for starting enterprises developed in France earlier than the other European countries. It was due to the initiative taken by Maria Nowak, founder of the Association au Droit a l’initiative Economique’ (Adie). It was principally founded as an anti-poverty programme with the financial support of the government and several private foundations.

Founding of Adie was inspired by success of the Grameen Bank in Bangladesh. However, the joint liability group loans did not work in France; hence Adie adopted the model of individual loans. The target group of Adie are the socially and financially excluded people. It has forged ties with various cooperative banks and local government bodies and diversified its financial products to assist those in difficulty to set up an enterprise.

Other organisations operating in the field are quasi-equity or guarantee schemes that provide necessary guarantees and access loans below € 25000 to new enterprises. In
1985, France Initiative was created as public and a para-public initiative in the form of a federation of 20 local business support programme, combining the provision of financial support with additional human support of mentoring. Non-bank, bank and para-bank actors in France provide different kinds of products such as non-bank microcredit for unemployed individuals and welfare recipients to start their own business, facilitate access to bank credit by disbursing quasi-equity in the form of personal, reimbursable, interest free loans without guarantee to ‘almost bankable’ persons with projects aimed at creating three to ten jobs. Besides, social credit and micro insurance products are being tested in France for the financially excluded people.

There is a huge untapped demand for microcredit in France where 91% enterprises are micro enterprises (Lämmermann, 2010). Adie is an impressive example of the impact microcredit can have in an environment that promotes entrepreneurship and access to microfinance and envisages a 15 to 30% growth of lending each year.

2.2.5 Microfinance in Other Parts of Europe

Microfinance existed in various forms and degrees in other European countries such as Austria, Italy, Denmark, Norway, Sweden, Portugal, Luxemburg and the Netherlands. In Austria microfinance has recently evolved and the financial establishments are still considering it with apprehensions. Micro credit operations did not begin here till 2004. The European Social Fund (ESF) and the Federal Ministry of Economics and Labour have coordinated certain programmes which can be considered as microfinance initiatives. Presently, liability programmes, subsidies and low interest loans aimed at SME sector are the few financial products and services available in Austria (Meyer; Maunz, 2010).
**Sweden** is known to be one of the richest countries with high rates of growth. However, there is high rate of unemployment especially among the immigrants and young people (OECD, 2007). Around nine per cent of the population lives below poverty line, majority of whom are single parent families, the young and old and immigrants (Swain, 2010).

In Sweden, there are no micro credit programmes in general, though government programmes to support small and micro enterprises come close to the concept. The commercial banks have not shown much interest in small and micro enterprises (Siewertsen, et al 2005). According to a study, (Siewertsen, et al 2005) the financial sector in Sweden does not show keen interest in supporting self-employment as a career for the unemployed and micro credit sector is underdeveloped (Swain, 2010).

In **Belgium**, microfinance can be seen in the form of financing of SMEs. There are three major lenders in Belgium; Fonds de Participation, Crédal and Brusoc. Fonds de Participation provides 42% of all approved credit. The three lenders provide a range of credit products to target two general groups – those vulnerable to poverty e.g. the unemployed and the elderly and micro entrepreneurs who are excluded from credit access from mainstream banking (Cayrol and Marchand, 2010).

In **Bulgaria**, microfinance operations started as a pilot project funded by international financial institutions such as the United States Agency for International Development (USAID), EU PHARE Programme, bilateral cooperation with Switzerland and Germany, Soros Open Society Institute and Catholic Relief Services (CRS). These organisations provided loans to entrepreneurs and disadvantaged groups in urban and rural areas, where borrowers could not provide guarantees to access bank loans. Thus microfinance in Bulgaria emerged as a donor driven tool to address the issues related to its transition in
the 1990s. It played an important role in re-establishing business in the private sector and developing entrepreneurship. Micro and small enterprises account for 99% of business activity in Bulgaria, out of which 60% of the business is dominated by services and trade companies, 31.4% by industrial enterprises, and 8.6% by the agricultural sector (Munev, 2010).

The United Nations Development Fund (UNDP) also piloted some microfinance options through small projects between 1998 and 2000. In 2001, ProCredit Bank Bulgaria started its microfinance operations with the support of International Finance Corporation (IFC) and the European Bank for Reconstruction and Development (EBRD). MFIs exist in Bulgaria under various legal forms such as not-for-profit NGOs, credit funds, guarantee funds, credit unions or for-profit funds (Munev, 2010).

**Denmark** is home to one of the wealthiest population in the world with per capita income of $57000. The national economy has a strong presence of SME sector and 92% of enterprises are micro enterprises employing fewer than ten employees. Realising the development of entrepreneurial activity, the government has implemented various schemes and has adopted a holistic approach. But the immigrant population has remained marginalised and has to depend on informal financing due to lack of microfinance (Wallgren and Awan, 2010).

In **Luxemburg**, with a per capita income of € 58000, the highest in Europe, the potential for micro credit market is small. Public sector plays an important role, employing 98.6% of the nationals (World Development Report, 2009). With low self-employment rate and risk-averse nationals of Luxemburg, there is neither any prospect nor any significant need for a national microfinance institution (Faber, 2010). In Netherland also there is little
awareness about microfinance, though it has been sending microfinance experts to developing countries for various projects.

In Norway, microfinance appeared in 1992 to target female and immigrant population. Network Credit Norway (NCN) and Innovating Norway (IN) dominate the microfinance market; both operating with funding from the government. These two entities along with the government provide a variety of micro financial products and services such as loans, training and entrepreneurial grants (Ljunggren and Holm, 2010).

Microfinance initiatives in Hungary started in 1992 with projects backed by the EU PHARE and Local Enterprise Agencies (LEAs) and can be considered a success story. Restructuring of the micro credit industry for sustainability and to reduce dependence on EU PHARE, it was brought under the purview of National Microcredit Fund (NMF). Some believe that centralised control worked as an impediment to growth due to politicization and increase in costs. Microfinance industry focuses on SMEs, doing little for the neediest in the society (Kovács, 2010).

In Poland, commercial banks, cooperative banks, credit unions, specialised non-banking financial institutions and micro loan programmes provide micro credit. Microfinance was introduced in Poland in when it was undergoing an economic transformation in the 1990s. The share of banks is 98% of the total value of loans. To scale up microfinance operations, proper linkage between specialised non-bank institutions, commercial banks and cooperatives is necessary. Appropriate delivery models, viable to the stakeholders especially for commercial players are required for scaling up operations (Szostek, 2010).
In Portugal the current microfinance market is limited in size, range and diversity. Non-profit organisations, Association of National Direct Credit (ANDC) and Millennium BCP are the two major players in microfinance in Portugal. Due to restrictions on collection of funds and direct lending the microfinance industry is unable to expand (Alves, 2010).

Microfinance industry in Romania dates back to the time of its transition from a centralised economy to a market based economy in the 1990s. International NGOs and MFIs established the microfinance industry but it is independent and sustainable now. It provides a variety of financial products but has not reached its full potential as there is still 30% unmet demand for financial services as reported by some studies (Doiciu; Bialus, 2010).

In Spain, microfinance activities started in 1990s with the Spanish savings bank system starting micro credit programmes. Subsidies from national and European level institutions helped in impressive growth of micro credit in Spain (Garrido et al, 2010).

2.2.6 Conclusion

Microfinance industry in Europe has emerged from both the ‘developing world’ and the U.S.A., combined with some historical precedents. Most of the microfinance providing institutions in Europe receives funds from the state and to a lesser extent from banks. Each nation in Europe has its own unique microfinance sector with some similarities and distinctions from others in the region.
2.3 Microfinance in Africa

History of microfinance in Africa dates back to the 16th century where we find evidence of microfinance in the form of ‘esusu’ or ‘susu’; a rotating savings and credit association (ROSCA) among the Yoruba. The ‘esusu’, a form of social capital used to be transported during the slave trade to Caribbean islands (Bascom, 1952: 69), where both the institution and the term still exist, and are now carried by a new wave of migrants to major American cities. Its origin is found in the rotating work associations, where labour as a scarce commodity was accumulated and allocated to one of the members at a time. With the advent of money and commercialisation, these transactions were replaced with money such as cowries, pounds and naira. In Nigeria, informal financial institutions continue to play their role and there may be only few Nigerians who are not a member of one or more of them (Seibel, 1970). Both the name ‘esusu’ and the institution have spread as far as Liberia, Congo and Zaire.

In 1934, C.F. Strickland, a British cooperative expert, examined the ‘esusu’ as a possible basis for modern cooperative societies in Western Nigeria but found them “improvident and fraudulent” and declared that he could not reform ‘esusu’. Heavy state interference has undermined the self-reliance and growth of cooperatives in Nigeria (Strickland 1934:14).

Micro credit market in South Africa began in 1980s with a variety of institutions such as for-profit companies, NGOs and the government playing an important role. Its growth can be studied in four distinct phases such as the pioneer phase (1980s to 1994), the breakout phase (1995 to 1999), the consolidation phase (2000 onwards) and the maturity phase (not yet reached). Various players from NGOs and government agencies to MFIs
in the private sector have contributed to the growth of modern microfinance sector in South Africa (David, 2003).

In the pioneer phase, a few not-for-profit and commercial micro lenders introduced some products for promoting micro enterprises and absorb growing labour force in the upwardly mobile urban population outside the mainstream banking system. These lenders charged high rate of interest, in excess of the Usury Act 1968, but due to small size of their operations often remained undetected by the law enforcers.

The breakout phase consisted of rapid expansion of micro credit market and success of the pioneers. By 1992 micro credit was legalised by removing restrictions of Usury Act in South Africa. This led to a large flow of funds to the micro lenders from formal financial sector, contributing to its rapid expansion.

The consolidation period followed the rapid expansion of the nineties which could not be sustained mainly due to two reasons. First, growing competition among the micro lenders searching for finite number of credit worthy loan seekers; and second, establishment of Micro Finance Regulatory Council (MFRC) reduced margins of micro lenders forcing them to quit the industry. While there were 3500 formal micro lenders in 1997, there were only 1334 registered MFIs in 2000.

The maturity period has not yet reached but it is within sight. When the microfinance industry achieves a steady growth in the long run and reaches a sustainable phase with

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1This section is taken from “Is Cinderella Coming to the Ball? SA Microfinance In Broad Perspective” by Porteous David (2003), www.finmarktrust.org.za/research
regulatory framework set in place one can finally say that microfinance industry has reached its maturity phase (David, 2003).

The informal sector in South Africa has undergone transformation from the mid-nineties onwards. ‘Susu’ (savings) collectors no more go from door to door to collect savings, instead they have established offices (kiosks) at various points in cities and their clients can actually walk up to them for carrying out their transactions. Their savings collection is institutionalised and record keeping is more systematised. This transformation, however, has not hindered the growth of ‘susu’ collectors (Barclays Bank of Ghana, 2006). Other aspects of collecting deposits and lending informally has not changed much (Steel; Andah, 2005) even after reforms were introduced in the 1990s in Ghana and the informal sector is still vibrant.

Several banks in Africa have shown keen interest in acquiring more information about the informal sector to strengthen their group schemes for micro credit programmes. Merger of Nigerian Agricultural and Cooperative Bank (NACB), Peoples Bank of Nigeria and Family Economic Advancement Programme (FEAP) to form Nigerian Agricultural Cooperative and Rural Development Bank (NACRDB), was aimed at strengthening and providing micro credit. In Tanzania, Cooperative and Rural Development Bank Ltd. (CRDB), and Akiba Commercial Bank (ACB) have established financial links with the informal sector by offering a range of financial services to MFIs (Pipreke, 2005).

In Uganda, institutions such as Centenary Rural Bank (CERUDEB), Equity Bank and Kenya Rural Entrepreneurship Programme (K-REP) in Kenya, MFRC in Malawi, Afriland Bank, BICEC and Union Bank in Cameroon and CNCA in Senegal, have shown
that commercial banks in Africa can be effective in providing microfinance on a substantial scale. Banks in Benin, Chad and Zimbabwe have established microfinance subsidiaries to provide micro financial services to the financially excluded. Barclays Bank is considering starting informal banking operations in Zambia, Zimbabwe, Kenya, Botswana, South Africa and Tanzania.

According to Priya Basu (2005), “The African experience suggests that MFIs have built on pre-existing informal sector mechanisms to create viable channels for capital infusions from formal sector banks, donors and governments”.

2.3.1 Conclusion

The African experience of microfinance can be summed up as:

a. In Sub-Saharan Africa, there is sizeable demand for deposits and credit facilities.
b. There are strong linkages between formal and informal microfinance institutions.
c. The group based saving and credit institutions prevalent in Africa rely on peer pressure and joint liability rather than MFIs engaged in either only savings collection or extension of credit.
d. Linkage between banking and MFIs is expanding.
e. Donors and NGOs have played an important role in the development of MFIs.
f. Governments have played a key role in promoting MF sector by putting in place necessary laws, regulation and effective supervision of the sector.
2.4 Microfinance in Latin America

In the 1970s new thinking questioned the well-established wisdom that “bigger is better” giving way to the establishment of informal enterprises which could generate employment and income for the poor (Schumacher 1973; ILO 1972). Against this backdrop, the pioneers of microfinance launched their innovative programmes in the 1970s and 1980s. Modern microfinance in Latin America can be explained with Projeto Uno in Recife, Brazil in 1972, which offered working capital loans to micro enterprises with main focus on quick approval and disbursal of loans than the rate of interest. Other precursors to the Latin American microfinance industry included a loan fund that targeted the ‘tricicleros’ (men who pedal huge tricycles that hold huge baskets laden with goods for sale) in the Dominican Republic, which led to the creation of Banco Ademi in the country; and Fedecredito in El Salvador, a cooperative that offered loans to its members using group guarantees and offered financial incentives to its staff based on loan recovery (Berger, 2006).

In 1975, at the United Nations Women’s Conference in Mexico City, a group of women started planning Women’s World Banking which launched its affiliates worldwide including Dominican Republic and Columbia (Berger, 2006). The microfinance industry has been growing ever since at an estimated annual rate of 30 to 40% over the past few years and even at a higher rate in Mexico, Brazil and Peru. Latin American microfinance institutions are larger than their counterparts in Africa, Eastern Europe and Middle East but have yet to reach the massive scale of Asian microfinance institutions.

Another distinct feature of Latin American MFIs is that they rely on private sources of funding for growth and continued operations than on deposits or equity. Moreover a
greater proportion of their finance or equity comes from commercial sources at the market rate of interest. Maybe this is the reason behind their high interest rate structure (Barrés, 2005). They serve a broad range of customers on the credit side, even more so on the savings side.

Microfinance in Latin America is not exclusively focused on poor, though most of the pioneer MFIs in the region began with this orientation. Its focus is more on providing credit to enterprises with insufficient access to financial services. Three quarters of the people live in the urban areas in Latin America and the MFIs have made greater headway in providing finance to them.

The percentage of women among microfinance customers is lower in Latin America as compared to other regions. Microfinance institutions targeting women in Latin America are – Women’s World Banking affiliates, Compartamos and Pro-Mujer. Only 38% microfinance borrowers are women in Latin America as compared to 60% in Asia and Africa. The average size of loan is higher as Latin America is better off than other regions. Banks, finance companies and NGOs hold the bulk of their loans in the $1 to $800 range (Marulanda and Otero, 2005). But loans by NGOs are in the range of $1 to $500 (50%) and much lower than the average proportion of loans in the over $1600 range. Recent studies carried out in Bolivia, Haiti and Peru with ACCION clients from BancoSol, SogeSol and MiBanco show that a large percentage of borrowers of these institutions are below national poverty line: 49% in case of BancoSol, 37% in case of SogeSol, and 27% in case of MiBanco. One can infer from these facts that with a good network of institutions providing microfinancial services microfinance in Latin America has made huge strides in the sector in the past two decades (Berger, 2006).
2.5 Microfinance in Asia

It is not possible to discuss the origin and growth of microfinance in all Asian economies; however, economies where microfinance has played an important role in alleviating poverty have been taken up in this section. Microfinance movement in Asian continent is discussed here in context of countries in Southeast Asia and South Asia embracing it as a tool to provide access to financial services to the poor and to alleviate poverty. There is considerable diversity between countries in provision of micro financial services within Southeast Asia. Some of the economies in the Southeast Asia are ‘market’ economies while some others are ‘transitional’ economies. The distinction is based on the extent and degree to which they have accepted market principles. There is significant difference in the incidence of poverty even in the ‘market’ economies e.g. – Malaysia and Thailand have higher levels of per capita income than Indonesia and the Philippines.

In Southeast Asia, formal microfinance began with the establishment of a private bank, Bank Dagang Bali (BDB) in Bali, Indonesia, in 1970 and attained nationwide coverage with the restructuring of the unit desa in 1984, or local banking system of the state owned Bank Rakyat Indonesia (BRI). The BRI’s unit desa is the largest chain of formal micro financial service providers in Indonesia and has helped in bringing down the poverty from 40% of the population in the mid-1970s to 11% by 1996. The BRI extended its micro banking services to urban areas in 1989 (Bedson, 2009). In 1997, when the East Asian Crisis began and poverty started to rise in Indonesia, BRI’s microfinance system helped the poor who had lost their jobs, finance informal enterprises.

In the 1970s, the BRI operated more than 3500 village units to channel subsidised government credit to rice farmers through BIMAS (acronym from Bimbingan Massal
meaning package offer), the credit component of Indonesia’s massive rice intensification programme. An Indonesian anthropologist, Marguerite Robinson, who has researched the Indonesian microfinance sector extensively, proclaims that there is a paradigm shift in the provision of microfinance from donor driven not-for-profit microfinance institutions to for-profit commercial microfinance institutions. Poverty lending approach based on the Grameen model required large amount of subsidised funding but this model could not be adopted on sustainable basis globally. In the 1970s the world started developing sustainable commercial model of microfinance by capturing local savings and accessing commercial funds to lend to the low-income people at interest rates that enabled full cost recovery and sustainability of the financial intermediary.

Robinson (2001) asserts that there is an absurd demand and supply gap in microfinance services in developing countries. Demand for microfinance services such as savings and credit remains unmet because of two reasons – one, that it is not generally perceived and two; there is a wrong perception that microfinance cannot be profitable for banking institutions. The Bank Rakyat Indonesia (BRI) and micro banking system in Bolivia, BancoSol, are examples of commercial microfinance institutions showing that banks can provide microfinance extensively and profitably.

Around 90% of poor people in developing countries lack access to financial services such as savings and credit. It is often believed that the cost of delivering small scale financial services will be too high for non-subsidised institutions. Often these services are provided at a small scale by the NGOs and non-bank financial institutions. Thus the gap remains between demand and supply of financial services. The demand for microfinance comes from households and enterprises operating in unregulated and informal sector of the economy (Robinson, 2001). According to the World Bank’s ‘World Development
Report 1999-2000: Entering the 21st Century’, in 1998 about 1.2 billion people – 24% of the population in developing and transition economies lived on less than $1 a day. Around 360 million people do not have access to formal financial services in the developing economies and microfinance can play an important role in improving the conditions of the financially excluded.

Another Southeast Asian country, Malaysia, has a diverse range of financial institutions, both private and public, including Islamic banks. It is the wealthiest country in the whole of Southeast Asia which is an important factor in its approach towards poverty alleviation. There are credit guarantee corporations (CGCs) which provide guarantee on lending by other financial institutions to small and medium enterprises (SMEs). There are credit cooperatives in the urban areas for the salaried clientele but the cooperative movement is weak in the rural areas. Due to interest rate regulations by the central bank, the commercial banks stay out of microfinance (McGuire; Thapa, 1998).

Amanah Ikhtiar Malaysia (AIM) established in 1987, is the dominant MFI. It disburses small loans to the poor for starting income generating activities (Gibbon; Kasim 1990). AIM had 40 branches and 6 area offices serving some 39000 borrowers and almost 56000 members by 1998 (Kasim, 2000).

In Thailand specialised micro financial services are not important (McGuire et al 2000). The role of NGOs in providing microfinance services is limited. Government agencies operate three programmes – Community Development Department (CDD), the Government Saving Bank (GSB) and the Urban Community Development Office (UCDO). The Bank of Agriculture and Agricultural Credit (BAAC) receives subsidies, soft loans from donors and the government agencies and lends them to the rural poor.
In Philippines, three types of MFIs are found operating in microfinance sector. These are rural thrift banks, NGOs which provide microfinance and credit unions or cooperatives. Most of the NGOs are financed by foreign donors, domestic philanthropists or foundations (Llanto, 2001). Commercial banks have limited engagement with microfinance in the Philippines. The Development Bank of the Philippines, the Landbank and the People’s Credit and Finance Corporation (PCFC) have provided wholesale loans to MFIs for on-lending to the microfinance clients. In Philippines microfinance flourishes with government support and in a liberalised financial system. The regulatory provisions make possible establishment of small banks with minimum capital requirement. A second tier financial institution, PCFC, established in 1995, provides funds and supervises a diverse range of micro financial institutions.

In South Asia (Bangladesh, Pakistan, India and Nepal), while the informal sector financing can be traced back to the era of Kautilya in the fourth century B.C.E. (Rangarajan, 1987), the modern microfinance took shape after passing of Cooperative Credit Societies Act in 1904. The cooperative movement was aimed at providing agricultural credit rather than non-agricultural credit. In Nepal, the cooperative movement was formalised with the cooperative legislation in 1911 and the formal credit services were made available to a small number of clients in1950. The failure of cooperatives to serve the rural farmers, artisans and persons of limited means, led to the nationalisation of commercial banks in the seventies in the region initiating the launch of microfinance as we have it today (World Bank, 2006).

The origin of modern microfinance in Bangladesh dates back to the 1970s when Dr Mohammed Yunus, a Chittagong University professor, started experimenting with the rural poor by providing small loans to them. South Asian microfinance is more focussed
on poverty alleviation than development of microenterprises. According to a study conducted by the World Bank in 2005, 86% of the 14.3 million active borrowers are served by NGO-MFIs including pioneers like the Grameen bank and the Bangladesh Rural Agricultural Cooperatives (BRAC) in Bangladesh. The Grameen Bank alone has 29% share in micro lending with BRAC, Association for Social Advancement (ASA), and Proshika, making for the rest.

In Sri Lanka, 65% of micro credit is provided by the government with the Samurdhi Development Programme (started by the government in 1995 under the purview of the Department of Cooperative Development) being the largest of such initiatives aimed at poverty reduction. In Nepal Micro Finance Development Banks (MFDBs) provide microfinance directly. There is a move to privatise MFDBs so that the commercialisation may widen the outreach of the sector. Financial NGOs (FINGOs) and Savings and Credit Cooperatives are the other microfinance providers in Nepal (Bedson, 2009).

In Pakistan, microfinance banks, rural support programmes and specialised MFIs are the key players in the microfinance sector. In China, there is a multi-layered rural financial system with Rural Credit Cooperative (RCCs) as the major provider of micro credit. In Vietnam, Vietnam Bank for Agricultural and Rural Development (VBARD), Vietnam Bank for Social Policy (VBSP) and People’s Credit Funds (PCFs), are the major microfinance providers. In Philippines, rural banks, NGOs and cooperative societies are the major providers of microfinance (Bedson, 2009).
2.6 Microfinance in India

The origin of microfinance in India predates its reported existence anywhere in the world by two to three millenniums. It existed in the form of financial intermediation, comprising lending, deposit taking and other financial services known as merchant banking during the first millennium B.C. and even beyond it. One can find examples of merchant guilds dealing in goods and money in Vedic scripts dating back beyond first millennium B.C. These merchants’ guilds eventually turned into strictly hereditary castes and trading became the main occupation of the Vaishya caste. In the first two century A.D., regulation of lending deeds of traders came under the purview of a law code, Dharmashastra\(^2\). As per this code, rate of interest of 15% per annum on secured loans was considered as ‘reasonable’ and on the unsecured loans higher rates could be charged on the basis of caste. Depending on the degree of risk of lending money on the basis of caste, rate of interest of 2% per month from a priest (Brahmin) and 5% per month from a cultivator (Shudra), could be charged on unsecured loans. There was provision for interest free loans to the deserving and poor (Bhargava 1934; Schrader 1997:71-83).

In the medieval India i.e. the period from the mid-thirteenth century to eighteenth century, due to rapid growth of trade between India and Asian countries merchant banking got a considerable boost. They charged interest rates between 0.5% and 1.25% per month on secured loans and between 40 to 60% per trade venture on risky trade (Seibel, 2005). Other forms of informal finance existed in the form of micro lending by money lenders, traders, merchant bankers, chit fund companies and ROSCAs. The oldest

\(^2\) Manusmriti, also known as Manava Dharamshastra is the most important and earliest metrical work of the Dharmashastra textual tradition of Hinduism. It was first translated into English in 1794 by Sir William Jones, an English orientalist and judge of the British Supreme Court of judicature in Calcutta. According to Hindu tradition, the Manusmriti records the works of Brahma.
of these categories is the **money lenders** who existed probably 1700 to 2200 years ago when it became an organised and subsequently regulated profession. Money lenders still exist in both rural and urban India with some of the historical remnants of this profession. The importance of money lenders as a source of finance is elicited by the Report of the Study Group of the Banking Commission on Indigenous Bankers (2006) based on the fifty ninth round data of NSSO (2003) which shows that the cash dues to urban households from the money lenders increased from 10.2% in 1991 to 14.1% in 2002. The share of institutional finance to the urban households increased from 72% in 1991 to 75.1% in 2002. In case of rural areas, the survey shows that share of institutional finance came down from 64% in 1991 to 57.1% in 2002. The share of money lenders in rural finance in the same period increased from 17.1% to 29.6%. The survey also reveals that out of every 1000 outstanding of farmer households in the rural country, Rs257 was sourced from money lenders. The share of money lenders in the indebtedness of farmer households in Bihar, Manipur, Punjab, Rajasthan, Tamil Nadu and Andhra Pradesh was well above the national average (RBI, 2006).

**Chit funds** or Rotating Savings and Credit Associations (ROSCAS) have also existed in ancient India in many forms and are widespread in South India even today. In its conventional form, small contributions at regular intervals by a group of people are allocated to one amongst them either by a lot or by demonstrated need or by a pre-determined sequence. In the modern form the amount collected is auctioned to the lowest bidder and the balance is divided amongst the rest of the members. These ROSCAS existed in many other Asian countries also such as China, Vietnam and Nepal. As the business of these chit fund companies expanded, to cover the risk, need for regulating them was felt and in 1945 Travancore Chit Fund Act was passed in India. In 1982, a federal Chit Funds Act was passed, providing legal status to chit funds as non-banking
financial intermediaries. This has led to considerable expansion of chit funds all over India. In Kerala, 20% of all bank deposits of banks were composed of ROSCAS funds (Bouman, 1977).

2.6.1 Financial Service Providers in the Formal Sector

The share of formal sector has increased over the years due to the proactive role played by the government and the Reserve Bank of India.

2.6.1.a Cooperatives

In India, the Britishers promoted credit cooperatives to serve their trade interests. In the 1890s the Government of Madras considered the German cooperative movement as a possible solution to eradicate poverty in India and passed the Cooperative Credit Societies Act in 1904. The Indian cooperative movement was basically initiated against the exploitation of unscrupulous money lenders to free the farming community from the clutches of poverty and indebtedness. By 1912, four lakh people joined credit cooperatives and by 1946 the membership increased to nine million individuals (Bedi, cited in Woolcock, 1998). Soon the credit cooperative movement in India spread to the state of Bengal, the eastern part of which went to Pakistan, now Bangladesh, after partition.

In 1942, the British Government enacted the Multi-Unit Cooperative Societies Act, 1942 with an objective to cover societies whose operations are extended to more than one state. In the post-independence era many lessons which the government learnt over the years with respect to the cooperative movement, helped in fine tuning of the Act and it was later replaced with the Multi State Cooperative Societies Act in 1984. Currently,
there are 230 million members of cooperatives spread across the country. These cooperative societies have advanced more credit to the agricultural sector than the commercial banks. Though these credit societies were set up with noble intentions, their performance was undermined by inefficient management and corruption (Sisodiya et al. 2005).

2.6.1.b Government Schemes to Increase Access of Credit for the Poor

After Independence the government adopted a more interventionist stance to increase access of credit for the rural poor as a pre-requisite for removal of poverty and providing distributive justice. With the nationalization of 14 major commercial banks in 1969 and another six in 1980 (at present total number of nationalized banks is 28), the formal sector has been expanding at a fast pace. Between 1973 and 1985, bank branches in rural areas grew at an average of 15.2% each year, about double the growth rate of branches in semi-urban (7.8%) and metropolitan (7.5%) areas (Basu, 2005). The average population served per commercial bank branch was 15,000 in 2002, and including the branches of rural cooperative banks, at 12,800 which are close to Indonesia and Mexico (Basu, 2005).

The government also initiated the microfinance movement through formal institutional channels in the sixties through branch expansion in rural areas, mandating priority sector lending for the commercial banks and lending through various village developments programmes like Integrated Rural Development Programme (IRDP), National Rural Employment Programme (NREP), Rural Employment Guarantee Programme (RLEGOP) etc. In the late seventies and early eighties (RLEGOP, 1983 and NREP were combined and renamed as JRY) but provision of financial services was skewed towards agricultural labour. IRDP was cited by bankers and senior government officials as the world’s largest
microfinance programme. It involved commercial banks in giving loans of less than Rs15,000 to poor people and in nearly 20 years it provided financial assistance of around Rs250 billion to roughly 55 million families. It ran into problems due to huge subsidy it provided and also due to corruption and malpractices. Similarly Regional Rural Banks (RRBs) and the entire network of co-operatives in the country showed poor performance due to restrictive interest rate directed credit regime, mismanagement, corruption and excessive state patronage. Thus we got a dichotomy of a financial system in which we had an organized and formal mainstream banking system, way beyond the reach of the poor people due to conditionality attached to loans, and an informal sector, ready to give loans to the poor but at exorbitant interest rates.

The Reserve Bank of India (RBI) guidelines on priority sector lending requires all commercial banks to lend at least 20% of their loan portfolio to the poor farmers, agricultural labourers and artisans. Banks are shy of lending to the poor farmers because of fear of non-performing assets (NPAs). In spite of good progress made by India in the financial sector, majority of the poor remain unbankable. NSSO (2003) data reveals that 45.9 million farmer households in the country (51.4%), out of a total of 89.3 million households, do not access credit, either from institutional or non-institutional sources. In spite of a good network of bank branches, only 27% of farmer households borrow from formal sources. The main reason behind this is lack of good collateral.

The government has also taken initiative to provide microfinance through two schemes – Swarna Jayanti Gram Swarozgar Yojana (SGSY) and Swarna Jayanti Shahari Rozgar Yojana (SJSRY). SGSY was launched on April 1, 1999 by merging various existing schemes of self-employment for the rural poor. The objective of the scheme is to bring the assisted poor families below poverty line (BPL) by organising them into SHGs. The
scheme aims at social mobilisation along with training, capacity building, bank credit and
government subsidies to create income generating activities to alleviate rural poverty.
The scheme is financed on 75:25 cost sharing basis between the centre and the state.

To alleviate urban poverty, the government launched Swarna Jayanti Shahari Rozgar
Yojana (SJSRY), counterpart of SGSY, for urban areas on 1st December, 1997 by
merging various existing schemes for removal of poverty. The main objective of the
scheme is to provide gainful employment to the urban unemployed and under-employed
by creating opportunities through training, skill development and capacity building. The
scheme focuses on creating self-employment, self-employment opportunities for women,
skill training for employment promotion, community development and wage employment
programmes for the urban poor. Funding of the scheme will be shared between the centre
and the state government on 75:25 basis.

2.6.2 Formal Microfinance Movement in India

To fill the vacuum in the financial system, Self Employed Women’s Association
(SEWA) Bank in Ahmedabad and Working Women’s Forum (WWF), Chennai, and a
significant number of Non-Government Organisations (NGOs), in a way revived concept
of microfinance albeit with a difference. Four thousand women contributed Rs10 each
towards share capital to establish the Mahila Cooperative SEWA Bank in 1974 which
covered approximately two lakh clients and had loans outstanding in excess of Rs13
crores in 2003. In Southern states like Tamil Nadu, Karnataka and Andhra Pradesh
commendable work is being done by Microfinance Institutions (MFIs) such as Swayam
Krishi Sangham (SKS) Finance, SHARE, BASIX, MYRADA and Spandan Spoorthy.
2.6.2.a NABARD’s SHG Movement

In fact, the interest in microfinance was evoked by the success of Nobel laureate Dr. Mohammed Yunus’s, Grameen Bank in Bangladesh in mitigating poverty with microfinance, all countries of the world have taken a fancy to this wonder financial product as a tool to mitigate poverty. First official interest in informal group lending in India was taken up by National Bank for Agriculture and Rural Development (NABARD) in 1986-87, when it initiated certain research projects on Self Help Groups (SHGs) as a channel for delivery of microfinance. Amongst these the Mysore Resettlement and Development Agency (MYRADA) sponsored “Action Research Project on Savings and Credit Management of SHGs” was also partially sponsored by NABARD. In 1988-89, in collaboration with some member institutions of the Asia Pacific Rural and Agricultural credit Association (APRACA), NABARD undertook a survey of 43 NGOs in 11 states in India to study the functioning of the MFI-SHGs and possibility of their collaboration with formal banking system. These research projects encouraged NABARD to initiate a pilot project called SHG Bank-Linkage project (SBLP) in 1991. By 2004 over eight lakh SHGs were linked with banks. By 2009-10, Rs69.53 lakh SHGs were linked with banks (NABARD Report, 2009-10) with total loans disbursed to women SHGs to the tune of Rs12429.37 crores. Incidentally, what started as a pilot project has now, become a movement.

Initially, many NGO-MFIs were funded by donor support in the form of revolving funds and operating grants. Since the donor funding has almost dried up, the microfinance institutions are borrowing in the commercial markets at competitive rates and lending through SHGs. Thus microfinance emerged as a possible solution to provide financial
services to the poor at reasonable interest rates, which the state run institutions failed to provide.

Since 1994, along with NABARD, development financial institutions such as the SIDBI and microfinance promoting organizations like Rashtriya Mahila Kosh (RMK - the National Women’s Fund), have also started providing bulk loans to MFIs. This has resulted in MFIs becoming intermediaries between largely public sector development finance institutions and retail borrowers, consisting of groups of poor people or individual borrowers living in rural areas or urban slums. In yet another model, NABARD provides refinance to commercial banks which provides loans to SHGs.

2.6.2.b Loan Disbursement by Banks

The cumulative disbursement of bank loans to SHGs stood at Rs.2049 crores as on March 31, 2003 with an average loan of Rs28,559 per SHG and Rs1766 per family (RBI, 2003). As on March 2002, SHG advance formed only 0.15% of outstanding priority sector loans and 0.51% of the accounts of scheduled commercial banks (RBI, 2003). Even if credit disbursal of Grameen like MFIs is taken into consideration, the share of micro credit will be well below 1%.

There are many constraints on growth of microfinance on demand as well as supply side. On the demand side, factors determining the absorption capacity of households and regions constrain growth of microfinance. Since microfinance is explicitly biased towards rural areas, factors like rural infrastructure, especially irrigation, are critically important from the development perspective. MFIs prefer providing loans for non-farm
activities. On supply side, lack of access to risk capital, restrictions on mobilization of savings are the major constraints (Gibbons 2002).

2.6.3 Microfinance Models Evolved in India

All over the world there are various ways in which micro loans are delivered to the poor. It will be appropriate to have an insight into these delivery mechanisms aimed at helping out the poor in India for further analysis.

2.6.3.a The Grameen Model

It was initially promoted in Bangladesh by The Nobel Peace Prize winner Dr. Mohammed Yunus. In this model, around five members form a Joint Liability Group (JLG) and later get together with seven to ten other groups from the same village or neighbourhood to form a centre. Savings are a compulsory component and credit worthiness is determined by overall credit worthiness of the group. Around two dozen MFIs in India follow this model. In India the major MFIs which are replicating the Grameen model are SHARE in Andhra Pradesh, CASHPOR in Uttar Pradesh and ASA in Tamil Nadu.

2.6.3.b The SHG Model

A group of 15-20 members, mostly women, initially pool their savings for lending to each other. They augment their resources by approaching an MFI or a bank. Sometimes some NGOs operate microfinance programmes by organizing federation of SHGs to act as an MFI, which obtains external loan funds in bulk to be channeled to the members via the SHGs. Sometimes it also takes the shape of a group of 15-25 people pooling together
their savings and approaching an MFI for acquiring additional funds as well as depositing their savings. The SHG-Bank linkage programme of NABARD in India is such model and on international level, PHBK project in Indonesia and Chikola groups of Kenya Rural Enterprise Programme (K-REP) in Kenya are also based on similar model.

### 2.6.3.c The NABARD SHG -Bank Linkage Model

The NABARD SHG-Bank Linkage (SBLP) model has three variations:

a. SHGs formed and financed by banks. Here banks take the initiative of forming and nurturing the groups, opening their savings accounts and providing them with loans.

b. SHGs formed by formal agencies other than banks, NGOs and others but directly financed by banks.

c. SHGs financed by banks using NGOs and other agencies as financial intermediaries.

In this model, NGOs take on the additional role of financial intermediation.

### 2.6.3.d The Individual Banking Model

In this case, credit is given directly to individuals and everything from loan appraisal, loan disbursement, repayment and savings collection is done on individual basis. In India RRBs and co-operative banks are examples of such type of microfinance.

There are many individual banking programmes through which small loans are provided to individual clients though sometimes they may be organized into joint liability groups, credit and savings cooperatives or even SHGs. SEWA Bank in Ahmedabad, Indian Cooperative Network for Women, Tamil Nadu, Annapurna Mahila Cooperative Credit Society in Mumbai and Pushtikar Samiti – cooperative bank in Jodhpur serve as
examples. A survey conducted by network of MFIs, Sa-Dhan, shows that individual microfinance lending in India is only seven per cent of total micro loans (Babu and Singh, 2007).

2.6.3.e The ICICI – Bank Partnership Model

This model is popularized and used by the ICICI bank. All the ground work such as evaluation, sanction and recovery of loan is done by the MFI but the loan appears in the books of the ICICI bank and not the MFI. The Bank is having such partnership with more than 30 MFIs in India. MFIs charge a service fee from the borrowers for credit management services. This model utilizes the benefits of social intermediation of the MFI and financial intermediation of the bank. Both entities utilize their core competencies to provide the best results.

2.6.4. The Present State of the Indian Microfinance Sector

Microfinance plays a modest role in India with less than five per cent of rural poor households having access to microfinance as compared to 65% in Bangladesh. There is a lot of variation though across states, with Southern states accounting for almost 75% of funds coming from microfinance programmes. The most successful programme SHG-Bank Linkage Programme (SBLP) has linked 7,17,306 SHGs to banks till 2003 (World Bank, 2003).

The outreach of MFIs was 22.6 million clients in 2008-09, with a growth of 60% over the previous year (Sriram, 2009). The massive growth of MFIs in terms of both the client base and loan outstanding indicates potential of the MFIs. Sa-Dhan (Network of MFIs in
India) reported that MFIs had reached 234 of the 331 poorest districts identified by the
government. The microfinance penetration index shows that there are gaps in the
outreach of micro financial services in Bihar, Madhya Pradesh, Rajasthan, Utter Pradesh
(BIMARU states) and north region (Sraram, 2009). MFIs have a strong presence in
Southern states – Andhra Pradesh, Tamil Nadu and Karnataka.

A crisis in Andhra Pradesh in 2006 has dampened the growth of MFIs in the state and
they are passing through a tough phase. The Andhra Pradesh government closed down 57
branches of two of the largest MFIs in the state, Spandan Spoorthy and SHARE, in
March 2006 and borrowers were given the impression that they need not repay MFI loans
as the MFIs had violated a number of laws including criminal laws (Ghate, 2007). Data
from the “State of the Sector Report, 2009” (Sraram, 2009), shows that more than 20
million microfinance clients were financed to the tune of Rs123 billion. The average debt
outstanding is estimated at Rs49,000 per household which is about eight times the
national average MFI loan outstanding and about 11 times the average member level loan
outstanding in case of SHGs. There is a clear indication of fierce competition and
multiple lending in three Southern states- Andhra Pradesh, Tamil Nadu and Karnataka.
Multiple loans from various MFIs and indebtedness led to a spate of suicides among
micro loan borrowers in 2008-09.

In 2010, about 9.2 million borrowers in Andhra Pradesh defaulted in repaying money
borrowed from MFIs- the largest number of defaulters in any location of the world. The
MFIs that bore the brunt are SKS, Spandan Spoorthy, SHARE, Asmitha Microfin and
Bhartiya Samruddhi of Dr Vijay Mahajan (Mint, 2011). This prompted the Andhra
Pradesh government to promulgate an ordinance in October 2010 which later became
law-tightening regulation of microfinance companies following alleged coercive recovery practices adopted by them. Subsequently an RBI panel capped the loan rate charged by MFIs at 26% and the margin at 12%. The MFI industry’s total exposure in Andhra Pradesh was around Rs7,200 crore in 2010 and they have been able to collect from the borrowers only 10% of this money. They are carrying on their books Rs6,500 crore worth of bad assets, and when they write off this amount in March, at the end of the current fiscal, many of India’s big MFIs’ net worth will turn negative (Mint, 2011).

The Reserve Bank of India (RBI) set up Malegam Committee on microfinance regulation and the Microfinance Development and Regulation Bill is approved by the Union Cabinet and will be passed in near future. The Committee has recommended several measures to curb issues related to over borrowing, multiple lending, ghost borrowers and forceful; recovery methods by the MFIs’ recovery agents (The Economic Times, March 4, 2011).

2.6.5 Conclusion

Microfinance sector in India has taken a big leap; however, in size and outreach it may not be comparable to the neighbouring Bangladesh. A suitable regulatory framework, innovative products, self-regulation by MFIs, appropriate governance, technology to reduce transaction costs, training and marketing facilities to the micro entrepreneurs are the key factors that can contribute to the growth and deepening of this sunrise sector. In the present state the liquidity crunch faced by the MFIs, and the banks – lifeline of the sector, shying away to lend to MFIs, can sound death knell of the sector. Imminent steps by the government are required to sustain the growth of the microfinance sector.